McKinsey&Company

# European Private Banking Survey 2016 – Ascending against strong headwinds

**McKinsey Banking Practice** July 25, 2016

# Executive summary

2015 marked the sixth consecutive year in which Western Europe's private banking sector reported a growth in absolute profits, approaching the pre-crisis levels of 2007.

In Western Europe, the industry benefited from another year of net asset inflows combined with a solid capital market performance, while the cost margin improved in part from the resulting economies of scale.

Nonetheless, these favorable high-level results cannot mask the market forces – including regulatory factors, heightened client expectations, and digital disruption – that continue to create headwinds and will suppress industry margins over the near and medium term. Rising levels of assets under management (AuM) cannot be counted on to offset these downward pressures for much longer, even less so considering the direct and indirect effects of Britain's vote to exit the EU.

While the speed and magnitude of these forces are difficult to anticipate precisely, we see many private banking executives taking early action to create new opportunities along different dimensions:

- As clients increasingly self-segment, in part by leveraging unprecedented transparency on fees and charges, private banks must sharpen their value proposition and adapt their offerings to capitalize on their areas of differentiation

- To match their clients' increasing digital affinity, private banks must design segment-specific service experiences – through digital-only or omni-channel models as appropriate

- Ongoing regulatory, competitive and client pressures require private banks to remain lean and agile in their operating models and to continuously optimize their cost base

- The above changes also alter the role of the private banker, requiring a new talent profile going forward. This shift requires a renewed focus on training, recruiting, and talent management

The challenges facing the private banking industry in Europe that we cite in this report may take on greater scale for some players as a consequence of the UK's Brexit decision. However, it is premature to be more precise at this stage.

Evolution of wealth

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Strategic imperatives for the industry

# Global rebalancing of wealth continues

The global assets of wealthy individuals have increased by 40 percent over the past five years, standing at EUR 53 trillion in 2015. Developed markets grew at a CAGR of five percent, less than half the developing markets' rate of 12 percent. One-third of global growth was contributed by Asia (13.4% CAGR from 2010-2015), followed by one-quarter from North America (5.8% CAGR) and roughly 15% generated by the Middle East and Africa (11.1% CAGR). Western Europe was the fourth-largest growth contributor, but has produced a five-year CAGR of only 2.8 percent and remains the second-largest wealth globally.

Stock market volatility, slower GDP growth, and political uncertainty led to a slowdown in growth for wealthy investors in 2015 compared to 2014. The global assets of the wealthy grew by 5 percent in 2015 compared to 7 percent in 2014. Developed markets grew at 2 percent compared to 5 percent in 2014, while developing markets slowed from 11 percent to 9 percent.

Over the next five years, these global asset pools had been expected to grow by a further 6.4 percent annually (before taking into account any impact from Brexit).

Developing markets – which have historically benefited from higher GDP growth, savings rates and disposable income – should begin to generate more modest growth in the near future. Nine percent growth is expected in developing markets compared to 5 percent in developed markets. Asia, as before, is envisaged to contribute the largest with expected growth of 9.9 percent (the highest globally) over the next five years. China mainland (excl. Hong Kong) will contribute roughly 50 percent of the growth in Asia, which by 2020 will account for the second-largest high net worth (HNW) asset pool after North America. Asia will also account for the top-three fastest growing countries globally (India, Indonesia and China all have double-digit growth).

Across the mature markets, the US has significantly outperformed Europe since the economic crises of 2008 with annual growth of 8 percent as compared to Europe's 4 percent. The UK, Germany, and Scandinavia continue to outperform Mediterranean Europe. The UK, Germany, and Switzerland have contributed two-thirds of Western Europe's total growth over this period. Given UK's relevance for Western European private banking asset growth, the Brexit's expected macro-economic impact is likely to translate into lower private banking asset growth for the region.

In 2010, seven of the top 20 countries in terms of wealth assets were in Western Europe. By 2015, this number had fallen to four. Through 2020, we expect Western European countries to continue to fall in these rankings. India, which was not among the top 20 in 2010, is projected to be ranked 7th by 2020. China will rise to second, moving ahead of Japan and trailing only the US. Exhibit 1 is a striking illustration of the need for Western European private banks to extend their geographic focus lest they miss out on the greatest growth opportunities. It is worth noting, however, that even those countries that are falling down the rankings are expected to generate reasonable levels of asset growth.

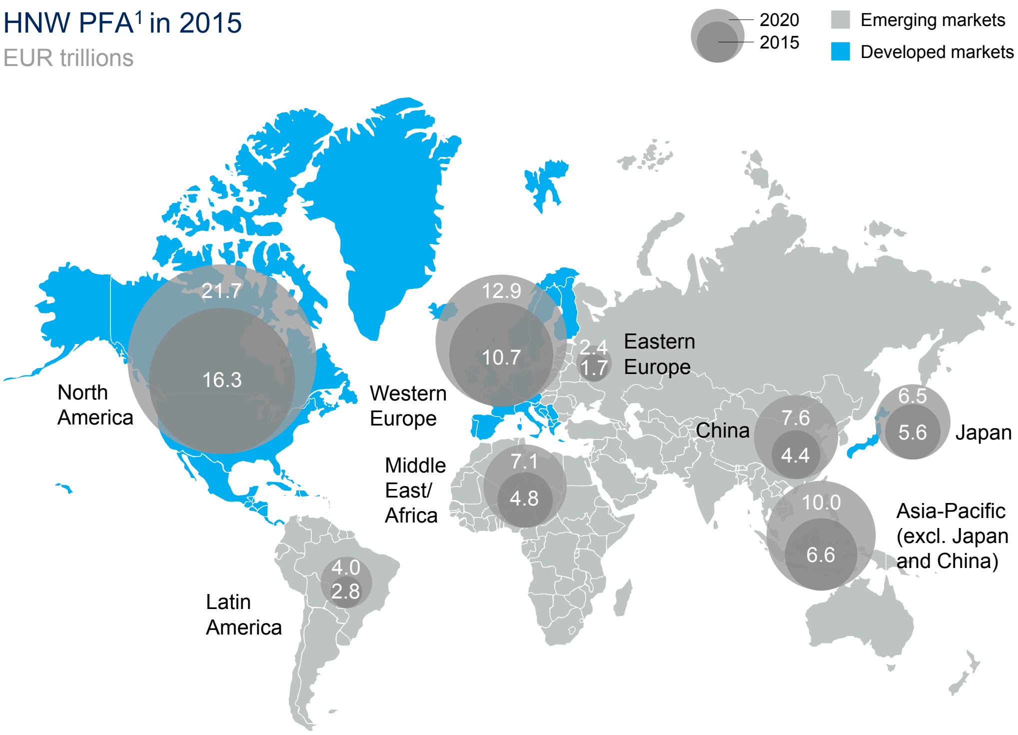
HNW household assets continue to grow faster than those of average households, driven by their higher proportional holdings of riskier assets and access to better investment products. Globally, ultra-high net worth (UHNW) assets are growing faster than those of core millionaires. In developing markets, UHNW households account for 35 percent of asset pools with a global growth rate of 9 percent, the highest of all client segments.

Globally, offshore-managed wealth accounted for a quarter of total HNW PFA in 2015. Offshore constitutes an important portion of total HNW PFA, particularly in developing markets, representing 65% of total offshore HNW wealth. The high share of offshore in developing markets is driven by the desire to access more sophisticated product offerings, portfolio diversification, investment in safer and more stable markets, and to facilitate offshore business needs. Amongst today's offshore centers, regulatory pressure in mature markets and higher offshore growth in developing markets (9% versus 2% in developed markets) are leading to a stronger asset growth in offshore centers like Hong Kong and Singapore than in mature centers like Switzerland and Luxembourg. A closer examination of the Western European centers reveals an interesting trend: Luxembourg – which benefits from a membership of the EU – still had a net inflow of a moderate 4 percent while Switzerland stagnated in 2015 with a net inflow of 0 percent.

Exhibit 1

## HNW PFA[1] in 2015

EUR trillions




1 PFA refers to onshore personal financial assets (excluding life insurance and pension) and offshore

SOURCE: McKinsey Global Wealth Pools 2016 update

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# Western European private banks profit from a favorable environment while preparing for the next gusts of change

***Editorial remark:*** *The survey insights presented in the chapter hereafter are based on data for 2015 and were conducted before the UK EU referendum decision. Therefore, the report does not seek to assess the implications of a UK exit from the EU on the UK or European market. This will require a separate study.*

### A pattern of favorable AuM growth for core HNWI and UHNWI is extended

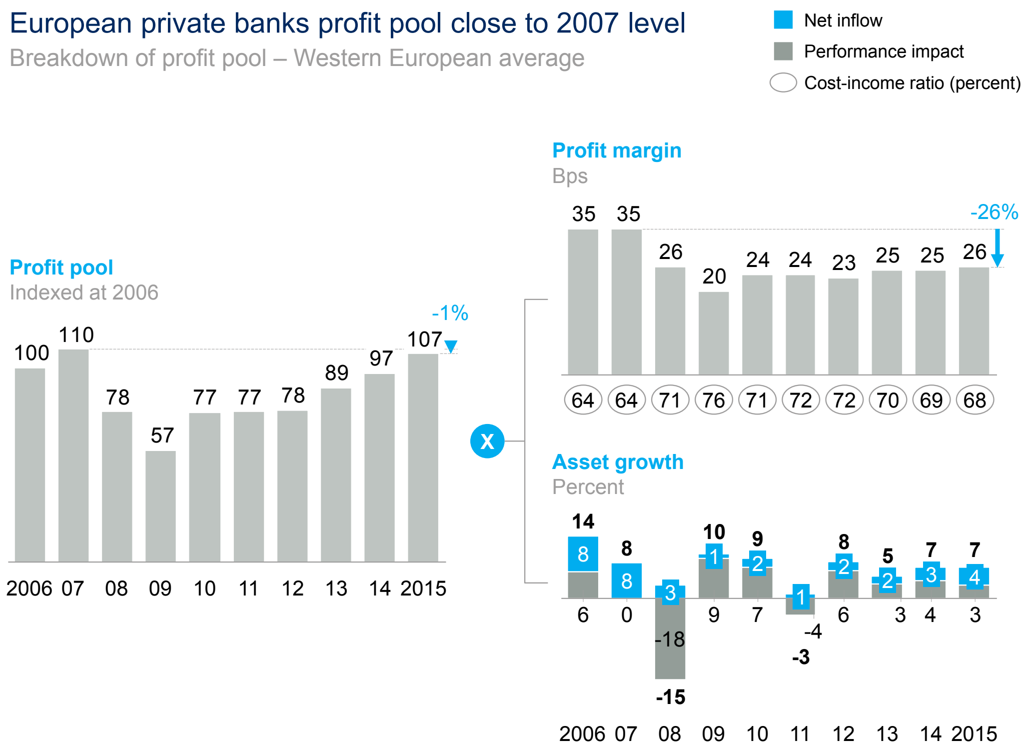
Western European private banking AuM grew by 7 percent in 2015, driven by a 3 percent increase in performance (interest, foreign exchange, and capital market gains) and 4 percent net inflows – the latter reaching its highest level in the last ten years. The impact of strong capital market performance was limited by the conservative allocation of client portfolios; specifically, the high share of cash and equivalents (31 percent of portfolios, slightly higher than in 2010) and equity allocations remain well below historical levels (29 percent, compared to 34 percent in 2005/06).

The rate of net inflows exceeded both Western Europe's 2015 GDP growth of 2 percent and also its HNW wealth creation rate of 4 percent; this indicates a continued concentration of economic wealth in the upper bands, segments in which private banking plays a more significant role.

Inflows differed strongly by business model, however, as onshore players enjoyed more than double the net inflows of offshore. Offshore models faced increasing pressure, generating net inflows of just two percent. Typically, small onshore players such as independent boutiques and foreign entities profited from a generally favorable investment environment and generated net inflows averaging 5 percent. Universal private banks, the largest players in most continental European markets, attracted inflows at the 4 percent average. Despite this overall positive average, however, roughly one in five private banks lost net assets.

Clients with assets of less than EUR 1 million continue to represent a declining share of the portfolio of private banks. Since 2008, the share in total assets of clients below EUR 1 million dropped from 24 percent in 2008 to 17 percent in 2015. This negative trend was mainly due to the shortage of attractive propositions for lower-wealth offshore clients. The drop in this segment was most severe for pure offshore players (from 21% to 9%) compared to onshore players (from 26% to 20%).

Exhibit 2




SOURCE: McKinsey Private Banking Survey

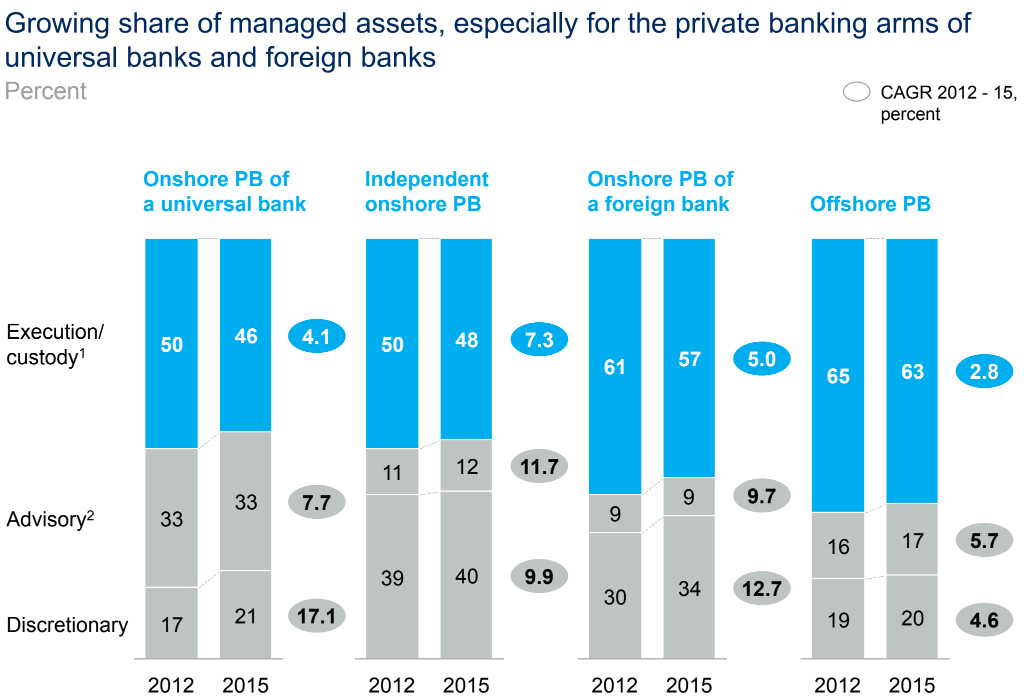
## Expanded share of managed assets in client portfolio due to regulatory forces

Despite the fact that “execution only” remains the predominant service model across all players and that overall shifts tend to occur incrementally, the trend of increasing asset shares in discretionary mandates continued, growing from 22 percent in 2012 to an aggregate 25 percent share in 2015. Anticipation of new regulations has spurred players to re-segment their product offerings accordingly. When differentiating by business model, the shifts into discretionary models in the industry from 2012 to 2015 become more obvious: While onshore boutiques increased their already large share from 39 to 40 percent, the discretionary share within primarily offshore players gained 1 percentage point (p.p.) from 19 to 20 percent. The most significant uptake since 2012 was observed at universal onshore banks (up 4 points, to 21 percent) and foreign players (up 4 points, to 34 percent).

In line with the trend of increased discretionary allocations, the proportion of AuM held in funds increased from 26 percent in 2012 to 29 percent in 2015. This includes balanced or multi-strategy funds, some of which can be considered discretionary-like products.

Despite intensified efforts to promote fee-based advisory mandates, the total share increased by only 1 p.p. in this area from 17% to 18%. On average, the penetration of advisory mandates is highest among lower-HNWI clients (EUR 1 to 2.5 million of wealth) at around 20 percent and lowest for mass-affluent (EUR <0.5 million) at approximately 15 percent; many private banks have initiated efforts to migrate clients in this latter group to more cost-effective solutions. The most predominant pick-up in fee-based advisory mandates compared to 2014 was observed for UHNWI (EUR >30 million), growing by 3 p.p. to almost 20 percent.

Exhibit 3




1 Including deposits
2 Assets which are not discretionary but for which the client pays a recurrent management or advisory fee, transactions occurring with prior reference to the client

SOURCE: McKinsey Private Banking Survey

## Recurring fees compensate for decreasing interest margin, stabilizing overall revenue margin

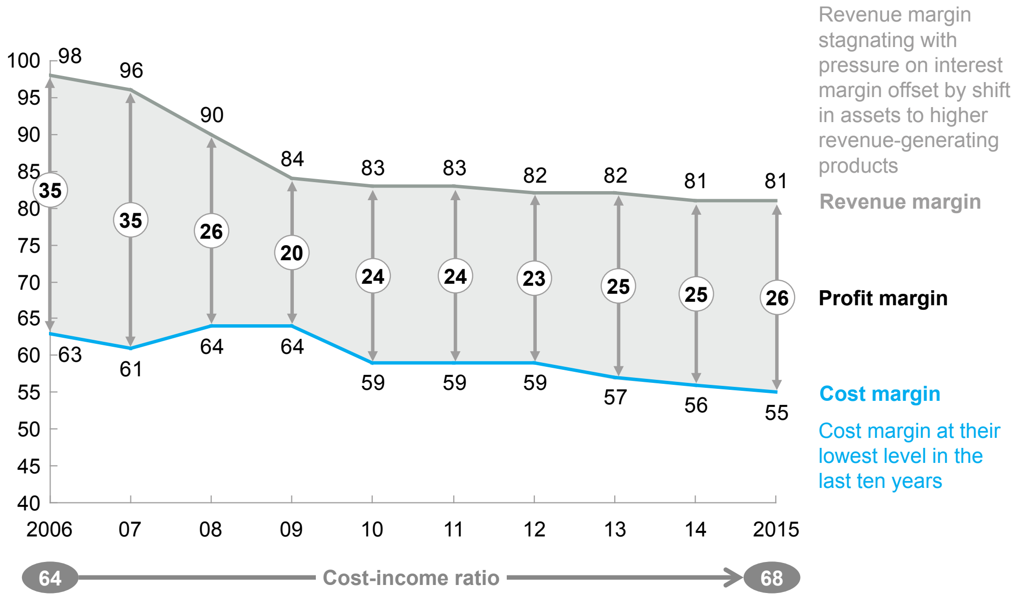
The industry's revenue margin held steady from 2014 at 81 bps, but remains on an overall downward trend in the longer term. A significant decrease in interest rate margin (down 9 bps to 33 bps compared to 2014) and a nominal decline in inducement fees were offset by increases in recurring fees. With MiFID II taking effect in 2018, however, inducements – which still represent 13% of revenues today – will decline.

Over the long term, we see on- and offshore margins converging. In 2015, offshore revenue margins declined slightly (from 87 to 86 bps) but remain 9 bps higher than the margins generated by pure onshore players.

Exhibit 4

Slightly rising profit margin driven by continuous cost margin decrease over last four years

Margins – Western European average, bps




SOURCE: McKinsey Private Banking Survey

## Economies of scale enable slight improvements in cost margins – for now

Cost margins decreased by 1 bp to reach 55 bps in 2015 – the lowest level in the last 10 years – driven by the scale effects of increased assets. This is consistent with the long-term trend in which revenue margin productivity measured as AuM per RM has improved from EUR 154 million in 2010 to EUR 195 million in 2015, reducing the sales and marketing cost margin from 27 bps in 2010 to 23 bps in 2015. Operational cost margins have been stable since 2010 at 6 bps for investment and 26 bps for IT and overhead.

The relevance of scale in private banking is illustrated by a comparison of the cost margin across business models: private banking aims of universal banks – with a larger average AuM base of EUR 41 billion per booking center and broader operational backbones – operate at a cost margin of 39 bps, while independent boutiques with average booking center sizes of EUR 10 billion operate at 53 bps. Interestingly, mid-size and large booking centers (EUR >10 billion) have decreased their cost margin since 2007 by 6 to 7 bps to an average of 42 bps, while the average cost margin for booking centers smaller than EUR 10 billion has increased by 3 to 8 bps, reaching cost margin levels of up to 82 bps.

While cost margins steadily decreased from 59 bps in 2010 to 55 bps in 2015, the absolute private banking cost pool grew by 20 percentage points over this time. Despite the industry's ongoing cost reduction efforts, only 20 percent of private banks managed to reduce their absolute cost base – and half of those banks also shrank in AuM. Roughly half of private banks managed to grow their asset base faster than their cost base, generating cost margin improvements. The remaining 30 percent of private banks grew, but with negative cost margin implications.

In recent years, regulatory requirements have been a significant driver of the overall cost base and in particular of IT and overhead costs. In 2015, the absolute pool for IT and overhead costs increased by 5 percent. More than two-thirds of this increase is explained by change-the-bank costs, while only about one-third of the cost increase stems from running regulatory staff or IT maintenance.

### Total private banking profits are at highest since 2007, profiting from growth of the asset pool

Despite the manifold challenges, private banks managed to increase industry profitability margins by 1 bps in 2015 to 26 bps. Since the financial crisis, absolute private bank profit pools have experienced a strong rebound, with a particularly strong year in 2015 nearly returning the pool to pre-crisis levels.

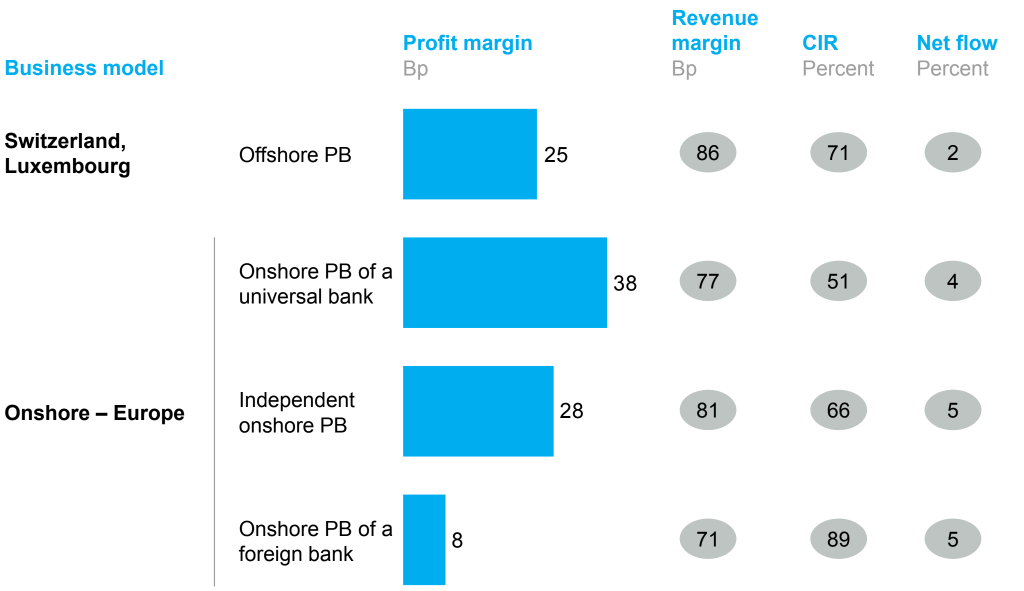
Profit margin, like cost margin, correlates strongly with private bank size. Accordingly, onshore universal banks show a profit margin of 38 bps (12 bps above the industry average), enabled by a low cost margin of 39 bps (CIR of 51 percent). The scale-driven universal onshore model contrasts with the low profitability of 8 bps for typically small-scale foreign banks.

Private banks with top-quartile profit margins combined a series of characteristics to outflank their industry peers: (1) Attracting net inflows that were 2 p.p. higher, (2) Creating economic flexibility by reducing absolute costs while at the same time increasing revenue margin, and (3) generating a significantly higher share of assets in discretionary or advisory mandates.

Exhibit 5

Foreign players with strong net inflows in 2015 but profit margin still under pressure

2015




SOURCE: McKinsey Private Banking Survey

## Excursus – Global industry comparison

In 2015, private banking asset growth in Western European outperformed that of its peers in North America and Asia. The higher private banking asset growth in Western Europe was primarily driven by the positive capital market performance. Net of performance, however, Asia continues to outpace developed geographies.

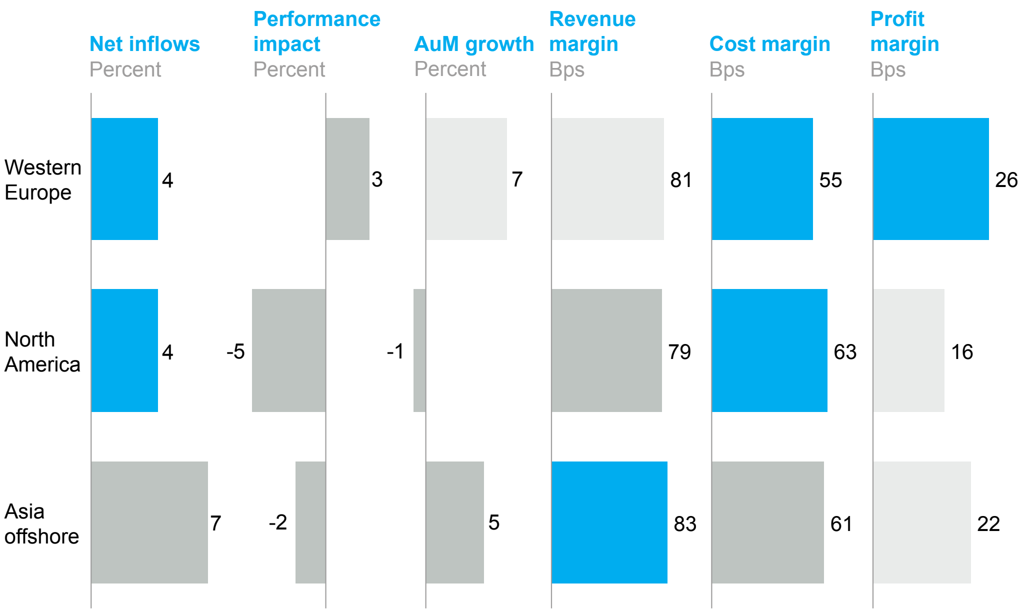
As in 2014, Western European private banks also showed more attractive profitability, which is primarily due to European private banks' cost advantages over North America and Asia.

Despite regional differences, our survey reveals two global trends: first of all, profit margin in all three geographies stabilized or improved compared to the year before. Secondly, there is also a trend towards increasing managed assets across all of the three regions.

Exhibit 6

### Western Europe with a continuously attractive profit margin, but Asia offshore with overall still higher net inflows

2015




SOURCE: McKinsey Private Banking Survey

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# Ascending against strong headwinds

As covered in previous reports, we believe that long-term market forces such as the self-segmentation of clients, digitization of service delivery as well as continuously tightening regulation will continue to shape the future strategic priorities of private banking executives.

Due to increasing transparency on fees and charges, and a greater ability to compare services across providers, private banking clients have begun to demand a stronger alignment of interests between client and bank. Accordingly, clients are starting to self-segment for both service models (e.g., UHNW clients who want execution-only accounts) and product choices, requesting standardized solutions (e.g., ETF trackers) as well as tailored products. The increasing reach of digital propositions from FinTech disruptors as well as banking and non-banking incumbents (e.g., retailers, telecom) has altered client expectations for banking interactions. Anytime/anywhere access through digital or remote channels, including outside of office hours, is no longer seen as an unreasonable request.

Therefore, we expect digital service functionality to quickly become market standard in an integrated private banking offering. Today, 40 percent of basic client interactions (e.g., portfolio checks, payments and trades) are already routed through digital channels and private banks expect about 20 percent of more sophisticated interactions (e.g., advisory, credit) to move into digital channels over the next two years. Accordingly, private banks are planning significant step-ups in their digital capabilities, both to automate end-to-end core processes (i.e., onboarding) and to improve the overall investment experience. Among digital investments, robo-advisory models have created great excitement, although to date the stand-alone models have met limited success in attracting net new inflows. The robo-advisors of incumbent players – which are often a combination of robo- and remote-advisory offerings – have fared better. On the one hand, incumbents pursued massive shifts of existing client segments into new service models; on the other hand, this experience implies that clients who are new to robo-advisory appreciate bank backing for their investments.

MiFID II implementation will bring significant changes to the industry's operating model. A new service model with changes to client advisory and product platforms will be required, while at the same time regulatory changes will impose significant burdens on internal structures and/or heightened IT/Ops capabilities. MiFID II also has implications for the revenue model, through enhanced fee transparency and/or the ban of fees that cannot be compensated. At the same time, private banks face increasing "run-the-bank" costs. Some banks have started to anticipate the likely impact of MiFID II by refining their value proposition and business model, investing in digital capabilities and fundamentally transforming client interactions in their frontline.

### Excursus – Status of digital in private banking

To accelerate a sustainable digital transformation but avoid the development of disjointed digital functionality, it is essential for private banks to clearly articulate a digital strategy. McKinsey & Company conducted a survey of 18 Western European private banks (14 units of universal banks and four independent banks) to assess their digital capabilities and priorities through 2017. This survey provides a much-needed overview of the landscape.

These survey results clearly show that digital has arrived in private banking. However, the digital activities of the majority of banks have so far been focused on daily banking self-service offerings, e.g., online transactions, reporting and the provision of product information. Capabilities in deeper private banking functionality, such as advisory, portfolio management, or news and information, remain low. In addition, there is currently no consistent customer experience across channels, with tablet and mobile functionality exhibiting only a fraction of these capabilities (mainly basic transactions).

Future improvements will be focused on key processes, with the most significant step-ups centered on three core private banking areas: (1) digital and paperless onboarding of clients to the maximum extent possible (from less than 10 percent of banks today to approx. 45 percent by 2017); (2) online or mobile interactions with client advisors (from 0% to approx. 40 percent by 2017); and (3) analytically supported investment advisory (from less than 10 percent to approx. 50 percent by 2017). These focal points are aligned with clients' interests, which are clustered around information transparency and easy and secure interactions.

In terms of functionality, the relationship management workplace currently has the highest digital capabilities of all interfaces. The top quartile players excel in functionalities related to advisor productivity, such as lead generation using analytically supported client lead generation; client interaction recommendations, such as the active CRM tool that includes the activity planner for relationship management; and workplace integration, that is, the combination of most of the functionalities in one interface. These capabilities are expected to improve significantly across all relationship management advisory cockpit functionalities by 2017.

Generally, universal banks have a higher degree of sophistication in mobile and tablet capabilities than independent banks. Independent banks envisage improvements, but while they are targeting a user experience on a par with universal banks, they expect that the functionalities they offer will be less sophisticated than their universal counterparts. By 2017, the channel offering is expected to converge more fully and the tablet/mobile setting will be the standard for online interaction going forward.

Overall, the industry has diverse starting positions in terms of digital capabilities. The most significant gaps between the average and top-quartile players were observed in data-related capabilities, the availability of talent, and the banks' capability in the agile development of new solutions.

In combination, external market forces are likely to drive more change for traditional private banking models in the coming three to five years than in the last decade. To address resulting challenges and to successfully navigate the emerging future private banking environment, banking executives must consider four central, strategic imperatives:

**Sharpen the value proposition and adapt the offering –** In many cases for the first time, clients will understand the total cost of their wealth management service by getting full transparency on both production and distribution fee. In such an environment, clients will increasingly self-segment toward better and/or cheaper solutions. In response, private banks will need to enhance both the real and perceived value of their services, by determining and emphasizing the investment types for which they can add the most value, and by doubling down on the distinctiveness of their related non-investment services (e.g., financial planning, risk management). For instance, some private banks may opt for simplicity, offering a restricted passive investment portfolio with remote client interaction only.

**Decide on a segment-specific digital or multi-channel experience –** Depending on their advisory needs, channel preferences and willingness to pay, clients will self-segment for all or parts of their wealth relationships to either multi-channel, remote, or robo-advisory models. As these three offerings evolve, the differences will become blurred such that traditional advisory models will include options for remote client counsel and an increasing number of players will offer robo-advisory as a service. Although digital attackers have yet to gain significant share, they are establishing new price points and are pushing incumbents to innovate on channels, products, and pricing. In doing so, incumbents must redesign their operating model, clarifying client ownership across channels and redesigning their front-office setup accordingly. The requirements for both systems and more agile organizations to deliver these are becoming increasingly clear.

**Radically adapt the operating model and cost base –** Regulatory, client, and macro-economic pressures will continue to create economic stress and require private banks to radically rethink their operating models and to more radically drive cost reduction. Booking centers with less than EUR 10 billion will face particular struggles and be pushed toward consolidation. Therefore, private banks must simplify processes, reduce the degree of customization by geography or segment (including the potential exit of some segments), and limit the number of services and products. Further, both front and back-office efficiency must continue to improve, through either centralization or outsourcing of labor-intensive activities offering limited differentiation. In particular, mid-size or smaller private banks should explore opportunities to join local industry utilities for mid- and back-office work. To further increase efficiency, private banks should explore the end-to-end automation of core processes, e.g., digital onboarding.

**Build and enable new private banking talent –** The scale of the ongoing change to the private banker role remains underestimated. The proliferation of multi-channel servicing is a meaningful shift from the traditional private banker-centric model and will require adjustments to day-to-day activities: first, the seamless use of multiple communication channels, secondly, the relative shift in importance from investment advisory to wealth planning and, lastly, the increasing need for differentiation through client experience. Similarly, bank IT and Operations talent must break with previously siloed IT work to apply agile and flexible techniques spanning

IT and business functions as well as the frontline. To build and cultivate this new type of talent, banks might consider piloting a “new private bank” model in a ring-fenced environment before deploying it in the rest of the bank.

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Navigating the extremely fast-changing environment will require private banks to make clear choices on what type of private bank they want to be. These choices will give guidance on how private banks want to differentiate themselves in building multi-channel experiences or on how to push the traditional boundaries around the operating model. Therefore, helping private banking executives to make these directional choices in an environment of uncertainty will be one of the most critical success factors for one of the transitions indicated above.

# Methodology

McKinsey's annual Private Banking Survey, launched in 2002, provides comprehensive information on the private banking industry. The survey comprises all relevant markets: Western Europe, Central and Eastern Europe, the Middle East, Asia, India, Latin America, and North America. A total of 194 banks participated globally this year, in line with recent cycles. This document provides an overview of the latest survey's key findings for the Western European market. The issues raised are discussed in more detail in other McKinsey publications (*see below).

Participating banks cover a range of sizes and business models. Approximately half are the private banking units of universal banks, a quarter are the private banking units of foreign players, and the remaining quarter are independent players. Approximately 70 percent operate onshore, while the other 30 percent are based in offshore centers. The banks provided detailed economic data based on their 2015 financial results.

Players allocate revenues and costs within their private banking operations and between their private banking activities and parent companies in different ways. Although these differences have been clarified as much as possible through interviews with the participants, some variations may nevertheless remain and may distort the final results. To account for any changes in the sample across years (i.e., total number of participants, bank profiles), dedicated sample comparisons have been made where appropriate.

Survey participants receive customized benchmarking and feedback sessions and have access to more detailed information than that presented here, but within the bounds of confidentiality governing the data supplied by individual participants. McKinsey would like to thank everyone who participated in the 2016 survey for their valuable contributions, which will help us all gain a better understanding of the economics surrounding the private banking industry. The survey will be conducted again in early 2017.

**Some of these insights relate to our publication "Digital Wealth Survey 2015". McKinsey's Digital Wealth Survey was conducted in Q2 and Q3 of 2015 with 18 Western European wealth managers to assess both current digital capabilities as well as priorities through 2017. More detail on this survey can be found in the sidebar on page 15.*

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