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McKinsey Banking Practice

# McKinsey Global Private Banking Survey 2013
## Capturing the new generation of clients

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# Introduction

Over many years private banking[1] has been one of the most attractive segments within the financial services industry. Private banks have combined strong asset growth and rising profitability with low capital requirements and ample liquidity.

Since 2008, however, the industry has faced a series of challenges related to the sharp increase in the volatility of capital markets, the low-rates environment and the increasing scope of regulation in the US, Europe and elsewhere. The impact of these factors means that the profitability of most private banks worldwide is far below the levels before the financial crisis. What some industry observers were describing as cyclical changes have now become structural, hence requiring significant changes to traditional business models.

In 2012, for a fourth consecutive year, many private banks have faced substantial challenges, regardless of where they are based or their business model. Despite capital market performance driving attractive growth in assets under management (AUM) top line revenue growth remains subdued. This has caused players to focus their attention on actively managing their cost base to maintain - or improve - profitability.

Private banks, regardless of where they operate across the globe, also face similar demands emanating from a much more complex operating environment. A number of developments are shaping the future of the private banking industry. Among them are: the shift in growth and profit pools towards developing economies; the need to change the value proposition and delivery models to serve the specific needs of a new generation of clients; and the necessity to restore trust in the true ability of private banks to deliver superior investment advice. Coupled with these demands is a rapid multiplication of local tax and regulatory requirements. Furthermore, all of this is occurring as increasing competition blurs the frontiers between onshore and offshore markets, which is pushing private banks to be more selective in their geographical coverage, client mix and services offered.

We believe that the traditional value proposition for most private banks is indeed fading. In order to succeed in capturing profitable growth in the future it is our view that private banks must define what makes them distinct from rivals and combine this with a high quality of execution. The truth of this is clearly shown by an increasing performance gap between winners and laggards in most markets. In Western Europe, for example, one booking center in six recorded pre-tax operating losses in 2012. Inevitably, not all banks will be able to adapt. For this reason, we believe the growing pressure on private banks will continue to fuel industry consolidation, a sign of which emerged in the rising M&A activity seen in major markets in 2012.

The McKinsey Global Private Banking Survey 2013 incorporates results from the McKinsey Wealth Sizing database and detailed performance analysis of more than 160 private bank participants globally. This report looks at the current and future state of global wealth, at the context in which private banks operate and with a regional view of markets: Western Europe and North America, but also the dynamic developing markets of Asia, India, Latin America as well as the Middle-East. We conclude with a selection of strategic and operational levers that shows how private banks can capture the next generation of growth through more segmented value propositions, innovative digital delivery models as well as seamless execution.

1 Private banks are defined as any financial institution or unit within a larger financial institution whose main source of business comes from individuals with at least USD or EUR 1 million to invest. Private banks typically offer banking, investment, lending and other financial services.

# Global Wealth: Perspectives on growth

- Despite slower global economic growth the number of millionaires expected to rise 30 percent by 2016 to about 16 million.
- Over the next four years we expect Asia (excluding Japan) to surpass other regions by creating about USD 7 trillion in net new millionaire wealth.
- Major shifts in High Net Worth (HNW) country ranking show China, India and Brazil continuing to move up the league table.
- Offshore wealth has stabilized at around USD 12 trillion with emerging market wealth compensating for a decline in offshore wealth from traditional Western European markets.
- Emerging HNW markets are more skewed towards Ultra High Net Worth (UHNW), enjoy higher asset growth and have a larger offshore share compared to developed markets.
- Private bank profit pools to grow by over USD 20 billion to some USD 70 billion over the next four years, led by Asia (excluding Japan).

**Millionaires prosper.** Over the past four years, millionaire wealth has grown by 8.5 percent annually to around USD 60 trillion at the end of 2012. By 2016, we project that some 16 million millionaires will control about USD 80 trillion in personal financial assets – 30 percent above current levels and nearly double the post-crisis trough. Future growth will be particularly fueled by the UHNW with over USD 30 million. We expect their wealth to increase by about 8 percent annually compared with about a 6 percent increase for core millionaires with USD 1 to 10 million. Millionaire wealth in emerging markets is expected to grow at about 13 percent annually (vs. about 4.5 percent in developed markets), which accelerates the shift in wealth from developed to emerging markets. By 2016, we expect that emerging markets will represent roughly 37 percent of global millionaire wealth (Exhibit 1).

Exhibit 1

**Emerging markets will soon represent 37% of global millionaire wealth[1]**

| | Share in 2008 Percent | Growth 2008-12E CAGR[2] | Growth 2012E-16F CAGR[2] | Share in 2016F Percent |
|---|---|---|---|---|
| North America | 36 | 9.7 | 5.0 | 34 |
| Western Europe | 27 | 4.1 | 3.5 | 19 |
| Japan | 13 | 4.4 | 3.8 | 10 |
| **Developed markets** | **76** | **6.9** | **4.4** | **63** |
| Asia Pacific (*ex. Japan*) | 11 | 16.0 | 15.1 | 20 |
| Middle East | 4 | 12.1 | 11.8 | 6 |
| Latin America | 4 | 8.6 | 9.8 | 5 |
| CEE | 2 | 13.6 | 11.0 | 3 |
| Africa | 3 | 6.1 | 10.5 | 3 |
| **Emerging markets** | **24** | **12.9** | **13.1** | **37** |
| **Global** | **100** | **8.5** | **7.1** | **100** |

1 Personal Financial Assets (PFA) of High Net Worth Individuals (HNW) – Onshore and offshore including life insurance and pension
2 Compound annual growth rate (CAGR) calculated in local currencies and therefore excluding currency impact

**Asia no longer 'emerging'.** Over the next four years, we expect Asia (excluding Japan) to create around USD 7 trillion in net new millionaire wealth – only about 15 percent below the combined wealth creation of North America, Western Europe and Japan (Exhibit 2). China, India, South Korea and Taiwan are the leading wealth generators in Asia. Despite the attractive market potential, international private banks with a traditional offshore focus struggle to significantly raise market share, as roughly two-thirds of the Asian wealth is generated onshore (something we expect to rise) and onshore markets are still dominated by local banks. Nothing really wrong with that last sentence but suggest it read: Local banks outperform most international private banks, as offshore assets are typically only one-quarter to one-third as profitable as onshore assets in Asia.

**HNW country rankings.** In 2008, six Western European countries ranked among the top 12 HNW markets worldwide (No. 3 UK, No. 4 Germany, No. 5 Italy, No. 8 France, No. 9 Switzerland, No. 12 Spain). In 2014, we expect China to overtake the UK in the global HNW ranking and become the third-largest HNW market worldwide after the US and Japan. Furthermore, we expect Brazil and India to move into the top 10 by 2016 (vs. No. 13 and No. 11 today). However, we expect Russia to remain further down the table, but inside the top 20 HNW markets.

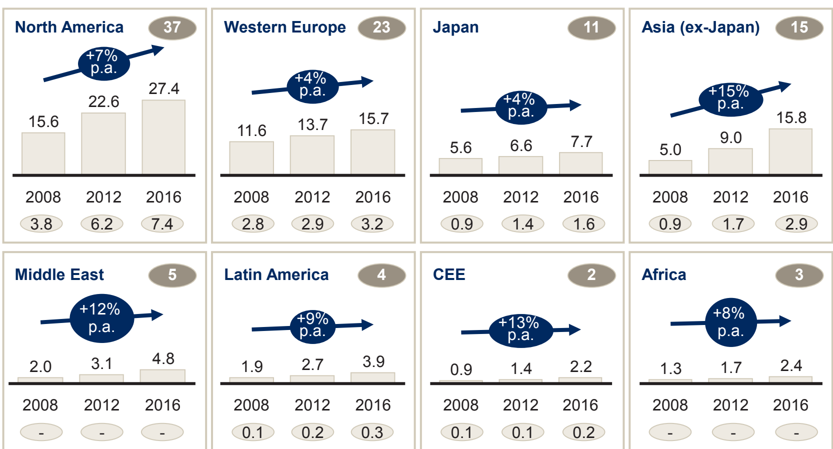
Exhibit 2

**Asia (excluding Japan) to lead net new millionaire wealth creation**

HNW PFA (onshore and offshore, including life insurance and pension), USD trillions

2012 Share of global HWN PFA
Percent

# of HNW Households
Millions




**Offshore wealth.** Offshore private banking has come under significant pressure in recent years from stricter regulation. Despite this, the offshore markets registered almost the same net inflows as onshore markets in both 2011 and 2012 – after trailing in each year since 2003 amongst other for wealth preservation. HNW individuals in emerging markets still put a significant portion of their money offshore for wealth preservation, thereby compensating for the decline in offshore wealth held by private bank clients in traditional Western European markets.

**Wealth management practices.** Emerging HNW markets are more skewed towards UHNW, enjoy higher asset growth and have a larger offshore share compared to developed markets. Furthermore, private banking is also perceived differently across the regions. In Europe, for example, private banking often starts when clients have EUR 0.5 million, whereas in the US the threshold of private banks is roughly eight times higher at EUR 4 million.

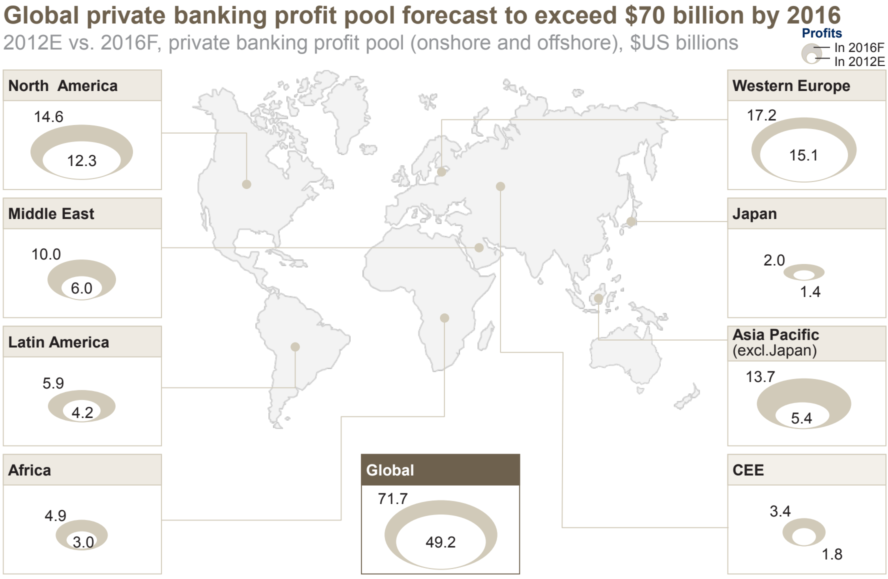
**Asia to lead profit pool growth.** We forecast that global private banking profit pools will grow by over 10 percent annually over the next four years. This will see the profit pools expand by over USD 20 billion to exceed USD 70 billion (Exhibit 3) by 2016. Roughly 35 percent of the absolute growth will be generated in Asia (excluding Japan). The key driver of profit pool growth is the increase in millionaire wealth. It may come as a surprise that the private banking profit pool in North America is smaller than in Western Europe, given that the personal financial assets of a North American HNW are roughly 70 percent higher than a HNW client in Western Europe.

This is driven by the low penetration of US private banks, which are serving only about 20 percent of the estimated market (if brokers are excluded). This contrasts with a private banking penetration rate of about 60 percent in Western Europe.

Exhibit 3

**Global private banking profit pool forecast to exceed $70 billion by 2016**

2012E vs. 2016F, private banking profit pool (onshore and offshore), $US billions



# Global view on regional economics

xx Below last year
xx In line with last year
**xx** Above last year

| 2012 | Western Europe | North America | Asia | India | Middle-East |
|---|---|---|---|---|---|
| **Growth** | | | | | |
| Net inflow | **2%** | **3%** | 7% | 14% | 14% |
| Performance | **6%** | **5%** | **10%** | **18%** | 4% |
| AUM growth | **8%** | **8%** | **17%** | **32%** | 18% |
| **Economics** | | | | | |
| Revenue margin | 82 bps | 95 bps | **82 bps** | **88 bps** | **108 bps** |
| Cost margin | 59 bps | 63 bps | 65 bps | **73 bps** | 40 bps |
| Profit margin | 23 bps | **32 bps** | **17 bps** | **15 bps** | **68 bps** |
| **Mandates** | | | | | |
| (share of AUM in advisory or discretionary) | 39% | 65% | **43%** | 23% | **17%** |
| **Asset mix** | | | | | |
| Cash and equivalent | 31% | 22% | 32% | 17% | **54%** |
| Fixed income | 27% | 25% | **18%** | 35% | 15% |
| Equities | **25%** | 35% | 36% | **46%** | 7% |
| Alternatives | 8% | **10%** | 6% | 1% | **8%** |
| Other/Balanced | 9% | 8% | 7% | 1% | **16%** |

# Western Europe: AUM grows but profitability remains under pressure

- AUM up 8 percent, mostly driven by capital markets performance and slight net inflows of 2 percent.
- Profit and revenue margins down 1 bp for the first time since 2010, amid an environment of low-rates and increasing regulatory pressure.
- Attractive economics for a reduced number of players with growing polarization between leaders and laggards; just 24 percent of private banks regaining pre-crisis profitability levels above 35 bps.
- Delivering distinctive value added vital in a period of intense competition among onshore booking centers, risk-adverse asset allocation and emergence of new client needs.
- A sustainable offshore value proposition needed to preserve still attractive but declining economics of offshore banks given increasing regulatory convergence with onshore markets.

Traditionally, private banking has been one of the most attractive sectors within European financial services. Up to 2007, it enjoyed a healthy pretax profit margin of 35 bps of assets, attractive growth rates, limited capital requirements and significant excess liquidity.

Since the financial crisis of 2008, the profitability of private banking has fallen by more than 30 percent. A partial recovery ensued over 2009 to 2011 as cost reductions helped to keep revenue margins stable. Since then, investment performance has been volatile and disappointing to clients despite the gains in capital markets recently experienced.

Beside, most private banks experienced an additional drop in revenue and profit margins with an increasing number of Western European private banks becoming unprofitable in 2012. It is thus a good time to rethink the value proposition of European private banks, especially given the opportunities emerging from the disappearance of competitive advantages held by offshore competitors.

## Industry economics: Still no recovery

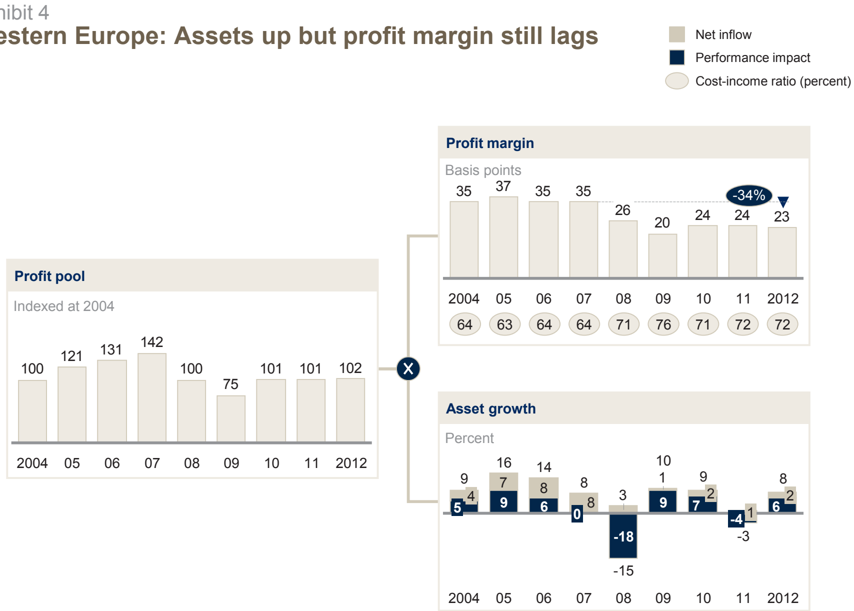
AUM in private banks in Western Europe increased 8 percent in 2012 mainly thanks to the 6 percent gain in capital markets. Net inflows also grew 2 percent. But the profit margin of the industry got hit again, falling 1 bp from 2011 (Exhibit 4).

Clearly, net inflows have yet to recover completely from the 2008 crisis. With a 2 percent inflow in 2012, the average of the last five years (1.9 percent per annum) is just one quarter of pre-crisis levels. Even if investor interest in real estate and other tangible assets is still high, it demonstrates that client trust in private banks is still to be restored. This is especially true in developed markets with outflows from clients there being offset by inflow from emerging markets.

For the last few years, the profit and revenue margin have been fairly stable at 24 and 83 bps respectively. In 2012, however, for the first time, private banks experienced a slight decrease of profit and revenue margins: the profit margin fell 1 bp to 23 bps, while the revenue margin fell 1 bp to 82 bps (Exhibit 5).

Exhibit 4

**Western Europe: Assets up but profit margin still lags**




The drop in profit margin is mostly due to declining revenue margin as the cost margin remained stable at 59 bps. This is driven by a significant drop in deposit margin, from 59 bps to 47 bps, mainly due to the very low interest rate environment. In fact, the fall in deposit margin is responsible for close to two thirds of the decline in revenue margin since 2008 for an average Western European private bank. We do not expect the situation to change in the near term as banks will continue to search for liquidity and capital in a low-rates environment.

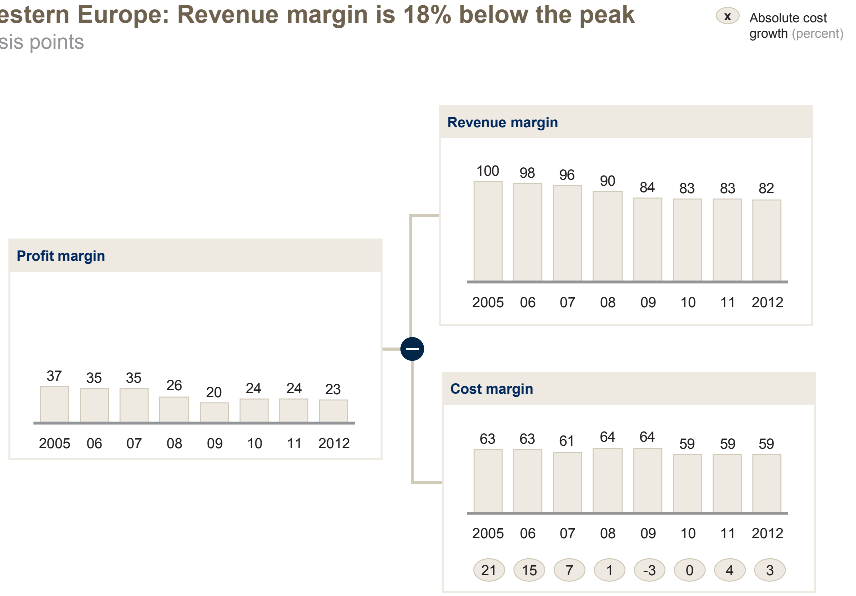
Several other positive effects helped to mitigate but not fully offset the falling deposit margin. Among them: more appetite for riskier asset classes (on the back of a 1 percent increased weighting for equities); greater use of funds in portfolios; a rise in advisory mandates; and an increase in the lending margin (from 91 to 97 bps).

Expenditure cuts after the crisis helped reduce the cost margin (to 59 bps in 2010 from 64 bps in 2008). Since then, the cost margin has been unchanged at 59 bps (25 bps for sales and marketing, 6 bps for investment management and 28 bps for back office/IT/ overhead). Only one in ten private banks has reduced its cost margin each year since 2009. This group improved their cost-to-income ratio by 11 percentage points to 61 percent (from 72 percent).

The data shows clearly the widening performance differential between leaders and laggards. In 2012, just over one bank in four (24 percent ) demonstrated levels of profitability higher than the historical pre-crisis level of around 35 bps. Yet the modest improvement among the better performers occurred at the same time as the percentage of unprofitable banks rose to 16 percent in 2012 from 14 percent in the previous year.

The pressure on private bank economics has combined with increasing regulatory constraints. As a result, many players are reviewing their geographical footprint, especially in offshore markets, leading to renewed M&A activity. In particular, they are assessing the strategic relevance of booking centers which may be subscale. In the

Exhibit 5
**Western Europe: Revenue margin is 18% below the peak**
Basis points




McKinsey Private Banking Survey 2012, we observed that the threshold to maintain attractive economics in a booking center is moving from EUR 5 billion of AUM to EUR 10 billion. Still, four Western European booking centers in 10 reported AUM below the EUR 10 billion.

Fee-based advisory mandates represented 17 percent of total private banking AUM in 2012, a record high. This followed net inflows of 5 percent during the year (compared to 2 percent net inflows for both discretionary and execution-only mandates). The data shows that clients are attracted to a solution that lets them make the final investment decision. The revenue margin on advisory mandates is getting closer to discretionary mandate margins, but remains about 10 bps less. This gap may disappear in the near future with the potential ban on commissions being extended to other markets beyond the Netherlands, UK and Switzerland where it is already in force. We believe that advisory mandates offer potential to the 30 percent of banks which have yet to set up a real offering.

## Market structure: Increasing regulatory convergence between offshore and onshore markets

Offshore private banks need to find a new value proposition given the increasing convergence with highly competitive onshore markets. The need to do so is exacerbated by the significant pressure that the offshore private banking market has come under in recent years from stricter cross-border and domestic regulation. In particular, double-taxation agreements and tax information exchange agreements that seek to increase transparency in the banking industry have begun to shape a new operating environment for offshore banks. As a consequence, offshore private banks are experiencing a faster trend of profitability margin contraction (from 36 bps in 2008 to 25 bps in 2012), compared to onshore players. In 2012, offshore players recorded a profit margin almost in line with onshore players (25 bps vs. 23 bps), driven by rising costs and a slightly increasing revenue margin, coupled with lower net inflows (1.7 vs. 2.6 percent for onshore players).

Consequently, European offshore centers are focusing on developing a more viable and sustainable proposition. Switzerland continues to attract significant flows from emerging markets, while Luxembourg retains its appeal for Western European ultra-high-net-worth individuals. These two offshore centers are seeking to promote greater diversification, higher quality service, superior capabilities, discretion and overall safety. Meanwhile, as the traditional tax rationale for offshore markets becomes less compelling, customers with less than EUR 1 million of invested assets continue to return onshore. They now account for only 16 percent of assets in offshore private banks (vs. 18 percent five years ago).

The convergence observed between onshore and offshore private banks is accompanied by a widening gap between top performers and laggards in another key metric, namely, net inflows. For the third consecutive year, the modest increase in net inflows across Western Europe masked stark differences between those private banks leading the charge for new money (top-quartile banks had average net inflows of 12 percent) and those that struggled in the tough environment (bottom-quartile banks had average net outflows of 7 percent).

The data shows that a number of Western European private banks may not be viable. Indeed, nearly one third of private banks in the region experienced outflows in 2012, while about one bank in six recorded a loss. Against this backdrop, we expect a continuation of merger and acquisition activity.

The profitability of onshore universal banks has proven to be more resilient than that of boutique competitors with the latter suffering mainly from lower brokerage revenue. In 2012, universal private banks saw the profit margin fall to 33 bps, while boutiques saw their profit margin fall 2 bps to 24 bps. In 2012, the universal bank-based private banks were particularly affected by their higher exposure to deposits. Moreover, boutiques demonstrated higher net inflow growth (4.5 percent), benefitting from investors' perception of their greater independence. As in previous years, many foreign onshore players continued to struggle in 2012, reporting net outflows (on average 1.5 percent) and a lower profit margin. This should also fuel M&A activity.

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We expect private banks to face fresh challenges from growing competition and regulation. Pressure on industry economics will intensify amid a further widening of the gap between top- and bottom-quartile performers. This will require private banks to rethink their value proposition by focusing on particular markets and clients.

Differentiation of the service model will need to incorporate varying client needs. Some clients, for example, will be advice seekers while others will be self-directed. Clients will also require help to adapt to the new regulatory environment, in particular, through tailored solutions to different tax rules related to their domicile. Finally, private banks also need to refine their operating platform to set up a sustainable, scalable delivery model to cope with profit margin reduction over time.

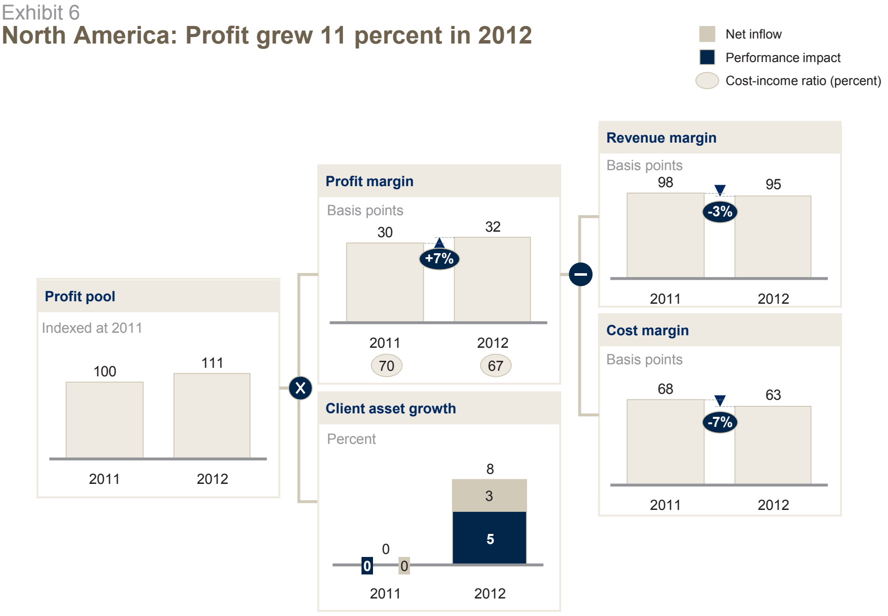
# North America: A return to profit growth

- Private bank client assets grew 7.8 percent in 2012, including net inflows of 2.9 percent following three years of flat or negative flows.
- The number of highly profitable “core millionaire” households served by private banks, the USD 1 to 10 million segment, jumped 12 percent after several years of decline.
- A 7 percent fall in the operating cost margin and healthy asset growth helped operating profit rise 11 percent.
- Improved frontline productivity as compensation costs fell fractionally amid a 9 percent reduction in client-facing head count.

## Industry economics: Cost cuts and net inflows drive profit growth

US and Canadian private banks enjoyed a banner year in 2012. Two factors drove the healthy 11 percent increase in profits: client assets grew by 8 percent over the year, and the average profit margin on client assets rose by over 2 bps to 32 bps (Exhibit 6).

Exhibit 6
**North America: Profit grew 11 percent in 2012**

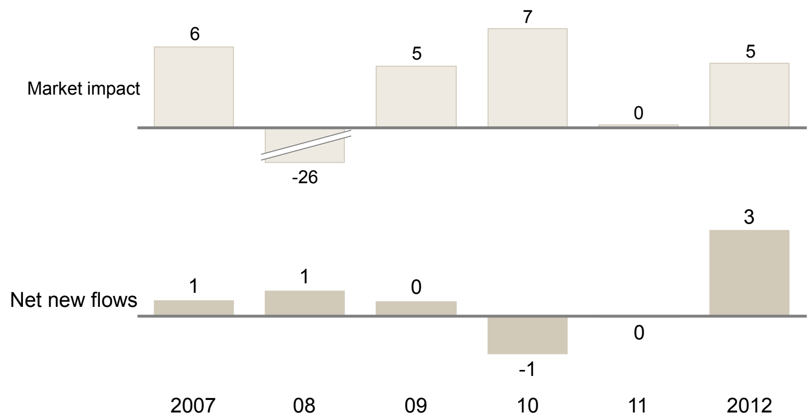



Note: Average 2012 client assets increased 3.6% over average 2011 client assets

Prior to 2012, North American private banking asset growth had been anemic since 2007. Traditional private banks have been challenged by three trends: one is the success of small independent boutiques that promise bespoke investment planning and services. A second is increased competition for clients in the USD 1 to 10 million segment from full-service brokerages, independent broker dealers, retail banks and independent advisors. Finally, the third trend is a self-inflicted outflow in which many sub-USD 5 million relationships were moved out of the private bank and into the lower-cost wealth channels run by the parent organization.

Despite the strong net inflows in 2012, 5 percent market appreciation was decidedly modest (Exhibit 7). With over 40 percent of private banking client assets residing in either deposit products or fixed-income investments, clients did not participate fully in the strong 2012 equity market performance (the S&P 500 Index, for example, gained 16 percent). In addition, alternative investments such as hedge funds, private equity, real estate, structured products and commodities, which account for almost 10 percent of clients' non-deposit assets, significantly underperformed the equity market.

Exhibit 7
**North America: Net flows rise as markets supply decent returns**
Percent



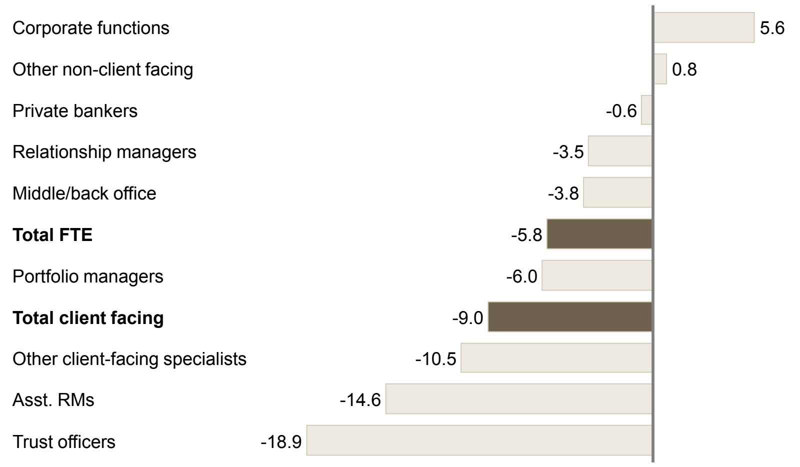

One encouraging sign of our preliminary 2012 data is that the number of clients in the USD 2.5 to 10 million segment served by private bank participants grew an impressive 12 percent. This would suggest that private banks are devoting more effort to attracting "core millionaire" clients – a group that we estimate will represent over 80 percent of the profit growth in the American market over the next five years. Provided that these clients receive an economically appropriate service model and product offering, future profits and revenue growth will benefit from a strategy of growing this segment.

The cost margin of North American private banks plunged in 2012, falling 7 percent to 63 bps. The deepest reductions came in support and back-office services as reported expenses in the back/middle office, and other direct costs declined 7 percent from 2011 (and by more as a percentage of assets). Total head count fell by almost 6 percent. Coupled with a modest increase in per employee compensation of 5 percent, US private banks saw their overall total compensation expense decline 1 percent from the previous year (Exhibit 8).

Exhibit 8

**North America: Headcount falls, particularly in client facing roles**

2011-2012, Change in number of FTE by role, Percent




The revenue margin also declined in 2012, preliminary data shows, but only by approximately 2bps to 95 bps. This continues a long-term trend driven by at least two factors. One is that, post-2008, private banks moved upmarket, focusing their efforts on attracting and retaining UHNW families and foundations. Despite their high asset levels, these clients often receive fee discounts (although this was less prevalent in 2012) and also tend to keep a higher proportion of assets in low-fee "custody-only" accounts. The second factor is the negative impact of a continuing ultralow-interest-rate environment where spreads are compressed. This saw interest rate spreads between rates earned on loans and securities, and rates paid to customers in 2012 decline another 7 bps to 194 bps.

It is also clear that frontline relationship managers and product specialists deserve significant credit for the improving profitability of private banks. They have shouldered an approximate 16 percent increase in the average number of USD 1 million plus households per frontline FTE. While the number of USD 1 million client relationships increased an impressive 5 percent, the number of client-facing professionals (including relationship managers, assistant relationship managers, private bankers, portfolio managers, business development officers and product specialists) declined by 9 percent. The reduction in client-facing professionals was concentrated in non-relationship manager roles. Trust officers, assistant relationship managers and other specialists all saw double-digit percentage decreases. Meanwhile, the number of relationship managers fell 3.5 percent.

## Market structure: A path to sustainable growth

North American private banks face intense competition from a variety of firms. Independent boutiques and investment specialists have been capturing most of the net inflow growth over the last decade, while private banks have at best only maintained their market share. In what amounts to a paradigm shift, newer players have been winning and based on current trends may control close to 30 percent of millionaire's financial assets by 2017.

We believe North American private banks should focus on four opportunities:

- **Delivery of world-class banking and wealth expertise.** Traditionally, many large UHNW- and HNW-focused institutions have focused on either wealth management or lending. For these players, we believe sustained profit growth depends on their ability to combine banking and wealth management expertise in their advisory model.

- **Sharpen the "core millionaire" proposition.** Private banks face significant competition from peers and other players for high-net-worth clients. Serving these clients effectively and economically may require a structurally distinct subchannel – which delivers a high level of service, but more limited investment customization and less specialist support.

- **Capture intergenerational wealth transfer.** To capture the next generation of heirs and wealth creators, private banks must adapt their brand image, value proposition and delivery model. The average age of a private bank client is over 60. This issue is particularly acute for regional private banks, which tend to have the largest proportion of older clients.

- **Respond to regulatory changes.** The Foreign Account Tax Compliance Act (FATCA) is meant to deter tax evasion in offshore accounts. Although the full impact of FATCA is still unclear, the requirement to report the transactions of US account holders will raise the regulatory reporting costs for private banks. These changes are already creating significant opportunities for US-based banks to gather assets and recruit talent. We anticipate this trend to become more important as implementation progresses.

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The North American private banking sector rebounded strongly in 2012. Robust equity market performance in the first-half of 2013 portends another strong year. This turnaround creates an important window for private banks to invest to sustain growth amid an increasingly competitive landscape.

# Asia: Profitability improves, but only for a few players

- Profit margin up for the first time since the crisis from 11 to 17 bps.
- Inflows positive, but lower than in previous years.
- Clients beginning to allocate more to advisory and discretionary mandates.
- Developing a differentiated value proposition and go-to-market model that reflects the diversity of Asia's markets are the keys to success.
- Offshore is the existing opportunity, but onshore will be the future.

Asia is the highest growth region for private banks and will continue to be so. However, forecast growth is lower than in previous years. Profitability has improved for the first time since the financial crisis due to improvement in the revenue margin. Asian clients continue to demand the freedom to make their own investment choices along with customized, sophisticated products. Recently, we have started to see a move from traditional execution to fee-based advisory mandates. This will influence how private banks think about their value proposition to serve different client segments. Wide differences in performance among top-quartile and bottom-quartile players continue to exist.

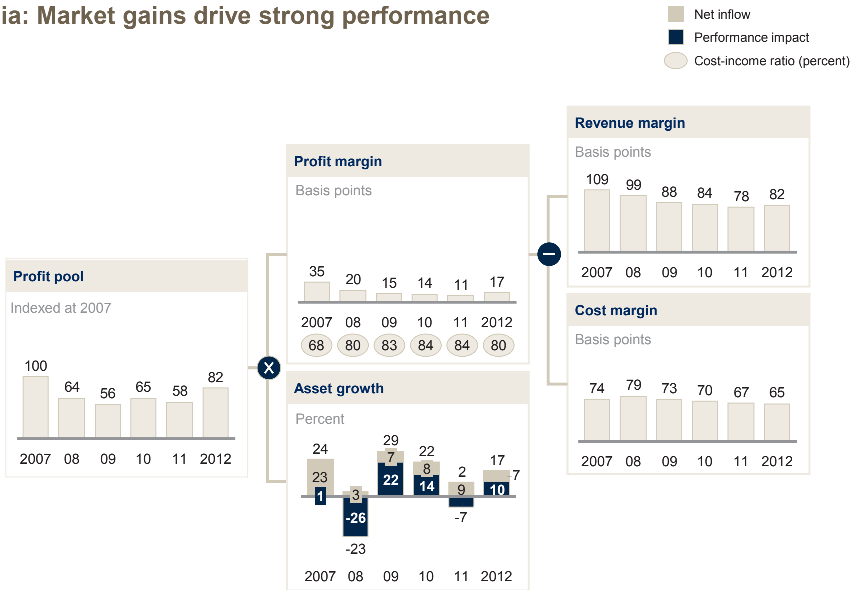
## Industry economics: Profitability improves

Private banking AUM grew 17 percent in 2012, primarily due to a rebound in market performance (up 10 percent in 2012 vs. a drop of 7 percent in 2011, Exhibit 9). Net inflows remained positive in 2012, but grew more slowly than in 2011 (7 percent vs. 9 percent respectively). Asia has been the fastest-growing global region for high-net-worth money and will continue to do so, however growth is expected to slow slightly to 15 percent per annum over the next four years compared to 16 percent annual growth during 2008-12.

The improvement in economics reflects profit and revenue margin improvement of 6 bps and 4 bps respectively (reaching 17 bps and 82 bps). These margins are slowly climbing back to the pre-crisis level (20 bps for the 2008 profit margin and 99 bps for the revenue margin). The revenue margin is up 4 bps compared to 2011. This is partially driven by a 5-percentage-point improvement in the deposit margin and higher demand for fee-based advisory mandates. As the Asian private banking industry continues to mature, we have observed a gradual shift to more advisory and discretionary mandates from pure execution and custody. Advisory and discretionary assets slightly increased in 2012 to 43 percent of the AUM mix from 41 percent in 2011. This trend is in line with the more mature private banking markets including Western Europe. The cost margin decreased to 65 bps in 2012 compared to 67 bps a year earlier. Although mid-back-office costs are increasing, other costs such as sales and marketing have declined.

Asia (excluding Japan) is expected to be the second largest wealth market globally. HNW personal financial assets (PFA) are expected to reach USD 16 trillion by 2016 with a compound annual growth rate of roughly 15 percent from 2012. China is estimated to contribute over 50 percent of the growth in Asia. Currently, private banking penetration in these HNW assets is only estimated at around 15 to 25 percent – suggesting significant room for growth.

Exhibit 9
**Asia: Market gains drive strong performance**




Unlike developed markets, Asian HNW are still mostly first-generation wealthy. Most of these high- or ultra-high net worth individuals have made their fortune from their own business. Our latest HNW survey in China and India highlights that the entrepreneur segment represents the largest opportunity and also has the highest proportion of UHNW wealth. For instance, in China, entrepreneurs represent over 40 percent of total HNW with 5 percent of them being ultra-HNW (the highest among all HNW profiles). Asian private banks are targeting the UHNW segment, and they now represent 43 percent of total customer AUM in 2012, up from 42 percent in 2011.

For UHNW entrepreneurs, investment banking services are in high demand. They are specifically looking for in-house services on co-investment/direct deals, alignment of family and business portfolios, and learning sessions from family offices. Private banks could adopt a 'one-stop shop' approach for all these clients, offering them not just best-in-class private banking products, but products that satisfy their business needs as well.

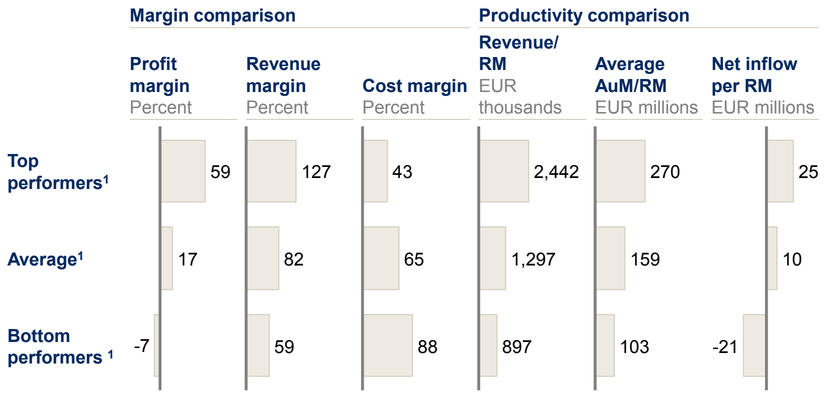
Most private banks are trying to broaden their product offerings to cater to the specific needs of an Asian clientele. However, not all banks have been able to reap the benefits of this investment. In such uncertain times, clients prefer banks with a strong private banking platform rather than those with a somewhat smaller private bank setup. This has led to noticeable polarization among players as well as a large variance in margin and productivity performance among different private banks (Exhibit 10). The revenue margin, for example, varies from 127 bps to 59 bps between top and bottom performers.

The cost margin varies substantially as well with top performers at 43 bps and bottom performers at 88 bps. With an uncertain regulatory environment, costs, particularly for compliance, are expected to increase unless dealt with proactively. Scale can serve to partially mitigate such cost increases and helps to explain why M&A activity in the region remains robust.

Exhibit 10

**Asia: Frontline productivity separates top and bottom performers**

2012




1 Different bank samples for each criteria

## Market structure: Onshore market is the future

Though the majority of assets are onshore (representing more than three quarters of total HNW AUM), competition is most intense offshore. This is due to the tighter regulation in the onshore markets (in particular, in China and Taiwan) and the behaviour of clients in these markets. For some Asian private banks, onshore will be the primary source of future growth. However, these private banks will still need to actively maintain an offshore presence while developing their onshore strategy over the medium to long term.

In the latest China onshore HNW survey, our findings highlight both opportunities and challenges in China's onshore market. We found that there are abundant opportunities not only in Tier-1 cities such as Shanghai, but also in Tier-2 cities, and below, which represent over three-quarters of the onshore opportunity in China. In addition, though entrepreneurs are the largest segment, we found that there are large variations in their needs, ranging from active investment advisory to strong linkages in their business and personal requirements. Our findings also show that the market is still open to competition, as nearly half of China's HNW have only a limited understanding of private banking. Finally, though product choice is a key consideration for clients, we found that investment advisory is of increasing importance.

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In summary, Asia's private banking market is diverse with onshore and offshore characteristics in addition to the special attributes of large onshore markets including China. Thus, business models will need to be tailored accordingly. Several trends are at play in the region that underscore the continued importance of certain segments, notably entrepreneurs, and the growing adoption of certain services, in particular, advisory. Adapting to these factors is the key to private banks operating successfully in the region.

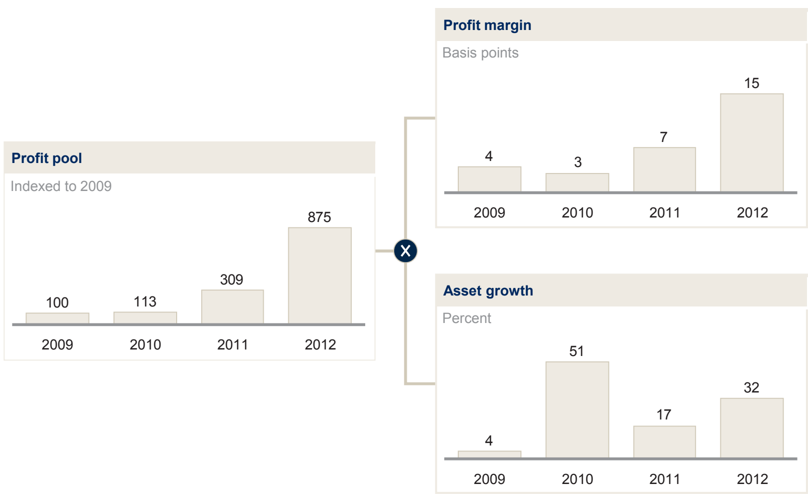
# India: Rapid growth fuels rising profitability

- Private banks in India are growing very strongly; AUM in 2012 surged by 32 percent following a 17 percent gain in 2011.
- Profit margins have consistently increased over the last two years to reach 15 bps.
- The Indian private banking industry is dominated by the UHNW segment as well as Mumbai and Delhi geographically.
- Economics for Indian players vary significantly based on scale and the business model (banking-led vs. pure advisory).

Private banking is one of several areas undergoing rapid development in the Indian banking sector. Many banks have developed specific private banking services to build on existing affluent segment offers.

With 32 percent AUM growth in 2012, Indian private banks are expanding rapidly (but coming from a low base). Since 2010, when AUM soared by 51 percent, India has been one of the fastest-growing private banking markets in the world. In 2012, this growth combined healthy net inflows (14 percent) and strong market performance (18 percent). We expect net inflows to continue to expand significantly.

Exhibit 11
**India: Profit pools grow significantly since 2010**

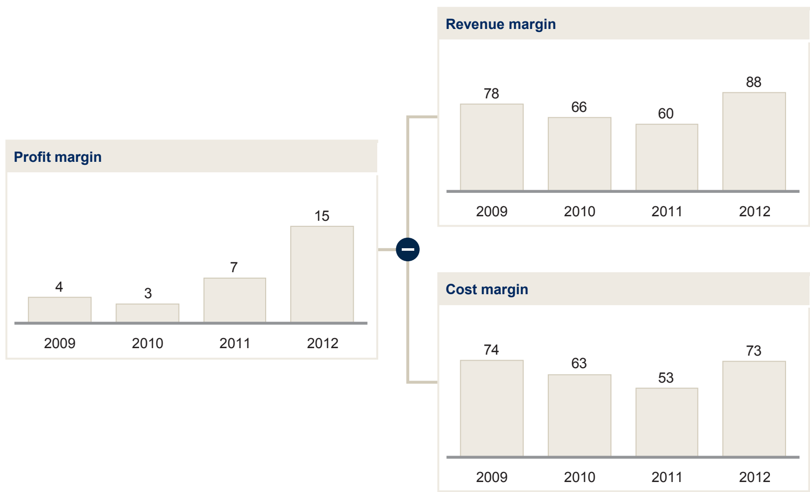


## Industry economics: Emerging profitability

The Indian private banking industry is showing emerging signs of profitability (Exhibit 11) with profit margins having doubled each year since 2010 (rising from 3 bps in 2010 to 15 bps in 2012). This came on the back of a one-third increase in the revenue margin (to 88 bps in 2012 vs. 66 bps in 2010) and a lower 16 percent rise in cost margins (to 73 bps in 2012 vs. 63 bps in 2010).

A higher share of revenue from standard banking pools, a higher share of revenue from brokerage income and a higher fee structure led to the increase in revenue margin (Exhibit 12). The cost margin has also grown due to higher sales and marketing expenses (following a slight decrease in relationship manager productivity) and an increase in back-office and IT costs.

Exhibit 12
**India: Revenue margin drives profit growth**
Basis points




## Market structure: UHNW account for over 60 percent of AUM

The UHNW segment with assets in excess of USD 40 million is the prime opportunity in India and accounts for over 60 percent of private bank AUM. Moreover, with an annual growth rate of AUM in excess of 50 percent, this segment is expanding faster than the overall market. On a geographic basis, Mumbai and Delhi dominate with over 65 percent of AUM, though other metropolitan areas (notably Chennai and Bangalore) are growing significantly faster than the private banking industry as a whole. The implication is that AUM will be spread more widely around the country in future.

The Indian private banking industry consists of several different models, including banking-led and pure advisory, that is, players without a banking license. However, banking-led players are the most profitable owing to significantly better cost margins than pure play advisors. Indeed, the profitability of Indian private banks (with a margin of 38 bps) is close to the level of European peers. In addition, scale has a significant impact on profitability. Firms with AUM of USD 1 billion or more, show higher profitability (at 27 bps) due to better cost margins. What's more, the larger private banks show a higher rate of AUM growth than smaller players (34 vs. 23 percent), reflecting the significant concentration in the market.

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We expect the Indian private banking industry to grow strongly on the back of rising income levels. This will fuel demand for more sophisticated private banking services as well as alternative asset classes and structured products. Serving specific customer segments, notably entrepreneurs, should be the chief priority. We would also highlight the importance of building a capable sales force to ensure best-in-class service and superior product development in response to evolving client demand.

# Middle-East: A growth market becomes increasingly competitive

- Regional private bank AUM grew by 18 percent in 2012, driven by rising net inflows (14 percent) and market appreciation (4 percent).
- The average revenue margin rose slightly in 2011, while the average cost margin fell by 5 bps as banks streamlined middle- and back-office operations.
- AUM allocated to equities and alternative products increased from 2011, but liquidity balances remained high (54 percent of AUM).
- About 70 percent of assets are still booked offshore though onshore competition is heating up.
- Entrepreneurs and family business owners represent 40 percent of non-oil GDP in the Gulf Cooperation Council (GCC) area; having a distinct value proposition is the key to winning their custom.

The Middle-East remains an attractive growth market for private banking. Inflows continue to climb, and profitability is rising. However, competition among private banks is intensifying both among onshore and offshore operators.

## Industry economics: Profitability improves for onshore private banks

Three things are improving the economics of onshore players. One factor is a shift in the product mix, a second is a renewed focus on lending and the third is cost reduction measures.

The improving profitability is also helped by healthy growth. Total Middle-East HNW and UHNW wealth (onshore and offshore) grew to USD 2.2 trillion in 2012, up 18 percent. The outlook for the region remains positive. We estimate total HNW wealth will increase to USD 3.3 trillion by 2015. Saudi Arabia accounts for about 40 percent of the total wealth pool in the GCC. It is followed by the UAE, Kuwait and Qatar (with about a 22 percent, 15 percent and 12 percent share of HNW wealth, respectively).

The revenue margin continues to grow from the levels of 2010 and 2011 – increasing slightly in 2012 to 108 bps from 106 bps a year earlier. Cost margins have declined from 45 bps to 40 bps in 2012 as onshore private banks have started to streamline their middle- and back-office operations, while more effectively leveraging the corporate functions of their universal bank parents.

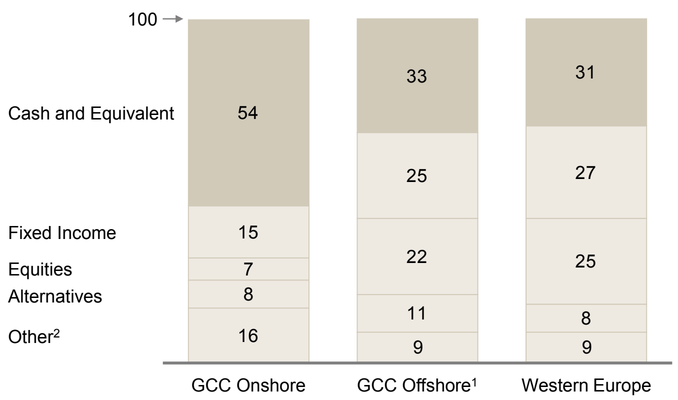
The product mix for asset allocation has not significantly changed since 2011, but demand for collateralized lending solutions is growing. The data also shows that most of the asset inflows have been in favor of cash and cash equivalent products (which represent about 54% of AUM). HNW and UHNW clients have maintained high liquidity onshore in order to take advantage of investment opportunities in the region, particularly in real estate. At the same time, the data shows a slight increase in equities and alternative products, a sign of improving confidence in the market outlook (Exhibit 13).

The ability of private banks to lend to their HNW and UHNW clients is an increasingly important differentiator in a very competitive market. Our data suggests total lending to HNW clients as a percentage of AUM ranges from 10 to 20 percent. The private banks that are at the higher end of this range are the ones that draw on a deep understanding of clients to assess credit worthiness and provide tailored lending solutions. Lending is also an important contributor to the healthy revenue margins earned by private banks in the region.

Exhibit 13

**Middle-East: Distinct investment behaviour drives asset allocation**

2012, HNW asset allocation, Percent




1 As estimated by investments in Switzerland, where most Gulf Cooperation Council offshore assets are booked
2 Includes balanced funds and direct equity investments

## Market structure: Offshore dominates, but onshore is increasingly important

The share of assets booked offshore is still dominant, averaging about 70 percent. The proportion of assets booked offshore for each country in the region ranges from 55 to 80 percent.

Most of the assets of Middle East HNW and UHNW clients continue to be booked offshore in the traditional booking centers of Switzerland and London. However, some clients, particularly among the UHNW, are considering the use of alternative booking centers such as Singapore and Hong Kong for a portion of their wealth. This is from a low base since we estimate that only 3 to 5 percent of Middle East offshore wealth is currently booked in Asia. It would appear, however, that this is set to rise given the more attractive investment opportunities in Asia.

Meanwhile, the battleground for onshore private banking is becoming more contested. Universal banks are increasing their focus on the HNW and UHNW client segments. In particular, universal banks are extending their established affluent banking service offering to new clients in higher wealth bands.

The productivity of relationship managers in the region shows a big gap between the top and bottom quartiles. This is displayed in measurements of both net new money and revenue per relationship manager. Significantly, our data shows that top performers are on average four times more productive on both counts than bottom performers. Moreover, the data shows that the productivity differential between the top and bottom quartiles is widening.

Private banks in the Middle East have enjoyed positive asset inflows and high growth in new clients. We think it is important that bank executives continue to focus on productivity to sustain the positive performance trajectory observed in recent years.

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It is apparent that many private banks in the Middle East continue to struggle with the shift from providing a "red carpet" banking service to offering a true wealth management proposition. Taking an interim step might help bridge the gap. This could involve relationship managers earning credibility with clients by building competence in specific products. By doing this, they would get a deeper understanding of each client's investment objectives, asset preferences and risk appetite.

That knowledge would feed into offering a better wealth management solution. It could also help with tailoring the offering of more sophisticated services targeted at small and medium-sized business owners. Here the target should be family-owned businesses, which account for 40 percent of non-oil GDP and 50 percent of private sector employment in the GCC. We believe this approach could play a key role in winning clients and assets in an increasingly competitive market.

# Latin America: Brazil and Mexico lead a fast-expanding market

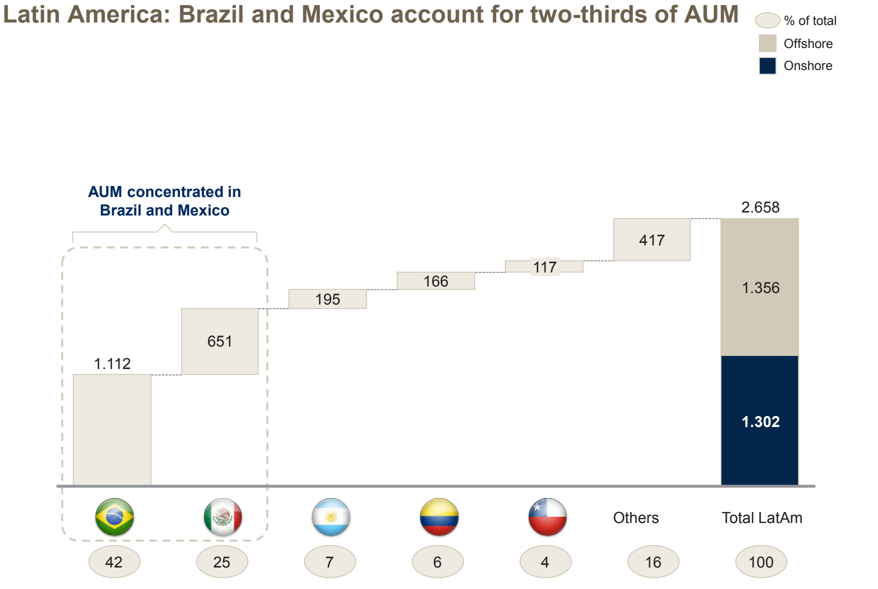
- Around 67% of assets come from Brazil and Mexico with about one-half invested offshore.
- Concentration in UHNW segment which accounts for 31 per cent of wealth in both Brazil and Mexico.
- Brazilian private bank customers still have greater than 50% allocation to fixed income (direct allocations and multimarket funds).
- Increasing demand in the region for advice and financial education.
- Growing demand from UHNW for exclusive products and services unavailable to regular private bank clients.

The private banking industry in Latin America has roughly USD 2.7 trillion in AUM, or about 4.5 percent of the global market. Overall, approximately half of the assets are invested offshore (down from about 60 percent in 2008), but this varies considerably by country.

## Industry economics: Growth to continue

We expect the solid growth recorded in the Latin American private banking sector to continue over the next three to five years, driven mostly by Brazil and Mexico. This reflects a stable economic outlook, a higher concentration of wealth among traditional and stable millionaire households, and the emergence of a new generation of wealth from entrepreneurs and top executives, who have benefited significantly from the region's economic prosperity over the past decade. Brazil and Mexico account for two-thirds of the Latin American AUM in private banks (Exhibit 14).

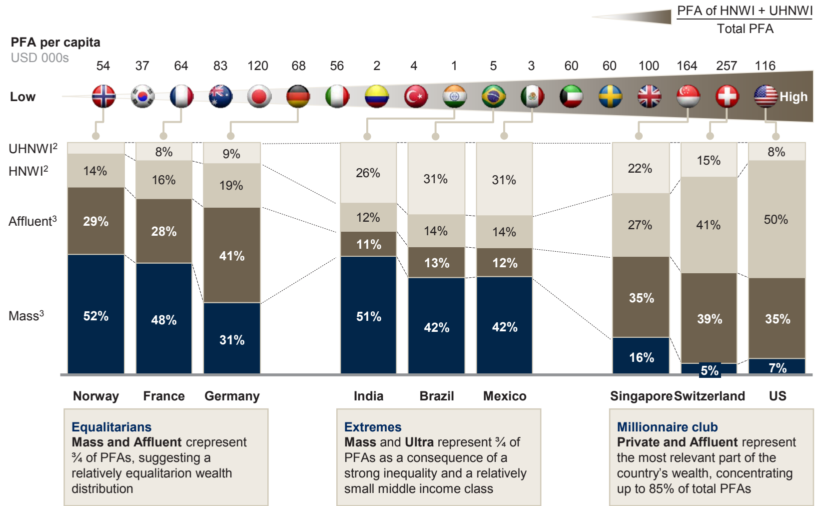
Exhibit 14
**Latin America: Brazil and Mexico account for two-thirds of AUM**




2012, HNW PFA (onshore and offshore, including life insurance and pension), USD billions

Not only is Brazil the largest private bank market, it is also the fastest-growing one in the region. The significant development of capital markets has occurred in tandem with a substantial expansion in wealth creation and liquidity levels during the past five years. As a result, all client segments experienced major growth. Moreover, Brazil remains one of the countries with the highest concentration in the top segment – ultra-high net worth clients (Exhibit 15).

Exhibit 15
**Latin America: Wealth is concentrated in the UHNW segment[1]**




1: 2000-10 average, Breakdown of personal financial assets by segment, countries ranked according to the share of HNWI + UHNWI
2: UHNWI: individuals with PFA > 30 MM USD; HNWI: individuals with PFA 1 - 30 MM USD
3: Affluent: individuals with PFA 100,000 - 1 MM USD; Mass: individuals with PFA < 100,000 USD

## Market structure: Sector dynamics are changing

As Brazil's economy evolves, structural changes have the potential to alter the dynamics of the private banking market. This has much further to run, potentially creating both opportunities and challenges for private banks and their clients.

Historically, the Brazilian market has been extremely concentrated. The top 10 players hold about 90 percent of total onshore AUM with the top three having a share of around 60 percent. Clients have traditionally favored integrated players. However, new players have entered the market, boosting competitive pressure further.

Until recently, high Brazilian interest rates meant investors favored deposits and fixed income products. The nominally low risk exposure and high returns limited the need for advice. At the same time, the limited breadth and depth of Brazilian capital markets mean that high-quality products are a scarce resource.

From this emerged two successful business models. One model is that run by universal local banks, which combines a strong distribution network and client base with access to sophisticated products either through their asset management or capital markets business. The second model is one featuring product-led players. With superior development capabilities, they are able to push proprietary products (which are in high demand and command a fee premium) through their own and others' distribution network with minimal revenue sharing.

Nonetheless, different business models targeting different client segments co-exist. Typically, UHNW are served by the private banking arms of universal banks, by multifamily offices in the onshore market and by international players offshore. In contrast, universal banks and global players with a local presence compete with boutique private banks to serve the HNW segment.

Even with the move towards alternative investments and offshore assets, client allocations remain relatively conservative. Private banking clients, though more sophisticated and diversified than other client segments, still have roughly a 30 percent weighting to fixed income and a 50 percent weighting to multimarket funds, most of which have a large allocation to fixed income products.

But the decline in real interest rates in Brazil (from 6.2 percent in 2008 to 1.0 percent in 2013) and the development of local capital markets is shifting the investment dynamic. Data suggests that investors are beginning to shy away from fixed income products and allocate to hedge funds, private equity and real estate.

At the same time, negative trends for the Brazilian real and the local stock market (the iBovespa market index fell by over 15 percent in the first half of 2013) are increasing the attractiveness of international investments. We believe offshore investments have the potential to grow further as clients adopt a more fluid approach to allocating to local and international investments.

The need for advice and financial education gives relationship managers an opportunity to move clients to an advisory and asset allocation approach from a product-centric one. Clients need to increase the risk exposure in their portfolios to boost returns. However, uncertainty about how economic developments may affect investment portfolios is feeding investor anxiety and increasing the demand for professional financial advice. It is still unclear, however, to what extent clients are willing to pay for it.

In recent years, a new social group, which we call the "high middle class," has become prominent. It is comprised of increasingly wealthy executives and entrepreneurs who have closed the gap with the more traditional, old money, private banking clients. This new social class, highly educated, information-savvy and with international experience, is impeding on the more traditional, old money, private banking clients, who feel less well served than previously.

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In response, The UHNW segment is demanding higher levels of personalization and access to exclusive, customized products. This poses challenges to the established players, who need to cut costs, redesign the value proposition and rethink their business model. But it also creates opportunities, particularly for international firms with strong product and advisory capabilities.

# Priorities for capturing the new generation of clients

The performance of private banks in a difficult market environment has put pressure on operating models. It has also raised questions about what value private banks are delivering to HNW clients. New regulations and higher client expectations are also pushing private banks to embrace fundamental change. Not all banks are at the same stage of transformation, but it is our view that the majority of private banks must address a number of issues to build a sustainable model for the future.

Amongst the various issues faced by private banks, three themes emerge as critical for the industry:

- **Protect the economics by running private banking as a real business.** Here it is imperative to ensure discipline in pricing practices and sales force effectiveness, while applying lean techniques and building scale wherever possible.

- **Rethink the footprint and operating model.** Do this by reviewing the viability of various booking centers, questioning and adapting the presence in the offshore market, and leveraging the digital opportunity to reduce the cost-to-serve.

- **Prepare to capture the new generation of clients.** Develop truly segmented value propositions to capture the pockets of growth in both emerging and mature markets, while setting up distinctive advisory and investment offers to meet changing customer needs in a more complex regulatory environment.

## Run as a real business to protect the economics

**Discipline pricing practices to boost profitability.** We believe that optimizing pricing can generate between 5 and 12 basis points of additional revenue margin within nine to 12 months, depending on the starting situation of the bank. We have observed that regulatory change and margin pressure have led many banks to adjust pricing practices. However, we believe that only a few banks have delivered the full potential that is available.

**Free up and reinvest in frontline capacity to boost growth.** The journey to frontline excellence is about initiating a cultural change within the entire bank. In our experience, an average relationship manager spends less than half of his time on client-related activities. Changing this requires a simultaneous focus on customers' needs, process efficiency, staff performance management as well as organizational and behavioral changes. Many banks in the past have addressed these issues individually and failed to deliver the desired results. An approach covering the full range of activities is required. We believe the target should be to increase the time of relationship managers on client-related activities by 50 percent.

**Apply lean techniques to improve overall efficiency of middle-office, back-office and support functions.** Although some crisis-driven cost reduction pro-grams have started to bear fruit, many of our survey participants report that the impact of these initiatives has been less than they had expected. In our experience, well-executed lean programs can deliver efficiency gains ranging from 15 to 30 percent. To get this result, it is necessary to take a holistic approach, including eliminating waste in end-to-end processes, shortening lead times, standardizing operating procedures and tightening performance management in non-front-office functions.

**Build scale and reduce complexity across the board.** Scale plays a decisive role in driving cost efficiency, especially for investment, operations and IT functions. Successful banks based in multiple countries are increasingly sharing functions across individual markets. Some have developed blueprints to establish common standards for private banking across these territories, a development that will facilitate both new market entry and integration. A few banks have combined near- and offshoring along with the outsourcing that has become common in other areas of financial services. Duplicated functions, in our experience, are most often a result of legacy from past acquisitions or limited coordination between various business units (e.g., corporate and investment banking, retail banking and asset management). Sharing resources and optimization can reduce operational risks, improve customer experience and cut costs.

## Rethink the footprint and operating model

**Assess the viability of booking centers.** In mature markets, according to our survey, a booking center with assets of more than USD 10 billion has a cost margin that is 35 percent lower than one with assets of less than USD 5 billion. In Western Europe, this gap has widened since 2007. Regulatory changes are likely to drive up the minimum scale at which private banks can operate, given increasing capital requirements and the cost of ensuring heightened regulatory compliance. To ensure sufficient scale in selected regions, while of course guaranteeing that individual relationship managers have the local knowledge they need, private banks will have to review which clients they serve with which teams and consider, when needed, divesture as an option for sub-scale booking centers.

**Re-assess and adapt offshore presence.** The traditional offshore markets are experiencing significant pressure for change, mostly driven by stricter cross-border and domestic regulation. In mature economies, double taxation agreements and tax information exchange treaties that seek to increase the transparency in the private banking industry are beginning to shape a new operating environment for offshore banks. Offshore centers have shown their resilience in recent years by promoting the benefits of diversification, high-quality services, strong structuring and investment capabilities and safety. However, as the lines separating on- and offshore markets become more blurred, private banks need to decide on a cross-border strategy and understand the implications for their business model. They need to choose which client domiciles to serve, coverage models, their value proposition for customers, what skills and capabilities are required as well as how to organize the business's portfolio of subsidiaries and locations (including divestitures, rundowns and new business units).

**E-enable customer experience to reduce cost to serve.** Technology will affect the traditional relationship model in private banking. It is our view that this trend will accelerate with the next generation of clients. Recent digital developments (including new sources of information for clients and the impact of social media on client trust and brand equity) will require private banks to adjust. Considering how technology-enabled channels have changed retail banking in the past five years is instructive: fewer client visits to branches; an increasing number of touch points offering more opportunity for cross-selling; customers becoming more self-directed and only looking for advice in a few key moments; and for banks that managed this transition, an over-all lower cost to serve. It is clear that the rapidly evolving digital environment will require private banks to act.

## Using digital innovation to help clients

Our advice about digitalization for private banks emphasizes putting in place truly integrated multichannel access linking clients and bankers. Thus we are not focusing on the direct banking models, typical of several pure online retail banks.

The digital revolution has significantly changed retail banking over the last decade. Branch visits are down 30-50 percent, while the use of remote channels has jumped up to five-fold. What's more, client segmentation is increasingly structured around channel usage rather than by the level of wealth.

Retail banks that have undergone the transformation journey have benefitted significantly from higher client satisfaction, an increasing number of touch points with clients (i.e., more opportunity for cross- and up-selling) and a substantial decrease in cost-to-serve. The transformation has spread across all client groups, whether segmented by age (up to 65), source of wealth or location (rural vs. urban). It has taken banking far beyond the traditional segmentation of affluent vs. mass market.

Clients may fear that such a transformation in private banks will alter the traditional one-to-one physical contact they have with relationship managers. A private bank must reassure clients that personal service will be maintained, while defining its digital strategy in one of three possible ways:

- "Stay at par" – that is, close the gap with the basic retail banking digital offer.
- "Tailor made" – adapt the digital offer to specific client requirements.
- "Shaper" – invest significantly in digital as a true competitive differentiator and use it to create a compelling value proposition to attract younger private bank customers while reducing cost-to-serve.

Not many private banks have opted to become a digital "shaper". However a number of private banks have embraced digital innovation in the following four areas:

- Product and service: use iPad and mobile applications to change the conventional client wealth offer to include more dynamic reporting and additional real time capabilities; increase offer velocity with innovative products and services such as live scenario modeling and ad hoc reports.
- Distribution transformation: structure the private banking relationship based on personal client preferences (such as more frequent and shorter remote client interaction, for example, via video-calls); reduce the cost of administration and back-office.
- Risk minimization: use more accurate client risk profiling for wealth management planning with automated controls to reduce risks in the event of specific portfolio events.
- Better corporate management: improve management information systems and performance management for private bankers, while reshaping the talent model and banker recruitment.

Finally, digitalization brings increased transparency that will enable clients to better compare offers and prices. Increasing demand from a self-directed segment may drive down margins on the execution-only brokerage service. However, advisory clients looking for specific solutions will focus more attention on the quality of their private banking relationship.

## Get prepared to capture the new generation of clients

**Capture attractive pockets of growth in fast-developing markets.** Emerging market economies are of critical importance to private banks. Despite different dynamics, emerging markets now and in the future offer significant opportunities to private banks seeking to grow and develop long-term recurring profit streams. In these high-growth markets, the challenge is to better serve the business owner/entrepreneur segment, which is a cornerstone of developing economies and an increasingly attractive opportunity for private banks. Local primary banks generally hold the majority of the business assets of these entrepreneurs but have a smaller share of their personal assets. Yet they are ramping up efforts to capture a bigger share of the entrepreneurs' personal assets. The primary banks are tough competitors given their superior knowledge of these clients as well as their ability to assess creditworthiness and provide tailored lending solutions. To be successful, private banks will have to adopt a more granular approach and a clear business model.

## Addressing entrepreneurs in emerging markets

The entrepreneur segment in emerging markets provides an increasingly attractive opportunity for private banks. However, to succeed with this segment, private banks need to develop innovative business models and a deeper understanding of what these clients need.

Private banks face several challenges in attracting entrepreneurs:

- Organizational silos and a lack of trust and collaboration between the private banking business unit and the SME/corporate banking unit as well as concerns about customer ownership and revenue recognition.
- Lack of a differentiated value proposition with existing product and service offerings designed for either a business need or a personal need.
- A limited talent pool in these markets makes it difficult to find experienced, high-caliber corporate/SME relationship managers and private bankers, and frontline staff with capabilities in both areas.
- The key enablers of cross-business unit collaboration, such as management information system support, remain weak, while others, including joint account planning, are poorly enforced.

In addition to these organizational challenges, private banks must develop a more granular understanding of the entrepreneur's needs. Here the aim should be to understand the life stages of an entrepreneur's business and the key banking needs associated with each stage.

- "Setup" stage: key needs include flexible access to credit, basic transaction banking products (including current accounts) and liquidity support; minimal private banking needs.
- "Growth" stage: key needs include support for acquisitions and cross-border services along with a basic wealth management offering (namely, simple investment products to support wealth accumulation).
- "Mature" stage: key needs include advisory (capital re-investment vs. dividend income; corporate finance advice on restructuring) and core private banking services, including investment advice.
- "Transfer" stage: key needs include merger and acquisition services, and UHNW private banking solutions (succession planning, wealth structuring, etc.).

There are several business model options for private banks looking to improve how they serve entrepreneurs. The best option will often depend on how a private bank has developed. For example, for a firm that has only an emerging private bank franchise and is strong in commercial lending (from SMEs to corporates), it makes sense to use a model that plays to this strength. This could see the private bank relationship managers co-located at existing commercial banking facilities and act as product specialists to support those relationship managers. Customers would continue to be owned by the commercial banking operation with incentives, such as double accounting, to align both business units.

Entrepreneurs have played a vital role in the development of emerging market economies and are an important source of growth for corporate banking franchises. As their businesses grow and mature, the importance of the entrepreneur segment to private banks in these markets will only increase.

**Develop truly segmented value propositions.** It is now well accepted that the structural changes in the industry will shape a new way of banking for private clients. Consequently, private banks have no choice but to develop much more tailored value propositions to serve existing clients and attract new ones. Economic change will force private banks to adapt more comprehensively than most have done until now. Private banks need to select what clients to serve in which geographies in a much more focused way. For each defined segment priority, private banks will need to define value propositions (product and service offering, delivery models) in line with the segment's potential value. This will lead to highly differentiated models with variable pricing schemes. Self-directed solution seekers using technology-enabled interaction will have different services than in-person clients, for example. The role of the relationship manager may also vary depending on whether the delivery model is organized around team service or a single point of contact. What's more, we expect to see product specialists become more targeted in what they offer to specific client segments.

**Set up distinctive investment and advisory offers.** Regulatory change may speed up the introduction of pricing schemes that see investors pay transparent advisory fees for access to research, investment advice and regular reporting. Since most banks have provided advisory "for free," a re-think will be needed. This is likely to see private banks reconfigure the investment and advisory process, while using specialist personnel and analytical tools to truly differentiate the service they offer. A stronger investment function is needed to restore client trust in the ability of private banks to deliver superior portfolio performance. The move to fee-based advisory services is already underway in the UK and the Netherlands, but it is unclear whether this will compensate for the loss of commissions or be accepted by investors.

## Searching for new advisory models

Advisory, defined as providing advice to clients where clients maintain an active role in decision making, remains a core offering of private banks. In times of high volatility and uncertainty, the need for advice increases. Many banks, however, don't offer a true advisory service, though many believe they do. Advice is often granted ad hoc and the quality varies considerably, according to which relationship manager is involved.

Today private banks face two particular challenges. The first is simply getting paid for advisory services at a time when retrocessions are at risk and the cost to serve clients is on the rise. The second challenge is setting up a true advisory service (which includes tools, training and other resources) to comply with new regulation and growing customer demands.

With increased pressure on retrocessions, banks need to search for alternative revenue streams. We expect a compression in the profit margin of up to 7 bps resulting from a ban on retrocessions combined with higher a cost to serve clients to comply with regulation. At the same time, whether clients will pay for advice remains unproven. Preliminary evidence from the UK is mixed and points to a cannibalization of existing commissions by a combination of fees levied for discretionary portfolio management, advice and execution. We believe that quality of advice and proof that it is the best investment solution will determine the clients' willingness to pay banks for advice.

For private banks to be successful there must be fundamental change in what advice is offered and how it is delivered by frontline personnel. Put simply, banks need to fundamentally redesign how they serve clients. Central to this is the creation of a distinctive advisory service that clients will be willing to pay for. To do this, we believe that private banks should consider offering:

- A differentiated and stronger segmentation of clients by behavior and a clear distinction between advisory and non-advisory, with clearly defined service packages.

- A product and service offer that exactly matches those service packages and clearly distinguishes the level of services provided (such as regular portfolio monitoring and reviews, research, etc.).

To offer a differentiated advisory service, private banks need to redesign the operating model to support the advisory process linking relationship managers and clients. The overall aim should be to provide more sophisticated investment advice to clients that incorporates the use of quantitative tools and features a house view on various asset classes.

Clearly, investment in remote channels is required to lower the cost of serving clients and to stronger differentiate advisory from the self-serve execution model. For the new advisory model to succeed, we would emphasize that the mindset and behavior of relationship managers must change amid a broad improvement in frontline service delivery.

# Methodology

McKinsey & Company's annual Private Banking Survey, first launched in 2002, seeks to provide comprehensive information on the private banking industry. Thanks to its worldwide coverage the survey represents a global effort comprising all relevant markets: Western Europe, the Middle-East, Asia, India, Latin and North America. The total number of banks participating in the survey has increased to more than 160 this year.

This document provides an overview of the latest survey's key findings for all the markets analyzed. The issues it raises are discussed in more detail in other McKinsey publications and at regular events held by McKinsey's Private Banking Practice.

The participating banks cover a range of sizes and business models, with all geographies well represented. Some 73 percent are private banking units of universal banks, whereas the other 27 percent are specialist players. Approximately 76 percent operate “onshore”, with the remaining 24 percent based in offshore centers. The banks provided detailed economic data based on their 2012 results.

Players allocate revenues and costs within their private banking operations and between their private banking activities and parent companies in different ways. But while these differences have been clarified as much as possible through interviews with the participants, some variations may nevertheless remain and may distort the final results. The increased number of participants this year may induce a slight sample bias on occasion, affecting the comparability of this year's results with those of previous years. Sample comparisons have been made where appropriate.

Survey participants are entitled to customized benchmarking and feedback sessions and have access to more detailed information than that presented here, but within the bounds of confidentiality governing the data supplied by individual participants. McKinsey would like to thank everyone who has participated in the 2013 survey for their valuable contributions, which will help us to gain a better understanding of the economics surrounding the private banking industry. The survey will run again in 2014.

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For their valuable contributions to this global survey, our special thanks go to the following colleagues:
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McKinsey Banking Practice
July 2013

www.mckinsey.com