

European Private Banking in 2018 – Running for scale

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Executive summary

After a drop in profits in 2016, private banks in Western Europe rebuilt their profit pool, reaching a record high of EUR 15 billion in 2017. However, more than half of the profit growth since 2013 was the result of favorable returns in the financial markets rather than new business, and this reliance on market performance raises questions about the industry's ability to sustain a growth in profits.

Over the last five years, rising markets have allowed private banks to outgrow many of their problems. We believe, however, that banks need to assert greater control over their profit growth in two ways. The first is by redoubling their efforts on building net inflows. The second is by exerting greater control over growth in fee margins and the cost base.

On banks' ability to attract net inflows, in our 2017 survey we observed an increasing divergence according to size and business model. Larger private banks, with assets above EUR 30 billion, as well as private banking units of universal banks, have outpaced their peers on net flows by a factor of two. Other private banking models – in particular independent firms – therefore crucially need to capture a greater share of the new business available in the market.

With respect to managing profitability, private banks have two tactics at hand. The first is raising revenue margins: over the last five years, shifting assets under management (AuM) into advisory and discretionary mandates proved successful for boosting fees, and given the historically slow growth in contracted investment management, firms still face a significant opportunity. The second is controlling costs: for the first time in five years, banks held their overall expense growth to 2 percent in 2017, and should strive to sustain that discipline.

Our 2018 report: A new vantage point

For the last several years, McKinsey's Private Banking Survey results have included a comprehensive review of core industry KPIs across business models, client segments, and geographies. This review provided valuable points of reference – particularly after the market disruptions from 2007 to 2012, when private banks were forced to find a new economic footing. The results of the last five years, however, revealed an evolution of banks' economics, rather than revolution. This year's review takes a different perspective, looking into selected industry drivers shaping the progress from 2013 to 2017.

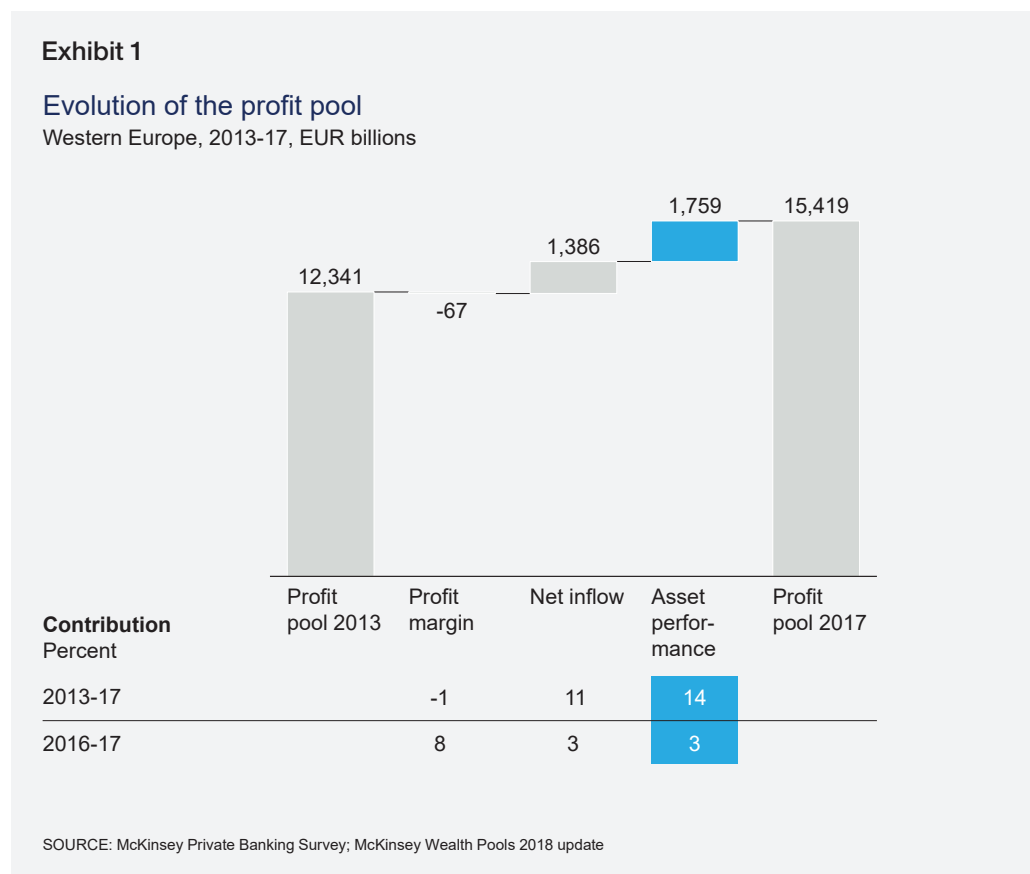
The exhaustive set of KPIs can be found in the appendix; individual results have been provided to survey participants.

Industry dynamics 2013 to 2017

Over the last five years, favorable markets were the primary factor in profit growth

Earning a return on equity of 13 percent, wealth management remains one of the most attractive segments of the Western European banking industry. Organic growth has been strong, as Western European HNW personal financial assets¹ (PFA) have grown at 3.3 percent annually over the past five years. Moreover, capital requirements are low relative to other banking businesses, and profit margins are high.

But a closer look at the evolution of private banks' profit pool over the last five years shows that the average annual growth of 5.7 percent was almost exclusively driven by rising AuM, and that average profit margins remained stable at 25 bps. Importantly, AuM growth in that period enjoyed a significant tailwind from bullish financial markets, which contributed more than 50 percent to AuM – and in turn, growth in profits (Exhibit 1).



A dependence on rising markets prompts questions on private banks' ability to sustain long-term growth in profits. The outlook for future returns is muted: The McKinsey Global Institute expects the next 20 years of capital market returns to fall below the stellar markets of the last 20, with equity and fixed income return levels of almost half of their historic rates.

¹ Households with personal financial assets >EUR 1 million (including both onshore and offshore).

As net inflows become a more important source of profit growth, independent boutiques need to sharpen their value proposition

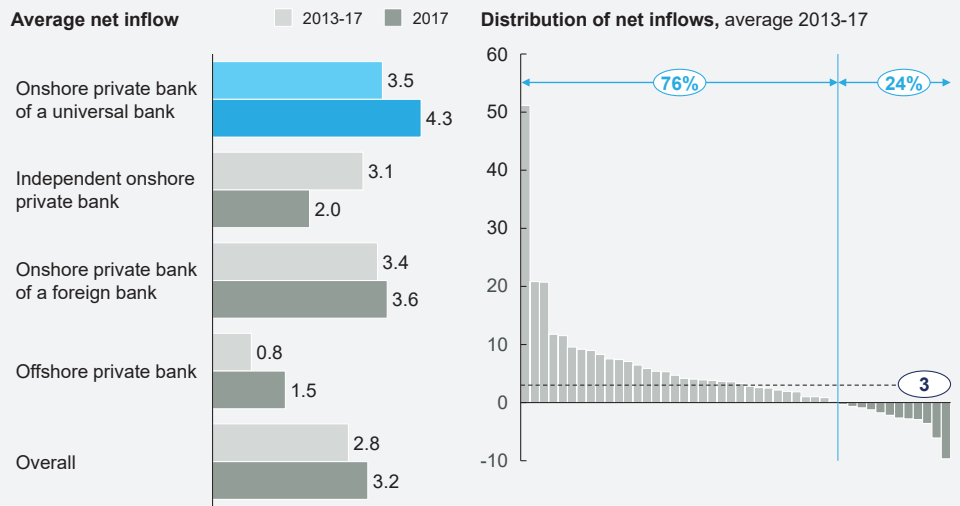
In Western Europe over the last five years, independent boutiques gathered average net inflows in line with those of the leaders, that is, private banking arms of universal bank institutions. However, the recent survey shows diverging new business patterns.

In 2017, private banking arms of universal banks collected net inflows of 4.3 percent of prior year-end AuM – more than twice the 2.0 percent of independent boutiques (2014 showed a similar shortfall) (Exhibit 2). A single year’s observations are subject to idiosyncrasies and reversal, but we believe that due to universal banks’ efforts at hiring RMs, promoting integrated wealth propositions – such as bundling investment banking and asset management services – and a focus on cross- or upselling, their more rapid growth trend could endure and hold true in 2018.

In an environment where net inflows become a key driver for profit growth, independent boutiques need to clearly differentiate their value proposition from universal banks, For example, better client services or a more attractive investment offer.

Exhibit 2

Differentiated momentum in net inflow by business model
Western Europe, percent



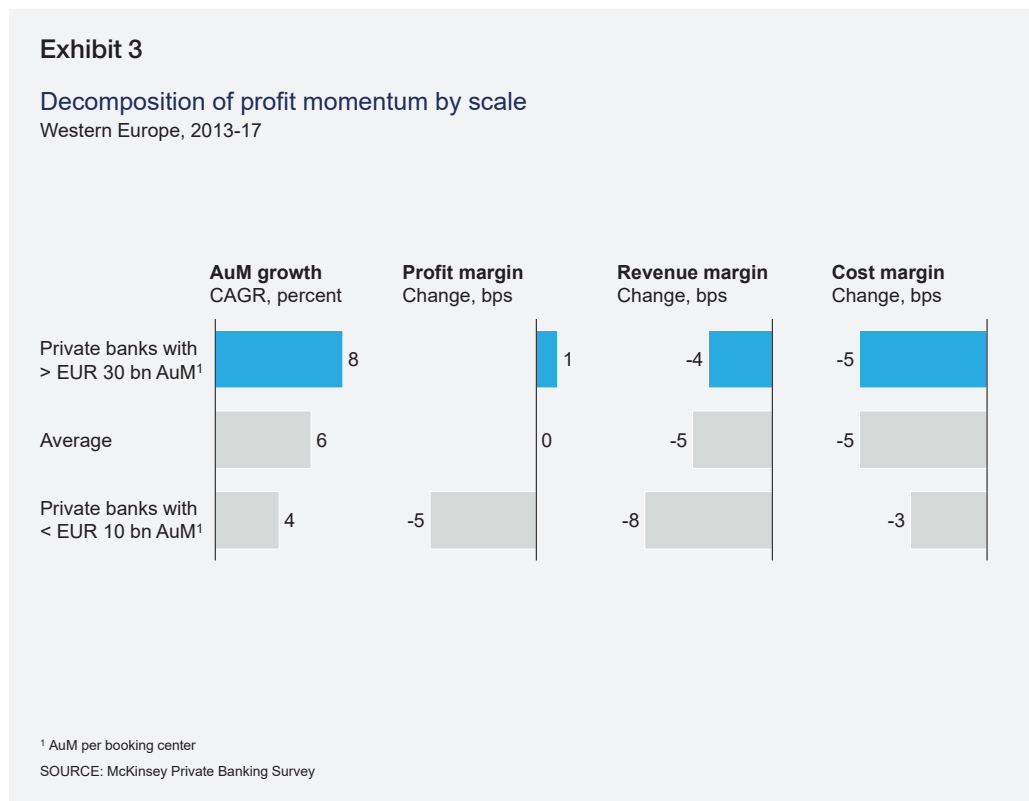
SOURCE: McKinsey Private Banking Survey

Scale is an advantage in profit growth; larger banks had both higher net inflows and better profitability

Larger firms enjoyed a growth advantage over the last five years, as profits at private banks with AuM over EUR 30 billion grew 8 percent annually, while the average European profit pool gained only 6 percent.

One factor is more rapid growth in AuM: from 2013 to 2017, the total AuM of large banks rose at an average 8 percent per year, double the 4 percent pace of firms with AuM below EUR 10 billion.

A second driver is a higher profit margin. Large firms held their margins stable between 2013 and 2017, while smaller banking players saw decreases of almost 20 percent, or the equivalent of 5 bps of AuM. Larger banks also managed to achieve slower decreases in their revenue margins, as well as stronger improvement in cost margins.



Industry profitability

Revenue margins were squeezed by an unfriendly environment, as well as a change in the client mix

Private banks' aggregate revenue margin decreased 5 bps, from 82 bps in 2013 to 77 bps in 2017, as revenue growth of only 4 percent could not keep up with the AuM gains of 6 percent (Exhibit 4).

Two causes are behind the erosion in revenue margin. First is an unfavorable external environment, with falling interest rates and tightened investor regulation. Second, private banks actively repositioned their business toward more wealthy client segments, and thus reduced their books of affluent clients. Affluent client AuM slipped from 19 to 16 percent of total AuM, while the UHNW share increased from 26 to 30 percent.

Taking these two drivers together, between 2013 and 2017 the industry lost a total of almost 8 bps in revenue margin:

- **Lower net interest income.** The lower interest rate environment, and thus a lower margin on deposits, combined to decrease revenues by 4 bps.
- **Lower revenue margin for mandates.** Margin levels for mandates had an overall reduction of 2 bps for two reasons: (1) revenues from retrocessions at private banks decreased due to MiFID II and the likes and (2) trading revenues fell on brokerage fee pressure and uncertain market conditions.
- **Change in the wealth band mix.** The increasing focus of private banks on wealthier clients, that pay lower fees, explained a 2 bps reduction.

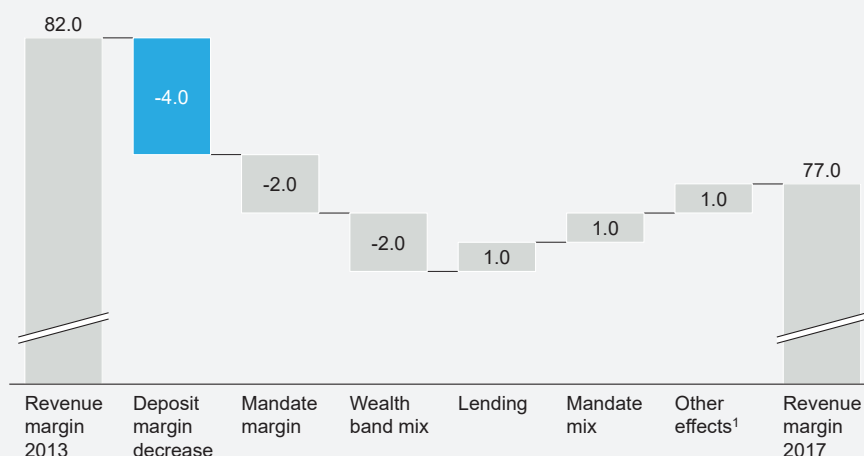
A little less than half of the loss in revenue margin, or 3 bps, was recovered by mitigating measures, in particular:

- **Increase in managed assets.** In the last five years, the share of managed assets increased by five percentage points, from 40 to 45 percent of AuM. This effect boosted revenue margin by 1 bp.
- **Expansion of lending margin.** An expansion of the interest rate spread helped increase revenue margin by 1 bp.
- **Other effects.** A collection of other factors – including a slight increase in higher-earning alternative assets – increased the revenue margin by 1 bp.

Exhibit 4

Revenue margin fall primarily driven by deposit margin decrease

Revenue margin evolution, 2013-17, Western European average, bps



¹ Pricing innovation (incl. nonfinancial services), price realization, others

SOURCE: McKinsey Private Banking Survey

While external factors, such as macroeconomic effects, can be mitigated only partially, revenue-enhancing measures, such as repricing or initiating new chargeable services, must be a future priority of private banks. MiFID II is expected to create additional revenue pressure until 2020, and estimates of the additional impact vary between 1 and 2 percent (on private banks) and 5 and 10 percent (on financial advisors and asset managers) of revenue margin decrease.

The industry must limit the expansion of overall costs

While private banks' revenues grew at 4 percent annually, the total cost pool was not far behind, rising at 3.5 percent. Despite numerous cost optimization efforts, the industry did not attain its goal of fixed platform costs. In 2017, however, a slowdown in cost growth to 2 percent helped to shore up industry profitability (Exhibit 5).

A more detailed view of cost evolution by type of bank reveals that offshore firms managed to keep the absolute cost pool growth at 2 percent over the last five years, while independent private banks allowed a continued expansion of the cost pool by 6 percent annually.

Overall, only one-quarter of private banks in the industry were able to reduce absolute costs over the last five years. Accordingly, the industry needs a broad-based effort to control outlays.

This cost push is needed despite the decline in the industry's cost margin over the last five years, from 57 to 52 bps, as the decrease in cost margin is primarily due to rapid growth in AuM. Out of the total 5 bps cost margin reduction, 3 bps can be attributed to increasing efficiency in the front office, driven by an annual increase in absolute frontline AuM loadings of about five percentage points (in line with industry AuM growth). The increase in AuM loadings was supported by a 1 percent decrease in the number of RMs in 2016 and 2017.

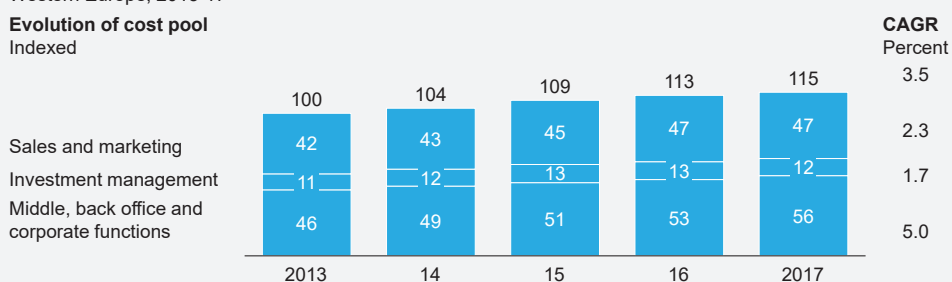
Exhibit 5

Details on the evolution of cost

Western Europe, 2013-17

Evolution of cost pool

Indexed



Cost margin bps	2013	14	15	16	2017
Cost margin bps	57	56	55	54	52

By player

Percent

Player	2013	14	15	16	2017
Universal onshore with retail	2	5	5	6	2
Onshore independent boutique	10	8	9	2	5
Foreign onshore bank	3	6	7	3	2
Offshore	0	3	3	1	-1
Overall	3	4	5	3	2

SOURCE: McKinsey Private Banking Survey

Underlying business characteristics

Despite an encouraging environment, contracted investment models grew at just 1 percent per year, or EUR 60 billion

In an environment where advisors' degrees of freedom in investment advice are limited by MiFID II and margins continue to be under pressure, contracted client service models, such as advisory or discretionary mandates, should be in high demand. However, from 2013 to 2017 the share of execution-only serviced AuM dropped only slightly, from 60 to 55 percent in total AuM.

Discretionary assets grew at 10 percent annually from 2013 to 2017, and expanded their share of total AuM from 23 to 27 percent. The share gain was enabled by more segmented offers, including standardized discretionary mandates by risk profile for smaller clients, and dedicated efforts of client reallocation as banks prepared for MiFID II. During the same period, the share of fee-based advisory mandates grew just 1 percent, to 18 percent of total AuM. The slow uptake in share gives evidence of private banks' struggle to move clients into more structured forms of advice.

Clients are searching for yield and have expanded holdings of alternative assets

Despite low interest rates from 2013 through 2017, cash holdings in client portfolios remained stable at 30 percent. The constant share of cash or cash equivalents – even in a cash-averse market cycle such as that of recent years – results from a balance between private banking clients' desire for a liquidity buffer and a perceived shortage of attractive and flexible investment opportunities.

For invested assets, we observe an increasing share of risk-bearing investments, driven by their higher return momentum as well as an active shift by clients. The shift to risk resulted in a rebalancing away from fixed income (from 26 to 20 percent of total AuM) into equities (rising from 26 to 30 percent). Additionally, holdings of alternative assets grew at 9 percent annually (although from a low base, so that their share of AuM held steady at 8 percent).

Within alternative assets, a decrease in hedge funds was compensated for by a significant uptake in structured products. The share of other alternative assets, such as real estate and commodities, stayed relatively stable. Private equity grew at a rapid pace of 12 percent annually; however it still accounts for 1.4 percent of AuM in 2017.

Assets invested outside of banks – art, commercial real estate, or private equity – represent a separate but relevant fraction of total HNW client assets. According to industry estimates from our survey, investors hold average return expectations for these investments of 10 to 20 percent. And yet only 40 percent of private banks embrace those investments as part of a comprehensive investment advisory approach.

Strategic outlook

Five steps for banks to reclaim profit generation

From 2013 through 2017, the key drivers of profit in the Western European private banking industry were for the most part outside of private banks' control. AuM was propelled by rising markets, which in turn were driven by macroeconomics, while decreasing interest rates and the introduction of MiFID II significantly limited value generation. Private banks need to get back in the driver's seat.

Private banks' core priorities should include (1) a more segmented value proposition, through differentiated offers, supported by a rationalized cost of service to protect profits.

To enable these new propositions, private banks must (2) innovate their approach to investment management and upgrade their product and services capabilities, and (3) combine the new offers with true omnichannel delivery.

To achieve self-driven AuM growth, private banks should (4) identify and tap into new markets while emphasizing net new money growth in existing markets through sales-force effectiveness. Banks can also selectively consider growth through mergers and acquisitions.

To convert these revenue gains into sustained profits, private banks must (5) aggressively manage their total costs to suit the scale of their operating platforms.

Appendix

Overview of KPIs in 2018

Key KPIs for Western Europe's private banks

2017

■ Better than 2013 ■ Same as 2013 ■ Worse than 2013

	Western Europe	WE onshore	WE offshore
Net inflow, percent	3	4	1
Performance, percent	4	4	4
AuM growth ¹ , percent	7	8	5
Revenue margin, bps	77	74	81
Cost margin, bps	52	49	58
Profit margin, bps	25	25	23
Share of UHNW assets, percent	30	27	38
Share of affluent assets, percent	16	20	7
Discretionary share, percent	27	29	22
Advisory share, percent	18	19	18
AuM/RM ² , EUR millions	220	211	225
Revenue/RM ³ , EUR thousands	1.697	1.553	1.815

¹ Excl. perimeter change

² Color coding based on delta of EUR 10 m

³ Color coding based on delta of EUR 50,000

SOURCE: McKinsey Private Banking Survey

Methodology

McKinsey's annual Private Banking Survey, first launched in 2002, seeks to provide comprehensive knowledge of the private banking industry. The survey is a global effort comprising most relevant markets: Western Europe, Central and Eastern Europe, Asia, and North America. For Western Europe, a new high of a total of 111 banks participated in the survey this year.

The participating banks in Western Europe cover a range of firm sizes and business models. Differently to previous years, slightly more than one-third of total participants were offshore banks. Another third were private banking units of universal banks. The last third was split between 20 percent private banking units of foreign firms, and 15 percent independent boutiques.

Firms apply varying methods to allocate revenues and costs within their wealth management operations, and among their wealth management activities and parent companies. These differences have been reconciled as far as possible, but some variations may remain, which could distort the final results.

McKinsey thanks all participants for their valuable contributions to the 2018 survey, which have enabled a better understanding of the economics of wealth management.

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