Asian Private Banking
Today's Boiling Frog?

A perspective on the Asian Private Banking industry.

A.T. Kearney
Newtong Associates
Overview

Fuelled by the rising number of newly wealthy, the market for high net worth (HNW) wealth management in Asia has soared over the past decade. The region accounted for more than a third of the cumulative growth in global HNW wealth over this period and the boom is expected to continue for the next decade. The current low level of penetration of services being offered to the HNW market and the beginnings of intergenerational wealth transfers present a unique and lucrative opportunity for private banks.

The Asian private banking industry, however, is made up of very different dynamics when compared with the traditional world of Swiss private banking, which is distinguished by strong bank-client relationships developed over generations and "capital preservation" client expectations. In Asia:

- The source of client wealth is often first generational and entrepreneurial.
- It's a fragmented market, characterised by intense competition between wealth managers who typically focus on short-term results, such as top line increase and growing assets under management (AuM), rather than sustained profitability.
- A shallow talent pool is hampering client development and delivery of promises made on the back of aggressive client acquisitions.
- Increasingly stringent regulations are being implemented that add to the cost of doing business; this especially impacts Asian wealth managers who generally have less developed compliance and risk-management practices but are now increasingly held to international standards.

The combination of these factors has, in fact, resulted in deteriorating economics for wealth managers in Asia, threatening the long-term viability of many of the current players. Their existing business practices have been put together without a defined vision or a well thought-out strategy and are, for the most part, ill-suited to address market fundamentals. This has led to the industry's cost-income ratio (CIR) on average to hover at an unsustainable 80% (or higher) today — a solid 10 to 20 percentage points higher than in Europe. This is even more skewed for new and small to midsize players, some of which have cost-income ratios that exceed 100%.

Irrespective of their circumstances, most banks have been guilty of taking the opportunistic route to growth. Private banks so far have largely adopted an "experience-based" model, i.e. either by using an investment banking (IB) approach to address private individual needs, by upscaling a retail-based strategy or by transplanting the Swiss “trusted relationship” model instead of evolving business practices based on the very different needs of wealthy clients in Asia. We clearly see the industry at an inflexion point, where emerging business logics are a far cry from principles in place in Asia or in Europe today.
Industry players regard the current situation as unsustainable for most institutions. However, they do not seem to feel there is a need to urgently reform the private banking industry. About 80% expect any changes that occur within the industry to be gradual, or evolutionary. From our perspective, this lack of awareness of the scale of the changes required brings to mind the metaphoric tale of the “boiling frog” that — when placed in water slowly being heated — didn't perceive the danger until it was too late.

We believe the industry needs to aggressively pursue revolutionary change. The winners of tomorrow will be those willing to make tough choices today, starting with the re-evaluation of value propositions as well as business and operating models to be able to deliver client-driven services in an economically viable manner. Going forward, private banks will need to:

- Adopt a differentiated business model, based on a sound set of values, by concentrating on consciously chosen client segments (those sharing the bank’s values) and then building in-depth expertise and a suite of products and services aligned to that market position. The generic private bank that purports to provide everything to everyone but excels at nothing will not survive.

- Build a cost-efficient operating model aligned to their value proposition. This can be achieved by deciding which layer of the value chain — management, products, transactions and operations — to focus on and which to outsource, and by rethinking the compensation model for relationship managers. While doing everything in-house was the norm of the past, focusing on specific layers will be the norm for the future.

- Provide value for money by focusing on real returns and price transparency. The largely concierge/red carpet banking-based players will become relics of the past.

Evolutionary scenarios presented here are based on a comprehensive series of interviews conducted with industry leaders at 30 European and Asian banks.
Rapid Growth and Fundamentally Attractive...

Asia is the fastest growing region in HNW wealth management, and constituted a third of cumulative total global growth in HNW wealth over the period 2001–2011 (see Fig. 1). Despite current global economic dislocation, the Asian HNW segment is fundamentally sound and will continue to grow briskly over the next decade, underpinned by the continued economic growth in Asia, the rapid pace of business owners becoming HNW individuals and the increasing wealth concentration in Asia that is bolstered by the flourishing ultra-high net worth (UHNW) segment.

In terms of market potential, Asia’s wealthy present an attractive opportunity for private banks due to the:

- Nature of Asia’s HNW individuals, who largely achieved their wealth through entrepreneurial activity and possess a demonstratively higher appetite for risk compared with their counterparts in Europe, although this has somewhat been tempered after their experience in the 2008 financial crisis.
- Low penetration of wealth managers*, with an estimated 80% of HNW wealth in Asia still not under professional management.
- Transference of family capital, with aggregate wealth in Asia at the cusp of passing from the first to second generation.
- Maturing customer base, which is becoming more familiar with the private banking experience and its offerings. Constant marketing from the banks is progressively creating the need, de facto increasing the piece of pie in terms of potential customers.

* Refers to private banks and other financial wealth planners and advisers.

Figure 1: Regional Contribution to Cumulative Growth in Global HNW Wealth (2001 to 2011).

Source: A.T. Kearney and Newtone Associates
...But with Very Different Dynamics

The dynamics for banking the wealthy are markedly different from the traditional world of Swiss private banking, a fee-based model characterised by strong bank-client relationships often developed over generations. The new Asia paradigm is based on far greater complexities and significantly poorer economics as a result of rapidly evolving client demands, increasing competition, talent shortage and regulatory pressures.

Clients
A large proportion of Asian wealth is relatively new with the entrepreneur segment dominating the market. In fact, anecdotal evidence indicates as much as two-thirds of Asian wealth comes from entrepreneurs, in contrast to Europe where more established, inherited wealth dominates. It's therefore not surprising that Asia's wealthy want to play a more active role in decision-making and aren't as willing to pay for advice. Fee-based mandates (active or discretionary), which are a highly profitable element of European private banking, make up only a small fraction of the overall business in Asia and are not likely to play a bigger role soon. Over the medium term, fee-based mandates are expected to grow from today's low base, but are still unlikely to reach anywhere near the levels seen in Europe.

The 2008 financial crisis has left Asian investors more risk adverse, tempering their appetite for leveraged and complex structured products that until now have been the mainstay of Asian private banking. Industry leaders who we interviewed believe even as markets recover, the appetite for risk will remain diminished compared with pre-crisis levels. However, this monolithic market in terms of private banking client expectations is changing to a more complex landscape. Bank will need also to serve second generation wealthy Asians who are increasingly aware of market offerings with needs shifting from wealth creation to preservation.

Competition
The rapid growth of Asian wealth has resulted in a highly competitive private banking environment — over the past decade, the number of private banks operating in Singapore and Hong Kong has nearly tripled — with a focus on top line growth at the expense of the bottom line. Private banks in Asia can be largely grouped in three sets of players.

- Most universal banks introduced a private banking arm in Asia, almost as an afterthought, to leverage infrastructures developed for other banking divisions, primarily IB. Their private banking divisions did not have a vision or real strategy, but instead largely depended on a product-push platform.

- Local players have long enjoyed a very strong and large retail base of customers in the region. But as increasing wealth in Asia led to these clients becoming affluent, a large number of HNW individuals have expected that their local banks improve their proposition with private banking products and services. In reality their offerings are not up to the standards of more mature private banks. However, investment capacity and local market knowledge are key strengths.
Traditional Swiss-model pure-play private banks have attempted to replicate the success that they have achieved in mature markets by adapting to the more transactional Asian client or by emphasising their signature wealth-preservation services.

Industry incumbents face competition from new European private banks expanding into the region as well as domestic retail banks expanding into the HNW market in hopes that private banking will rebalance revenue toward fee income with the advent of Basel III and similar regulations. The number of independent financial advisers/external asset managers is also growing, and some investment vehicles are starting to bypass the private bank by directly approaching HNW individuals and family offices. Competition is further exacerbated by Asian HNW clients who typically spread their assets over a number of banks — it’s not uncommon for a HNW individual in Asia to have ties to four to five banks — and will shop around for the best deal in terms of price. This has drastically increased costs associated with customer acquisition/retention and further squeezed profit margins.

Talent
The rapid growth and relatively short history of private banking in Asia has resulted in a talent shortage with poaching common between banks. This has exponentially driven up personnel costs, especially the salaries/bonuses of experienced relationship managers, which have more than doubled over the past decade according to one senior manager.

More critically, the scarcity of talent has resulted in private banks falling short on delivering promised propositions as well as hampering the development of value-added, fee-based services. In the words of a senior banker we interviewed, the typical profile of a relationship manager in Asia today is “a 30 year old who has been in the job only a few years and will likely move to another bank in the next two years”. In contrast, the average age of a relationship manager in Europe is much higher and he or she will change employers only once or twice during his or her private banking career.

Regulations
Increasing stringent domestic and global regulations — including strict product suitability and anti-money laundering measures adopted in Hong Kong and Singapore as well as the Foreign Account Tax Compliance Act in the U.S. — have hugely increased compliance costs. This has greatly added to the cost of doing business in Asia as banks have been forced to expand their compliance and risk teams as well as invest in training front-office staff.

As a result of these dynamics, the financial position of many private banking players is deteriorating as they are beset by cost-income ratios averaging 80% or higher. In some cases, particularly for new and small to mid-size players CIRs exceed 100% today.
Evolution versus Revolution

The majority of industry participants believe that the current private banking models are unsustainable and the economics will not improve in the short term. However, they see little chance of the industry “righting” itself in the near term. Indeed, 80% believe private banking will undergo only evolutionary change unless an external event, for example a severe or an even more prolonged financial crisis, shakes up the industry and forces wealth managers to take action (see Fig. 2).

81% Evolution

19% Revolution

Figure 2: Response from Industry Leaders to the question - “Will the Private Banking Industry Undergo Revolution or Evolution?”

Reasons for this evolutionary opinion include:

- Too many players focusing on AuM and top line growth with a belief that private banking in Asia will converge towards a profitable Swiss like model.
- No one wanting to make the first move towards developing new propositions for fear of adverse short term revenue and growth impact.
- Complexity of adopting separate business and operating models for Asia.
- Relationship managers maintaining a general resistance to change and avoiding policies or actions outside their comfort zone.

We, however strongly believe the industry is in dire need of a revolution. The winners of tomorrow will be those willing to make the tough choices today about their value proposition as well as business and operating models to deliver on promises made to clients in an economically viable manner.
There is room for all types of banks to succeed in the market, but they require immediate action and a strong will to adapt to the oncoming challenges. At one end of the spectrum are banks that cater to the sophisticated and transactional Asian client and deliver wealth-creation, while at the other end are the traditional banks that offer capital preservation. In the middle, hybrid alternatives are possible, but they require a well thought-out vision and sufficient differentiation to establish a niche in the market.

**Survival of the Fittest**

In the new world of private banking, an overhaul of value propositions is required for success. Effective players will increasingly be characterised by delivery of true value creation (as opposed to many of today's concierge banking-based propositions) with an organisation that promotes cost efficiencies. The key factors for success are:

**Differentiated Business Model / Positioning**

Today's opportunistic expansion approach in Asia with a "land-grab" mind-set has resulted in little differentiation between banks, with each trying to be everything to everyone under the guise of open architecture and comprehensive service.

- **Clearly defined and established values**: The fundamentals of the bank should be based on a sound set of values referring to what the bank believes in and what it stands for. Banks need to be able to express these values clearly, both internally and to clients. The values represent the foundation on which any subsequent development will be built and provide the framework for long-term future strategy, irrespective of changes in management.

- **Segment focus**: Banks need to be selective in targeting clients in line with their vision. A bank should have little interest in accepting a client that does not fall within its target. A specialist player would focus on clients that recognise and are willing to pay for specialised services instead of qualifying clients solely on the size of their assets.

- **In-depth expertise in product and service offering**: Banks should focus and specialise in the specific products and services aligned with their vision and targeted segment to deliver significant results. Specialisation also opens the door to alliances with other banks that are present in non-competing segments or locations.
Cost-efficient Operating Models

As a direct consequence of focusing on specific segments or products, banks will be able to reduce their CIRs. To maximise effectiveness, classical efforts for optimising costs and operations, which include standardisation, straight through processing (STP) and reorganisation, should be complemented by “stronger” initiatives:

- **Outsourcing entire operating model layers**: It is increasingly untenable for most wealth managers to provide the required breadth of integrated services in-house. In order to completely meet clients’ needs, small and medium size private banks need to forge close links with specialist service providers and consider outsourcing entire parts of the value chain, such as operations or IT, to third-party providers that have the economies of scale. This will be a key lever to prevent erosion of profits. Support structures have to enable the bank to meet their private banking objectives, and not the other way round where some institutions consider what private banking services they can deliver given their current organisation and IT.

- **Revised compensation packages**: Compensation packages currently offered to relationship managers (RM) in Asia constitute a disproportionate share of expenses, with poaching amongst banks significantly inflating salary levels. Also, the largely commission-based model used by banks today encourages RM to take a short-term view of their employment, which can conflict with banks’ longer-term view of value creation for the client. A fundamental rethink of how banks pay their RM is required to drive down costs as well as align RM behaviour to better serve the client. The European private banking industry has already begun adapting compensation models, thus providing an opportunity for wealth managers in Asia to learn from their experiences.

Value for Money

Wealth managers need to deliver real returns in a price transparent manner.

- **Value added services**: Banks need to focus on delivering true value added products and services with concrete performance implications in an effort to differentiate themselves from competitors.

- **Pricing transparency**: Banks need to move away from the current opaque product-pricing model, in which the cost of private banking services is implicitly bundled, to more innovative pricing models that offer greater transparency and linking of fees to performance.
**Market Niches to Shape Industry**

Against this backdrop, we see a shift in industry structure over time towards one where wealth managers develop more specific and differentiated propositions. Continuing to stay in the grey zone will result in much financial pain for banks.

We believe four types of players will dominate the future landscape, each with their own area of focus.

**One-stop Shop Private Banks**

Global universal banks with economies of scale and scope as well as global reach, offering a truly integrated suite of services from investment advisory to investment banking that are largely focused on providing seamless support for the HNW and UHNW segments and their range of needs. They will have to keep up with more agile institutions that have a narrower scope of services but higher concentration of expertise in their core offering as clients will constantly compare their services.

**Specialists Private Banks**

Whether positioned on advising clients or managing products, niche players possessing a recognised business expertise and will most likely not engage in other financial services. For example, a bank that positions itself as an expert in investment advisory will not have in-house asset manufacturing or proprietary trading to avoid any conflicts of interest. These players will largely focus on serving clients who recognise their value-added advice and are willing to pay accordingly. They will outsource or share their operations and IT.

**Super Affluent Banks**

Regional or domestic retail-banking-based players — will compete on a value-for-money proposition — focusing on highly effective, standardised products for the affluent segment based on expertise in their home market and offering a full suite of banking services. These players, leveraging their existing infrastructure, will provide a steady pipeline of customers looking to upgrade to private banking services as their assets grow. Their ability to retain the growing assets of clients will reflect the evolution, e.g. breadth and quality, of their value propositions.

**Private Banking Enablers**

A number of institutions will be built on the back of total or partial insourcing capabilities of operations and IT services, such as the processing of back-office activities or hosting complete information systems. Targets of these service providers are small-to-medium wealth managers that focus on the upper part of the value chain. In a hunt for ways to maintain profits, not only dedicated operators but some large banks will enter this space. However, they should not underestimate the complexity of providing such services and the fierce competition ahead. Indeed, banks often launch this activity within their current structure while this activity
corresponds to a very different business that requires a dedicated organisation, information systems, fee model and management style.

At the same time, external asset managers (EAM) will increasingly play an important, though limited, role in wealth management throughout the region. EAM are still only a small part of the landscape with an estimated 5% of industry AuM today (compared with approximately 30% of the market in Europe), but their business is growing rapidly. Their position in the market can serve as a useful barometer of client trust in private banks. A rise in their numbers implies private banks are not adequately fulfilling client expectations.

Imperatives for Today’s Players

Regardless of their respective situations, the winners of tomorrow will be wealth managers who act upon these long-term trends today and initiate the journey away from opportunistic strategies. This isn’t happening yet in Asia, and future market leaders need to consider the following:

Large, Universal Banks: Greater Integration, Complexity Management

These banks need better integration of multiple business units and services to give clients a more seamless experience while curbing complexities and their associated costs. They need to build expertise and avoid conflict of interests to counter competition from niche players. Given their size, manoeuvring towards new targets will require colossal effort.

Key Elements

- Choices around “what is the core of the bank” — private banking versus investment/wholesale banking — need to be made to ensure adequate synergies between business units, i.e. between the private bank and small and medium enterprise (SME)/corporate banking, asset management and investment banking.
- Alignment of organisation/governance structures across reporting lines, incentives structure and client coverage model to the core business of the bank.
- Dealing with shareholders’ expectations while investing for the future.
Standalone Private Banks: Specialization and Segment/Asset Class Focus

These banks need to be much more selective in choosing where to play in terms of customer segments and asset-class focus to build the necessary level of depth and expertise. In addition, these banks should aim to be independent of any in-house asset manufacturing or proprietary investments to avoid real or perceived conflicts of interest. Given their origin and the historical success factors, they might want to keep a more traditional (wealth preservation) image and not fight with universal or local banks for the same segments.

Key Elements

- Must choose customer segments that are in line with their business strategy. The selection process for clients should be based on clients’ individual needs and the price they are willing to pay.
- Mid- to small-sized players need to specialise in one or two asset classes/services to truly become market leaders.
- Outsourcing or infrastructure sharing will have to be considered, both in terms of operations and IT, with their profit margins at stake.

Domestic/ Regional Banks: High Efficiency, Straightforward Propositions

These banks require — by buying, building or outsourcing — a platform capable of providing standardised yet highly effective services targeted at the affluent segments with aligned service costs. It is more costly to constantly adapt a platform that was designed for another division, such as retail or IB, than implementing a simple packaged solution that is designed specifically for private banking operations.

Key Elements

- Focus on synergies with the retail bank. Build a wealth-business platform that operates across the retail and private bank and effectively manages the migration of clients and cross selling between units. It will require upgrading current infrastructure to support all impacted dimensions such as product palette or reporting portfolio performance.
- Take advantage of local market(s) expertise to potentially develop the business of local product provider to other private banks.
- Manage talent to build sales-force expertise in parallel with evolving client needs. Considering the very limited loyalty of affluent clients, meeting their expectations will become critical on all dimensions, whether tangible (i.e. performance or competitive level of fees) or intangible (i.e. relationship or quality of service).
Conclusion

Given the market forces in play today, the private banking industry is ripe for a revolution. But while banks have historically resisted change, it’s clear that they are increasingly acknowledging that drastic readjustments to their business and operating models are not only advantageous but also necessary. The time for team poaching talent, concierge-type service offerings, red carpet and opportunistic growth is over. Those players who are quicker to overcome resistance to revolution stand a better chance to maximise opportunities to serve Asia’s wealthy — who will remain a fundamentally attractive constituency over the long term — and are well positioned to become future market leaders.
A.T. Kearney

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A.T. Kearney Pte. Ltd.

438 Alexandra Road
#05-03 Alexandra Point
Singapore 119958
Tel : +65 6298 7200

Website : www.atkearney.com
Email : Henri.Guedeney@atkearney.com
        Sean.Choo@atkearney.com

Newtone Associates Pte. Ltd.

Centennial Tower – Level 21
3 Temasek Avenue
Singapore 039190
Tel : +65 6549 7513

Website : www.newtone-associates.com
Email : Michael.Chaille@newtone-associates.com
        Abhinav.Chintamani@newtone-associates.com