

strategy&

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Private banking

After the
perfect storm



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Executive summary



Private banks have spent the last 18 months dealing with one of the most difficult periods in modern financial history. A “perfect storm” of asset-price declines and the near or actual collapse of some of the best-known wealth management firms has altered the behavior of clients, prompting them to move into less risky financial instruments that are much less profitable for the banks. All of this has pushed revenue levels 25 to 30 percent below where they were before the crisis. As an added challenge, governments are cracking down on their wealthy citizens’ untaxed offshore accounts, forcing many private banks to find new value propositions.

Not everything has been negative, however. Private banks have continued to deliver profits despite the huge declines in their revenue bases — proof of their ability to manage through cyclical downturns. And many banks are starting to move strongly into emerging markets, a huge growth opportunity, especially in places like Asia and India where the populations of high-net-worth individuals are expanding rapidly.

This report — based on quantitative market analysis complemented by in-depth interviews with more than 140 private banking executives, senior financial advisors, and regulators from the leading financial centers worldwide — provides a snapshot of the private banking industry’s evolving state, and highlights five new imperatives. To be successful in the future, private banks will need to become much more serious about emerging markets, they will have to combine their onshore and offshore businesses more strongly, and they will need to build scale and capabilities, often in inorganic ways. Successful private banks will also need to adapt their client service models to restore client trust while ensuring compliance and cost-efficient servicing. Finally, as pressure on revenue pools will endure, further cost reduction measures will be unavoidable.

An industry in transition

The last 18 months have been a period that most private bankers will never forget. Scared by plummeting asset prices and the surrender or near collapse of some of the world's leading wealth management icons, clients have shifted their assets away from the large megabanks to smaller private or regional banks on a massive scale. Furthermore, clients have changed their asset mix in favor of low-margin products, resulting in eroding profit margins. Western governments have turned the spotlight on the offshore banking model, looking at potential ways to get access to undeclared accounts.

Over the last few months, Strategy& has taken a closer look at the world's leading wealth management markets to understand the core drivers of private banking unchanged by the worst financial crisis in 80 years, while forming a perspective on the new rules of the industry and what it means for private bankers to adapt to the new realities "after the storm" (*see Exhibit 1, next page*).

The three core drivers of private banking: While the wealth management industry has yet to find its new equilibrium, there are three fundamental characteristics across all surveyed wealth management markets that remain unscathed by the recent financial turmoil: First, private banking is an industry fundamentally geared for growth driven by sociodemographic factors, entrepreneurship, and the increasing concentration of wealth. Second, revenue pools in private banking are cyclical in nature, strongly tied to the underlying equity market across all markets. Third, private banks have once again proven highly resilient, being able to generate profits even in difficult times.

The change levers: Apart from the core drivers, significant changes will affect the private banking industry going forward. The tectonic shift in global wealth distribution toward the East will further accelerate, and given the growing regulatory pressure, wealth will increasingly be kept onshore. High-net-worth individuals globally will behave more pragmatically as they have a more astute understanding of financial products. Widespread mistrust of state and financial institutions will increase the role of the client relationship manager as a trusted advisor.

Exhibit 1

Private banking: What it is, how it's changing, what's required to win

1. Key characteristics of private banking			
	Fundamentally geared for growth	Cyclical in nature	Profitable even in difficult times
2. The change levers			
Market environment	Tectonic shift in global wealth distribution		
Regulatory	The end of the tax-induced offshore business model		
Client behavior	More pragmatism in client behavior (for the time being)		
Operating model	Pressure on costs will endure		
Industry dynamics	New business models taking shape		

3. Adapting to new private banking realities

Source: Strategy& research and analysis

Pressure on margins is here to stay. Finally, new private banking business models will take shape as it becomes increasingly challenging for a private bank to be everything to everybody.

Adapting to the new imperatives: The long-term business prospects for the private banking industry are positive, but in response to the changes ahead, private banks need to make a number of strategic choices to adapt their business models to the new realities. First, private banks with growth ambitions need to seriously commit to emerging markets, where having a full multi-shoring value proposition will be critical to success. Private banks also need new client service models to restore client trust while ensuring compliance and cost-efficient servicing. The enduring pressure on margins will make further cost reduction measures unavoidable. Finally, the need to more clearly separate distribution, production, and operations — in response to regulatory and client demands and cost pressures — will prompt an industry consolidation along these boundaries.

We do not yet know whether the worst of this storm is over or is yet to come. But what is clear today is that private banking offers plenty of opportunities for those who are strategically prepared.

The three core drivers of private banking

While the financial crisis has jolted the private banking industry, three fundamental characteristics remain intact:

- Private banking is an industry fundamentally geared for growth.
- Revenue pools are cyclical in nature and highly dependent on the underlying equity market performance.
- Private banks have once again proven highly resilient — able to generate profits even in difficult times.

Fundamentally Geared for Growth

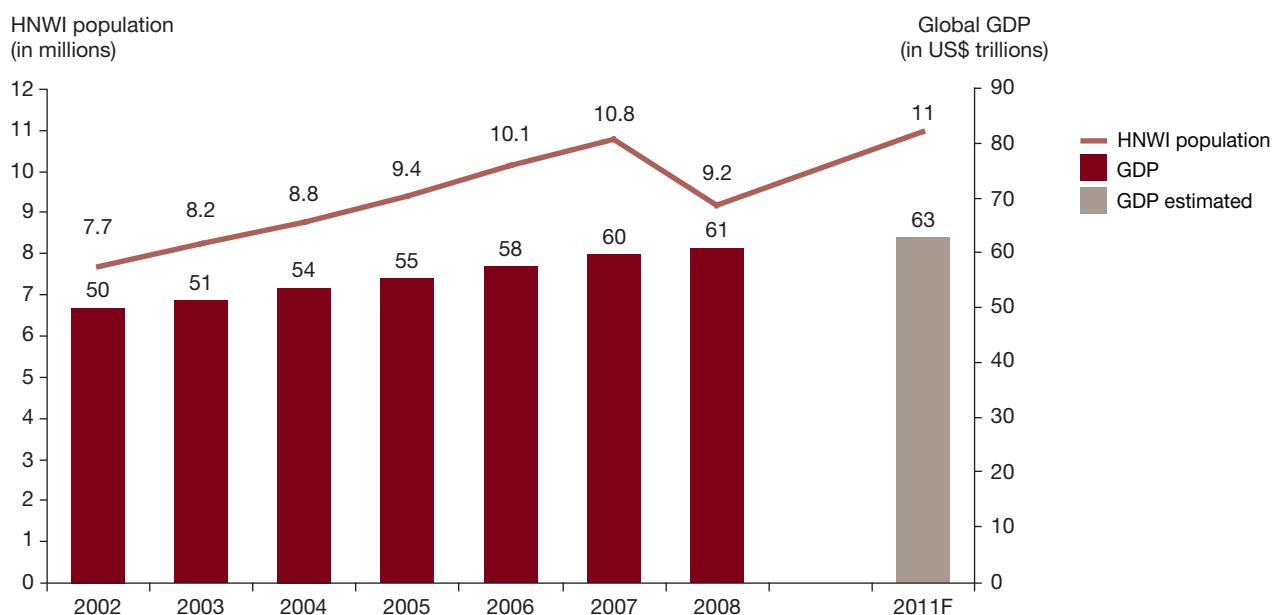
While world wealth generally expands at the rate of GDP growth, the number of high-net-worth individuals (HNWIs), defined as people with more than US\$1 million in investable assets, has been growing more quickly, at anywhere from 1.5 to three times the rate of GDP, depending on the market (see *Exhibit 2, next page*).

The increase in HNWIs is mainly the result of two factors. The first is wealth generation through entrepreneurship, innovation, and factor optimization, meaning the more efficient use of economic input to create economic output. These dynamics are creating substantial wealth, particularly in emerging markets where entrepreneurs are becoming first-time HNWIs on a massive scale and with breathtaking speed. The second factor driving up the number of HNWIs is wealth concentration, which is determined by the traditional wealth distribution structure and by income and (absence of) inheritance taxes in each market.

The financial crisis of 2008 took its toll on HNWIs as massive devaluations hit all major asset categories and geographies — none were exempt. But as economies around the world rebound, the population of HNWIs will return to its long-term growth trajectory, generating a steady flow of new HNWIs for the private banking segment.

Exhibit 2
Growth of HNWI population vs. GDP

GDP vs. HNWI wealth (2011 forecast)



CAGR 2002–07

Global		Europe		North America		Latin America		Asia-Pacific		Middle East and Africa	
GDP	3.6%	GDP	2.5%	GDP	2.8%	GDP	4.5%	GDP	5.2%	GDP	6.1%
HNWI	7.0%	HNWI	4.4%	HNWI	8.4%	HNWI	5.9%	HNWI	8.1%	HNWI	10.8%
Multiple	1.9	Multiple	1.7	Multiple	3.0	Multiple	1.3	Multiple	1.6	Multiple	1.8

Source: IHS Global Insight;
 Strategy& research and
 analysis

Cyclical in nature

There is no question that the revenue of private banks is highly correlated with the performance of equity markets (*see Exhibit 3, next page*). This cyclical nature is no surprise; revenue in private banking depends heavily on transaction volumes and asset-based fees (and sometimes even on performance-based fees). As a change appears unlikely for the industry's revenue-generating model — that is, we foresee no shift toward strictly advice-based remuneration — this correlation likely will hold. For the near term, that means the industry's revenues will depend on the extent to which the markets can continue the rally they started in March 2009.

Profitable even in difficult times

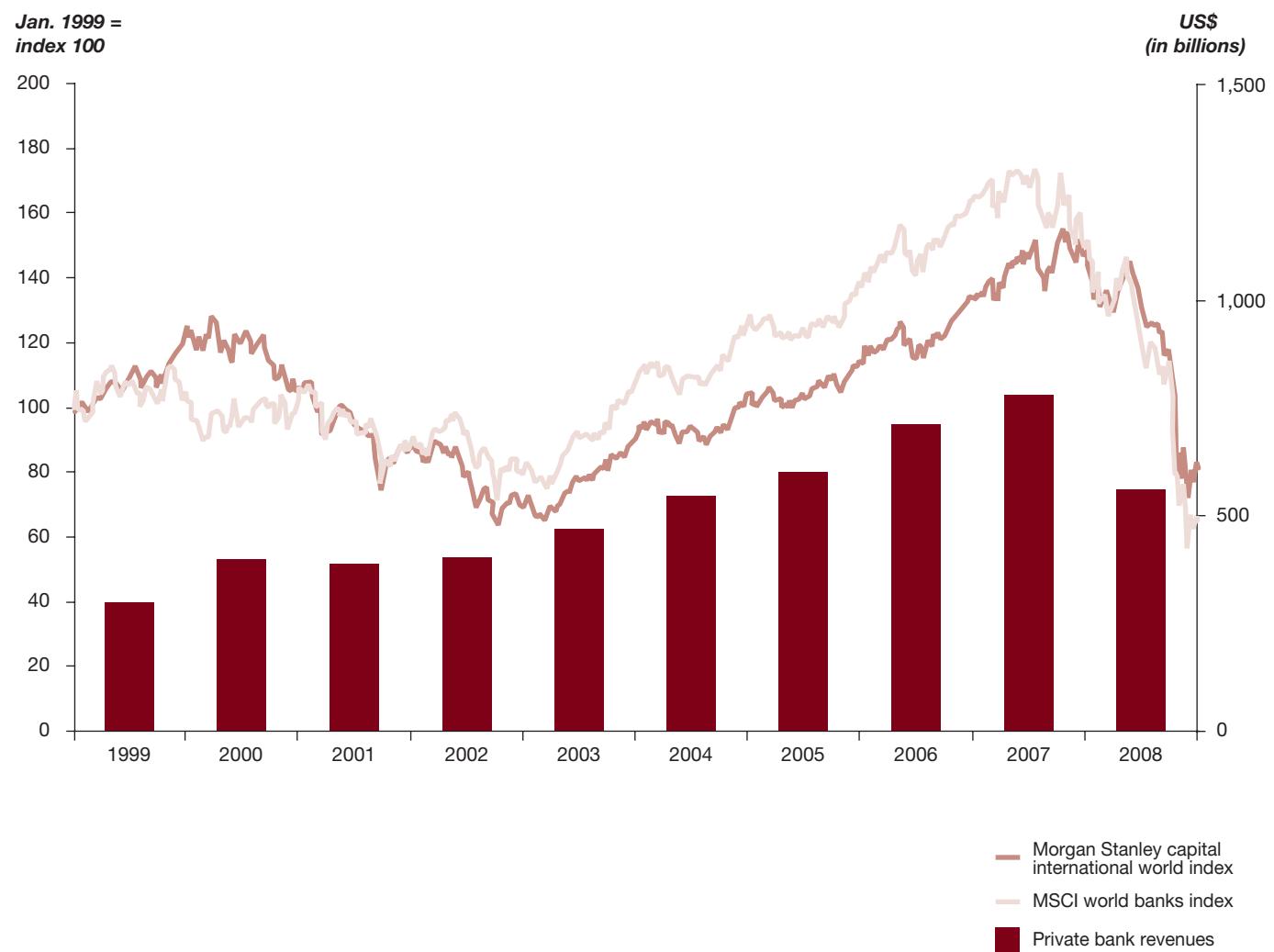
Since the beginning of this financial crisis, the wealth management industry has lost 25 to 30 percent of its revenue because of a lower asset base, cautious market behavior, and a shift toward low-margin financial products. The vast majority of private banks analyzed worldwide were able to deliver positive pretax profits during this period.

Private banks' persistent profitability is a reflection of the speed at which they can adjust their operating models to align them with current business conditions. For instance, all the banks in our survey quickly took steps to reduce their cost bases, mainly by reducing personnel expenses (limiting variable pay, laying off low performers) or slashing structural expenses (downsizing IT project portfolios, withdrawing from unprofitable markets). Regional or local banks that focus on one home market have proven particularly adept at making these changes, while large international wealth management players and large pure plays (those that focus exclusively on private banking) have moved more slowly (*see Exhibit 4, page 13*).

Exhibit 3

Moving in sync: Private banking revenues and the equity market

Market performance vs. private bank revenues (1999–2008)

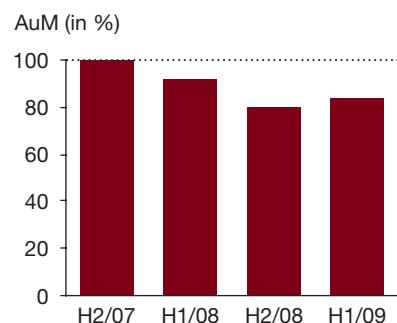


Source: Bloomberg;
company annual reports;
Strategy& research and
analysis

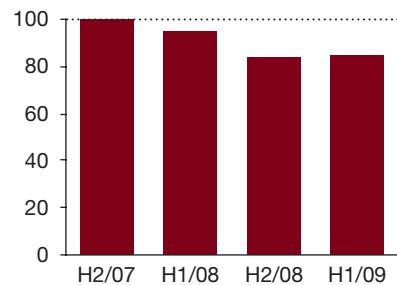
Exhibit 4

Regional and local banks have been fastest to recover
(assets under management, second half of 2007 through first half of 2009)

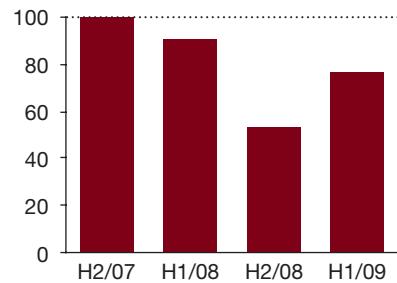
Large international players



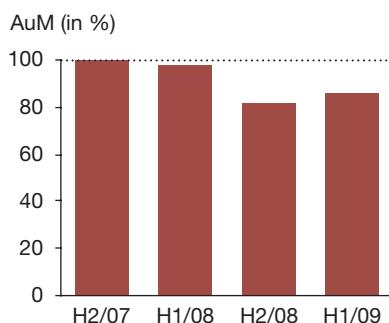
Revenues (in %)



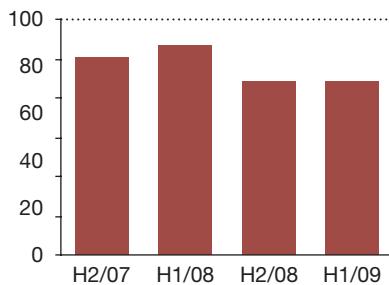
Net profits (in %)



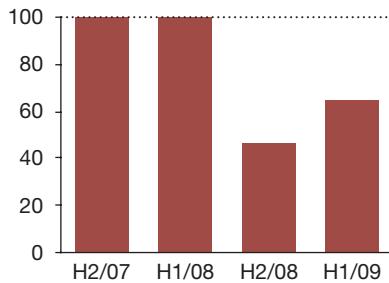
Pure-play private banks



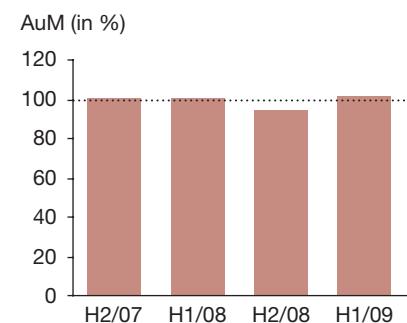
Revenues (in %)



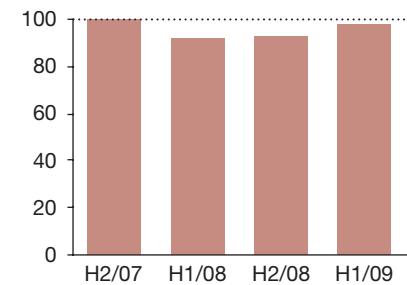
Net profits (in %)



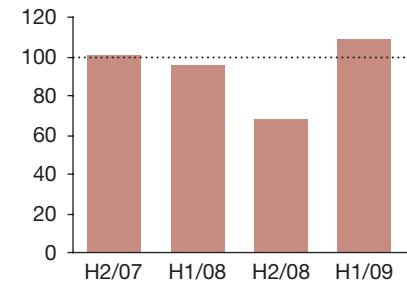
Regional/local private banks



Revenues (in %)



Net profits (in %)



Source: Company reports,
global sample; Strategy&
research and analysis

Private banking change levers

While the underlying dynamics are fundamentally promising for private banks, the industry must navigate through a number of significant changes going forward:

- The depth of the financial crisis and the various speeds at which different regions are recovering will accelerate the tectonic shift in global wealth distribution to the East, with China, India, and the Middle East emerging as new wealth centers.
- Shielding clients from taxes by holding assets offshore is fading as a benefit, now that many G20 states are enforcing stricter regulations. This has potentially disruptive consequences for markets and for players that previously capitalized on this value proposition.
- In the wake of the financial crisis, clients have been shying away from complex, nontransparent products. Bankers expect the appetite for structured/riskier products to return, but they also expect client behavior to remain more thoughtful, making the role of the trusted advisor even more important.
- With revenue pools depressed, high-margin offshore pools vanishing, and regulatory pressure and the cost of compliance on the rise, further cost reduction measures will be needed to ensure sustained profitability.
- New business models will emerge as private banks look for models that will be viable in the changed world.

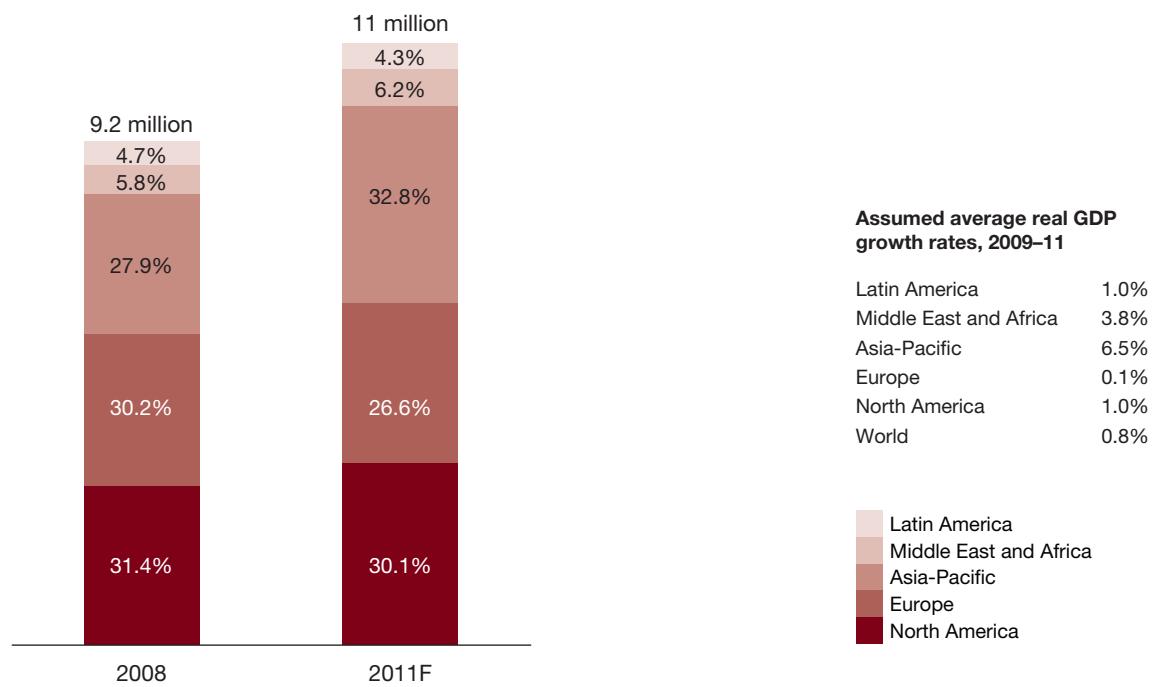
1. Tectonic shift in global wealth distribution

While the majority of industrialized countries are just beginning to recover from the financial crisis, most emerging markets have already returned to pre-crisis growth rates. We believe that these varying rates of recovery will persist for the next few years, shifting the global wealth concentration to the East (*see Exhibit 5, next page*).

Exhibit 5

By 2011, Asia will have the highest number of wealthy individuals

HNWIs worldwide, 2008 vs. 2011 (forecast)



Source: IHS Global Insight;
World Bank; Strategy&
research and analysis

Latin America: Prior to the crisis, private banking in Latin America was experiencing double-digit annual growth, with clients increasingly demanding onshore/offshore convergence (combined onshore and offshore offerings to holistically address their needs) and open architectures, which provide clients with access to best-of-breed products from top suppliers in each asset class. Onshore banks such as Brazil attracted roughly 50 percent of the new business. Though 2009 was challenging in the region for the same reasons that it was challenging elsewhere, Latin America's immediate future looks brighter as its equity markets pick up, creating wealth through IPOs and M&A transactions. This bodes well for onshore players and for major global players that can build out their local operations.

Middle East and Africa: Countries rich in natural resources (in particular the members of the Gulf Cooperation Council) will likely return to accelerated wealth creation even before the global economy fully recovers. Government-led infrastructure projects will further boost the HNWI population in these regions, and many affluent/HNWIs will prosper directly, via family businesses and small and medium-sized enterprises, or indirectly by inheriting wealth from older generations.

Asia-Pacific: Led by China and India, the Asia-Pacific region will be where most new HNWIs will be created, driven by the strength of the underlying economies and a strong entrepreneurial spirit. By 2011, the number of HNWIs in Asia-Pacific is expected to surpass those in Europe and North America, with China moving ahead of the U.K. in absolute number of HNWIs.

In absolute terms, Japan will remain the largest wealth management market in Asia during this period. But given the country's aging population, the main themes in Japan will be wealth preservation and intergenerational wealth transfer.

By the end of 2011, nearly 3.6 million (33 percent) of the global HNWIs are expected to live in the Asia-Pacific region, up from 2.6 million in 2008.

Europe: Despite some early signs of recovery, GDP growth rates for key European markets are expected to remain flat for the next few years. Limited underlying growth, paired with the distressed situation of state finances in most European countries, will further heighten the tax burden on HNWIs and limit HNWI population growth in Europe. Nevertheless, a significant shift of assets among European countries is likely, due to the new regulatory regimes (see "*The End of the Tax-Induced Offshore Business Model*," next page).

North America: North America continues to hold a significant share of the world's HNWIs and UHNWIs (ultra-high-net-worth individuals). Slow growth in productivity and in North America's economies is expected over the short to medium term, limiting the overall growth in asset markets and in the number of wealthy households.

In addition to generating new wealth, many emerging-market countries are expected to become more politically stable and thus offer good investment opportunities, especially compared with more mature, industrialized states. This will create another disincentive to bring the new wealth offshore. An exception will likely be Russia and the other former Soviet Union republics (GUS), where trust in state institutions and banks is not expected to recover soon.

2. The end of the tax-induced offshore business model

While the offshore business has traditionally been an essential part of private banking, it has recently come under increasing scrutiny, especially due to widespread perceptions that it enables tax evasion. In tandem with the recent G20 decision to crack down on tax havens, offshore locations are increasingly implementing standards of comprehensive tax cooperation and softening their banking secrecy. This change will presumably accelerate the crisis-induced changes in the competitive landscape and will affect banking in offshore and onshore locations. While the offshore model will continue to exist for asset segregation and privacy protection, the G20 countries have made it clear that they will no longer tolerate tax avoidance. Consequently, offshore management of tax-neutral money will become a thing of the past.

Regulatory changes will push the balance of offshore/onshore flows in Europe toward more regional investments, forcing offshore markets and players to make large-scale changes to their business models. This is particularly true for pure offshore domiciles that lack a strong local bank presence. Lack of scale and difficulties differentiating their value proposition from that of larger, established local players will raise questions about their “right to win” over the next few years. However, the demand for offshore offerings will not cease anytime soon. Apart from tax optimization, considerations regarding security of funds, diversification, and privacy protection play vital roles in investment decisions. As political and financial instability persists in large parts of the world, local investors will need private banking value propositions that offer confidentiality and discreet services for declared funds.

Expected changes in the regulatory environment will have implications for key offshore domiciles (*see Exhibit 6, next page*).

To avoid law enforcement, private investors have started to repatriate undeclared offshore funds. The announcement of comprehensive tax amnesties in certain countries is putting pressure on offshore centers and has already resulted in a significant repatriation of offshore assets, depending on how the amnesties were structured. Examples:

- *Italy*: Payment of 5 percent penalty tax if declared between September 15, 2009, and December 15, 2009, 6 percent if declared before the end of February 2010, and 7 percent if declared in March or April 2010.
- *U.K.*: Payment of all tax owed plus 10 to 20 percent of accrued tax on declarations made prior to March 2010. For funds in Liechtenstein, payment of tax arrears for previous 10 years plus interest, and 10 percent of tax load (alternatively flat 40 percent

Exhibit 6

Offshore domicile changes and implications for banks

Offshore domicile	Key changes	Implications
Channel Islands	<ul style="list-style-type: none"> Historically protected by powerful government but increasingly under pressure from OECD* regulation initiatives Adopted fraud investigation and anti-money laundering law as well as double tax conventions with most Western countries 	<ul style="list-style-type: none"> Will undergo consolidation and see its position erode in the global offshore market Will likely maintain its standing as a tax haven for U.K. investors
Luxembourg	<ul style="list-style-type: none"> Currently in negotiations with the European Commission regarding an abolition of banking secrecy 	<ul style="list-style-type: none"> Net new assets stagnated in 2008; assets under management fared better than in other regions Threat of reduced capital inflow if pricing and performance of “declared offshore” products and services proves uncompetitive with offerings elsewhere (e.g., in Switzerland)
Singapore	<ul style="list-style-type: none"> Private banking sector has been growing rapidly in recent years Legislation is expected to push banking regulations toward international standards Has remained an advocate for financial privacy and an opponent of Western efforts to exercise more control over international financial transactions 	<ul style="list-style-type: none"> Benefiting from its proximity to countries with high growth in HNWIs (e.g., China, India, Russia)
Switzerland	<ul style="list-style-type: none"> Will adopt OECD standards with respect to administrative assistance in tax matters Will need to cooperate with other nations on suspected cases of tax evasion instead of just tax fraud (the narrower policy it followed in the past) Despite its more cooperative posture, will still only exchange information on a case-by-case basis through legal processes Will adopt double tax treaties with most large countries (e.g., U.S., U.K., Germany, France) 	<ul style="list-style-type: none"> Will remain key offshore domicile and leading global wealth management hub due to high quality of service, independent currency, and stable political situation Large players are already adapting to the new environment and adjusting their value propositions to focus on “declared offshore” offerings Consolidation will accelerate as smaller players that lack scale exit the market
U.S./Delaware	<ul style="list-style-type: none"> Offers incentives for businesses in terms of tax advantages and flexible legislation Has mostly flown under the G20 radar, though it has recently come under some scrutiny amid increased attention to tax evasion in global offshore centers 	<ul style="list-style-type: none"> Exceptional position looks sustainable due to protection by powerful government

* Organisation for Economic Co-operation and Development.

Source: Strategy& research and analysis

penalty tax) upon self-indictment before 2015. After 2015, account holders risk total loss.

- *U.S.:* One-time payment of 20 percent of account balance and 5 percent on inherited accounts. IRS program (no official amnesty) expired on September 23, 2009.

Interestingly, the countries laying out amnesty programs have made little attempt to coordinate those programs; instead, they have been designed to suit domestic market conditions and political sentiment. Asset repatriation will depend on several factors, including experiences with past tax amnesties (e.g., later retaliations), level of tax penalty, credible signaling from the governments that “this is the last chance,” and simplicity of procedures.

How much tax information must be exchanged is still under negotiation. Offshore financial centers are striving to protect client confidentiality to the extent possible, providing bank information only in criminal tax matters. As long as the Organisation for Economic Co-operation and Development (OECD) continues to ban so-called fishing expeditions, investors may be tempted to keep their undeclared assets in offshore locations. After Italy started a tax amnesty program in 2002, Italian investors repatriated about €40 billion (US\$54 billion) from Switzerland. That amount was huge compared with most repatriation efforts, but still less than what the Italian government expected. The recent tax amnesty has been more successful. According to Italian government data, approximately €95 billion have been declared, of which about 85 percent of the assets have been physically repatriated.

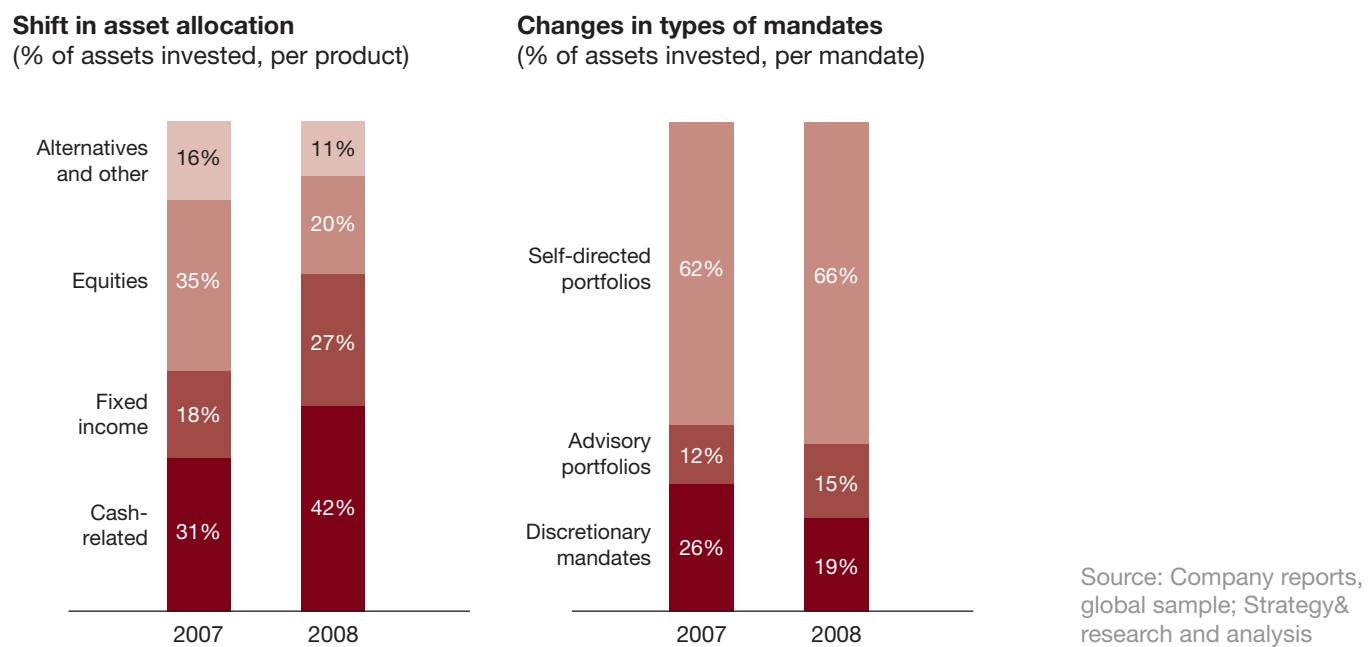
3. More pragmatism in client behavior

Amid the financial crisis, client behavior has changed. The changes have come in phases and have created significant challenges for private banks.

The first phase came after the market collapsed and clients lost money in late 2008 and early 2009. In the wake of this implosion, clients shifted their assets toward simple, transparent, liquidity-oriented products with lower margins. Structured products in particular fell from favor, and clients largely retreated from risky and complex asset classes. A main cause of this behavior was the reduced trust that clients had in banks, products, and relationship managers — a problem worsened by the fact that relationship managers, in turn, did not trust their own product providers anymore. The result is that clients have become more hesitant to delegate and have shifted assets from managed portfolios to nondiscretionary and self-directed mandates (*see Exhibit 7, next page*).

Exhibit 7

A move into cash and away from managed accounts

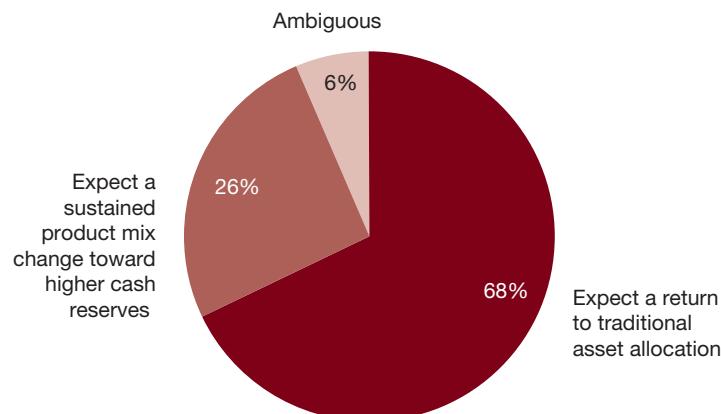


Since the second quarter of 2009, the financial markets have been recovering and optimism has started to replace fear. Clients have begun looking for alternatives to their low-performing investments and are increasingly willing to participate in the upside potential of riskier products to make up for the losses they incurred during the crisis. Even in this phase, however, low-risk products still predominate and clients are discerning about the quality of products and services they accept. High-net-worth clients expect much more clarity and transparency with respect to risk/reward ratios and the true performance of their portfolio after all fees are taken into account. While private banking clients are generally not overly price-sensitive, demand for price transparency will remain high. And clients will learn to distinguish between fees for alpha and beta performance. Moreover, HNWIs have traditionally been reluctant to pay for financial advice, making it unlikely they will accept new models, such as hourly advisory fees. In addition, most investors are also unlikely to accept performance fees, the device that triggers an additional payment to money managers who exceed agreed-on benchmarks (*see Exhibit 8, next page*). Again, new regulatory requirements might fundamentally change this behavior going forward.

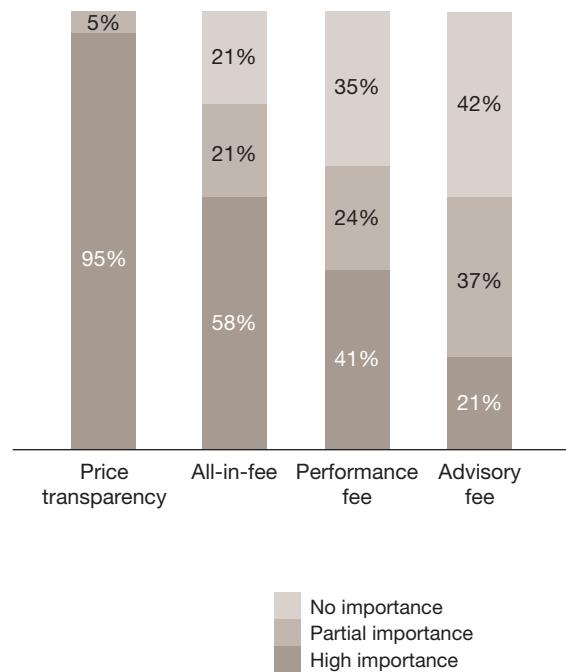
Exhibit 8

Clients want lower risk and higher transparency

**Sustainability of recent trend toward lower risk
(% of responses)**



Expected importance of new pricing structures in future (% of responses)



Source: Interviews with experts; Strategy& research and analysis

4. Pressure on costs will endure

Most private banks have responded to diminishing revenue pools by removing costs from their operations in a variety of ways (see Exhibit 9, next page).

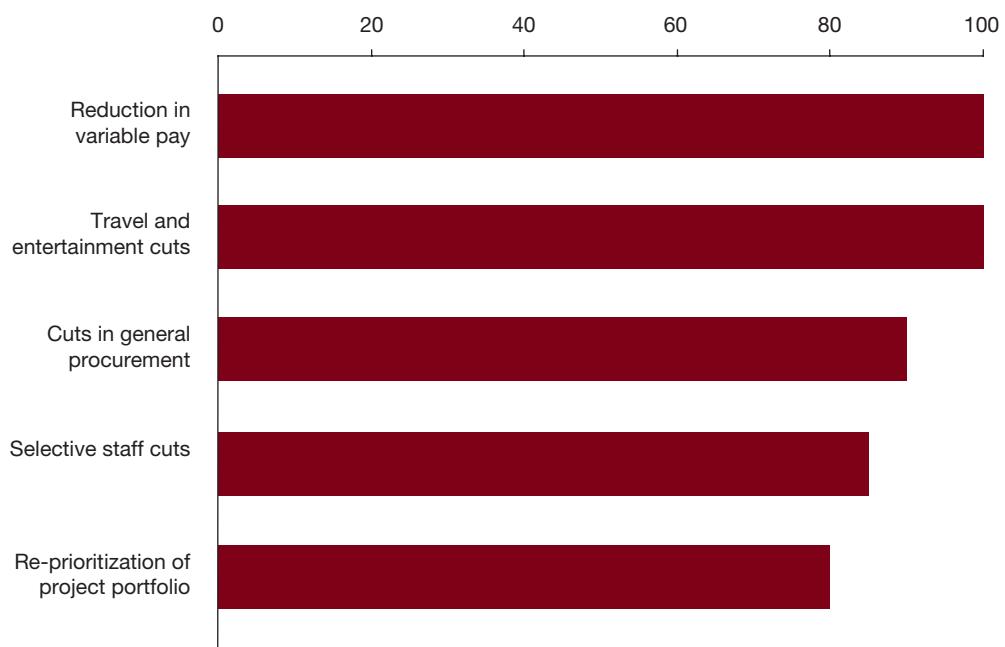
Although the rebound in financial markets since March 2009 has certainly helped private banks to stabilize their top lines, profitability will remain under pressure for several reasons:

- Transaction volumes during the recent market recovery have stayed quite low, and asset allocation remains biased toward low-risk asset classes.

Exhibit 9

Top cost reduction measures used by private banks

What are the main cost reduction measures you have taken in response to the financial crisis? (% of positive responses)



Source: Strategy& research and analysis, 2009 Private Banking Survey

- Clients have become wary of complex, nontransparent, or expensive products.
- Many clients have shifted assets from managed accounts to self-directed mandates, significantly lowering the profitability of their accounts.
- The relatively high-margin offshore assets will gradually transform into local onshore assets, at far lower price points.
- Compliance requirements (e.g., the European Union's Markets in Financial Instruments Directive and Britain's "Treating Customers Fairly" principles) and the need to cope with operational and reputational risks will further increase the cost of doing business.

To ensure profitability, further cost reduction measures will be needed. There may be even more pressure to cut costs if the recent market rebound isn't sustained in 2010.

5. New business models taking shape

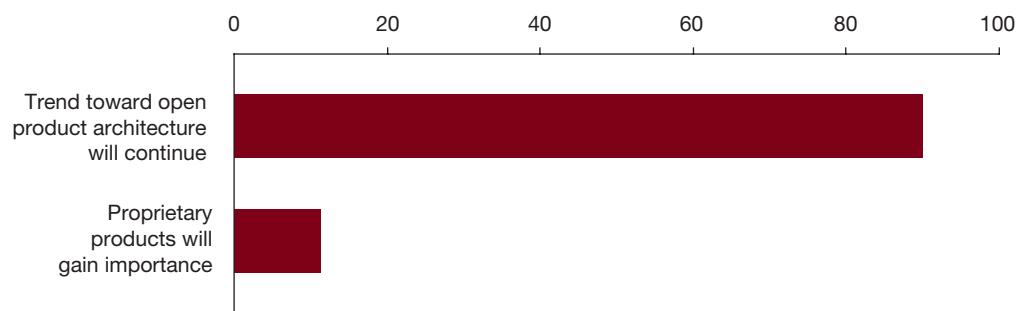
There is a distinct sense that open product architecture solutions will predominate in the future, with clients demanding access to best-of-breed products from top suppliers in each asset class (see *Exhibit 10*). This is inevitable, according to those who responded to the Strategy& survey, because of the focus on greater transparency and the mistrust that clients feel toward players that distribute the same products they produce. That integrated operating model served clients poorly in the financial crisis, eliminating the possibility of an objective intermediary and increasing the moral hazard of selling the structured products that were profitable for the banks but risky for clients.

In the wake of that trust-shattering period, private banks need to further demonstrate their expertise in the areas of risk profiling, asset allocation, product selection, and due diligence. This also means that the model of the integrated bank — the bank that covers all distribution, manufacturing, and operations — will be more closely scrutinized than in the past. Some integrated players (Julius Bär, Barclays) have already taken steps to separate their asset management arms from their distribution arms; other players seem sure to follow.

On the other end of the value chain, specialist operations service providers are rapidly gaining maturity and scale, making it attractive for private banks to outsource at least some parts of their back-office operations. Those operations include administration, accounting, and the handling of corporate actions (dividend payments, share splits).

Exhibit 10 Private banks are moving toward open architecture

Will the trend toward open product architecture continue? (% of positive responses)



Source: Strategy& research and analysis, 2009 Private Banking Survey

The new imperatives for success

While long-term prospects for the private banking industry are distinctly positive, private banks need to adapt their business models to the new realities:

- Emerging markets, led by China, India, and the Middle East, will be the main places where new wealth is generated in coming years. With fundamental private banking needs in these regions underserved today, wealth managers should be looking for ways to penetrate these markets.
- As a value proposition, tax-neutral wealth management is becoming a thing of the past. The transition will be painful for many clients, and private banks need to help. In particular, they need to become declared offshore players ensuring full cross-border compliance while preparing for a time when offshore players are able to offer onshore services in target markets.
- Different client segments have sharply different needs. Private banks need to adopt new client service models to regain client trust while ensuring compliance and cost-efficient servicing.
- The ongoing pressure on margins will make it necessary to get costs down along the entire value chain and to learn to make money again. Besides the measures already taken, a more rigorous approach will be needed to restore client profitability.
- All the changes taking place will set the stage for consolidation. Smart private banks will use M&A to build scale and add capabilities.

1. Seriously commit to emerging markets

The expansion and evolving behavior of the HNWI population in China, India, and the Middle East will require private banks to operate in new ways in these markets.

HNWIs in emerging markets have traditionally sought to hold their assets at least partly offshore, due to a lack of political stability, poor investment opportunities, and inadequate banking services in their home countries. This preference is likely to fade in the next few years as these factors improve, prompting more individuals to hold their wealth in onshore accounts (*see Exhibit 11, next page*).

Wealth management players with global ambitions need an emerging market strategy to capture the large wealth expected to be generated in these regions in the coming years. They will also need to acquire or develop a deep understanding of, and access to, local investment opportunities as new wealth is increasingly invested locally.

Here we spotlight three emerging markets — China, India, and the Middle East — with respect to their private banking potential and the factors it will take for banks to succeed with them.

Spotlight on China: A fast-expanding market

China's wealth is currently concentrated in six cities: Beijing, Shanghai, Guangzhou, Shenzhen, Hangzhou, and Suzhou. More than half of the country's HNWI population can be found in these cities. As the economy continues to develop, however, HNWIs will increasingly be found in smaller cities.

Most Chinese HNWIs are business owners or entrepreneurs; thus, they need both corporate and personal wealth management. Chinese HNWIs have diverse product preferences — including higher-risk stock trading and property investments (as much as 60 percent) and low-risk deposits (as much as 30 percent) for consumption or pensions. Given the promotion of the private equity and IPO markets, direct investment opportunities are expected to increase.

Private banking offerings from both local and international banks began only around 2006 and were aimed at clients with at least \$1 million in investable assets. The competitors include foreign banks with local networks (e.g., UBS, Deutsche Bank, and ABN Amro); local universal banks (e.g., the Bank of China and China Merchants Bank); local trust companies that offer a balanced portfolio of stocks, companies, and infrastructure; and investment houses (e.g., General Pacific and Shihua Union) that mainly target institutions and UHNWIs with local investment products.

Stringent regulations still restrict offshore activity, though Chinese HNWIs who do business in Hong Kong have more flexibility. A private banking license isn't required to operate in China; only a banking

Exhibit 11

Emerging-market wealth management, 2008 and 2011

Region	Country	Propensity to book offshore today	Offshore share 2011	Key offshore centers
Middle East	Qatar	High	↗	Switzerland, London, Singapore, Cayman Islands (trusts)
	Saudi Arabia	High	↗	
	UAE	High	↗	
Asia	China	Medium	↗	Singapore, Switzerland
	Hong Kong	High	↗	
	India	Medium	↗	
	Indonesia	High	↗	
	Malaysia	High	↗	
	Singapore	Medium	↓	
	South Korea	Medium	↗	
	Taiwan	Medium	↗	
	Thailand	High	↗	
Russia	GUS	Very high	→	Switzerland, London
	Russia	Very high	→	
Latin America	Argentina	High	↗	Switzerland, London, Singapore, Caribbean Islands (trusts)
	Brazil	Medium	↓	
	Mexico	High	↗	
Africa	Nigeria	High	→	London, Switzerland
	South Africa	High	↗	

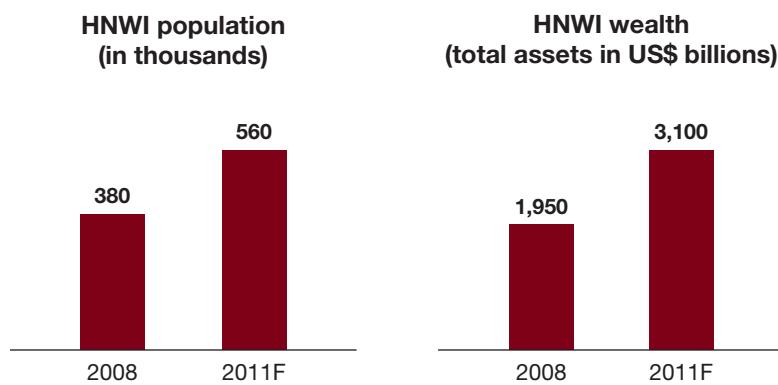
Source: Strategy& research and analysis

license is needed. Regulation results in average fees of about 130 basis points — a level that should allow private banks to generate a reasonable profit margin.

Western private banks should try to accomplish three things as they get started in the market for Chinese HNWIs, whom we believe will grow in number by almost 50 percent between 2008 and 2011 (see *Exhibit 12*):

- *Establish a strong presence in Hong Kong.* Chinese HNWIs perceive Hong Kong as a safe place to park and channel money in and out of China. A strong presence in Hong Kong is critical to provide a platform to serve these individuals.
- *Combine a low profile with differentiated services.* Privacy and confidentiality are hugely important to Chinese HNWIs. They may prefer to deal with banks that don't draw too much attention to themselves. One option for private banks may be to set themselves up as independent financial advisors, keeping a low profile while offering high-touch personal advisory services and sourcing the best third-party deals and investment opportunities.
- *Target the very wealthiest.* Western private banks should consider focusing on family offices, which manage the wealth for an entire family, and ultra-high-net-worth clients. This will allow the banks to concentrate on a few key cities, avoid competition from local players who have started entering the space, and exploit their superior skill in serving wealthier clients.

Exhibit 12
Growth in China's high-net-worth individuals and assets



Source: Strategy& research and analysis

Spotlight on India: A new generation of millionaires

India's economy is a huge success story, having grown 6 to 9 percent a year over the last decade. This has led to the creation of vast amounts of individual wealth. Fifty-five percent of the country's millionaires were created between 2002 and 2007, and the number of millionaires, which declined in 2008, is expected to begin rising sharply again as the worldwide economy recovers from recession (see *Exhibit 13*).

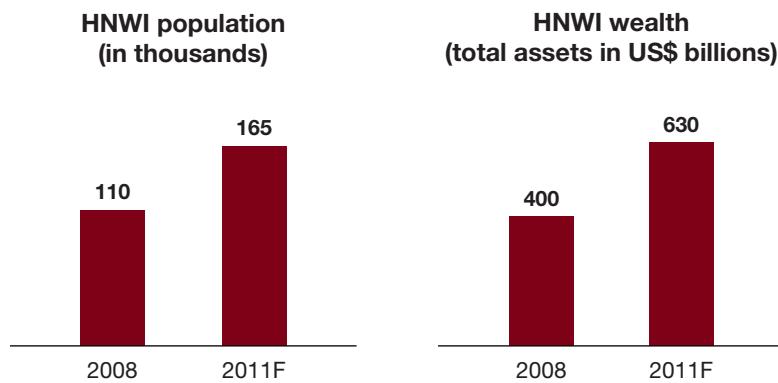
Wealth is currently concentrated: 80 percent of HNWIs are located in only 10 cities: Mumbai, New Delhi, Bangalore, Chennai, Pune, Kolkata, Hyderabad, Ahmedabad, Kanpur, and Surat.

A large proportion of HNWIs have made their own money — only 13 percent inherited their wealth. The fact that many are entrepreneurs or business owners means they have a combination of personal wealth management needs and corporate needs.

There are big differences in the level of service required by Indian HNWIs. UHNWIs require sophisticated products and services and high-touch personalized investment advice. Most clients in remaining high-net-worth wealth bands have limited wealth management experience and thus relatively low-touch needs.

Non-resident Indians, a large and important client base, require targeted products and advice on investing in India. Indian markets

Exhibit 13 **Growth in India's high-net-worth individuals and assets**



Source: Strategy& research and analysis

typically account for 15 to 25 percent of the portfolios of non-resident Indians.

Among HNWIs in India, 32 percent of their portfolios on average are invested in equities. Real estate is another key asset class, comprising 25 percent of HNWIs' total portfolios in 2008. Increasing investor sophistication and the search for yield have also shifted more money to alternative investments such as structured products, hedge funds, derivatives, and private equity funds. Together, those account for roughly 8 percent of the average Indian HNWI's portfolio.

The regulatory environment for wealth management has become more liberalized. Still, some constraints remain. For instance, foreign banks are restricted from expanding their branches in India or acquiring Indian banks without prior approval from the Reserve Bank of India (RBI), the country's banking regulatory authority.

Traditional players in wealth management/private banking in India include large domestic banks, domestic equity brokerages, foreign banks and financial institutions, and established offshore financial institutions. Large Indian banks have traditionally focused on providing a broad range of financial products directed mostly at the mass affluent segment. Indian brokerages such as Motilal Oswal and Indiabulls are increasingly expanding beyond equities to develop wealth management platforms that provide financial advisory and asset management products.

Foreign banks such as Barclays, Citibank, and Credit Suisse, which are relatively recent competitors in India, have taken the lead in developing specialized products targeting wealthy individuals.

To succeed in India, wealth management firms will need to do three things:

- Address the needs of a population that is highly divergent in terms of its language, culture, and wealth preservation objectives.
- Establish full-fledged advisory models (vs. today's largely transactional models) as the emphasis on individual financial responsibility increases.
- Establish an onshore/offshore presence with local representation to enable both onshore and offshore investments.

Spotlight on the Middle East: Attractive market of family wealth

The Middle East is poised to rebound financially in 2010, especially if high oil prices continue to reinforce budget surpluses of the major economies. This will lead to a revival of infrastructure projects (transport, rail, economic cities, water, oil and gas, alternative energy), propelling the HNWI segment (see *Exhibit 14, next page*).

Today, large wealthy families account for most of the region's wealth. In some cases these families have 100 or 150 members spread across different geographies, many of them running diverse, independent businesses. In the UAE especially, 20 percent to 30 percent of total wealth is also held by expatriates living and working in the country, including Asians and Westerners as well as other Arabs.

In the past, Middle East investors have been product-oriented rather than advice-oriented, especially in the lower high-net-worth and affluent segments. Going forward, the preference will likely shift more toward advice, reflecting investors' increasing sophistication and the significant hits their portfolios took during the crisis.

HNWI entrepreneurs and independent professionals are looking for comprehensive offerings on the private banking/personal wealth management side, along with help on the corporate finance side, with advisory services and investment banking transactions.

The Middle East has traditionally been the domain of international wealth managers, though many such managers lost market share during the crisis to midsized international private banks and newly aggressive local banks. A good part of the market is also held by independent intermediaries, especially those who act as advisors to family businesses or manage family offices.

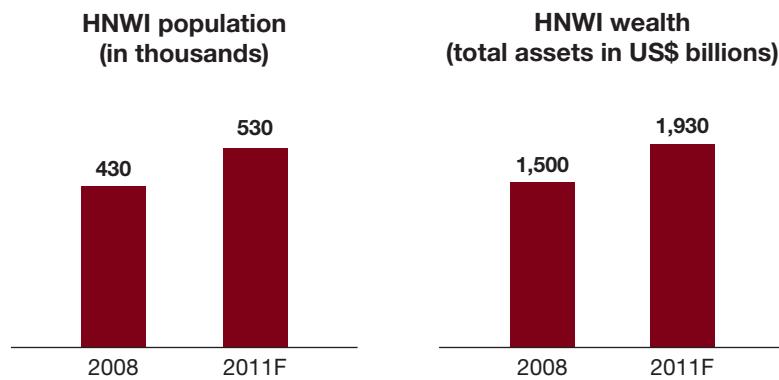
To succeed in the increasingly attractive and maturing Middle East market, private banks must do three things:

- Integrate their core offerings and extend them from individual wealth management to family business advisory services.
- Show sensitivity about cultural predispositions, family relationships, and behavioral preferences of the diverse client base in the region through a coverage model that takes into account investable assets, sources of wealth, ethnicity, and life-cycle and lifestyle differences.
- Implement a best-in-class model that delivers services in an efficient, personal, and friction-free manner, while satisfying specific client

To succeed in the Middle East, private banks must integrate their offerings and extend them from individual wealth management to family business advisory services.

Exhibit 14

Growth in the Middle East's high-net-worth individuals and assets



Note: Also includes North Africa.

Source: Strategy& research and analysis

requirements. Those requirements can be anything from complying with sharia (Islamic law) to being able to hold assets in such offshore domiciles as Switzerland and Singapore.

2. Become a declared multi-shoring player

The tax-neutral, offshore private banking proposition of many domiciles (Cayman Islands, Switzerland, Luxembourg) will not survive the current regulatory pressure — at least not with the largest part of the client base, those who live in G20 countries.

Offshore wealth will continue to move from undeclared to declared status, and the appeal of onshore investment will grow. Losing tax benefits and being induced by tax amnesties, offshore clients are likely to withdraw part of their funds and increase local investments.

Private banks will have to proactively approach and support offshore clients whose governments are applying pressure on tax-optimized accounts. Unfortunately, there is no transition process that will work for every client; each transition is unique and will depend on a client's level of wealth, portfolio, and country of origin. The goal is to serve as a truly trusted advisor and coordinator, helping clients repatriate their money and shift assets to onshore locations, thereby keeping assets within the bank, even if at significantly reduced margins (average onshore gross margins are half those of offshore accounts).

In the future, private banks will need to ensure full cross-border compliance and prepare for a time when pure offshore banking may be attractive only for selected domiciles. This requires banks to understand and closely monitor the regulatory environments in all markets in which they participate. By doing so, banks will be able to react quickly and appropriately to regulatory changes in countries where they have clients.

For large, mature markets (e.g., the U.S., U.K., Germany, and France), hybrid business models that combine offshore and onshore value propositions based on holistic client needs will be the norm. In the case of most offshore countries, only the biggest private banks have risen to this challenge thus far. For instance, in Switzerland the large private banks have all made large investments to build local onshore banking capabilities in key markets (*see Exhibit 15, next page*).

Offshore private banking will continue but will offer different value propositions, including the following:

- Strict confidentiality and discreet service
- Diversification of assets in different geographies and booking centers
- Excellence in service and execution
- Comprehensive tax structuring/planning capabilities
- Integrated financial advisory approach that incorporates both the impact of personal tax and the optimized post-tax investment returns on assets
- Facilitated client reporting for specific tax positions matching requirements of home countries

Smaller banks, as well as most subsidiaries of international banks (where international private banking is considered a non-core or undesirable business), will not be able to expand their onshore footprint and build the required level of capabilities. Because of their dependence on offshore assets, these smaller banks and bank units will become acquisition targets. Indeed, M&A activity has already started to increase.

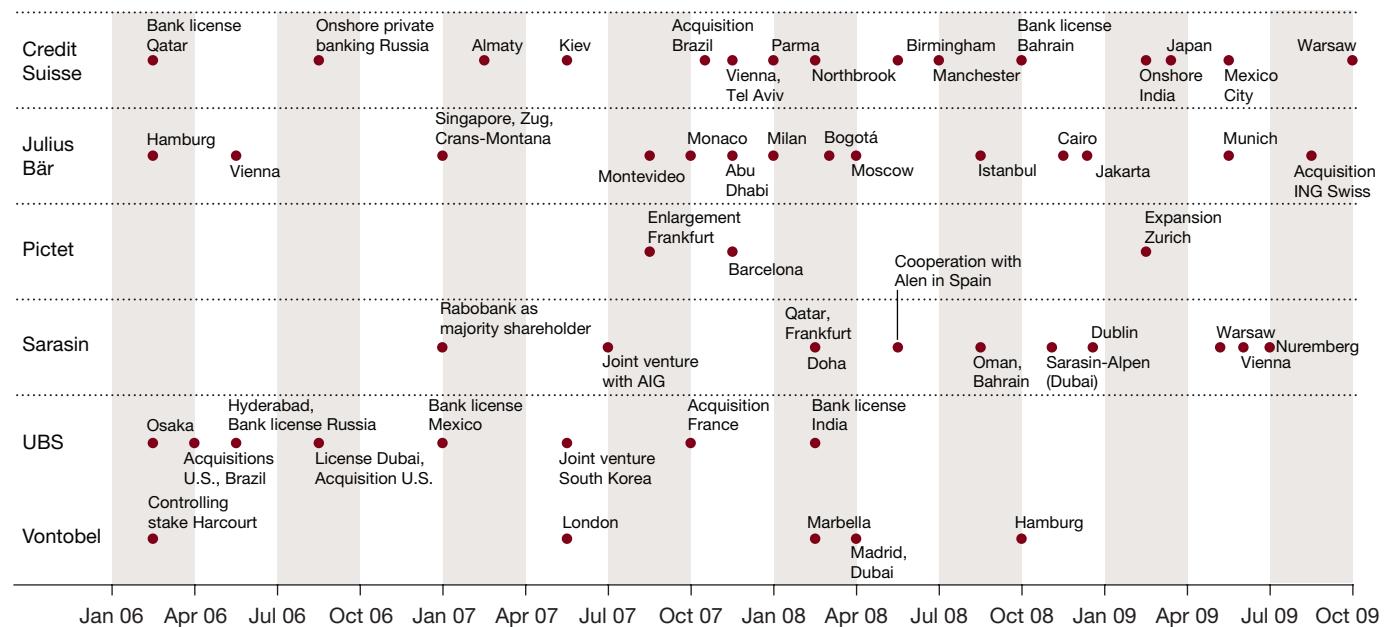
3. Develop new client service models

The financial turmoil of the last few years has changed how clients feel about their banking relationships. Clients are looking for consistent,

Exhibit 15

Selected Swiss banks' internationalization moves, 2006–09

Branch openings and acquisitions of Swiss private banks (2006–October 2009)



Source: Public sources;
Strategy& research and analysis

reliable, and unbiased advice with a focus on what is right for them rather than what is right for their banker.

The client service models of the future will have two main parts. First, clients will need to be segmented according to their true needs. Most wealth managers already segment their clients quantitatively, into small accounts, the affluent, HNWIs, and UHNWIs. Yet relatively few wealth managers use qualitative segmentations, such as source of wealth, client life-cycle, investment style, or degree of interaction (*see Exhibit 16, next page*).

These qualitative segmentations will become increasingly important in the future — they will put wealth managers in a better position to consider all client requirements, emotional as well as financial. Indeed, some private banks are already going one step further and applying advanced psychographic and behavioral profiling techniques. The jury is out on whether such sophisticated segmentation justifies the increased business complexity that comes with it.

The second change involves client coverage models. Leading private banks have started to adopt new client coverage models in which relationship managers focus on a limited number of client segments (in some cases, just one), as opposed to heterogeneous client portfolios in which the clients have diverse needs and backgrounds and are located in a wide range of domiciles (*see Exhibit 17, page 36*).

The benefits of a focused coverage model are obvious: The advisor becomes expert in that client category and understands those clients' needs. This makes the advisor appealing to similar clients. The focus also creates efficiency — advisors can serve more clients and thus handle a higher volume of assets. This is good for the advisors and good for the banks that share in their success.

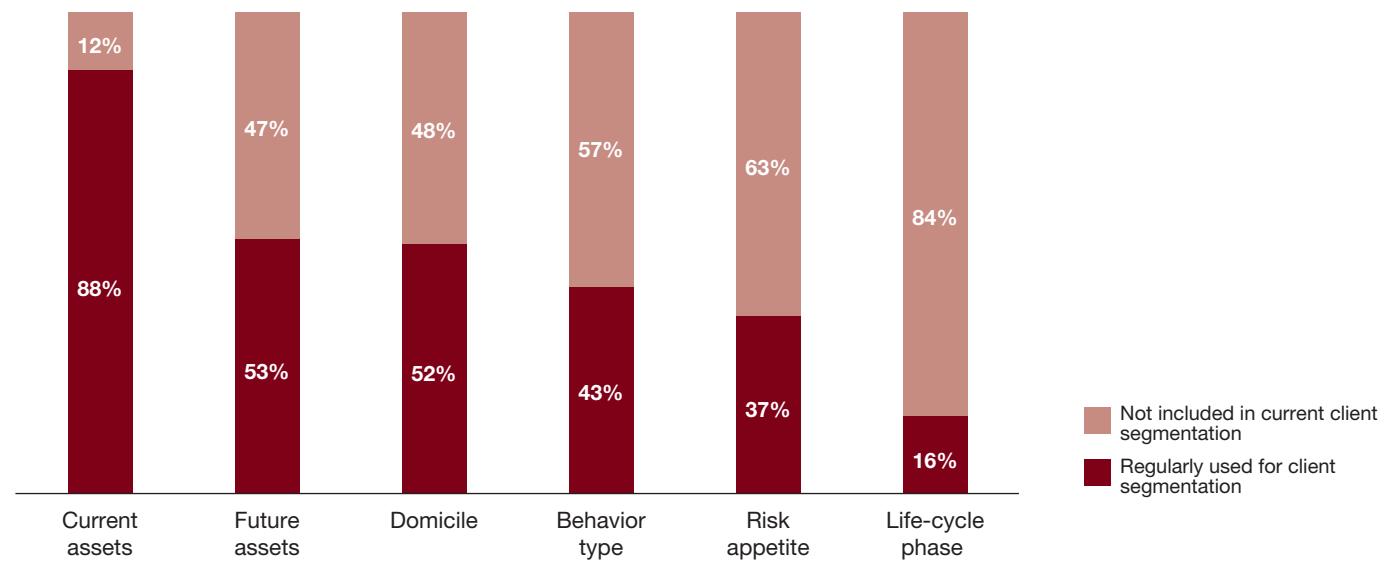
While the benefits are obvious, the transition to a more homogeneous client service model won't be easy for most banks. An across-the-board reassessment of which clients go with which advisors is an extremely sensitive and intricate undertaking. And when the change period actually comes, it creates massive disruption — more than one banking executive compared it to open-heart surgery.

4. Go beyond the obvious in cost management

With revenue pools likely to remain depressed for the immediate future, and with higher compliance costs, wealth managers need to learn — or relearn — how to earn money. Three areas will be key in this regard.

Exhibit 16
Private banks' ways of segmenting clients

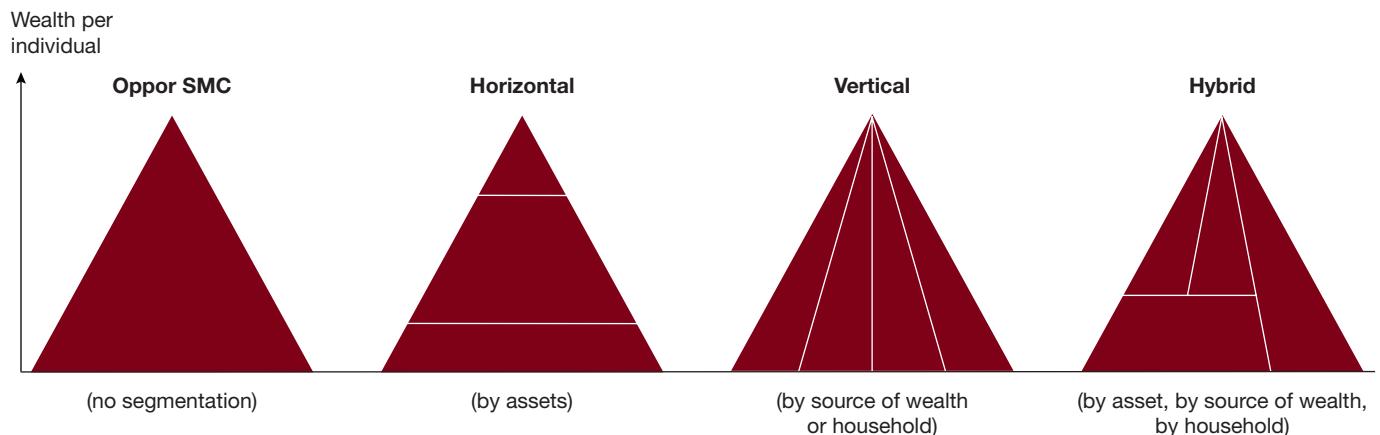
Criteria for client segmentation
(% of responses)



Source: Strategy& research
and analysis, 2009 Private
Banking Survey

Exhibit 17

New client coverage models are emerging



Source: Strategy& research and analysis

First, banks must use rebates and fee discounts more sparingly. Second, they must optimize the product/service mix for each client. Third, they must adopt a disciplined approach to cost management (*see Exhibit 18, next page*).

Top banks have already started to use advanced client profitability steering tools, which show the level of the economic profit by client, to fully understand where value is either created or destroyed.

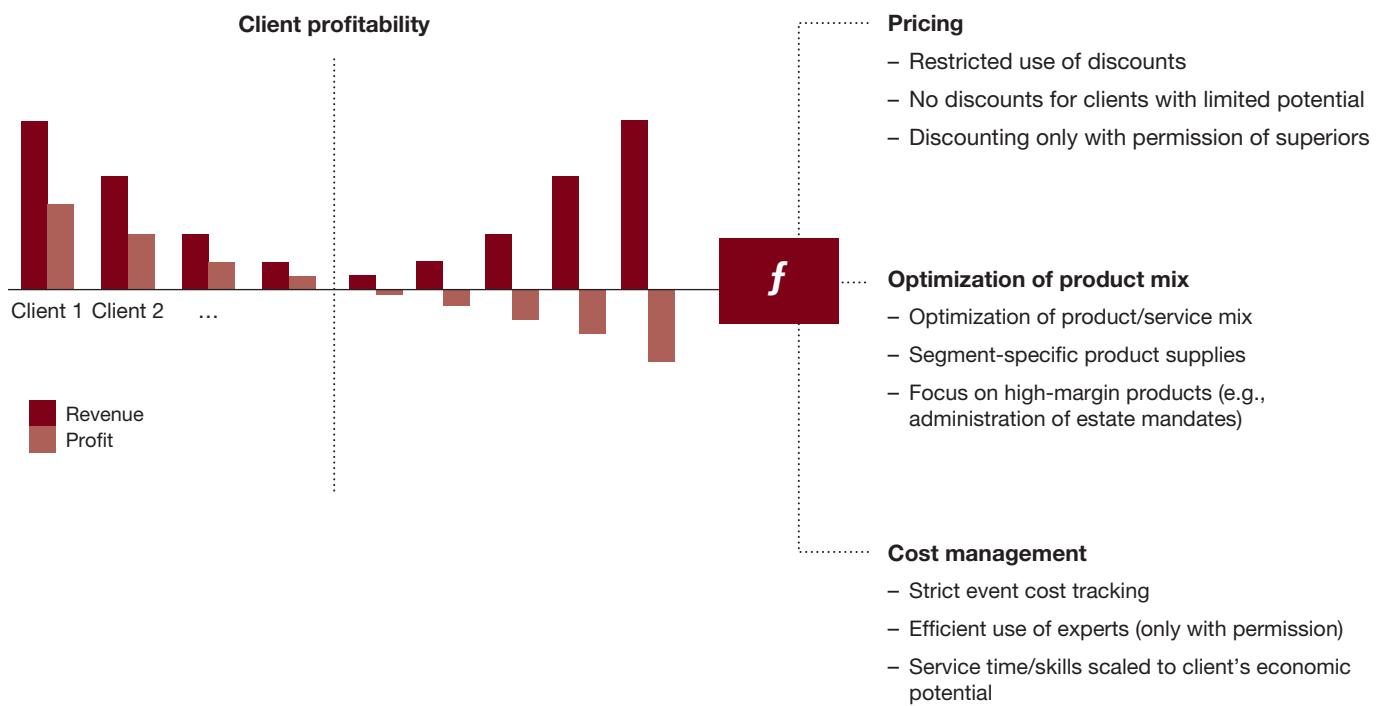
In terms of cost management, there is often potential to streamline banks' business models. First, banks need to scrutinize the organization design (including spans of control and layers of management) and the size of overhead functions. Banks should consider all activities along the value chain and then decide which to maintain. In addition, there is often duplication of activities and organizational overlaps among discrete business areas — e.g., private banking, asset management, and investment banking. That duplication is a logical place to look for efficiencies.

To achieve a step change in cost efficiency, wealth managers need to further industrialize their operating models. Even though private

Exhibit 18

Improving client profitability

Management of the most important performance drivers



Source: Strategy& research and analysis

banking is often a highly customized business, differentiating service levels based on the complexity of the product category helps in adopting lean processing. Global banks in particular have an opportunity to decide what they need to do locally versus what they may be able to do globally or regionally. By centralizing operational functions and establishing dedicated “centers of excellence” (onshore, offshore, or regional), banks can take advantage of economies of scale and benefit from lower labor costs in certain regions. The introduction of industrial methods such as lean management can further consolidate and streamline processes across functional boundaries.

Finally, many banks haven’t done enough to maximize the productivity of their relationship managers. Studies show that relationship managers typically spend just 30 to 40 percent of their time on client-facing activities and the balance on internal activities. If anything, this ratio is getting worse as a result of increased regulatory requirements. Time-motion studies help to clarify where potential client-facing time is wasted. Some private banks have set up “competency centers” to facilitate the sales management process or to concentrate activities where specialist know-how is most important.

5. Build scale, build capabilities

There are several factors causing M&A to intensify in private banking. We’ve already mentioned one — the push to separate distribution, production, and operations. A second factor (mostly affecting buyers) is the need to quickly build scale in new markets, where indigenous companies are rapidly adding capabilities and gaining momentum. A third factor driving M&A is the desire to add revenue at a time when revenue pools are depressed. A fourth factor — more a seller’s consideration than a buyer’s — is that regulatory pressure has left some banks without a viable business model. Together, these factors have led to a burst of deals in the last year (*see Exhibit 19, next page*).

Most of these deals fit into one of four categories:

- Distressed wealth management players under state control getting out of a business that is no longer viewed as “politically correct”
- A sale of the wealth management business helping to strengthen the balance sheet (e.g., ING selling off its wealth management business)
- Private banks breaking up their value chains, separating their distribution business from their production or operations business (e.g., Julius Bär spinning off its asset management arm)

Exhibit 19
Some recent M&A transactions in private banking

Date	Target	Acquirer	Stake acquired	Price (US\$M)	AuM (US\$M)	Implied equity value (% of AuM)
December 2009	Mourant International Finance Administration	State Street	100%	N/A	~170,000	N/A
October 2009	ING Private Banking, Asia	OCBC	100%	925	15,800	5.8%
October 2009	Sal. Oppenheim	Deutsche Bank	100%	- 2,000	87,000	2.2%
September 2009	ING, Switzerland	Julius Bär	100%	314	14,446	2.17%
August 2009	Commerzbank, Switzerland	Vontobel	100%	115–130	4,292	~3%
July 2009	Dresdner Bank, Switzerland	LGT	100%	N/A	8,577	N/A
April 2009	UBS Pactual	BTG Investments	100%	2,500	~57,000	4.3%
December 2008	AIG Private Bank, Switzerland	Aabar Investments	100%	288	19,736	1.46%
December 2008	Credit Suisse AM	Aberdeen Asset Management	100%	358	70,485	0.51%
February 2008	Caisse Centrale de Réescompte	UBS Global AM	100%	348	18,749	1.86%
July 2008	Heritage Fund Management, Switzerland	Bank of China	30%	8,700	362	2.4%
November 2007	Banca del Gottardo	Generali	100%	1,700	90,225	1.88%

Note: US\$ exchange rates as of respective month end.

Source: Strategy& research and analysis

- Financial-services firms buying private banking capabilities they don't have (e.g., Bank of China acquiring Geneva-based Heritage Fund Management)

All four deal types are expected to continue in the next few years, making the wealth management industry very attractive for players with a well-defined M&A strategy.

We also expect to see more alliances and cooperative deals in which traditional private bankers try to expand the scope of their business.

Conclusion

The face of private banking has been altered irrevocably in the last 18 months. Companies that were icons of the industry only two years ago either have disappeared or find themselves struggling to survive at a fraction of their earlier strength. Other once-powerful companies are now operating under the wings of one-time rivals.

Meanwhile, there are players who have done most things right and are positioned to lead the industry consolidation that is now taking shape.

As 2010 begins, we believe that the private banking industry is poised to find a new equilibrium. Given the industry's fundamental attractiveness, institutions that have lost ground will embark on strategies to regain the trust of their clients, employees, and markets, while the players who received significant net new asset inflows over the course of the financial crisis will try to maintain their improved positions.

Private banking after the 2008–09 storm will look familiar in some aspects but very different in others. The bottom line is that there are plenty of opportunities ahead for the private banker who is strategically prepared.

Key findings

- We see a tectonic shift in high-net-worth individuals from mature to emerging markets.
- The population of HNWIs is growing far more rapidly in emerging markets than in the developed world. By 2011, Asia-Pacific will have the world's largest population of millionaires.
- A crackdown on tax havens, especially on the part of G20 countries, is forcing offshore banks to come up with new value propositions.
- Client skepticism about complex financial instruments and insistence on price transparency in the wake of the 2008 market meltdown means bankers will have to find new client service models and value propositions.
- Disciplined cost management has helped private banks survive the downturn, but they will need to become even more diligent about cost cutting to ensure their continued profitability.
- M&A is emerging as a primary tool, helping big banks expand into emerging markets and increase revenue and offering an exit strategy to small banks not able to adjust to the upheaval.

Appendix: Methodology and approach

This report is based on Strategy& quantitative market analysis complemented by in-depth interviews with more than 140 private banking executives, senior financial advisors, and leaders of the regulating authorities worldwide, including Austria, Brazil, China, Germany, Hong Kong, India, Italy, Japan, Liechtenstein, the Netherlands, Saudi Arabia, Switzerland, the UAE, the U.K., and the United States.

The participating private wealth managers spanned all business models and regions. Thirty-six percent were the private banking units of global wealth management companies, 28 percent pure-play private banks, and 36 percent from the local or regional banking sectors (including cooperative banks).

The information collected through interviews was complemented by Strategy& research and analysis and the practical experience of about 30 Strategy& wealth management experts. HNWI market forecasts are based on a quantitative model built on economic, demographic, and fiscal factors.

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