

# European Private Banking Survey 2015 – Fundamental changes behind the scenes

McKinsey Banking Practice



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# Introduction

In 2014, for the fifth consecutive year, the private banking sector in Western Europe reported a growth in absolute profits. This growth was driven both by capital market performance and a rise in net new money. However, the growth in absolute profits should not mask the fact that the industry's profit margin has stayed roughly flat over the past 5 years as revenue margins have remained under continuous pressure and cost reduction efforts have failed to make meaningful inroads.

Despite this general stability, the industry is facing evolving client expectations, the rise of technology, and stricter consumer protection regulations. These changes will significantly affect the market and the competitive environment, both in the short and medium term, and we believe that private banks will need to act decisively on three key priorities:

- **Evolve the value proposition and pricing models** in light of the greater transparency on “total cost of ownership” for the client, as upcoming regulation will likely require full visibility on fee and charges paid to the financial intermediary and within financial instruments.
- **Industrialize the offering and servicing model** in order to improve the consistency and control of client processes, as well as to ensure segmented client coverage in line with client needs and better risk management for the institution.
- **Leverage digital as a key enabler in the transformation of private banks** to address front-office interactions in line with the new generation of customer expectations and behaviors (including remote servicing), as well as mid- and back-office operations, through better automation.

To make these changes take effect, private banks will also have to make significant changes, amongst other elements, to the role of relationship managers, who must bring the best of the whole bank to clients going beyond pure investment.



# Economic stability for European private banking

## AuM growth driven by capital market performance as net inflows remain below precrisis levels

In 2014, AuM grew by 7 percent, driven by a 4 percent performance effect (interest, foreign exchange, and capital market gains) and close to 3 percent net inflows, the highest level in the last five years, but still only half of the historical levels (Exhibit 1). The performance impact on private banking portfolios reflected the upswing in capital markets, but was limited because of the conservative allocation of client portfolios; specifically, the high share of cash and equivalent (around 30 percent of portfolios, stable since 2010) and a share of equities still far below historical levels (27 percent vs. 34 percent in 2005/06).

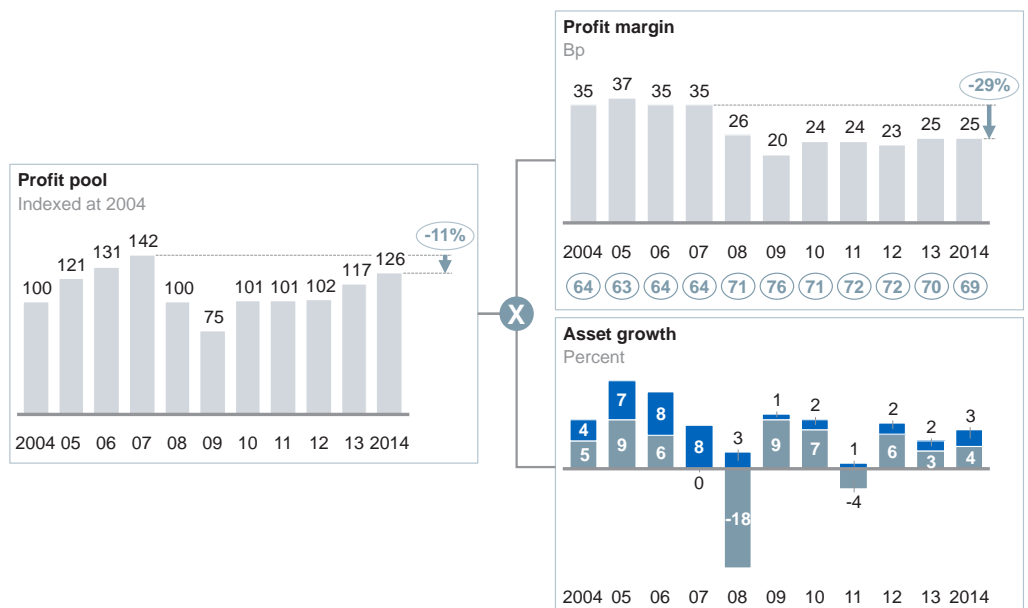
Although overall AuM growth is only moderate, the private banking industry in Western Europe has continued to gain market share over the last five years. Private banking AuM has grown at an average annual rate of 4.3 percent, while HNW wealth grew at 3.2 percent. Western Europe remains the second-largest region in terms of HNW personal financial assets, with EUR 9.2 trillion, behind North America with EUR 15.1 trillion. Even if emerging markets grow faster than mature markets in the coming years, the growth forecasts for HNW personal financial assets in Western Europe are still attractive, with an expected average annual growth rate of 3.9 percent till 2020.

Exhibit 1

## Increase in private banking AuM by 7% and profit margin stable at 25 bp in 2014

Breakdown of profit pool – Western European average

■ Net inflow  
■ Performance impact  
○ Cost-income ratio (percent)



SOURCE: McKinsey Private Banking Survey 2015

### Drop in revenue margin and limited changes in asset and mandate mix

The industry's revenue margin declined slightly by 1 bp in 2014 to 81 bp, continuing its slow downward trend from 83 bp in 2010 that was still preceded by a stronger hit during financial crisis. The recent decrease has been driven by lower trading activity, which accounted for 18 percent of revenue base in 2014 vs. 22 percent in 2010, and a slight drop in revenues from inducements (13 percent of revenue base in 2014 vs. 14 percent in 2010), combined with the low interest rate environment that has kept deposit margins low. Together, these effects have offset changes in the asset mix: in the last five years, the share of discretionary mandates increased by 2 percentage points to 24 percent in 2014, in line with the share of funds (28 percent of total AuM in 2014), while lending penetration rose 1 percentage point to 11 percent.

### Continuous improvement in cost margin, mostly driven by AuM growth

Absolute costs grew by 4 percent in 2014, well below AuM growth of 7 percent, continuing the trend of the past five years (3.5 percent average annual growth for costs vs. 4.4 percent for AuM). The cost margin has therefore been steadily dropping as players have been able to attract flows and increase efficiency despite the higher regulatory cost of doing business. Indeed, it has fallen from 59 bp in 2010 to 56 bp in 2014. The reduction has come predominantly from sales and marketing costs, which have fallen from 27 bp in 2010 to 23 bp in 2014. Private banks have also been able to increase the average amount of assets per relationship manager to EUR 191 million AuM per RM in 2014, up from EUR 154 million in 2010. This has come mostly from AuM growth, while the number of front-line staff has dropped by 3 percent in the last five years. Back office, IT, overhead, and investment management cost margins have been stable in the last five years.

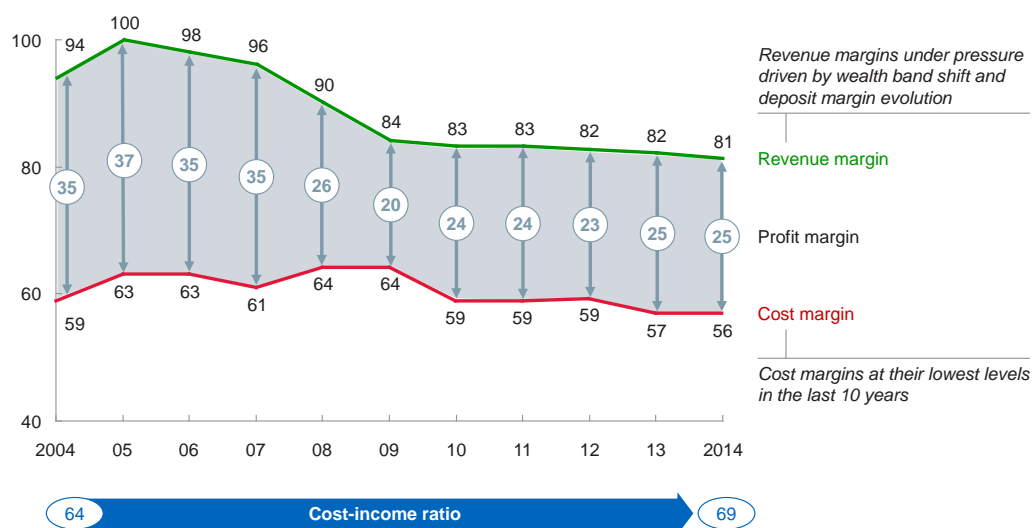
As a consequence of the drop in revenue margin combined with the improved cost margin, the industry's profit margin has remained stable at 25 bp, with an average cost-income ratio of 69 percent (Exhibit 2).



## Exhibit 2

### Fall in revenue and cost margin by 1 bp leading to flat profit margin

Margins – Western European average, bp



SOURCE: McKinsey Private Banking Survey 2015

### Offshore faces significant pressure on new flows and profits

Private banks operating from major European offshore centers (e.g., Switzerland, Luxembourg, Channel Islands, Monaco) reported a positive net inflow of 1 percent slightly higher than 2013, while their onshore competitors delivered 4 percent. In both Switzerland and Luxembourg, the share of clients with more than EUR 10 million with the bank has risen from 50 percent in 2010 to 52 percent in 2014, but the share of affluent clients (below EUR 1 million) dropped significantly from 16 percent in 2010 to 12 percent in 2014 as smaller client portfolios moved onshore due to increased regulatory pressure.

The profit margin of offshore private banks, historically higher than onshore players, has fallen by 2 bp over the past five years to 25 bp in 2014, and is now at the same level as that of onshore players. This has been driven mainly by an increase of the cost margin of 3 bp since 2010 to 62 bp, while revenue margins have remained almost flat. As discussed above, onshore players, by contrast, have managed to keep profit margins flat thanks to improving cost margins even as revenue margins have declined. Revenue margins currently enjoyed by

offshore private banks (87 bp in 2014, 10 bp above onshore players) are, however, expected to decrease in the medium term, as competitive dynamics would level the playing field, especially considering the persisting low interest rate and the pressure on fees.

#### **Significant differences by business model emerging amongst onshore players**

The private banking divisions of universal banks with a retail arm have been the most successful model over the last five years. Profit margins rose by 4 bp, reaching 36 bp in 2014, driven by continuous client referrals from retail networks, cost reduction efforts, economy of scale through the sharing of platforms with the rest of the group, and flat revenue margins.

The picture for independent onshore players is less rosy, with the profit margin falling from 32 bp in 2010 to 27 bp in 2014, mostly driven by a 6 bp drop in the revenue margin to 80 bp in 2014, while the cost margin remains stable. Independent boutiques also saw net inflows that were just half of those of the private banking divisions of universal banks.

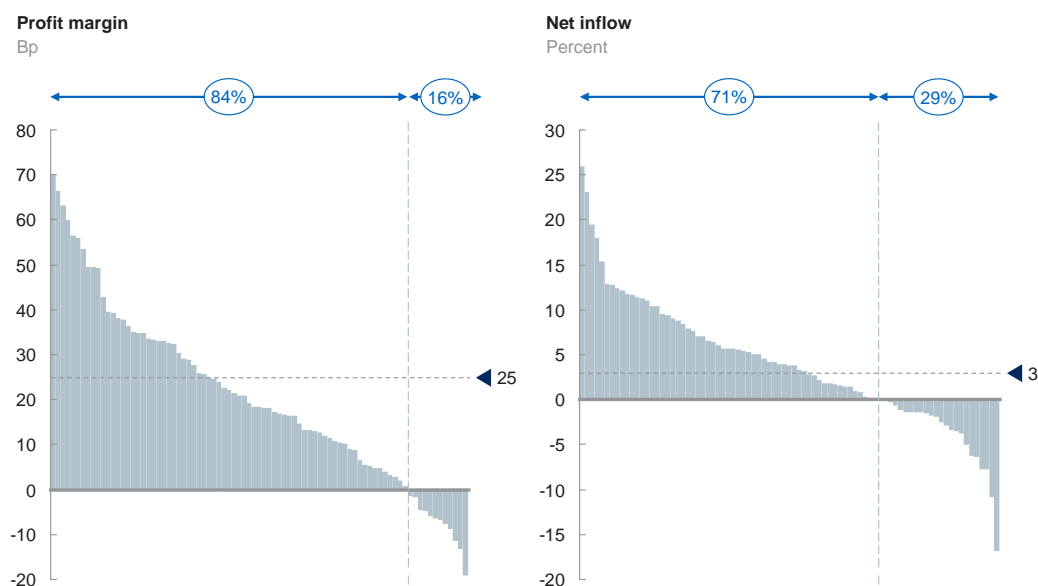
Foreign onshore players (stand-alone private banks that are part of international groups) are still facing challenges. Their profit margin was just 9 bp in 2014, mostly because of their higher cost base (64 bp), even though that has fallen by 4 bp compared to five years ago. They have also historically struggled to attract net inflows, averaging just 1.1 percent in the last five years.

#### **Further consolidation is inevitable**

Pressure from clients and regulation is increasing the cost-to-serve, and a number of banks are unable to maintain profitability. The minimum scale for profitability is approaching EUR 10 billion per booking location. Under such pressure, one out of six players actually made a loss in 2014 – in line with previous years – while a third reported negative flows (Exhibit 3).

## Exhibit 3

### Pressure on margins and growth expected to lead to further consolidation 2014



SOURCE: McKinsey Private Banking Survey 2015

Therefore, we expect a further wave of cost reductions, which will have to go beyond lean processes or near-/offshoring and encompass further optimization of international footprint for banks operating across various geographies. As observed in the last few months, this could include reviewing the number of booking centers, the number of domiciles served, and the legal setup of their local entities. We also expect consolidation to continue as already observed in a number of Western European countries.





# Three priorities for banks as they adapt to fundamental industry shifts

Despite the industry's overall economics remaining stable, there are a number of fundamental changes that will increasingly transform the relationship between clients and their private bank: client behavior, technology, and regulation.

Clients are looking for greater convenience, which means more choice in how and when they interact with their bank. Banks may also find that when clients are confronted with the real total cost of ownership, some will no longer be willing to pay and instead opt for different advice models or shift towards more self-directed models, which will require banks to rethink their value proposition and pricing models.

The raft of regulations related to consumer protection (e.g., MiFID2/MiFIR, FIDLEG, RDR, PRIIP), will result in stricter discipline on advisory practices. Most players have focused so far on technical and compliance requirements (e.g., suitability, appropriateness) and have invested significant resources to manage immediate imperatives.

Technology will represent a fundamental enabler of this process, supporting more frequent interactions between clients and private banks while boosting efficiency in several standard processes.

No one has a detailed view of how exactly all these trends will play out (e.g., how clients will react to increased fee transparency), however, we believe that private banks will certainly need to act decisively, in particular, on three key priorities.

## **Evolve the value proposition and pricing models**

At the time of publishing, the final recommendation of the European Commission on MiFID2, as well as its national transpositions (planned for 2016), are not fully known. These regulations, combined with the banks' increased drive to ensure fair and transparent business, will likely result in a clearer disclosure of their annual total cost of ownership to clients. Indeed, all fees and charges paid both directly (e.g., to the advisor) and indirectly (e.g., within financial instruments) will be completely visible for clients.

Even if clients have not reacted particularly strongly in the past to increased transparency, the magnitude of costs involved now is likely to trigger more reaction. For example, a 1 to 1.5 percent charge for a client with EUR 3 million represents a cost of EUR 30,000 to 45,000.

Some markets, particularly the Netherlands and the UK, and some individual banks have pre-empted some of these changes. It is instructive to see what lessons others can learn from them:

- Align prices with value to clients (e.g., why is an advisory proposition generally cheaper than a discretionary proposition?).
- Eliminate or adjust pricing of the remaining highly layered fee structures that add limited value for clients.
- Set a new pricing model in light of the retrocession ban (retrocessions accounted for 13 percent of the industry's average revenue in 2014) by introducing all-in-fees or new fees (e.g., platform fees) and a new price for advice, as well as ensuring thorough leakage reduction.
- Minimize the costs of underlying investment products, e.g., by including more passive products in subasset classes where benefits from active management are limited or by developing "clean"/"super-clean" share classes.
- Extend offering with more modular advice models (e.g., offering self-direct clients opportunity for one-off advice), and develop cost-effective step-up options from basic self-direct offering.

Required changes to value proposition and pricing scheme will differ from one market to another and amongst players. However, all private banks will have to further sharpen their competitive positioning and be clear on the source of added value to their customers.

### **Industrialize the offering and servicing model**

Private banks need to further industrialize both the offering and its delivery for three reasons.

First, pricing transparency will inevitably lead to margin pressure and require banks to develop more cost-effective advisory and self-direct solutions. This will require a better alignment of the service model to the real potential of clients, and reduce the over-servicing of some clients – especially the smaller HNW clients.

Second, banks (encouraged by regulators) are striving for more consistency and predictability in order to minimize risks. Historically, banks did not always have strict-enough standards and, accordingly, clear traceability, leaving them with selected risks of mis-selling.

Third, clients expect a certain service standard, which is impossible to deliver if each relationship manager has his or her own way of providing advice. Clients rightfully expect access to the bank's full institutional capabilities and not just to one relationship manager.



Standardizing a number of key practices and processes across teams, booking centers and operational platforms will help banks improve the consistency and control of the service clients receive. This would include the definition of standards for client on-boarding/Know Your Client (e.g., anti-money laundering and tax clearance), the investment approach (e.g., thematic investment ideas, core vs. satellite), and risk management (e.g., types of conditions for credit).

Such a transformation does not imply the end of customization of products and services that the majority of HNW clients still want, but rather a more professional and disciplined way to manage an increasing number of client touch points across channels with common taxonomy, compliance, and risk culture across teams and countries.

### **Leverage digital as a key enabler in the transformation of private banks**

Like other banking segments, digital technologies have and will continue to have a profound impact on private banks. They will represent a key enabler in their transformation process.

Digital is rapidly becoming a prerequisite for banks to enable some of the changes above and to continue serving wealthy clients. Private banks must therefore invest in seamless multichannel access as well as the end-to-end digitization of their business processing. Process digitization can dramatically help to bring down the cost-to-serve for select segments (and thus help mitigate the pressure on prices). Digital also helps to standardize delivery and ensure predictable and traceable quality through automated processes.

Preliminary results from the McKinsey Digital Wealth Survey confirm that European private banks are expected to invest significantly over the next three years in digitization, with the biggest efforts concentrated in three areas: (i) digitizing key end-to-end processes (e.g., client on-boarding or mortgages), (ii) building online advice capabilities (e.g., portfolio health checks with recommended actions or simulation tools), and (iii) improving capabilities, especially in front-office interaction (e.g., remote advice, co-browsing).



Addressing these three fundamental changes will not only require a thorough definition of the target end state, based on the existing franchise, value proposition, and brand equity, but also a sound transformation of front-, middle- and back-office practices. The role of relationship managers will need to evolve in light of the client, digital, and regulatory changes discussed. The relationship manager of tomorrow will act more as an integrator, bringing the advisory capabilities of the bank to clients, beyond the pure investment angle, across various physical and remote channels, managing a higher number of high-value-added touch points, and facing rapidly evolving client needs.

# Methodology

McKinsey's annual Private Banking Survey, first 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. The total number of banks participating increased to more than 170 this year.

This document gives an overview of the latest survey's key findings for the Western European<sup>1</sup> market. The issues it raises are discussed in more detail in other McKinsey publications and at regular events held by McKinsey's Private Banking practice.

The participating banks cover a range of sizes and business models. 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, the other 30 percent are based in offshore centers. The banks provided detailed economic data based on their 2014 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. The increased number of participants this year may induce a slight sample bias on occasion, affecting the comparability of this year's results to those of previous years. Sample comparisons have been made where appropriate.

Survey participants are entitled to customized benchmarking and feedback sessions and have access to more detailed information than that presented here, but within the bounds of confidentiality governing the data supplied by individual participants. McKinsey would like to thank everyone who participated in the 2015 survey for their valuable contributions, which will help us gain a better understanding of the economics surrounding the private banking industry. The survey will be conducted again in 2016.

<sup>1</sup> The Western European sample includes players from the following countries: Austria, Belgium, Denmark, Finland, France, Germany, Italy, Luxembourg, Monaco, Netherlands, Norway, Spain, Switzerland, Sweden, and the UK.

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