PRIVATE BANKING in the new era

A study based on insights from key stakeholders within the private banking industry.

Newtone Associates
A.T. Kearney
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Executive Summary

According to evolutionary theories introduced by Charles Darwin and Jean-Baptiste Lamarck, survival in a permanently modified environment takes place through adaptation. The same is true today in the private banking industry. Whether it is through circumstantial mutation, embodied by young start-ups, or through the transformation of existing institutions, only the ones who are willing to accept change and adapt shall prosper. This fundamental law of nature is more relevant than ever for the financial services industry, and particularly for private banking.

The private bank of the future will have to pick a side. Either it attempts to resist change to protect its assets over the short term or it embraces change to develop a sustainable model for profitability. We are convinced that the second alternative is the only viable option. Banks must rethink their vision and the way they operate. Existing models have been subject to unbearable levels of stress, putting at risk the very survival of several of these institutions.

“The old way of doing business in private banking won’t survive — it’s history.”

“Bankers themselves are often the ones blocking industry evolution.”

“It’s the number of changes faced by the industry, rather than the nature of the changes, that lead to revolution.”

“All banks want to be revolutionary but soon get caught up by reality.”
Only the ones who are willing to accept change and confront the future shall prosper.

The hypothesis presented here is not a result of exhaustive quantitative analysis, but is based largely on the interviews we conducted between September 2011 and March 2012 with European and Asian banks. At the outset, the objective laid out was to identify the genetic components required by the private bank of tomorrow. This is determined by one simple question: Is private banking experiencing an evolution or revolution?
Is private banking experiencing an evolution or revolution?

This query served as a starting point of our discussions, which largely form the content of this study. More than 30 top executives from leading private banks located in the financial hubs of Switzerland and Singapore spoke to us over the course of the past few months. The discussions were based on their observations of the global banking industry, hence this study expresses views relevant across Europe and Asia. These private banking institutions represent diversity in size and a range of activities, objectives and strategies. To complete the picture, we also included the views of industry associations and regulators.

This provides for an unbiased view of the industry and a basis for comprehensive analysis of trends, their impact and what they mean for banks of the future.

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AuM – Assets under Management
Evolution and Revolution

Singapore

Switzerland

Geographic Presence

Europe and Asia represent very distinct market conditions owing to the different stages of maturity of private banking in each region. This is evident across the three fundamental stakeholders of the industry — the banks, the clients and the regulators. Many European private banks have been in business for hundreds of years, while private banking is relatively new in Asia. In addition to a different starting point, the private banking industry in Asia has taken a slightly different path, evolving primarily from a retail and brokerage base. However, it would be wrong to assume that Asia is playing catch-up to Europe. As market dynamics continue to shift, the next stage could play out very differently in the two regions. For the purpose of this study, we observe the trends to be similar and the impact to be along the same lines worldwide. However, differences do exist and those have been highlighted where applicable.

Type of Bank

The participants represented a fair mix of pure-play private banks and universal banks, which have a private banking unit in addition to corporate and investment banking units. The type of the bank does not have a huge bearing with respect to the study, as the trends remain similar for these banks as well as the impact of shifting market dynamics. On the face of it, universal banks appear to enjoy a considerable advantage given their scale, but at the same time any decisions they take to implement change impact their other units, thereby making them slower to react to external forces.

Size of Bank

The size of the bank has a bearing on the degree and also the type of impact that the trends will have on them. The trends appear more clearly and exert a stronger force on the smaller banks, but they are more agile and can adapt to changes more easily. The bigger banks on the other hand may find it difficult to make quick and conclusive decisions. They could be too big to move. Closely linked to the size of the bank is the capital structure. Listed banks are under constant pressure of delivering short-term results and find it difficult to move towards sustainable long-term performance.
**Evolution** signifies a gradual transformation made by a series of small, successive changes that follow one direction.

**Revolution** signifies a violent and sudden change followed by a dramatic change of structure.

The essential elements governing change are the same, but it’s the time frame over which the changes occur that determine whether it’s an evolution (slower and more gradual) or a revolution (sudden and quick). All study participants highlighted a number of significant changes within private banking and their profound impact on the industry. However, some banks have been observing these trends for a number of years and have begun to adapt their business accordingly, reducing the likelihood they will face revolutionary change.

*Executive Summary*

*Banks have been guilty of hesitating over change, playing the wait-and-watch game.*

It appears that only a big crisis will shake up the industry, and although we witnessed a bumpy ride over the past couple of years, it hasn’t been enough to tip the scales and force banks to adapt to new market conditions. This is akin to the metaphoric tale of the “boiling frog”, that was unable to perceive danger until it was too late. With a short-term view, the perception of environmental changes tends to be gradual. Their predicament has been compounded by an inability to move swiftly, which is more evident in larger banks or universal banks.
81% Evolution

19% Revolution
Part I of the Study

Trends

The result of this exercise paints a picture that is anything but encouraging. Inherent imbalances that are affecting private banks’ ability to operate effectively and profitably are brought to the fore by four fundamental trends that are taking place in the private banking industry.

The Environment
The environmental factors all point toward market conditions that are tougher than ever. Margins are diminishing as market performance continues to fail to meet expectations while costs are rising due to the increased need for regulatory compliance.

The Business Model
The building block of defining a set of values for the bank has not been the logical first step. This has lead to an opportunistic behaviour where the banks try to be a “jack of all trades but master of none”.

The Operating Model
The operating models in private banking are under immense pressure and there exist extreme conflicts of interest between the three layers — namely management, products and transactions — creating a cascading negative effect.

The Pricing
Transparency in pricing is gradually increasing but this movement needs to go further in terms of linking each service to the fee that is being charged and justifying the price for these services based on the added value.
Part II of the Study

Vision

The transformations already underway are adding up and a lack of preparedness or decisive action will lead to dire consequences for the industry. It is no secret that those who make difficult choices today will increase their chances of coming out on top tomorrow.

The Environment

Environmental pressures that have negatively affected the industry are largely self-inflicted, at least indirectly. Corrective action will ensure that these are brought under control and that links with the real economy are restored. Expectations on performance have to reset to realistic levels by educating the client and restructuring the way the industry operates.

The Business Model

Banks have to define and communicate very clearly what their values are. This will determine the clients they work with, the purpose of their investments and the products and services they offer.

The Operating Model

The most fundamental change will take place within the operating model itself. In line with specialising products and services to create a niche market position, the layers of the operating model would become independent, eliminating potential for conflicts of interest.

The Pricing

Pricing needs to become even more transparent and be linked to the exact added value that a product or service brings. This will be a critical element for a bank to differentiate itself from competitors. Value will not only be about performance, but will also depend on a variety of other factors.
Part I

*Trends Affecting the Industry*

According to our discussions, the shock waves roiling private banking are in no way entirely external in nature. They have, in fact, been created by the industry itself. Previously camouflaged by regular positive returns, internal dysfunctions have multiplied the stress points. Now visible and white-hot, these nodes could suddenly rupture and cause the current private banking model to collapse.

"Banks are not very differentiated in their values, vision or propositions."

"Tighter regulations have improved the quality of private banking. It used to be the Wild West with bankers pushing products."

"The value proposition for different client segments is not very distinctive."

"The rise of EAMs [external asset manager] means they need to be consciously included in private banking strategies."
Part I will outline the four fundamental trends that have been identified to analyse the transformations causing imbalances in the private banking industry.
Shock waves roiling private banking are in no way entirely external in nature. They have, in fact, been created by the industry itself.

No longer masked by consistently strong investment returns, deeply embedded flaws within the private banking industry have been exposed. Banks need to reassess what they do and how they do it — and quickly — otherwise face a dwindling loss of profits, clients and market share, which could ultimately lead to their demise.

These shortcomings are related to the environment, the business model, the operating model and the innate pricing structure of banks active in private banking.

A Environment
The environment is the assessment of customer behaviour, market conditions and regulations.

B Business Model
The business model details the target customers, products and services, and sources of income.

C Operating Model
The operating model includes organisational aspects, work practices and quality.

D Pricing
The pricing structure refers to the manner in which the bank charges its customers for the products and services it offers.
The complex relationship between elements of the private banking industry may be viewed in the form of a simplified model comprising the environment, the business model, the operating model and the innate pricing structure.
A high degree of correlation of volatility in markets, low interest rates, the paradigm “Risk On, Risk Off”: it all adds up to a formidable operating environment making it very difficult for banks to generate sustainable returns. The industry is further hamstrung by a decline in the number of transactions, an increase in cash holdings and a squeeze on the margins. The parameters of this simple to comprehend and yet difficult to deal with equation throws no surprises to anyone.

At the same time, more stringent regulations are being implemented in most countries. The United States is determined to introduce the Foreign Account Tax Compliance Act (FATCA), Article 26 has been integrated in OECD double taxation agreements and Western countries are tightening their tax policy. Moreover, the application of international standards periodically clashes with local regulations.

The impact of the current penalising environment is the most evident in Asia, where the private banking industry’s cost-income ratio hovers at about 80%. This is an increase of almost 10 percentage points from pre-GFC (global financial crisis), and stands at significantly higher levels for many new and mid/small scale players. The majority of industry participants interviewed see this as unsustainable over the long term. At the same time they don't see radical changes in the short term that would fundamentally transform the industry to meet these challenges head-on.

- In Asia, margins continue to be compressed through competition. While the rate of new entrants into Asia has slowed, it is no doubt still significant.
- Investors, having learned hard lessons from the financial crisis, are more realistic about risk-taking and leverage.
- The cost of doing business is rapidly increasing, driven by regulatory compliance and rising personnel costs as talent continues to be in short supply.
In this context, private banks increasingly appear to be gripped by paralysis and unable to carry out business as usual. At the same time, the client’s needs have become more complex, specifically due to the unpredictable market and the reinforced requirements of increased transparency.

The first reflex is to label these factors as external. This paints a picture of the banks as victims of their environment. Upon deeper introspection, the participants identified these developments as the effect of deeply rooted behaviour that is prevalent in the industry, with particular reference to abuses committed by certain bankers in pursuit of opportunities that have proven disastrous. The authorities were left with no other choice but to respond by curbing financial misconduct with a barrage of legislation. The industry is now conveniently overlooking the fact that the banks themselves are the cause of their own suffering.

In addition, the changing dynamics between onshore and offshore wealth adds to the complexity of building a private banking franchise. An increasing number of governments now regulate the transfer of funds — even if it is legitimate investment activity — from the country. This puts even greater pressure on the business models of private banks operating in those countries. The obvious exceptions have been the big private banking centres, though their source of wealth has been impacted.

Establishing an onshore presence in multiple locations has not been feasible in the past as the industry lacked structure, quality of service, breadth of products and expertise, and relationship managers (RM) truly able to service the needs of high net worth individuals (HNWI). However, changes in the marketplace, coupled with regulatory and political stability, are gradually loosening these constraints, presenting banks with fresh opportunities to cater to these locations and pursue new avenues of growth.
Private banking has long enjoyed a favourable market environment, which allowed them to fulfil their promises of high returns. In Europe, the value gained out of optimised tax benefit has been able to mask below-par investment performance, thus surpassing client expectations. In Asia, however, growth in private banking has primarily come from HNWI who want to invest beyond their domestic market and are looking for differentiated products, potentially higher yields on their investments, safety, security and geographical stability. Backed by this guaranteed business, a bank did not have to clearly articulate its values, client segments or products.

Initially private banks were involved with the financing of major projects, playing an advisory role and serving as an intermediary between the investor and the funded project. The choice of supporting one project over the other was backed by faith in the success of the project — both in financial terms and in its contribution to the development of the economy. This close link and match between the values of the bank and the supported project contributed to the success and reputation of both.

In the past, we have seen examples of private banks being very closely involved with a large-scale project. The success of the project and the benefits that it promised to deliver became the value proposition of the investments of the bank. The clients who choose to invest in such banks clearly knew the end goal and the long-term goal for the project. Moreover, both the bank and the clients believed in the mid-to-long term success of the project. In addition to economic benefits, the project could involve social development and regional advancement, which provided another dimension to the investment. Notable among such projects where private banks were closely linked to the actual project have been the construction of the Suez Canal in Egypt and the Switzerland-Italy railway tunnel. The investment in such cases was not based purely on a product that promised returns.
Today, such a correlation no longer exists. By focusing on its own performance, the industry lost sight — sometimes intentionally — of the interests of both parties providing meaning to their existence. After the major financial crises of the past decade, the private banks are hard-pressed to meet client expectations on investment returns. This results in a further imbalance because the attention is exclusively focused on the investment vehicle and not on its objective — the choice is completely determined by the expected return.

This is a fundamental trend, but not obviously the biggest one. The impact of such an imbalance is not of the same degree to all client segments. Retail clients are inclined toward services relating to treasury management, loan and mortgages etc. which are more closely linked to the real economy. These investments are either backed by or fuel growth in tangible assets. On the other hand, ultrahigh net worth (UHNW) client portfolios are more likely to be exposed to complex and layered products.

In contrast to investments closely linked to a project, there have been numerous cases of complex products built with little or no obvious or direct link to any project. These are built — or at least promoted — on the basis of the returns that they can generate for the investor without detailing the actual purpose of the investment. Advertisements of such products or investments are dime a dozen in every country. Clients are equally at fault with their expectations of easy money and they tend to get drawn into these ventures, which delink the real and the financial economy.

Unfortunately, as an increasing number pursue such short-term objectives over investment vehicles with more sustainable strategies, the divide between the real economy and financial economy has only expanded.
An Obscure Business Model

2 Comprehensive Service at the Cost of Specialisation

Under the guise of open architecture and comprehensive advice, private banks offer investment in a wide range of markets and products, at times with little link or knowledge. This prevents specialisation of the advice and dilutes the added value. There is little differentiation between banks in terms of what they offer and the quality of the services and advice that they provide. At the same time, the increasing complexity of specific products and geographies discredits even the most credible of firms that do not clearly position their offerings.

The importance of the quality of advice is greater than ever before. A comprehensive understanding of the industry, the clients and of the market has always been critical but this was masked by opportunistic growth and the favourable industry conditions. These factors have now come to light and banks find it extremely difficult to acquire the right talent or to build a system to nurture talent. Newer markets such as those in Asia face a daunting task of finding ways to overcome this challenge. Increasing competition and the region’s relatively recent entry into private banking is expected to severely impede progress.

3 Lack of Effective Segmentation

In parallel, client acquisition has been largely conducted in an opportunistic manner, without actually targeting specific segments or even markets. Wealth-based segments have typically received poorly differentiated treatment due to a lack of well-defined processes and criteria for evaluating new client relationships. Banks have been guilty of depending on the obsolete process of selecting clients based on their assets under management (AuM). This deprives wealth managers of the opportunity to target self-made clients who now potentially qualify for private banking services.
The average AuM was historically sufficient so as to not question the match between the expectations of each client and the bank’s ability to fulfil them effectively.

More recently though, regulatory and taxation constraints have forced banks to better understand their clients’ needs. Information captured during customer due diligence, Know Your Customer (KYC) and Markets in Financial Instruments Directive (MiFID) compliance can systematically be used for analysis to better target the types of clients that the bank can assist and generate value.

The issue of geographic presence is also critical. The launch of a new service or product often stems from the possibility of attracting local clientele rather than clear segment-oriented strategy.

Another important element from a segmentation perspective is the source of wealth, which has a direct bearing on the client’s needs. A first-generation entrepreneur would have a completely different set of private banking needs compared with a HNWI possessing inherited wealth. The former would focus on capital growth while the latter on wealth preservation. The segments have to be carefully created to target clients who are in line with the bank’s values and proposition.

In general, Asia has a significant amount of wealth that is generated from business ownership, while inheritance is one of the key sources of wealth in Europe. Entrepreneurs have complex requirements, often seeking advice on both their business and personal wealth needs. They expect higher returns on their investments and seek a greater degree of involvement in decision-making.

Because the majority of wealth managers have not developed differentiated advisory services, the industry model is one where everyone does a little of everything but fails to excel in niche services. The “we’re all about the client” message — where banks claim to be the best investor — for the most part remains little more than a marketing speech.
Private banking has experienced phases of growth, albeit at different times in Europe and Asia, which allowed several banks to establish a strong market presence. The types of banks that currently offer private banking services can largely be grouped into three categories.

- **Upgraded Retail Banks**
  Local banks that offer retail services to clients who want to step up to private banking by upgrading their account.

- **Pure Play Private Banks**
  Pure play private banks that offer services only in this market segment.

- **Universal Banks**
  Large universal banks that offer a diverse set of services to all types of individual or corporate clients, including services such as private banking, commercial and investment banking.

Although the three sets of players have taken different paths to establish a private banking presence, their businesses are surprisingly similar. From a bird's-eye view, it quickly becomes apparent they are all vying for the same piece of pie but offer little in the way of differentiated products and services. This is largely due to their failure to define clearly what the bank stands for and believes in — a clear set of values. The trickle effect within the industry caused by this shortsightedness has been a lack of specialisation or focus on specific set of clients, products or services.

Today's wealth managers lack the determination that is imperative to success, from establishing a strategy that encompasses a vision, a set of values and a clear market position to evaluating the nuts and bolts that make up the business model, the operating model and the pricing structure. The way of thinking needs to be more holistic.
Some of the private banks piggybacked their way in Asia on their corporate and investment banking divisions. Nevertheless, universal banks have done well in Asia so far, owing to the scale of operations and services they provide to clients. On the other hand, pure-play private banks have performed well in Europe. One possible explanation for the disparity is the differing stages of industry maturity between the regions. Private banking in Europe has a long history while it’s relatively new in Asia and still evolving.

The underlying trends and changes in private banking are more or less similar across the two regions, but how they will affect industry players is another story. It remains to be seen if they will continue to be successful in a changing environment where a clear and close link between the vision and the value propositions is essential to survival.
Pressure on the Operating Model

As a consequence of the opportunistic manner in which business models were established, the operating model has also been developed with minimal constraint. During the years of growth, carrying out business required neither excellence nor efficiency, and risk management did not appear to be a priority. "Discretion" was the name of the game, and most players developed an integrated operating model to cater in-house to all the operations within the bank. Now, even with some of the historical reasons losing relevancy, most banks have not reassessed the need for integration.

Aggressive goals and the regulatory impedance to growth, combined with limited resources, does not allow for grey zones. You have to be good, if not excellent. But being successful at all three layers that make up the value chain, while being compliant with the constraints imposed on each of these, is progressively impossible to achieve. In addition, conflicts of interest often appear when the layers are integrated. These associated problems of the integrated model of private banking should be viewed in context of each of the three layers, namely the management layer, the products layer and the transactions layer.

- **Management Layer**
  The management layer forms the crux of the relationship between the bank and the client.

- **Products Layer**
  The products layer deals with the creation and administration of financial products and services of investment banking.

- **Transactions Layer**
  The transactions layer is the one that provides all transactional capability, whether personnel (operations) or technical (IT).
The management layer is closest to the client through its client-relations and advisory services and provides the foundation on which the bank-client relationship is built.

The management component is mainly comprised of front-office functions. Increasingly banks have focused solely on this layer. We have seen the emergence of centralisation or out-sourcing of the asset management, trading and other middle and back-office functions, with only the management layer present at some locations.

In parallel, we have witnessed a rise in external asset managers (EAM) or independent financial advisors. EAM work as though they were the front layer of a bank, although on a much smaller scale. But the critical distinction is that they own the relationship with the client. Banks with an integrated model accept a certain level of business introduced to them through EAM, as the client accounts continue to remain in custody with the banks.

However, this arrangement is not without conflicts as the two players have overlapping roles. Friction can arise between relationship managers’ objectives, which are subject to asset growth, and EAM who are not under direct control of the bank. Also, EAM eat into the bank’s share by promising better and unbiased services to clients. It won’t be long before banks become averse to partnering a competitor.

Similarly, the question over the division of responsibilities between the custodian and EAM remains largely unresolved. EAM represent a rapidly growing segment of the private banking industry, although from a low base. They are in a unique position to offer an unbiased form of open architecture where they are forced to search for the best products to fulfil the client’s asset allocation. The extent to which the EAM segment grows over the next decade will serve as an indication of how well today’s private banks respond to this demand for independent and value-added advice for their clients.
The products layer is involved with the creation and administration of asset management’s financial products and services.

The integrated model does little in the way of alleviating a client’s doubts about the validity of the advice they receive from a bank. Whether justified or not, the client perceives a bias in the recommendation of in-house products, believing that they will generate commissions internally and be easier for the bank to manage. Moreover, this layer demands greater scale to be able to provide a platform for complex as well as cross-market products. The need to conduct in-house research also adds to the requirement of scale. While it may not be feasible for a midsize player to manage and offer breadth in this layer, it could offer a niche set of customised products. But this is no exception to a possibility of conflict of interest between the bank’s own needs and the client’s needs. These products have to be superior and differentiated for the bank to justify the need to develop and offer them.

The biggest indicator of the pressure on the operating model has been the impact to cost-income ratio. It has gradually risen in recent years, now standing at almost 10% higher than the historical benchmarks. Explicitly, this is due to increased compliance and regulatory overheads, more demanding clients, greater need for price transparency, competition in the industry and higher costs associated with attracting and/or retaining talent, especially relationship managers.

Implicitly, the rise relates to the banks’ lack of vision and preparedness for change as well as poor strategic choices regarding the business and operating model.

The negative effect of high cost-income ratios has been particularly severe in Asia, to the extent that some players won’t survive.
The transactions layer is the one that provides all transactional capability, whether personal (operations) or technical (IT).

The transactions component in banking runs continuously on a tightrope in an integrated operating model. It must provide services to the other two blocks and generate revenue (e.g., processing charges), while managing operational risk. They have to strive to keep back-office and IT costs as low as possible. Achieving lower costs by applying economies of scale through processing large volumes is not really an option as the transactions layer operates for only a single entity. There has been recent evidence, however, that banks are expanding this layer to employ economies of scale by offering these services to other smaller banks. Focusing on operations and IT hubs is a start, and will be replicated for other business-process outsourcing services.

Cost-Income Ratio

Several factors have pushed up the operating cost of banks, and the cost-income ratio now stands almost at 85% : 10 points higher than pre-GFC levels. Business has become unsustainable for a few players.
After an era where price opacity was the business norm, transparency in fee structures is gradually allowing the client to understand what they are paying for and exactly how much they are spending, but this is only the first step in a more fundamental transformation.

Regulators across Europe and Asia are now enforcing transparency in fee schedules. This is linked to actual billing, theoretical billing and, more importantly, the added value of each service. The majority of private banks, however, do not yet have the capability to distinguish between these elements. The integrated business model further contributes to the blurring of lines by funding the cost of one layer from the proceeds of another.

Price transparency refers to three layers in the pricing mechanism:

**Layer 1 - Disclosure of the Fee**
The industry is being pushed by regulators to indicate the fee to clients and is moving toward full transparency.

**Layer 2 - Division of the Fee**
Today, banks tend to charge a combined fee to clients instead of indicating how much each service costs. For example, the fee for transaction services and the fee for the advice of a relationship manager are typically not listed separately.

**Layer 3 - Justification of the Fee**
The lack of allocation by service of the fee schedules makes it impossible for banks to justify the value that each of the elements in the fee brings to the client.
The bank’s ability to defend its pricing model depends on its value proposition, its level of charges and its differentiation in the market, including long-term performance. The bank must be able to demonstrate that it creates value, that its fees remain at reasonable levels and that it offers unique expertise. At the moment — under the current operating and business models used by private banks — these three elements remain difficult to prove.

Current level of transparency in fees
Banks are making progress, but clients demand more segregation and value-added justification.

In regards to the regulators, it is important to note that current statutes tend to employ the same yardstick for both retail and private banks. It is imperative for regulators to understand the difference in the level of maturity of clients, their needs and the sophistication of banks for the different client types. Unnecessary regulation can have the undesired result of steep overheads for the banks and clients. This puts a strain on the efficiency of a bank’s operating model as well as resulting in pointless fees that clients have to pay for services. Regulators must realise that retail and private banking services are worlds apart and not a mere multiple of the other.
Conclusion: Part I of the Study

Battered Trust and Performance

The environmental factors all point toward tougher market conditions for the private banking industry than in years past. Increasing global competitiveness is squeezing operating margins, resulting in falling revenue as business costs continue to soar on the back of higher levels of regulatory compliance. Furthermore, market performance in recent years has not matched historical benchmarks, while clients have become more demanding. This has made it tough for wealth managers to sustain profitability.

Banks have not yet clearly thought through and articulated a well-defined set of values and vision. This has led to opportunistic behaviour that is to their detriment, where they try to be everything to everyone instead of specialising in a set of clients, products or services. The building block for a private bank should be the values that it believes in, but this is found lacking across the industry. Most banks have poorly defined value propositions and this is reflected in the client segments that they target.

The results propagate to the operating model, which now faces unbearable stress levels. The three layers of the operating model — the management layer, the products layer and the transactions layer — are beset by clash of objectives and constraints. They need to act independently while at the same time depend on each other for revenue and economies of scale. Faced with this balancing act, banks have made the choice to do everything in-house, which has resulted in lost opportunity to specialise.

Pricing is moving in the right direction in terms of greater transparency in fee schedules, but there is still much room for improvement. Fees are now being disclosed to clients, but banks still fail to link each element of the fee to specific services. The ultimate goal for banks when implementing price transparency is to seize the opportunity to justify their fees in terms of value-added services compared with competitors.

Private banking should seek to set new benchmarks to measure its effectiveness by studying operational models and implemented strategy in other industries. Above all, banks must restructure their organisation to meaningfully enable this efficiency by radically changing their own business and operating model.
In this light, it is easy to see how the private banking models are precariously poised on the brink of a collapse. The industry is in dire need of a change and the time to act is now.
The underlying trends outlined thus far demand clear strategic decisions on the part of the private banks. There is no running away from a detailed introspection to define common values that will shape the structure of the organisation. The market no longer offers room for the existing uncertainty or blurred value propositions.

The fundamental question is not simple. Nevertheless, it is essential for banks to confidently define their course and decide on a consistent approach to the future.

An ideal institution will be built by acting simultaneously on different aspects of its business model and operating model. The overlap of various elements prevents treating the causes of dysfunction in isolation, especially since the business model largely determines the operational model. The various forces in play are closely interlinked, and for a total organisation overhaul to be successful they all have to be improved simultaneously. This calls for a gradual shift in the way the industry operates.
Part II aims to draw the outline of the private bank of the future, one that is adapted to the new environment. The basis of this outline is comprised of possible solutions to address the evolution — or revolution — of the wealth management industry.
Vision for the Future

Modifying the Environment

It would be wrong to assume that the banks have little room to manoeuvre or they have no leverage on their environment. By modifying certain parameters of their business, they could influence the environment in which they operate.

Regulations, for example, are mistakenly considered to be an external constraint to which the institutions must adapt. In fact, regulatory standards are created to control or correct aberrant behaviour. Corrective action at the level of these behaviours would eliminate the need to strengthen the regulatory framework any further than what it is today. Constantly looking out for ways to find loopholes will only bring the stick down harder.

At another level, the “Risk On, Risk Off” (RORO) configuration is not inevitable. It stems from the disconnect that exists between the real economy and the financial economy. This is a result of the excessive growth of the means of financing. The RORO market environment therefore is also a direct consequence of the choices that the industry has made.

The means are not the end and hence the focus of financing should be on the real project that it aims to invest in. These investments have to be long term and have to be directly linked to the performance and success of the real economy through the project. In addition, the performance is not just financial, but should also include the overall benefits that it brings to the economy, people and region.

This change in the entire process would be incomplete and difficult to imagine if not complemented by educating the client. Client expectations and behaviours require a paradigm shift in terms of realistic levels of returns that are achievable in the present scenario. In addition, as with the goals of the investment, the clients also need to link their needs and expectations to the real economy. Banks have been guilty of promising unrealistic returns to clients and it is their responsibility to re-educate the client on the new reality.
Recognising the Cause of the Effect
The bidirectional nature of the relationship between the bank and certain aspects of the environment it operates in needs to be accounted for in its actions.

A Holistic Approach to the Modification
A myopic view of the economy leads to a binary RORO mode of interacting with the environment. More foresight and a realistic perception of the economy is required. For the environment to be well and truly modified, the larger goals of private banks need to transcend, or at least not be limited to, the financial performance of projects.

Educating the Client
An important part of the process of modifying the environment is the modification of the client’s needs and expectations.
Business Model: Clear Positioning

In the view of market leaders interviewed for this study, the era of uncontrolled and inconsistent opportunistic growth is over. The private bank of the future should move toward a more specialised, thus optimised function.

1 Building a Sound Foundation — Values

The first element of this positioning is “values”. Each institution must determine its vision, its positioning and its target client before getting to the point of thinking about what financial products to build and sell. Does it want to invest in commodities or agricultural products? Do they wish to promote structured products or practice short selling? What are the objectives in terms of cash returns? These ethical or social commitments are the fundamental matter on which the bank has to be built. They will have a profound effect on defining its growth path. They will act as a strong differentiator that is to be presented to clients.

2 Effective and Multidimensional Client Segmentation

Once its presence is established, the private bank of the future should choose clients that are in line with its defined segments. The same holds true for clients — they should actively choose one bank over the other in accordance with their needs. This correlation implies that the client shares the bank’s values, and thus the relationship should begin by asking about goals or limitations. The important thing is that both share the same objective in terms of values and not an objective based on returns.

In addition to the alignment with the bank’s values, the criteria for selecting a client should not be based entirely on asset size but on the price the client is willing to pay for a service. The price should be acceptable for multidisciplinary advice and is essential for succeeding in a complex financial environment. Within this context, it’s in the bank’s best interest to act like service providers in other industries: to not be concerned with clients’ wealth as long as they are able to pay for services.
On defining its values and its target clients, future private banks should devote all their attention on strengthening their portfolio of investments. Specialisation and an in-depth expertise on a limited number of products would provide a boost to a bank’s position and credibility as well as promoting added value. They have to develop and showcase expertise, whether in an industry, a region or a specific market.

Equally important is a realignment of the investment horizon to the objectives of the financed company. This can be achieved by direct investments or through measures such as lock-up periods. A bank’s investment objective would return to being the company it finances, thanks to the removal of added layers of the invested capital. The investment vehicle itself would no longer be the focal point of the process. By concentrating on a defined set of clients and a limited number of investments, private banking of the future would be freed from the cycle of untenable promises, both on the investment performance to the clients and on the performance obligations of the institutions themselves. The original model of private bank, which supported projects in the real economy, underpins the basis of private banking in its new environment.
Vision for the Future

Operating Model: Restructure

The operating model faces unbearable stress levels and the three layers — management, products and transactions — are the source of much internal friction. Their revenue streams are tied together whereas their objectives are not the same.

1 Breakup of the Integrated Operating Model

We will most likely see the breakup of integrated operating model as it becomes increasingly unsustainable. This division of the three layers is indeed desirable as it would resolve several inefficiencies that exist today. Integrating the layers meant that the bank and the specific layers had to make trade-offs. These resulted in compromise on expertise and quality and an increase in costs.

As the interlocks between the three components disappear, each layer would independently define its strategy and set objectives, and provide the means to achieve these goals. The front office would provide only advice, which is independent to the asset management. The transactions layer would pursue two strategic objectives: to manage operational risk and to contain or reduce the costs.

The breakup of the integrated model would improve the consistency of human resource management, often considered the key to the performance of a private bank. The temptation to let relationship managers (RM) transform into external asset managers (EAM) using the bank as an independent custodian disappear, as well as the setting of unrealistic growth targets on client acquisition.

The end of the integrated operating model would also end the conflict of interest on products. Disengaged from its links with the "product factory", the front office would have complete freedom to select products that comply with its values and those of its clients.

As potentially unhealthy interactions between these two layers disappear — especially product-push — transparency and clients’ trust in the advice they receive would emerge as clear winners. Clients would in this scenario find it easier to accept the fee model that relates to the quality and independence of advice.
Finally, the disappearance of the integrated model would allow the transactions layer to achieve its objectives, in particular controlling costs. The creation of service clusters — destined for internal and external clients — would provide the scale of operations and volumes required to control or lower costs. The trade processing platforms should be grouped more and more in the future.

In fact, the operating model disintegration is largely dependent on the size/scale of the bank’s operations. Large-scale banks, which have a dominating market share will continue to perform both advisory and products layers in-house. They already have the scale that is required to achieve efficiency in costs, though at the cost of doing away with independence of advice. In addition, they come with the baggage of inertia. Smaller players will focus upon the advisory layer and outsource the product layer depending on their vision and their clients’ needs.

The scenario of the break-up of the integrated model described here is a likely one for Europe, but would be slightly different for Asia arising from disparate maturity levels of the industry. The experience of going through several ups and downs for both banks and clients will help them identify this as an unsustainable environment, which in turn will push forward a quicker and a more fundamental overhaul. On the other hand, new operating models could emerge in Asia that differ from the ones we have seen in Europe. It’s possible these changes could be more gradual in Asia.
Operating Model: Sustainable Outcome

Cost-income ratios are at very high levels, a fact that implies a number of imperatives for banks looking to build a franchise that is sustainable over the long term.

Breakup of the Integrated Operating Model

We anticipate a future with a bifurcated market structure. Universal banks would maintain their position on one side while specialists focusing on targeted segments of clients and in specific product domains in conjunction with EAM would stand on the other. Large universal players will be the ones that have the scale to maintain an integrated model and retain market share. We are already witnessing the adoption of centralisation among divisions of the bank or among locations to adapt to this new model, and the process of creating independent layers would continue to move in this direction.

Pure private banks and EAM will need to make their proposition clear or risk being squeezed out by the dominant banks. They have to position themselves as trusted and specialised independent advisors with global capabilities. Building a niche is important to avoid being left behind in the race to grow or sustain profitability. Clearly there is increasing evidence of these players focussing on specific layers, namely the management layer and to some extent the products layer. They bridge the gap by offshoring or by outsourcing components of the transaction layer.

Generalists will continue to make revenue but their profit margins will decline, while the specialists who come out with a niche product or service and a clear value proposition will be able to command a premium for the added value they deliver. Over the long haul, the number of players will gradually decline and we should see some consolidation in the industry.

The high levels of cost–income ratios dictate several imperatives for banks looking to build a long-term sustainable franchise. These imperatives include segmentation, aligning cost to serve and increasing cost efficiency.
On the cost to serve perspective, banks tend to cater to various client segments using the same model. Private banks of the future will have to determine the segments to which they want to cater, and once that is done, determine the business and operating models for each of these — keeping an eye on the value proposition, the requirements of the clients and the underlying costs. With streamlined processes, dealing with a client considered an exception, i.e., it does not match a bank’s natural segment would prove to be unprofitable and dilute the bank’s value. For example, accepting a client outside of the bank’s jurisdiction would lead to obvious overheads of understanding the tax implications, providing a different set of custody services and communicating in the client’s language, to name a few concerns.

Product and IT platform and relationship manager compensation costs have become unsustainable for many banks. Instead of dwelling on the obvious cost efficiency implications of automation and standardisation, our discussions with industry leaders focussed on relationship manager compensation. This is disproportionately higher in Asia due to the fragmented nature of markets and the intense competition for talent. Reducing costs in these areas are key to a sustainable business. For players lacking scale, especially those players focused solely on the management layer, outsourcing the transactions layer would be the obvious choice to make. Competition and commission-based elements are driving up relationship manager compensation while returns on assets are being compressed. This model is close to a breaking point. A less transaction driven and a more realistic (and innovative) approach to relationship manager compensation is required in the long run.
New Pricing Regime

Independent Fee Structure

The breakup of the integrated model should allow the emergence of a new fee structure that is tailored to each service and product. The three layers of a private bank would charge an independent and easier to understand fee component, since each layer would have to define its offer and its modus operandi. In addition, linking fees to specific services would also provide the bank with proactive justification of the value it brings to the table to demand the fee.

Logical and Relevant Composition

While the bulk of discretionary mandates decreases and the share of advisory services increases, billing for advice by the hour — akin to the model of practice by a lawyer or consultant — could possibly emerge. For the products layer, the quantum of fees may depend on the cost of setting up a product if it is tailored. For the transactions layer, the transaction cost would be paid at reduced rates through economies of scale achieved by offering services to a number of players.

Proactive and Realistic Value Communication

The private bank would shift from the logic of reactive justification of its fees to more proactive dynamics, in which it correctly accounts for the added value of its service and demonstrates that the relevant charges are included and are realistic. Performance in this new model has reduced relevance for the calculation of the fee. This is to the bank's advantage as track record indicates that they have very little control on the performance.
The pricing model in Asia is still heavily biased toward product commissions due to client attitude being transactional in nature. To charge for advice alone remains difficult as clients prefer to have a say and stay in control of their investments.

However, there is a trend in moving toward a hybrid model of increasingly discretionary management and advisory based services. The change is gradual, with an estimated 10% to 15% of clients choosing this model. But its prevalence remains a long-term objective that will take place with a generational shift.
The changes in the environment are borne largely from the decisions and actions of the industry. A direct consequence of corrective actions would be — at the very least — the end of worsening external constraints. Market performance in a way is linked to the high level of expectations that have been set, so realigning them to realistic levels will be a positive first step. Moreover, the changes to pricing will have a downward impact on revenues and banks have no choice but to adjust sooner than later to this harsh reality.

The business model of banks of the future needs to follow the logic of being built on a solid foundation of core values. The other elements of the business model and operating model will depend on this. The client segments that banks target would be closely aligned to this vision and so would be the products and services that they provide. The key to the success of these changes depends on the restoration of the critical link between the real economy and the financial economy.

As a direct consequence, the operating model would need a paradigm shift to enforce these changes. The three layers need to become independent in their function and specialised in their services. Although, the split would not be immediate or occur simultaneously in Europe and Asia, signs of this taking place are gradually surfacing.

Pricing will become very closely linked to the split in the layers as well as be associated to the value add that it brings to the client. An implied justification of the fee would ensure that banks differentiate themselves in what they offer and how they offer it, and that would be linked to the fee they charge.

All these factors and changes — building a closer link to the real economy, focussing on long-term growth and setting realistic expectations and goals — will combine to build up goodwill in the industry and allow banks to win back clients’ trust.

Conclusion : Part II of the study

Trust as a Collateral Effect of Good Models
With a carefully planned roadmap for the future, the private banking industry can transform what appears to be a vicious cycle of uncontrollable changes into a virtuous cycle that will in fact spur its growth.
The arguments presented in this study can obviously be interpreted differently, or contradicted. It is indeed desirable that they are challenged. Each element could be more detailed, but the objective was to provide for an overview of global landscape and specific perspectives on Europe and Asia.

The delinking of the real economy and the financial economy has never been so stark. The banks have been guilty of making larger-than-life promises, which builds up client expectations. The banks are then forced to try and deliver to these unachievable expectations. This leads to a vicious circle that has a damaging effect on the whole industry.

Private banking is expected to undergo a revolution given the build-up of changes that have occurred over a short duration of time. In fact, this is a necessary upheaval, which the banks will try and resist. They are beset by inertia, are fearful of tomorrow and are driven by an uncontrollable desire to achieve greater profitability now as opposed to planning for the future.

However, increasing pressure from regulators and markets, the emergence of Darwinian survival instincts and generational changes could spark this revolution.

Food for Thought

We have been discussing change for the past 10 years. The ones who have not moved yet will suffer.

The fear of losing control pushes banks to simplify both models and products.

This is not an evolution or a revolution — but a devolution. We need to go back to the origins of private banking.

Building a niche is key to survival, but building that niche is very difficult.
Tough decisions have to be made, and since all the factors are tightly inter-linked they should be improved or changed coherently. This is to the industry’s advantage as it would force banks to move forward. The link to the real economy has to be restored and the clients have to be educated to lower their expectations. Banks’ profitability will decline (employee salaries will decline proportionately) and fees charged to clients will be revised downward. It will be an incomplete solution without biting the bullet. Although the situation appears grim, there is tremendous opportunity to enforce a virtuous circle and get the industry on the right track.

In the more distant future, the next generation of bankers is likely to establish new performance indicators. They could, for example, include a mandatory contribution to community development as part of an investment according to a devised set of socioeconomic values.

As the moment of truth approaches, banks that make important strategic decisions now will be better able to capitalise on the opportunities presented by change. Wealth managers are becoming more aware of this approaching deadline, as shown by the interviews in context of this study.

To the other extreme, it might not to be too harsh to say the industry is facing neither an evolution nor a revolution but a devolution. This term signifies a return to the old-school way of banking where investments are always directly linked to a real project and the expectations of returns are realistic and not solely based on financial performance. The goal is also to measure benefits that are far reaching and long term.

**Independence, Investments and Regulations.**

Organisations must focus upon these critical building blocks and define them concurrently in a holistic manner. These interlinked blocks present an opportunity for the industry to right the wrongs of the past, enabling a complete turnaround of the “vicious circle” into a “virtuous circle”.

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Projects / Initiatives

The time to wait and watch is over, and the onus is now on banks to act to meet the demands of the changing landscape. The downside of being caught in the “boiling frog” situation is far greater than is perceived. Based on the discussions we had with industry leaders and our own insights, we believe there are several areas in an organisation where the banks can proactively roll out changes to transform into the ideal bank of the future.

The Environment

- Tax and Regulatory Impact
  Regulatory pressures continue to increase and there is no escaping the truth. To comply with the new regulations and any legal issues arising out of these changes requires the banks to deliver pragmatic responses that impact the processes, the IT systems and the accompanying behavioural changes.

- Client Expectations
  Client behaviour and the nature of their expectations are changing considerably with clients becoming more aware, involved and demanding. This calls for action on two levels: first to understand the degree and nature of these changes and second to adapt the way of working to respond to these changes.

The Business Model

- Vision and Values Setting
  Banks need to determine their set of values and thereby set their vision, which is then clearly communicated to the market to differentiate themselves from their competitors. This can be achieved through senior management workshops and reviews to help set their vision and high-level strategy making to define the target business model.

- Sales Force Effectiveness
  The key layer of the bank that interacts with the client needs the most attention. Improvements in revenue and profitability can be achieved through implementation of a set of organisational and technical measures for the sales force.
The Operating Model

- **Organisation and Process Restructure**
  The old way of working is no longer feasible. Demanding clients, increased costs and changes in service offerings demand new organisation models.

- **Operational Risk Management and Efficiency**
  Costs are on the rise while profit margins are on the decline. Cost reductions (tangible and intangible) need to be tackled by managing operational efficiency and the underlying risks through measures affecting people, processes or systems.

- **Consolidation and Post-Merger Integration**
  Although isolated, the industry trend will be toward increased consolidation. This will involve conducting integration within the context of merger and acquisitions in an efficient manner.

Pricing

- **Pricing review**
  The new reality demands transparent, fair and justifiable pricing structures, which will be enforced by regulators. On the flip side, a bank's objective is revenue maximisation. The efficiency of the flow from assets under management to revenue depends on multiple elements (people, processes, products or systems), which need to be streamlined to ensure profitability even in the new pricing regime.
**Glossary**

**Evolution**
A gradual transformation made by a series of small, successive changes that follow one direction.

**Revolution**
A violent and sudden change followed by a dramatic change of structure.

**Environment**
The environment is the assessment of customer behaviour, market conditions, regulations and other such elements external to the bank.

**Business Model**
The business model details the target customers, products and services, and sources of income.

**Operating Model**
The operating model comprises the organisational aspects, work practices and quality.

**Management Layer**
The management layer forms the crux of the relationship between the bank and the client.

**Products Layer**
The products layer deals with the creation and administration of financial products and services of investment banking.

**Transactions Layer**
The transactions layer is the one that provides all transactional capability, whether personnel (operations) or technical (IT). This is where the processing takes place.

**Values**
In context of this report, values refer to a bank's internal principles, in terms of its vision, its positioning and its target client base.

**Risk On, Risk Off**
Risk on, Risk off (RORO) is a concept within equity markets that describes current market sentiment as either Risk on or Risk off. If Risk on, the market is optimistic and more willing to take risk in exchange for possibly better returns. If Risk off, the market is pessimistic and favours lower risk investments.
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