McKinsey&Company

European Banking Practice

European Private Banking Survey 2009

Unprecedented change in wealth management ahead

Foreword

McKinsey & Company's Private Banking Survey, launched in 2002, aims at providing comprehensive information on the industry, both qualitative and quantitative. Having started as a pan-European effort, the survey now includes all relevant markets, including those in Central and Eastern Europe, the Middle East, Asia, and Latin and North America. The number of banks participating in the survey increased from 140 in 2008 to more than 150 this year.

This document gives an overview of the latest survey's main findings for Western Europe. The issues raised here are discussed more thoroughly in other publications and at other events held by McKinsey's European Banking Practice.

The participating banks span all different business models and sizes, and the geographical spread is relatively even. 68% are private banking units of universal banks, whereas 32% are specialist players. Banks were asked to provide detailed economic data based on their 2008 results and a wide range of qualitative data around, for example, their organization, product and service offering, delivery model, risk management procedures, and cost management efforts.

Some differences exist in the way players allocate revenues and costs both within their private banking operations and between their private banking activities and parent companies. These differences have been established and clarified as much as possible through interviews with the participants, but variations may remain and may slightly affect the final results. The increase in the number of participants this year may at times induce a slight sample bias, affecting the comparability of the results with those of previous years. Where appropriate, same sample comparisons have been made.

Survey participants are entitled to customized benchmarking and feedback sessions and have access to more detailed information than what is presented here, within the bounds of confidentiality governing the data supplied by individual participants. McKinsey would like to thank all the participants in the 2009 edition for their valuable contributions to the better understanding of the economics of private banking. The survey will be repeated in 2010.

Executive Summary

Private banking has a long-standing reputation as one of the most attractive segments in the financial services sector, historically with very healthy 35% pretax profit margins, attractive growth rates (10% average annual asset growth for the period 2003 to 2007), limited capital requirements, and significant excess liquidity.

Over the last decade, the economic equation has not changed dramatically. Changes to the business model have been very limited, and although differences existed between individual players, few business models really dominated others. A typical private banking client also did not experience drastic change, having the choice between discretionary, advisory, and execution mandates, with most portfolios managed actively rather than passively and 50% of mutual funds still sourced in-house. One noticeable change was the proliferation of a number of products and the increasing lack of transparency of some, especially in the “alternatives” product category.

This is set to change for multiple reasons. First, private banking economics have never before been under so much pressure with profits in 2008 declining 42% over 2007. Second, offshore pressure – even if it has not yet materialized in a halt in inflows or even massive outflows – is under unprecedented pressure. Third, client needs and regulatory pressures will require banks to shift their value proposition to deliver more value added and act even more consistently in the interests of clients. And lastly, depending on the speed of economic recovery and the final outcome of the offshore pressures, an acceleration of consolidation – mainly offshore – is expected in the years to come.

Profits down 42% full year and even 70% in Q4 2008. Industry-wide operating profits (before taxes and loan provisions) declined 42% between 2007 and 2008 through a combination of asset decrease and profit margin pressure. Assets under management (AUM) decreased by 15% on average, thus going back to 2005 levels. This was driven by decreasing net inflows (3% compared with 8% in 2007), but more so by plummeting performance (-18% compared with 0% in 2007 and 6% in 2006). Profit margins deteriorated from 35 bp to 26 bp between 2007 and 2008: revenue margins declined, largely driven by a shift to lower-margin products (mainly cash and equivalents) and a flight to execution-only mandates out of higher margin discretionary mandates. Cost margins were on the rise as cost reductions did not compensate for the decline in assets.

Unprecedented pressure on offshore. While we will not join the camp of prophets predicting the death of offshore banking, it is clear that it has come under unprecedented pressure and could suffer significant outflows depending on the vigor of policy makers in the months ahead. 2008 was all in all still a reasonable year for offshore bankers with net inflows of 2%. The future of the offshore business will depend on both the willingness of select political leaders to tighten the grip on offshore centers as well as the economic developments taking place, as negative economic changes will further fuel the need for governments to curb tax avoidance.

Clients and regulators pushing for accelerated shifts in proposition. Clients’ trust in banks and private banks has been severely eroded in 2008. Furthermore, regulators’ trust in banks to do the right thing has also been severely shaken. Increased demand for offering and pricing transparency and better alignment (through the regulators) of the interests of the bank, its relationship managers, and its clients are likely to develop.

Pressure on consolidation on the rise. The industry still is very fragmented. With 11% of the banks losing money in run rate at the end of 2008 and potential prolonged economic pressure and additional regulatory pressure on offshore players, a significant share of subscale players (especially offshore) could be structurally unprofitable and forced to change their business models. In addition, some universal banks might be forced to sell their private banking entities, following the provision of state aid packages and the need for re-capitalization.

This likely pace of change does not alter the positive long-term prospects for the sector as a whole as 1) 40 to 50% of assets of high net worth individuals (HNWI) are still not managed by private banks, 2) the uncertainty and related need for quality advice has never been greater, and 3) the economic wealth of HNWI is still expected to outgrow GDP growth as was the case in the past. Analyst expectations confirm this outlook with an average forward looking P/E of 15 for private banking players, which is significantly higher than for investment banks (12) or retail banks (10).

The implications for private banks are broad – their actions in the coming 24 months will determine how they will come out of the crisis. We see four categories of action:

Protect the P&L. This is about immediate actions with short-term impact regarding sales and pricing as well as cost management. Activities include tuning the front line (e.g., reviewing performance KPIs, restructuring of the frontline organization) and the revision of pricing (e.g., reduction of commercial leakage, re-pricing of lending), but also rebalancing the product and service offering (e.g., outsourcing of complex products, closure of high-risk ones), streamlining middle- and back-office operations, and the adjustment of corporate functions.

Respond to offshore pressure. Banks with a significant offshore presence should aim at playing an active role in the respective countries to respond to challenges to offshore banking, e.g., by maintaining or further strengthening relationships with regulators. Furthermore, they should internally determine the individual strategic stance by offshore country and, for active offshore locations, ensure tightened compliance at the overall, country, and relationship manager levels.

Redefine the value proposition and protect the franchise. Rebuilding the image of the bank and, thus, clients' trust, through a renewed corporate story is important. Furthermore, the advisory approach as well as the product offering should be adapted to the new risk environment and change in client demand. In doing so, great attention should be directed toward improving risk management in order to avoid further surprises. Last but not least, a consistent delivery at the front line, i.e., the client interface, is required.

Selectively seize potential growth opportunities. This includes both optimizing internal growth opportunities (for example, through relationship manager or, even more so, team poaching) and external growth opportunities. Especially well-capitalized players should seize the opportunity and evaluate M&A options.

The document presents the survey's main findings about the private banking industry in 2008 in Western Europe in detail in the two following chapters – first by analyzing in more depth the fundamental challenges the industry is currently experiencing and second by looking deeper into how the players can and should react to weather the current turmoil and be optimally prepared for the upswing.

Fundamental Change Ahead

Although not as severely hit by the crisis as wholesale banking, the current crisis is and will continue to structurally change the private banking space in four areas, pushing private banks to take bolder management decisions than in the past. Specifically, industry profitability has experienced a massive hit, offshoring is under unprecedented pressure, the private banking value proposition is at best under high scrutiny, and the pressure on industry consolidation is rising.

1. Industry profitability deteriorating: assets down 15%, profits down 42%

For the full year of 2008, the industry's operating profit pool was almost 42% below the 2007 level, leaving the industry at absolute profit levels below the year 2003 (Exhibit 1). Profit margins went down from 35 bp to 26 bp of AUM and the cost-income ratio rose from 64% to 71%. The run rate profit in Q4 2008 was down 70% compared with 2007. Thus, the quarterly pretax operating profit of a private bank managing EUR 100 billion in 2007 would have dropped from EUR 90 million in 2007 to below EUR 30 million in Q4 2008.

Steep profit decline driven by negative investment performance and lower revenue margins

Breakdown of profit pool – Western European average

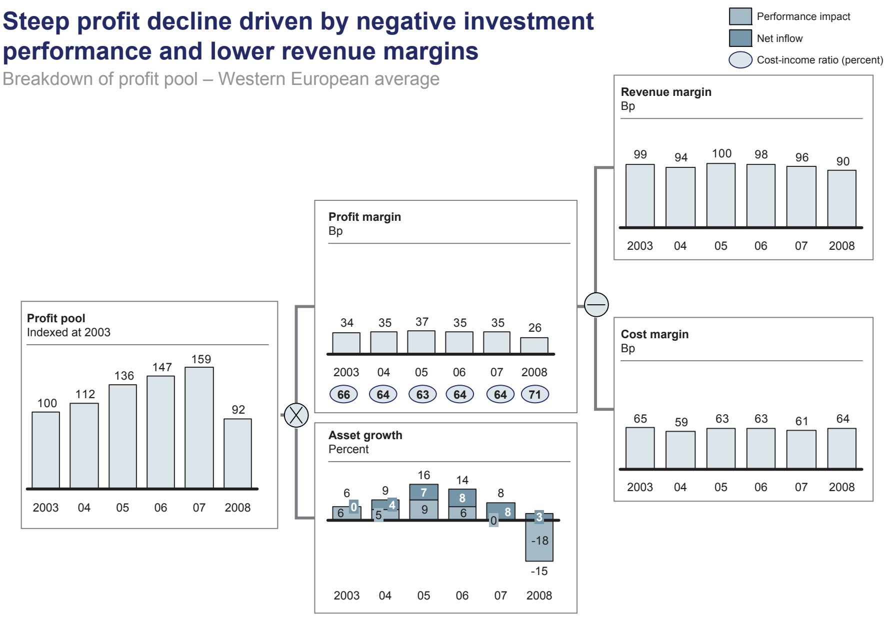


Exhibit 1

SOURCE: McKinsey Private Banking Survey 2009

This major shift in profitability has meant that many private banks (11%) are losing money and is calling all players to respond.

Asset decrease of 15% with net inflow gradually dropping to zero. In 2008, private banking assets dropped by 15%. This decline was primarily the result of a catastrophic fourth quarter with zero net inflows and a negative performance of -8%. Overall 2008 net inflows were still positive at 3%, but investment performance was at -18%.

This picture holds true for most countries in Western Europe, with total asset decline ranging from -20% in Switzerland to -5% in Austria, and net inflow ranging from 0% in Luxembourg to 7% in Belgium. In terms of types of players, even if universal banks got – on average – hit harder by the crisis as well as by reputational issues resulting from it, universal banks reversed the longer-term trend and outgrew specialists in 2008. Onshore universal banks enjoyed 5% net inflow on average vs. 0% for onshore specialists, compared with 8% and 11% respectively in 2007. With overall net inflows in decline, universal banks seem to benefit from internal referral mechanisms from the retail and corporate banking divisions. In terms of client segments, Ultra-HNW clients were hit even harder than other categories, given their traditionally more aggressive asset allocation. These clients represented 23% of total assets managed by private banks in 2007, but only 20% in 2008.

Looking forward, long-term fundamentals remain healthy. Nevertheless, the medium future is highly uncertain with scenarios for the next three years ranging from a flat asset base to historic asset growth levels of 8% or even more, depending on the economic and financial markets' recovery, further credit losses, and bailouts. After the dot-com crisis, HNW customers waited until 2004 to again entrust their money to private banks, resulting in zero net inflows in 2003, 24 months after the crisis. No economist can claim to be able to reliably predict the speed of the economic and financial markets' recovery, so banks need to be prepared to weather multiple scenarios.

Operating profit margins dropped 27% and even 54% in Q4 2008. The average revenue base dropped 21%. In relative terms, revenue margins declined from 96 bp in 2007 to 90 bp in 2008. In Q4, revenue margins were even down to 84 bp. The largest part of the decline in margin (nearly 5 bp) can be attributed to an unfavorable shift in asset allocation to lower-margin, lower-risk asset classes like fixed income, cash, and savings. The second largest part (nearly 4 bp) is attributable to the decline in the share of managed assets, both in discretionary and in mutual funds – a decline from 24% to 22% and from 29% to 25% respectively. General margin contraction amounts to more than 2 bp. Neither the asset class shift, nor the decline in managed assets is likely to be reversed in 2009. In the medium term, investors' risk appetite may well pick up, but getting back to 2007 levels will be a challenge.

The decline in assets and revenue margins puts significant pressure on costs. However, absolute cost levels were not adjusted accordingly. While the asset base decreased by 15%, the cost base only decreased by 10%, mainly driven by reductions in back-office and IT costs. Due to shrinking AUM, cost margins have increased from 61 bp to 64 bp of assets over the year, based on a rise in back-office and overhead costs from 28 bp to 29 bp and in sales and marketing costs from 28 bp to 30 bp. The cost margin for investment and product management was flat at 5 bp. When it comes to cost cutting, only one-third of participants managed to reduce their cost base in line with the decline in assets.

This operating margin view excludes increases in loan loss provisions. Due to the crisis, loan loss provisions have risen from 10 bp to 30 bp of the lending volume. The result is a decrease in profit margins over assets by 27% from 35 bp to 26 bp in 2008. In Q4, annualized profit margins were down by 54% to 16 bp. If we take into account loan loss provisions, the annualized profit margins in Q4 went down by 83% to 6 bp.

Will revenue margins and growth fully come back soon enough for private bankers to avoid more drastic cost measures? Encouraging reliance on this comeback would hardly be good advice. First, as already indicated, in the face of uncertainty, private banking CEOs should be prepared for multiple scenarios, including a longer recession with flat assets and limited shifting back to economically more interesting asset classes for the private banks. Second, even if the economic cycle turns fairly quickly, the majority of 90 private banking CEOs polled by McKinsey earlier this year at our annual Private Banking CEO Conference expected a structural decline of profits by 10 to 15%.

2. Offshore under unprecedented pressure

Some industry analysts have been predicting the imminent death of offshoring for over a decade. That is clearly not yet the case. While offshoring has continuously lagged behind onshore growth, net inflows are still positive. In 2008, offshore net inflows were 2% compared with onshore net inflows of 3%.

However, even the most enthusiastic offshore banker needs to recognize that the business is under unprecedented pressure. With offshore private banking representing more than one-third of the private banking industry, this pressure will not go unnoticed. While exact statistics of the share of undeclared money in offshore accounts are by definition hard to come by, the fact that 84% of relevant offshore account holders have chosen higher withholding tax under the EU savings directive rather than information exchange hints that we are not talking about pocket change.

The various offshore centers are likely to be impacted in different ways: the share of money from “tax-sensitive geographies,” the diversification amongst many countries of origin, the propositions beyond tax (such as talent availability, accessibility, or customer protection), and the prevalent regulatory framework (e.g., product regulation) will each play a major role in determining the assets lost and ability to compensate these losses. Confidence in each financial center, driven by a clear, resilient, and transparent strategy and reaction of its government and regulators will be key.

It is clear that smaller EU locations with almost exclusively EU resident money will be under more pressure than Switzerland, for example. The degree of impact is, however, still unclear. Inflows in Switzerland were 7% in 2007 and still 2% in 2008, of which – according to a small sample – only about 35% were from the EU, compared with 50% of the stock (Exhibit 2). Our sample for a country such as Luxembourg suggests a dramatically higher dependency on EU citizens: about 90% of both inflows and stock. The result is significantly lower net inflows at 2% in 2007 and 0% in 2008.

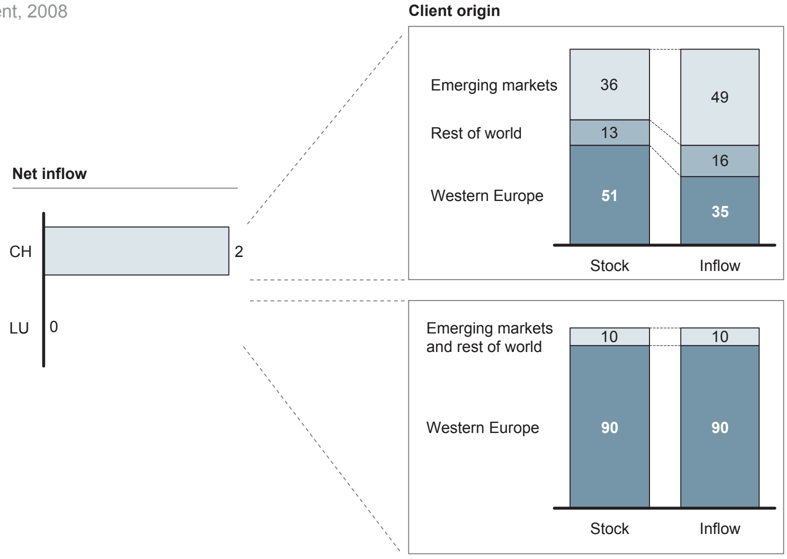
The future of the offshore business will depend on both the willingness of select political leaders to crack down on offshore centers (which even after the last G20 summit is still an open question) as well as the economic developments taking place, as negative economic changes will further fuel the need for governments to curb tax evasion.

As a result, multiple scenarios could still unfold, ranging from only limited reduction of inflow through the current coverage of recent G20 decisions to a much more drastic impact if authorities really push for automatic information exchange and heavily tax-undeclared money. But even in such an extreme scenario, offshore banking would not be dead: clients will continue to seek diversified booking centers, prefer relative discretion, and look for talented expertise. In such an extreme scenario – assuming a high share of undeclared money in the offshore location, significant repatriation of undeclared money, and high taxation of the remaining undeclared money – it is still unlikely that offshore locations would lose more than a third of their asset base.

Emerging market exposure key to offshore growth in Switzerland

SELECTED SUBSET

Percent, 2008



SOURCE: McKinsey Private Banking Survey 2009

Exhibit 2

3. Industry in search of renewed value proposition

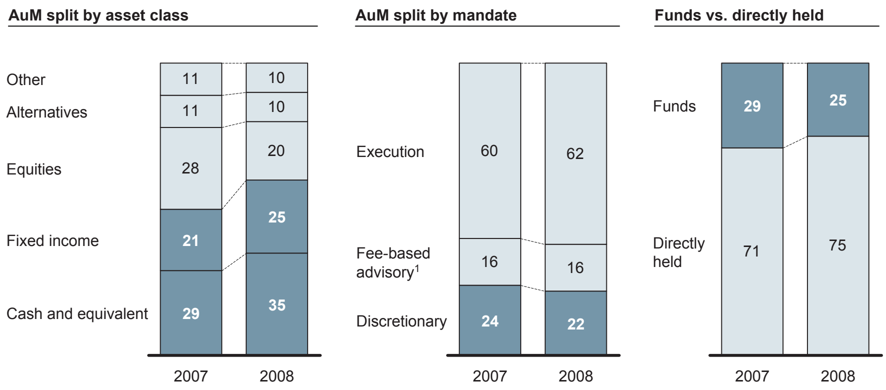
In 2008, the investment performance of portfolios with European private banks was 18%. Due to the higher volatility, the spread in investment performance between top- and bottom-quartile performers widened from 9 to 18 percentage points, resulting in investment performance ranging from -9% for top-quartile banks to -27% for bottom-quartile banks. Thus, in 2008, the choice of which private bank to invest with had a significant impact on one's portfolio performance. However, regardless of the private bank chosen, 2008 was a disappointing year in terms of client portfolio performance.

As a result, client trust in private banks has been severely damaged. Clients have begun a significant retreat away from managed assets (Exhibit 3). The share of discretionary mandates – over the last five years consistently at about 24% – was down to 22% in 2008. The share of assets in mutual funds dropped from 29% in 2007 to 25% in 2008. Within asset classes, clients are increasingly turning to simplicity, transparency, and safety in their investments – wealth protection has become the name of the game. Cash and equivalents showed a positive growth of 2% in 2008, raising its share of assets from 29% to 35%. Fixed income rose from 21% to 25% of total assets. In contrast, equities went down 39%, reducing its share of assets from 28% to 20% in 2008. The share of alternative products, a major engine of growth and profitability for private banking in the past, has decreased by 18%. Structured products have come under pressure from all sides and went down 30% in 2008. While these shifts were largely due to market performance, clients have started to lose trust in more complex and risky asset classes and this has triggered outflows.

This trend has called the entire value proposition of the industry into question. A core asset of many private banks, the reputation of the institution, has been damaged for many players due to issues within the private bank, the banking group, or just the industry as a whole. What is more, clients are starting to question the quality of advice

Significant product shift in 2008

Percent, European average



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

Exhibit 3

SOURCE: McKinsey Private Banking Survey 2009

given by their private banks as they realize that their defensive portfolios inherited some "enhanced fixed-income products" or that the counterparty risk assessment on selected certificates or hedge fund investments had been done inconsistently. With the 2008 investment performance, many clients have realized that the interests of their relationship manager were not fully aligned with their own investment needs and concerns. In fact, not only did a significant share of recommended products not really add any value, but it added risk to clients' portfolios. The industry clearly suffers from multiple shortcomings in its value proposition to clients. This has become more apparent through the impact of the crisis. It has triggered higher awareness and scrutiny from clients toward their banks and higher interest from regulators across the globe.

To put it another way, private banks earn on average more than twice what stockbrokers earn, as their clients allegedly pay for "value-added personal advice." In too many situations, the personalized advice focused solely on determining a standard risk profile and offering an asset allocation and a selection of investment products more or less in line with the risk profile. The advice on overall investment risks and on the underlying market, liquidity, or counterparty risk of individual securities was in many situations suboptimal. The offering of investment solutions in line with the economic context and the client's actual risk appetite, along with the proactive screening of individual exposures in an investment portfolio, requires a major overhaul of the advisory process, as some banks have started to implement.

Even if the debate amongst regulators is still ongoing, the degree of product, KYC, and incentive regulation is likely to increase, and therewith the tightness of controls. This is creating opportunities for private banks to preempt these changes by improving their service to clients and helping them. Thus, the players will be more forcefully positioned as private banks acting in the interest of clients. A good example is the recent FSA discussion on separating advice fees from product pricing and banning product kickbacks for independent advisors in the UK.

4. Pressure on consolidation on the rise

Despite all the talk about consolidation in private banking, only limited assets changed hands in the period 2000 to 2007. Even if targets remain rare for now, several forces may lead to acceleration in the years to come.

Pressure on marginal offshore players. Due to increasing regulatory and related cost pressure, banks likely to sell include subcritical private banking offshore units with less than EUR 5 billion in AUM. These banks suffer from a higher cost margin of 84 bp (compared with 62 bp of units with more than EUR 5 billion in AUM) due to higher back-office and overhead costs.

Pressure on marginal onshore players (although less than offshore). Onshore players under pressure include, similar to the offshore case, those with less than EUR 5 billion in AUM. They also suffer from a significantly higher cost margin of 78 bp compared with 55 bp for larger onshore private banks.

In-market universal banking consolidation. Private banking consolidation is likely to follow possible onshore universal banking consolidation in markets where this has not yet happened.

EU or government induced sale of entities following state-aid packages. Universal banks with difficulties might be forced by economic reasons or even by their regulators (or public stakeholders) to sell their private banking subsidiaries to comply with restructuring needs. This will most likely result in the sale of selected foreign entities, especially in offshore locations, but could also affect local entities that can easily be separated from the rest of the business.

* * *

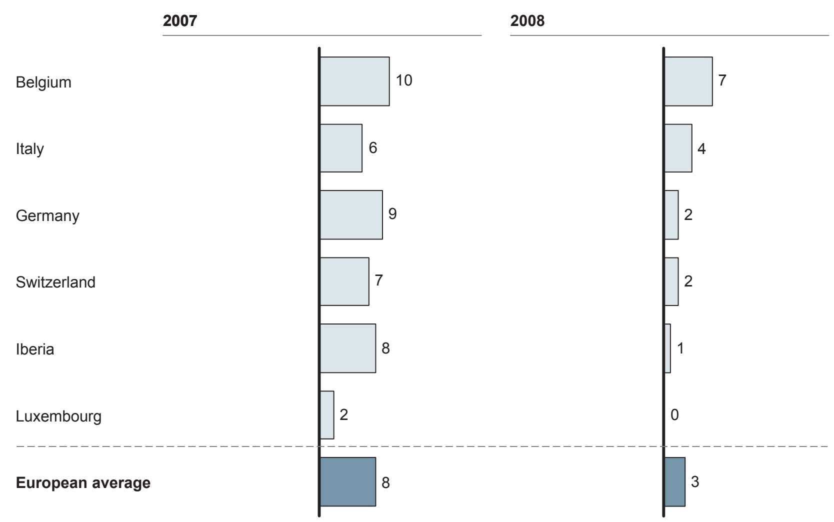
The downward shift in profitability, the rising pressure on offshoring, the rising need for a proper delivery of high-quality advice, as well as the increasing pressure on weaker players and consolidation have been discussed in depth. At the same time, this challenging environment is providing new opportunities for best-in-class players. The upswing will surely come, and banks can take actions now to ensure themselves positions of strength when that day arrives.

Regional specifics

The benchmarking effort of 103 private banks across Western Europe on what drives the best-performing banks reveals interesting country-specific as well as overarching developments. Growth rates and economics are increasingly converging (Exhibit 4).

Net inflow growth down to 3%, compared with 8% in 2007

Net inflow growth, percent



SOURCE: McKinsey Private Banking Survey 2009

Exhibit 4

Switzerland. With more than EUR 1,700 billion in AUM, it is not only one of the largest markets, but also the private banking market with the longest tradition and highest reputation. Due to their global reach, Swiss private banks have succeeded in attracting solid net inflows of 7% in 2007 and still 2% in 2008. Looking at Swiss inflows, 65% come from outside of Western Europe, a strong demonstration of the global attraction of the location for HNW wealth. Swiss private banks were able to keep their revenue and profit margins at high levels. One reason is the lower price sensitivity of offshore clients; the other, the greater stickiness as far as the product and asset allocation mix is concerned, i.e., Swiss private banks kept their share of discretionary mandates (21%) and advisory mandates (14%) at their 2007 levels, against the European trend. The share of high-margin alternative assets in client portfolios stayed at the high level of 16%. The impact of the increased pressure from politicians on Swiss private banks in 2009 remains to be seen.

Luxembourg. As in 2007 with 2%, Luxembourg again showed stagnating net inflows of 0% in 2008. The location suffers from its strong focus on Western European money, with over 90% of stock and inflows coming from the region. However, Luxembourg private banks have also held on to their role as profitability champions. Revenue margins stayed at the high level of 2007 (104 bp). As in other offshore locations, the share of managed assets stayed constant, and the shift in asset allocation was less pronounced than in other markets. With cost margins slightly increasing, the profit margins went down from 53 bp to 46 bp, which is still a very solid performance (CIR of 56%).

Germany. Net inflows fell from 9% in 2007 to 2% in 2008. Profit margins deteriorated (down one-third from 30 bp to 19 bp) due to decreasing revenue margins. The driver of the revenue margin development was the shift in asset classes with cash and fixed income increasing from 49% to 60%. Furthermore, the discretionary share went down by 3 percentage points to 20%. In line with the development in other countries, the cost margin slightly increased from 57 bp in 2007 to 61 bp in 2008.

Belgium. In 2008, Belgium saw the highest net inflow rates in Western Europe at 7%. Indeed, for the last five years, net inflow growth rates have been high. This can be explained by various drivers, including previous fiscal amnesties, securities dematerialization, as well as a growing expatriate segment moving to Belgium for tax reasons. Profit margins have slumped (down one-third from 41 bp to 27 bp) due to increasing cost margins (up to 55 bp from 50 bp), driven by a sticky cost base as well as decreases in revenue margins by 10% (from 91 bp to 82 bp). Revenue margin decreases are due to a higher share of lower-margin deposits, money market funds, and fixed income.

Italy. AUM decreased by 16%, driven primarily by a negative performance of -20% and inflows of 4% (compared with 8% in the previous year). Profit margins decreased from 32 bp to 25 bp, driven by a revenue margin decrease from 75 bp to 68 bp, while the cost margin stayed flat at 43 bp. The revenue margin decrease can be explained by increases of the cash share from 17% to 34%. At the same time, the funds share decreased from 33% to 26% and discretionary mandates fell from 31% to 25%.

Iberia. The profit margin decreased by 5 bp (from 39 bp to 34 bp). The cost margin remained relatively flat (increase of only 1 bp), while the revenue margin decreased by 4 bp (from 73 bp to 69 bp). Although low-margin products like cash and fixed income increased their share from 45% to 53% (thus weakening the revenue margin), execution/custody mandates decreased from 66% to 64% in favor of advisory mandates, leading to a comparatively lower overall revenue margin decrease.

Major Opportunity To Take The Lead

The crisis offers the opportunity and a reason for change in an industry that has long been characterized by conservatism and resistance to change. Indeed, there are huge differences in growth and profitability as well as underlying operational levers between individual banks. These differences have actually increased during the crisis. Top-quartile banks showed AUM growth of -2%, while bottom-quartile banks had AUM growth of -28%. Top-quartile banks had profit margins of 64 bp, while bottom quartile banks had an average profit margin of 0 bp. The gap between top- and bottom-quartile banks has widened from 23 to 26 percentage points in terms of growth and from 57 bp to 64 bp in terms of profit margins.

The starting position of each bank is, of course, one factor – the pace of change another. Those who want to take the lead in the crisis will have to work on four dimensions: protecting the P&L and establishing excellence in execution, protecting the offshore franchise (for those players active offshore), redefining and delivering a truly enhanced value proposition, and selectively seizing growth opportunities. The crisis now offers the opportunity to launch the fundamental changes required to be successful in the private banking industry in the long term.

1. Protect the P&L through excellence in execution

First of all, private banks need to protect their P&L and ability to grow organically. The downward shift in the industry's profitability requires a shift to new productivity levels for those players wanting to return to historic profitability. If we assume that 2009 economics will be at the level of Q4 2008, a cost reduction of 25% would be required to achieve historic profit margins of 35 bp. Benchmarking shows that for many operational levers the variation between top- and bottom-quartile players is significant and so is the potential for those banks committed to improve. Top-quartile players decreased their cost base by 31% in 2008, while bottom-quartile players actually increased it by 11%. The operational levers with the highest potential to increase profitability in the short term include sales force effectiveness, pricing, and cost management.

Sales force excellence. Consistent frontline performance remains a challenge for most Western European private banks. This is emphasized by the large discrepancies between inflows and revenue margins by relationship managers (Exhibit 5) – which can be observed both between private banks as well as within the sales force of each individual private bank. While average relationship manager productivity levels decreased in 2008 – per relationship manager, revenues were at EUR 1.2 million (down by EUR 0.3 million) and assets managed at EUR 129 million (down by EUR 24 million) – productivity was still highly variable between players: the bottom quartile of universal banks, for example, has relationship managers who generate on average only EUR 0.5 million in revenues, while the top quartile has relationship managers who generate EUR 2.5 million – this is five times as much.

Even more telling is a comparison of net inflows per relationship manager. The average net inflow fell from EUR 11 million in 2007 to EUR 4 million in 2008. However, top-quartile banks managed to generate EUR 17 million, which is the same level as in 2007. In contrast, bottom-quartile players suffered from net outflows of EUR 11 million per relationship manager (equivalent to 14 average clients). Top relationship managers do significantly better both with new client acquisition as well as retention and increases in share of wallet for their existing clients. This corresponds to our experience that

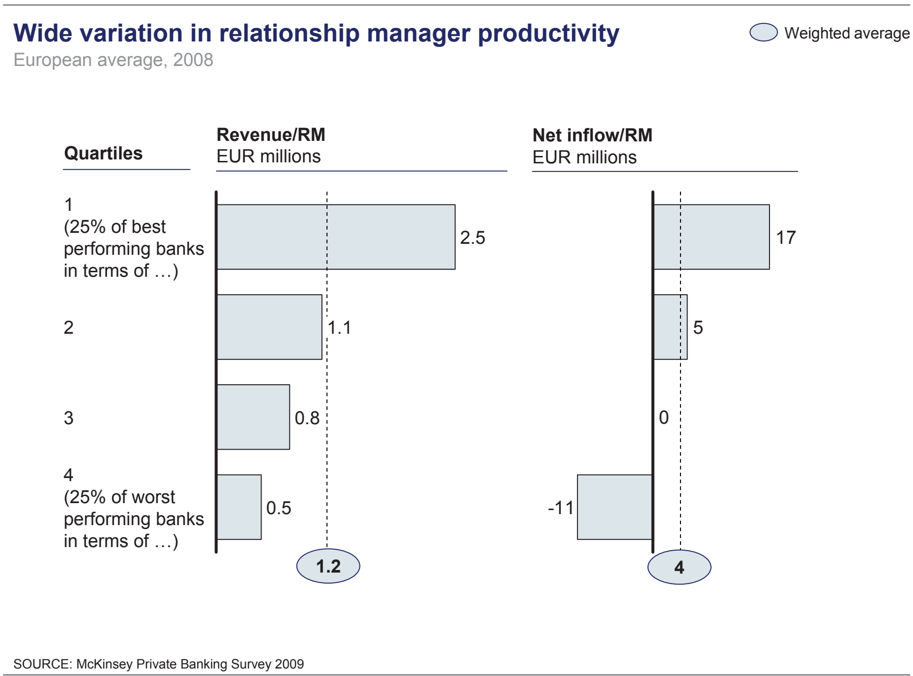


Exhibit 5

sales force effectiveness initiatives are among the most powerful levers that private banks can deploy to increase top-line and bottom-line growth. Usually, sustainable performance improvements of 10 to 30% can be achieved.

To improve their frontline performance, private banks have to bring three different elements to be best-in-class:

- Establish best-in-class processes in client acquisition, development, and retention. In the crisis, a thorough risk profile assessment and constant monitoring of the portfolio as well as retention measures like early-warning indicators and systematic reviews of clients at risk, are an integral part of client management. Indeed, only 33% of the players indicate having excellent sales force processes in place, including defined intake and revenue margins per relationship manager, defined action plans for relationship managers, tools as well as coaching to support the relationship managers.

- Thorough performance management. This includes establishing a performance-based compensation with vesting components attached in order to align the incentives for the front line with the longer-term interests of clients and the bank. It also includes a constant performance monitoring based on transparent KPIs. A transparent KPI logic focuses on a few indicators. The most prominent are net new money and revenues (both applied by 90% of banks), followed by total AUM, client feedback, and contribution margin (all applied by almost half of the private banks). In addition, many banks will put a particular emphasis on a consequent low-performer management with proactive identification and “managing out” of relationship managers in the current downturn. While almost every second private bank was actively managing out relationship managers, the share of relationship managers having to leave the bank varied from 1% of the sales force for the bottom quartile to 6% for top-quartile banks in 2007 – figures that increased in 2008.

- Adjustment of frontline organization. It is key to have powerful teams, consisting of three to ten relationship managers and a skilled team leader as well as access to relevant specialists (e.g., tax, heritage). With profitability under pressure, private banks should re-emphasize segment-specific service models, so to avoid serving lower-affluent clients with a cost-to-serve only affordable for clients in higher wealth bands.

Pricing. Revenue margins between private banks vary significantly, even if adjusted for country, business model, and client wealth bands. To give one example: revenue margins for clients with EUR 1.0 to 2.5 million in assets can vary by up to 60 bp for two comparable players in the same country. The differences can be explained by variations in client penetration (cross-selling) as well as pricing.

Pricing is a powerful lever to maintain profitability. It can be adjusted quickly and typically has a short-term impact on the bottom line – in the range of 5 to 10 bp revenue margin improvement (depending on the starting position), translating directly into a profit margin improvement.

Pricing potential can stem from various areas, the two most important being suboptimal discounting by the front line and the actual list price of products. Often the sales force overuses its pricing discretion. Of the survey participants, only about half (53%) have tight discount management practices in place – the others should follow by also introducing mechanisms to raise pricing discipline. When it comes to list price optimization, there are two levers at hand. One is about optimizing the structure and transparency of the presentation in the price list. The other adjusts the actual list prices of individual products, paying attention to the price points that really matter to clients. Many banks have neglected pricing and are left with an outdated pricing legacy.

Currently, there is a lot of discussion about the possibility of adjusting prices in a downturn environment and around introducing more innovative pricing models in private banking, e.g., pricing advisory services separately or introducing different levels of performance fees. We believe, however, that private banks are still far from best practice in price management and that just “getting the basics right” would already have tremendous impact. In fact, we believe that the current environment might even present a unique opportunity to optimize price management. Clients value increased transparency and a clearer communication on pricing as well as a structure in which the fees grow (or shrink) in proportion to the overall asset base. More innovative pricing models should be considered as medium-term strategic opportunities, depending on potential regulatory actions (e.g., following the recent FSA discussions), as they will not have significant impact in the short term.

Excellence in pricing

In the current economic environment, pricing is a powerful lever for achieving and maintaining profitability in the near term. Pricing offers fast bottom-line impact. From recent client experience, revenue margin improvements of 5 to 10 bp are achievable within 6 to 12 months. The extent mainly depends on the starting position of the bank and the applicability of individual pricing levers, in particular the potential for price list optimization.

McKinsey has developed a focused and impact-oriented approach to achieving pricing excellence based on three key levers:

Technical and commercial leakage/discounting. Identify and immediately implement "quick-win" technical leakage levers (e.g., false data entry or errors in the IT system) and create transparency on and reduce commercial leakage (e.g., excessive discounting). McKinsey's proprietary Private Banking Survey Database for qualitative and quantitative benchmarking of revenue and profit margins can be used to identify areas of strategic opportunity within and beyond pricing, e.g., regarding the product offering.

Price list optimization. Develop new price list based on the findings from qualitative benchmarking regarding structure, transparency, and layout and based on quantitative benchmarking of individual price points. McKinsey's proprietary Price List Database for qualitative and quantitative price list benchmarking can be used to analyze and develop a best-practice price list.

Institutionalization of pricing excellence. Develop and implement best-practice pricing processes, performance management systems, and an organizational setup to reduce commercial leakage and achieve excellence.

Achieving excellence in pricing and the benefit of short-term impact requires a pragmatic methodology and process focusing on quick wins. It also requires a profound understanding of customer preferences, extensive involvement of frontline staff and management from day one, and significant support of frontline staff during the implementation phase. But, most importantly, it requires decisive management from the top throughout the entire initiative.

Cost management. The industry increased its absolute cost base from 2003 to 2007 in line with asset growth, at an annual rate of 10%. Since the asset slump in 2008, however, costs have not been adjusted accordingly. Going forward, operating costs, including IT, risk management, and compliance, are likely to increase further as the regulatory environment continues to become more demanding.

Cost reduction efforts did not play a major role in 2008. Less than 15% of the survey participants have set aspiration levels for themselves of more than a 10% cost reduction. As economic pressure grows, players will be forced to take a harder look at costs. Participants' expectations for 2009 in terms of cost reductions mirror this: one in five plans cost reductions of over 10% for 2009.

There is still a long way to go – especially as the "easy" early cost measures have already been taken, basically through a reduction of marketing budgets, new IT investments, and discretionary bonuses – and more structural cost levers need to be pulled. There are multiple structural levers at hand to reduce the cost base via changes in frontline setup, product offering, operating model, corporate functions, and the business portfolio. For instance, private banking divisions have to date been relatively untouched by widespread changes in operations in other areas of financial services, such as lean banking, outsourcing, and offshoring.

Scale plays a decisive role in driving cost efficiency, especially for back-office/IT and overhead functions (Exhibit 6). Players with less than EUR 5 billion in assets show a 31 bp higher cost margin compared to players with more than EUR 30 billion in assets. Some 60% of the 2008 difference can be explained by the higher relative cost of investment management, IT, operations, and overhead functions.

Economies of scale exist, threshold at EUR 5 billion

Cost margin split by player size (AuM, EUR billions), bp, 2008

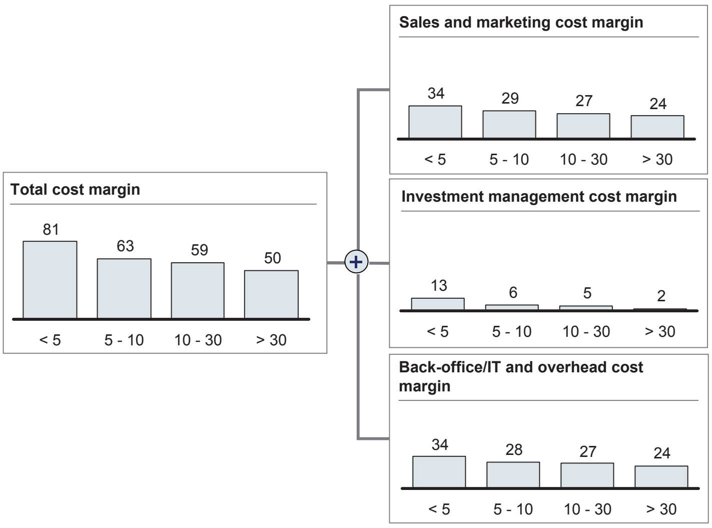


Exhibit 6

SOURCE: McKinsey Private Banking Survey 2009

Cost reduction measures should not shy away from targeting "holy cows" such as relationship manager compensation levels (only 25% have done so) or even significant staff reductions including layoffs of relationship managers. Regarding staff reductions, only 34% of the players reduced their headcount in 2008. Most likely, 2009 will be different.

Excellence in cost management

The private banking industry is under pressure to react to the sharp profit decline. To return to 2007 profitability levels, banks will have to adjust their cost base by 15 to 20%, while maintaining capacity to invest in the growth of their asset base.

We believe that most private banks will need to apply a combination of traditional discretionary spending cuts, capacity adjustments, as well as structural measures that change business and operating models in ways that close the profitability gap and create the necessary room for maneuvering.

We see five principal areas in which structural improvements can be achieved:

Improve frontline setup. Private banks should review and reduce their management layers and structures to lower complexity in the organization. At the same time, managers should focus on a more active and performance-oriented management of the front line. This includes more rigorous managing out of underperformers. The service offering should be adapted by introducing a segment-specific service model that reflects customers' needs and ensures the profitability of each segment. In other words, banks have to ensure that revenues cover the cost to serve each segment.

Change product offering. Banks must adapt to changing customer needs and preferences. Clients do not value excessive variety and complexity in the offering. A systematic review of the offering for client demand and suitability will reveal where existing products can be combined, phased out over time, or immediately discontinued. This will not only help limit business-induced complexity, but also reduce risks. A bank should also thoroughly evaluate and make its "make or buy" decisions based on an understanding of its in-house capabilities and scale.

Adapt operating model. Private banks often add services and locations without consideration of the implications for the underlying operating model. As a result, they lack uniformity in terms of systems (e.g., CRM) and standards across locations, leading to untapped efficiency potential. To illustrate, 50% of universal banks with low-cost private banking models share the client register back-office applications function with the rest of the bank, while only 38% of players with high-cost positions do the same. Modularizing, standardizing, and consolidating functions across geographies and locations will lead to efficiency and effectiveness gains for many private banks, but will require redesigning the operating model and IT systems.

Streamline corporate functions. Growing regulatory demands often lead to additional investments and activities in corporate functions. In the current cost environment, capacity and service levels will need to be systematically reviewed and adjusted to what is really required. Continuous improvement processes and the use of outsourcing and offshoring can help not only achieve a one-time cost reduction, but also bring effectiveness and efficiency improvements on an ongoing basis, without undermining corporate control mechanisms.

Review business portfolio. Most private banks have over the past several years greatly expanded their business scopes – geographically as well as segment-wise. Not all these activities have achieved or have the ability to achieve critical size. A full portfolio review will determine which locations or segments should be closed or divested and where an adjustment to the value proposition is necessary.

While the levers mentioned above are similar to those used in other banking businesses, it is critical to tailor the approach to the private banking environment. Client loyalty in private banking lies with the bank's reputation and service quality. Building this loyalty will require the heavy involvement of the front line as the ultimate bank's ambassador when defining adjustments. Measures need to be well targeted and specified to be fully effective. This starts with a thorough understanding of the major improvement opportunities. Via a combination of efficiency, productivity, and business model benchmarks, a bank can determine its potential for capacity adjustments as well as identify structural improvement opportunities.

2. Sustainable protection of offshore franchise

The spread between private banks regarding their ability to protect their offshore franchise is striking: some players lost significant funds in 2008 (up to a 35% decrease in AUM for bottom-decile players), while others successfully attracted new AUM (8% AUM growth rate for top-decile players). Differences by geography are significant: Switzerland has seen net inflows of 2% on average, whereas Luxembourg remained flat. Offshore players who are successfully protecting their franchise are significantly better than their counterparts in risk management and compliance methodology. For example, only 30% of offshore banks with growth rates within the bottom quartile claim to have a company culture that reinforces risk management principles – compared with 65% of top-quartile growth banks.

The strategies for individual banks will, of course, depend on what happens at the macro level. Banks should take immediate steps to ensure compliance for new and higher risk legacy business and relationship managers' behavior (e.g., acting radically on relationship managers operating in a "grey zone"). These no-regrets actions include conducting a thorough risk assessment of the client portfolio in terms of countries of origin and offshore solutions and developing a heat map to identify immediate actions to reduce risk exposure. Furthermore, a review of the offshore strategy should be initiated. This includes analyzing the bank-specific size and importance of offshore banking in light of the overall business portfolio, challenging and revamping the offshore strategy by defining potential scenarios for future legal and political environment, assessing risk levels for the most important countries, and reviewing competitors' positions and potential strategic moves. In parallel, contingency plans should be developed based on various scenarios in case of changes in the political and/or economic situation. A further set of more medium-term no-regrets actions targets the organizational setup and business processes. This could include, for example, initiating change management programs to address mindset and behaviors (e.g., conduct workshops, cascade down through one-to-one coaching, adjust objectives and incentives) or adopting risk management process and control functions.

Banks with a significant offshore presence should aim at playing an active role in the specific countries to respond to challenges to offshore banking, e.g., by maintaining or further strengthening relationships with regulators.

3. Redefining the value proposition and protecting the franchise

The unsatisfactory experience from 2008 offers the need and the opportunity to re-adjust the value proposition and delivery model for many private banks. It seems the right time to refocus the model on providing holistic, independent advice based on an understanding of the market environment and clients' specific needs. This requires work along three dimensions:

First, rebuild the image of the bank and client trust. This involves creating and communicating a clear and honest corporate story that should emphasize the stability of the bank and avoid extra surprises. Clients will also look for a renewed investment story, offering specific reasons why the bank should be their trusted advisor going forward.

Second, banks will have to adapt the advisory approach and product offering. Changes in the risk/regulatory environment and customer demand will shift the focus toward the client and wealth preservation. Banks should therefore ensure excellence in understanding client needs, advising on the asset allocation, product and manager selection, risk management, and transparent client information and reporting.

Risk management will play an increased role in all parts of the advisory and investment process. Giving greater attention to correlations, extraordinary cycle risks and counterparty risks will help avoid negative surprises in the future. Upgrading risk management will involve changes to reporting structures, but also changes in organizational setup, processes, and in some cases the firm's culture.

Regarding investments, core-satellite strategies with greater differentiation between passive core and active alpha investments are gaining in importance. In this respect, private banking is following the path of institutional asset management. On the one hand, ETFs and other low-margin passive products continued to grow their relative share of assets in 2008. On the other hand, active investments are coming under higher scrutiny, with clients looking more explicitly at their capability to generate alpha and/or meet their specific needs and concerns. As a result, traditional, active equity funds suffer from ongoing outflows. Still, there might be an opportunity for structured products with high transparency and a wealth preservation perspective.

The renewed focus on asset allocation advice offers the opportunity to expand the share of discretionary and advisory mandates. Both benefit from significantly higher revenue margins than the execution-only mandates (121 and 93 bp vs. 80 bp). Both also help in focusing the client dialogue on the more relevant determination of the appropriate asset allocation, given the client's objectives and the market environment. Despite the evidence, there is still a relatively large amount of resources being devoted to building individual line-by-line portfolios, as opposed to the selection of the best products and managers in the market. On average, private banks are sourcing more than 50% of funds from outside (unchanged from 2007). For the part outsourced to third parties, the recent past has demonstrated the importance of having proper manager selection capabilities in place.

Third, ensure delivery at the client interface. The quality of delivery of solutions and advice via the front line is crucial in the eyes of the client. It is in the dialogue with the RM that the client experiences the bank's delivery. Although most banks find designing appropriate advisory processes fairly straightforward, implementation and consistent delivery remain a challenge and often require a major cultural change, including developing superior leadership skills, installing supporting tools, and introducing better training, coaching, and incentives. In some cases, this might also involve upgrading the average quality by pruning the bottom relationship managers.

4. Selectively seizing growth opportunities

In 2007, and even at the beginning of 2008, growth topped the corporate agenda of many private banks. But even during the crisis, growth opportunities, be they internal or external, should not be excluded a priori, especially not by well-capitalized players with a long-term commitment to private banking. To the contrary, conditions have not been this favorable in a long time.

Those who want to capture the growth opportunity should understand the granularity of growth, i.e., the finer, disaggregated aspects of growth, in their industry. First, management should decide where it wants to play in order to prepare for optimal "portfolio momentum" – even in mature markets and industries, you can find fast-growing regions, products, and client segments that should be prioritized in a growth strategy. Second, inorganic growth through M&A should be considered to get a quick and established stance in that market. A recent McKinsey study revealed that of the growth in earnings of the top 20 European banks over a ten-year horizon, 40% came from portfolio momentum, 50% from M&A, and only 10% from better execution.

Particularly in the current environment, the relative attractiveness of M&A vs. hiring of relationship managers has increased significantly. Historically, due to a limited availability of private banking assets and high multiples, relationship manager poaching was the only realistic growth lever in many markets. This has changed. AUM multiples are down to below 2% from 3% to 5% of AUM in the last 24 months. Furthermore, the availability of assets is likely to increase, as some universal banks are putting their private banks up for sale due to capital constraints or pressure from regulators and many smaller banks with limited scale are coming under economic pressure.

* * *

The private banking sector has been hit hard by the financial crisis. However, it still is one of the comparatively more attractive subsectors of the financial services industry. Once the economy and financial markets get going, private banking economics will certainly improve again. In the short term, the actions and response of each private bank will of course depend on its current position and how much it has been affected by the crisis. For all banks the crisis offers the opportunity to launch the change initiatives required to establish a private banking model that allows for profitable growth in the new environment. Those prepared to act and committed to building real distinctiveness will ensure themselves positions of strength for the long term.

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