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European private banking: An inescapable call for action

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European private banking

Private banking has long been the most profitable sector in the global banking industry. Last year, the sector contributed a sizable 5 to 6 percent of profits with low capital requirement. Western Europe's private-banking sector has enjoyed a run of high growth till mid 2018, supported by positive market performance. European private-banking profits grew by an annual average of 6 percent in the five years before 2017. However, 2018 saw this run come to an end as profits shrank to €13.5 billion from the previous year's €14.7 billion. Profit margins were down to 22 bps, a loss of 3 bps over previous year.

The absence of long-running financial-market tailwinds, especially market deterioration in Q4, brought to the surface some of the structural challenges the industry has faced for a long time. Total assets managed by the industry fell by 4 percent in 2018. A rather steady 2 percent long-term rate of inflows wasn't enough to counterbalance a 6 percent fall in market performance. At the same time, revenue margins, which have also steadily declined for the last five years, fell to 75 bps in 2018—a loss of 6 bps since 2014. While European private banks have continued to take tactical measures to keep costs in check with revenue evolution, the absolute cost base has continued to grow 2 to 3 percent year on year. Together, these headwinds resulted in an 8 percent decline in absolute profits.

The 2018 performance further highlighted the benefit of scale in the industry. On average, small and midsize players have consistently underperformed. Over the last five years, profit margins of banks with total assets less than €10 billion per booking center fell to 1 bp from 7 bps in 2014. In contrast, profit margins of large banks (those with assets greater than €30 billion per booking center) grew to 40 bps from 39 bps in 2014. The benefit of scale, coupled with the fragmented nature of the industry, has meant that two-thirds of players have failed to improve profitability in the last five years.

Overall, these headwinds resulted in a rather challenging year and highlighted the need for

fundamental transformation. A high potential of a global slowdown adds to the urgency. Tactical measures like selective digitization of the service model or introduction of new investment themes (e.g., ESG investing—environmental, social and governance) may not be enough. Private banks will need to reconfigure their business model to operate in a market with flattening asset growth and ever-decreasing margins. We propose a three-part call to action for banks: (1) Double down on creating digitally enabled exceptional client experience, substantially improve front-office effectiveness, and consider new service value proposition models to drive growth. (2) Adopt a next-generation operating model that is akin to operating like a scalable technology platform—that is, automated and straight through with fully embedded mid- and back-office functions. (3) Benefit from structural shifts, including consolidation and sharing of costs by creating or participating in industry utilities (e.g. shareable technology platforms and mid- and back-office functions).

Longer-term challenge in Europe

Private banking has long been the most profitable sector in the global banking industry. Last year, the sector represented 5 to 6 percent of global banking profits, with low capital requirement. However, performance hasn't been uniform across regions (Exhibit 1).

Western European private banking profit margins declined over the last five years on the back of

Over last 5 years, Western Europe profit margin and C/I ratio deteriorating.

	Western Europe		APAC		North America ¹	
	2014	2018	2014	2018	2014	2018
Assets under management, € trillion	5.3	6.0	3.2	4.4	3.4	3.8
Total profit, € billion	12.7	13.5	6.4	10.0	7.9	10.6
Profit margin, bps	25	22	22	22	24	28
Revenue margin, bps	81	75	82	79	67	68
Cost margin, bps	56	53	60	57	43	40
C/I ratio, %	69%	70%	73%	72%	65%	59%

¹ Includes private banks only
Source: McKinsey Private Banking Survey

sharply declining revenue margins and rising costs. In contrast, North American private banks improved revenue margins (albeit from a lower base), and thereby, profitability. European banks are structurally used to operating in environments with higher revenue margins and have done less on costs than their North American counterparts. Those times seem to be changing, however, with almost all major regions heading towards somewhat similar margin environment.

2018's double strike on profitability: Performance loss combines with continued structural erosion

The absence of long-running financial-market tailwinds, especially market deterioration in Q4, brought to the surface some of the structural challenges the industry has faced for a long time. The year 2018 marked a turning point for Western European private-banking profits (Exhibit 2). The profit pool decreased by 8.0 percent in 2018,

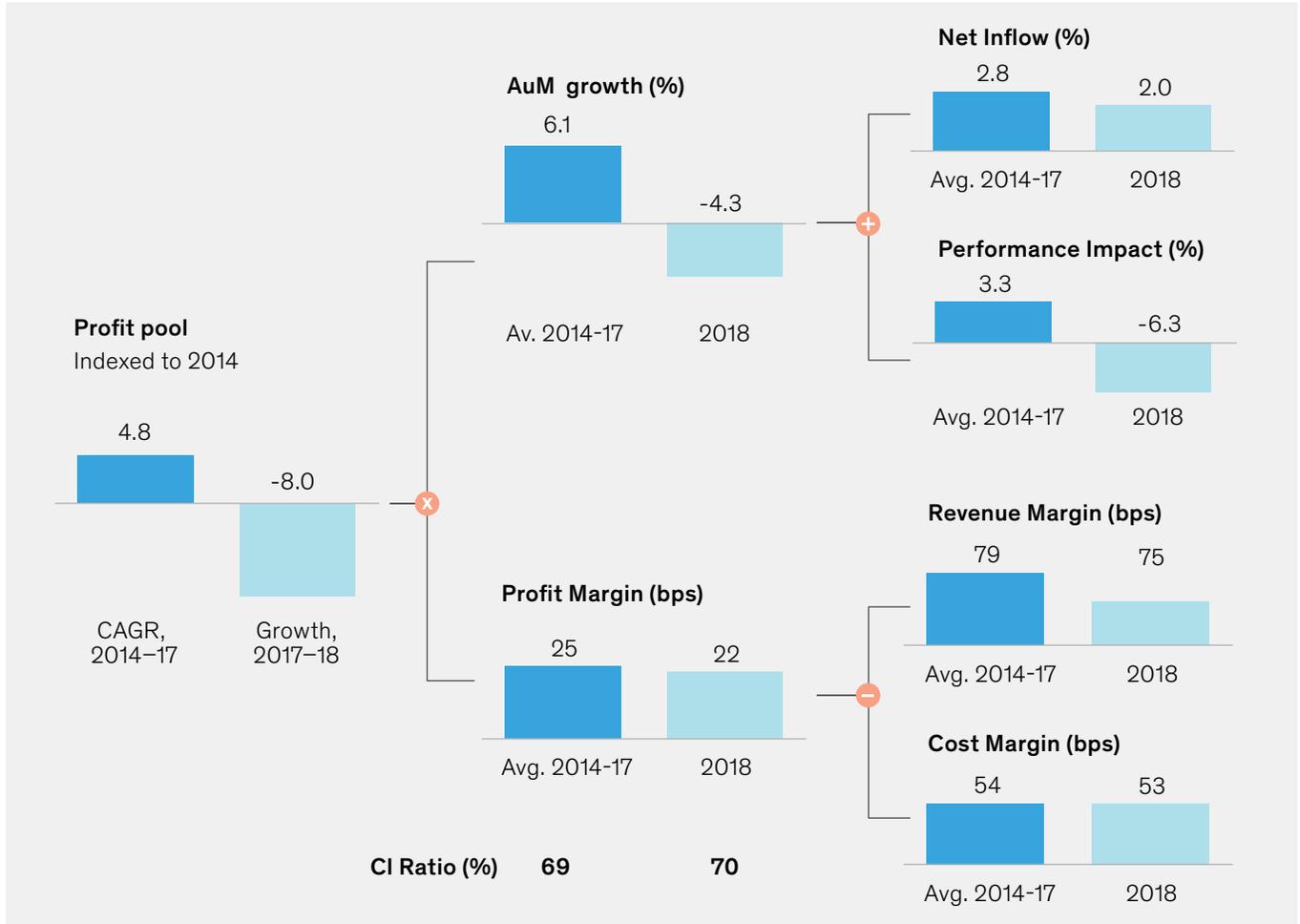
after four years of annual increases around 5 percent. The strong profit growth that the sector had historically enjoyed was driven by stable net inflows at 2.8 percent, moderate but positive market performance of 3.3 percent, and relatively stable profit margins at 25 bps. This run ended in 2018, with a profit decline driven by a 4 percent drop in assets under management (AuM), caused by negative financial market performance of 6.3 percent, particularly in the third and fourth quarters of 2018. At the same time, profit margins shrank to 22 bps, and revenue margins contracted to 75 bps.

Net inflows are hard to come by

The average net inflow between 2014 and 2017 was 2.8 percent, compared with, for instance, 5.8 percent between 2004 and 2008. In 2018, net inflow dropped to 2.0 percent, potentially driven by negative sentiment arising from weak stock market performance in the second half of the year.

Profit pool evolution.

Western Europe, 2014–18



Source: McKinsey Private Banking Survey

A few insights can be gleaned from decomposing net inflow growth (Exhibit 3):

- *Offshore inflows beginning to level with onshore inflows.* During the last five years, annual net inflow for offshore banks was 1.1 percent, compared with 3.3 percent for onshore banks, mostly due to automatic exchange of information and tightening of compliance standards. However, offshore private banks have been consistently improving net inflow during this period, after hitting their low point in 2014. In 2018, offshore net inflow was at 1.8 percent. This was similar to the onshore rate of 2.1 percent, which suggests that the offshore model is beginning to stabilize. However, significant differences remain between booking centers.

For example, Luxembourg has been outgrowing Switzerland for the last five years (+2.9 percent vs. -0.2 percent per annum).

- *No major differences between the different onshore business models.* As has been the case for the preceding five years, no noticeable differences exist between the net inflows for private-banking arms of universal banks, foreign players, and independents. If anything, in 2018, the dominance of private banks owned by universal banks took a hit, with net inflow dropping to 2 percent from 4 percent previously.
- *Ever-growing tail of shrinking banks.* In 2018, 32 percent of private banks experienced net outflows, compared with 25 percent five

years ago. Of the players that experienced net outflows, a majority did so for the second year in a row. While 2018 might have exacerbated the profitability challenge of the industry, a large proportion of private banks have struggled to generate net inflows for a long time.

- *Significant differences by country.* Over the previous five years, Spain and France had the highest average net inflows (at 7 percent and 4 percent, respectively), and this repeated in 2018 (6 percent and 4 percent). On the opposite end of the scale, Switzerland and Monaco posted an average inflow of 0 percent over the last five years, with Switzerland improving in 2018 (at 1 percent) while Monaco was at -2 percent (a net outflow) over the period.

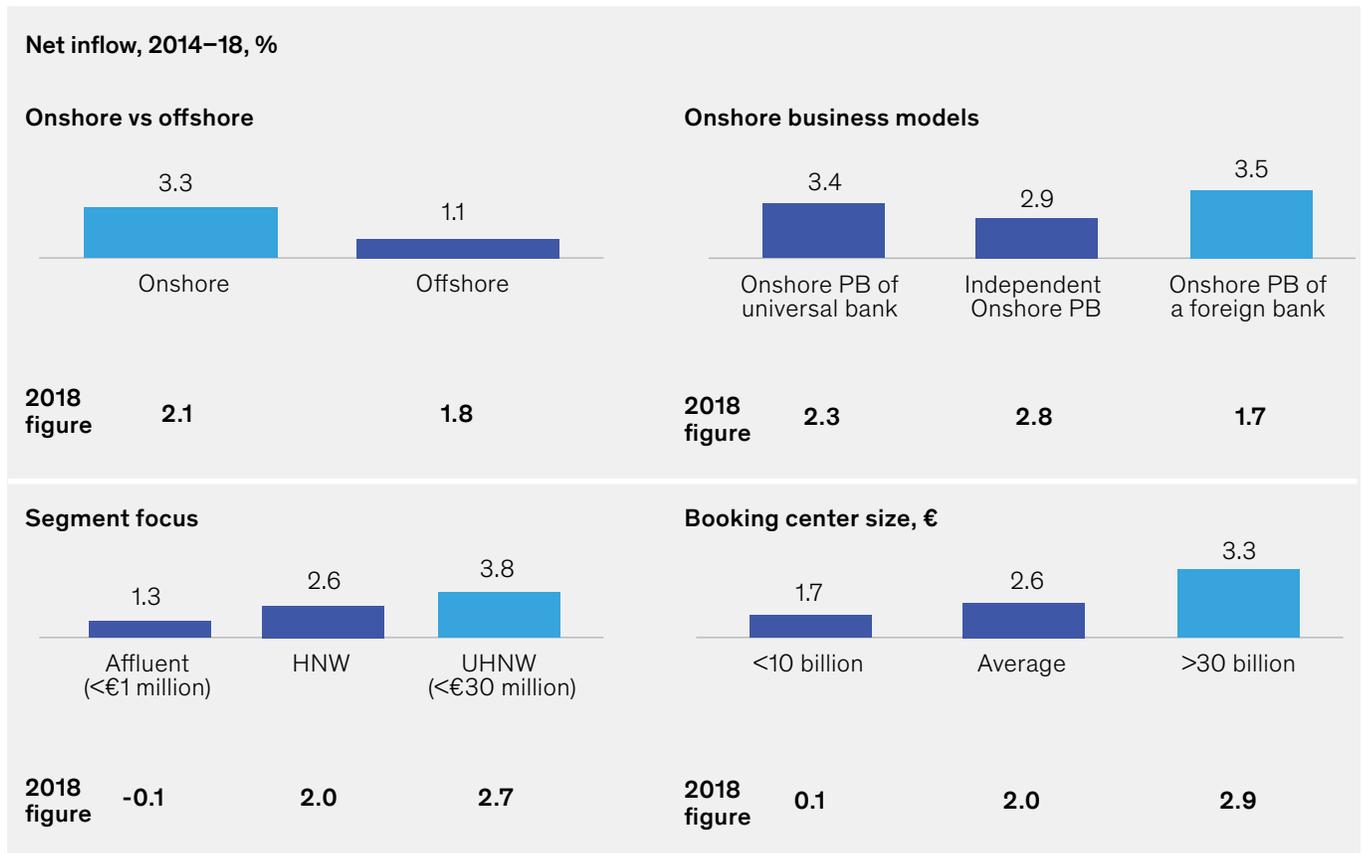
However, there are some emerging trends in positive performance :

- *Access to referrals.* In 2018, one-third of net inflows were generated by referrals from retail and corporate channels. This is understandably driven by private-banking arms of universal banks that also own large retail and corporate businesses.
- *Focus on clients with ultra-high net worth (UHNW).* Over the last five years, players with a UHNW focus have grown their net inflow at twice the rate of the industry at large (3.8 percent, versus 1 to 2 percent for their peers).
- *Scale.* Larger private banks have since 2014 had significantly higher net inflows than smaller banks (3.3 percent annual net inflow for booking centers with more than €30 billion each, compared with 1.7 percent for booking centers with less than €10 billion each). This trend was even stronger in 2018: 2.9 percent for those with

Exhibit 3

Success factors in an environment of overall lower net inflow levels.

Western Europe



Source: McKinsey Private Banking Survey

more than €30 billion, versus 0.1 percent for those with less than €10 billion.

Revenue margin continues to decline, with high-growth UHNW clients posing most challenge

Revenue margin decreased 1 bp annually between 2014 and 2017, from 81 bps to 77 bps. In 2018, margins fell by another 2 bps to 75 bps. The impact was more pronounced for offshore banks. Their margins declined by 3 bps in 2018 to 78 bps, in contrast to onshore banks, which saw a decline of 1 bp to 73 bps.

Contraction in revenue margin has been driven by several factors in the last five years (Exhibit 4):

- *Deposit margin contraction.* Deposit margins declined from 42 bps in 2014 to 26 bps in 2018, while share of cash in total AuM was relatively stable over the same period. This resulted in a decrease of 4 bps for overall revenue margin. Understandably, an even longer low-interest-rate environment has also posed challenges

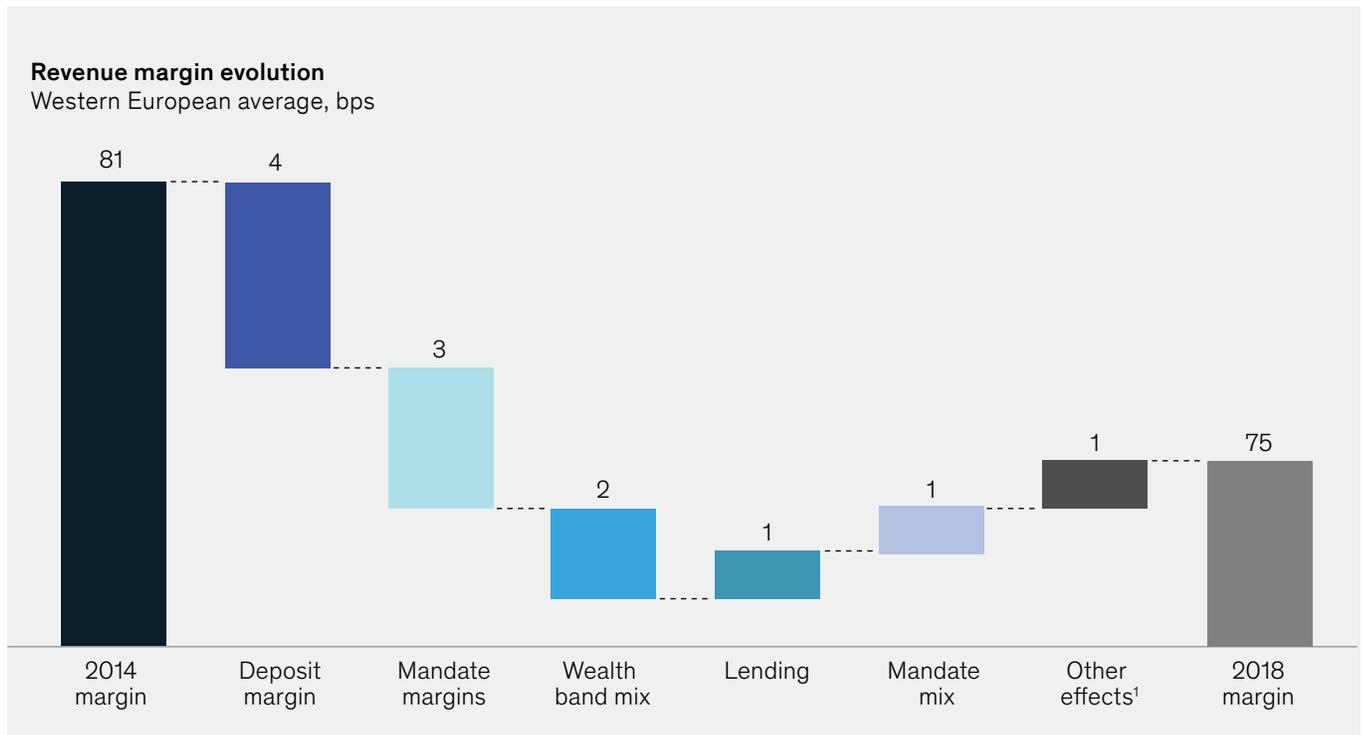
for the private banking industry, as it has for retail banks.

- *Pressure on mandates margins.* Investment margins on mandates also declined, falling 6 bps from 97 bps in 2014 to 91 bps in 2018. This resulted in a decrease of 3 bps for overall revenue margin. This revenue margin contraction on mandates was driven by an increase of the entry threshold for fee-based advisory mandates, increased transparency on fees through regulation and introduction of new pricing schemes (all-in or semi all-in) and a shift to a wealthier client mix, discussed next.
- *Change in client mix.* Revenue margins from smaller clients (those with less than €2.5 million in assets under management) actually grew from 131 bps in 2014 to 133 bps in 2018. However, this segment also had a share of total assets that was four percentage points lower in the same period. At the same time, margins from UHNW clients shrank sharply from 36 bps in 2014 to 31 bps in

Exhibit 4

Revenue margin evolution primarily driven by deposit margin decrease.

Estimate



¹ Pricing innovation (including nonfinancial services), price realization, others
Source: McKinsey Private Banking Survey

2018, even though this segment grew its share of total assets from 27 percentage points to 30 (Exhibit 5). The decline in margins from UHNW clients can be attributed to overall bargaining power in a challenged environment and greater share of lower-yielding assets (including cash and individual securities).

Private banks have been taking actions to counterbalance some of the structural margin pressures:

- Growing the discretionary and advisory share (from 41 percent in 2014 to 47 percent in 2018), resulting in a 1 bp counterbalance to otherwise declining overall margins, by strengthening their value propositions, enhancing client communication of those propositions, adapting relationship manager incentives, and demonstrating actual performance
- Increasing penetration of relatively higher-margin lending products within the client base from 11 to 12 percent

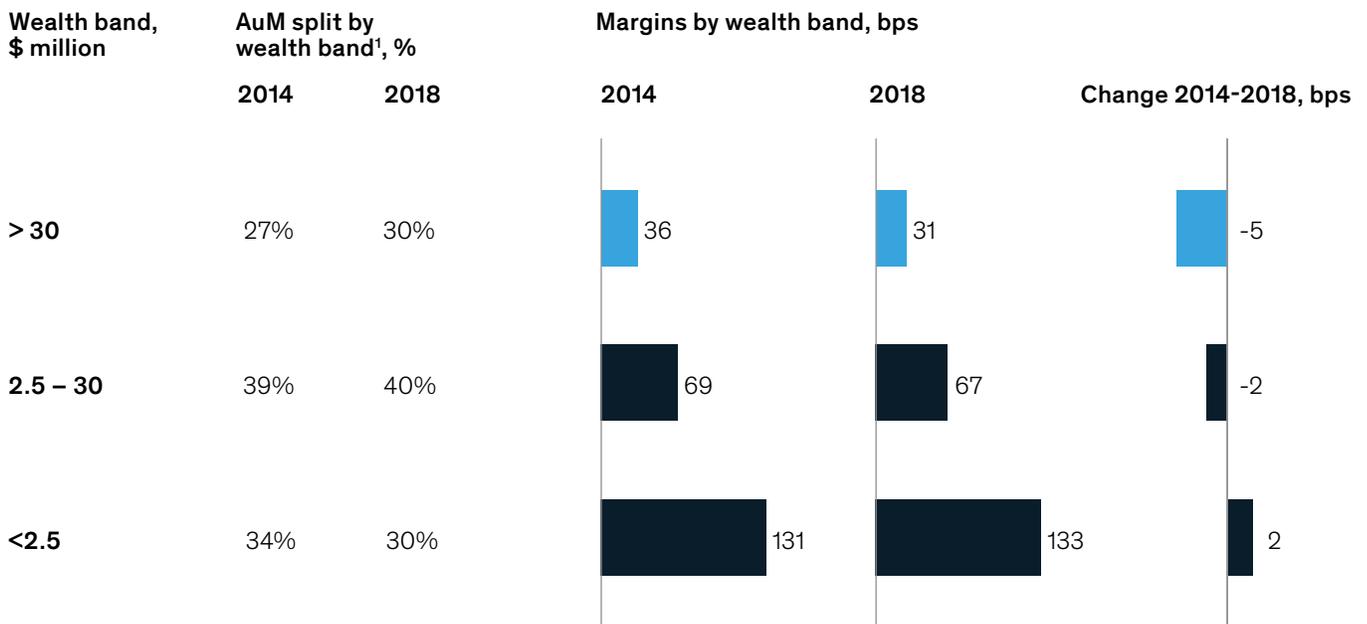
- Instilling greater pricing discipline, including leakage avoidance

In addition, private banks have been revisiting the core building blocks used in constructing their model portfolios, so they can better manage the total cost to clients. In part, they are focusing on total cost of ownership to reduce some of the pressure on their own share of margins. For example, the share of funds (which can be relatively more expensive building blocks) in managed assets decreased by one percentage point to 29 percent in 2018. In general, banks have continued to rely less on third-party managers, as they no longer receive retrocessions. Instead, they are either managing more of the assets internally or increasing reliance on passives, especially in asset classes where creating alpha over a longer time horizon is difficult. Share of passive instruments (ETFs) in private-banking AuM increased from 3.8 percent in 2014 to 4.5 percent in 2018.

Exhibit 5

Margins decline fastest in high growth ultra high net worth segment.

Western Europe



¹ Also includes shift effect between wealth bands
Source: McKinsey Private Banking Survey

Costs continue to escalate, partly due to limited operating leverage

The absolute cost base of the industry has been consistently growing at 2 to 3 percent annually since 2014. This highlights the lack of operating leverage and scalability in the private-banking model, despite increased investment in automation, technology, and the overall level of digitization, albeit from a low base. Cost inflation has been highest in the front office (including sales and marketing), at about 4 percent annually, followed by the back-office, at roughly 3 percent annually (Exhibit 6).

The industry's cost challenge has been somewhat camouflaged by healthy financial-market performance and net inflows in the period 2014–17,

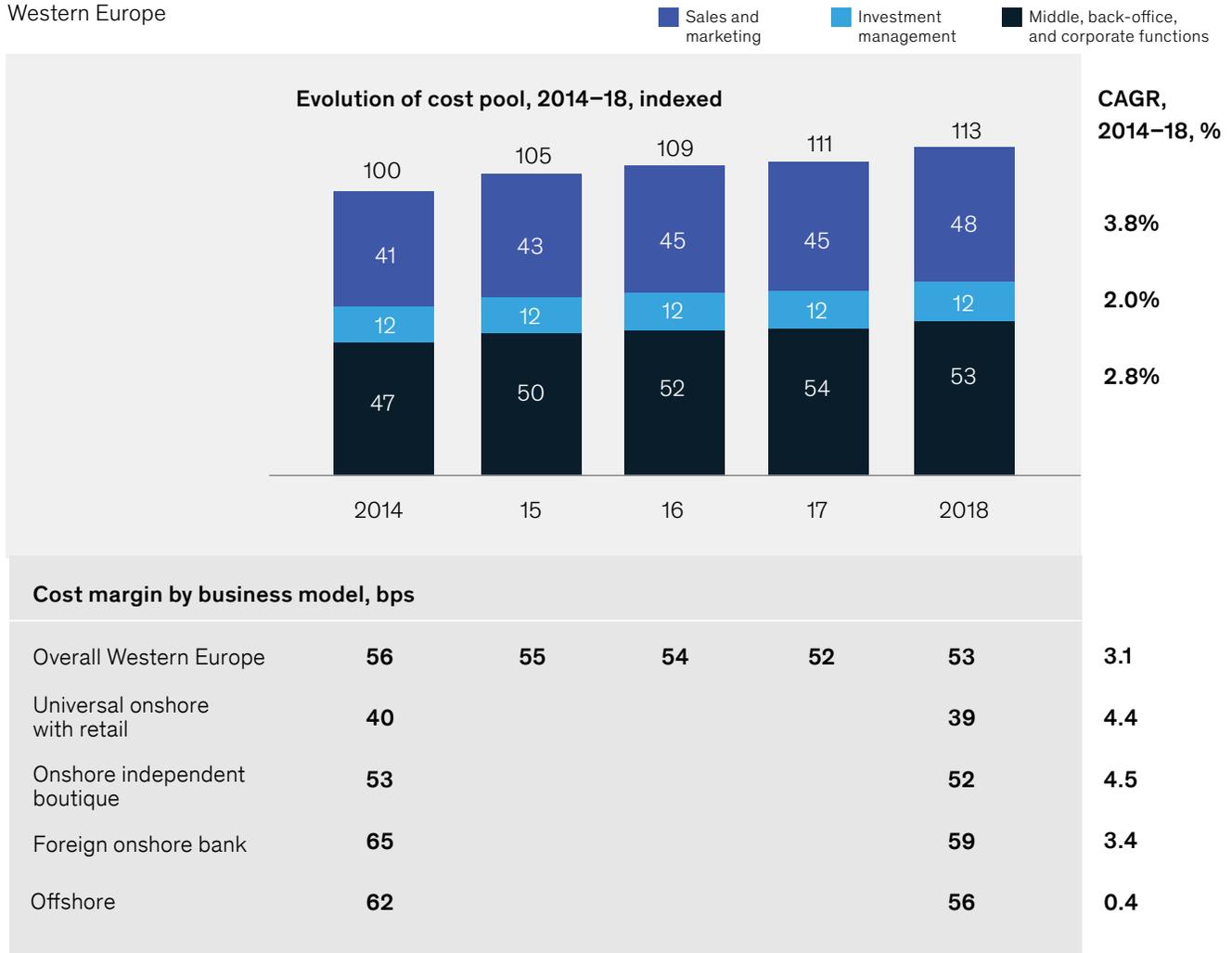
resulting in cost-margin improvement of 4 bps in the same period (from 56 bps in 2014 to 52 bps in 2017). However, the challenge became more evident in 2018 as cost margin rose by 1 bp to 53 bps, given the fall in total assets. It is important to note that we use average in-year assets to calculate cost margins. The cost margin is noticeable higher if we use year-end AuM, as Q4 was the worst quarter in terms of market performance. Given the general delineation between costs and total assets in the industry and lack of scalability in operating models, the 2020 cost-margin picture could become substantially worse, unless banks take near-term action.

Over the last five years, despite a cost margin decrease from 56 bps to 53 bps, private banks did not manage to truly scale up cost effectively, as

Exhibit 6

Continuous expansion of costs, despite decline in margin.

Western Europe



Source: McKinsey Private Banking Survey

total costs increased as fast as total revenues, at 3 percent annually. Along the value chain, total front-office costs grew fastest (3.8 percent per year), but cost margin (weighted by revenues) fell from 23 bps to 22 bps. Total middle and back-office costs also grew at 2.8 percent per year as cost margin decreased from 27 bps to 25 bps. Investment office costs increased moderately by 2.0 percent per year as cost margin remained stable at 6 bps.

In terms of business models, offshore banks reduced cost margin by 6 bps (from 62 bps to 56 bps) over the last five years, increasing their cost base on average by 0.4 percent. Onshore players on average increased their cost base in the same range (by 3 to 4.5 percent), also explained by higher AuM growth than for offshore.

Nearly two-thirds of banks failed to improve profitability and demonstrate resilience in the last five years

Given the anticipated turmoil in global markets, and consequently in total assets, we believe business model resilience will be critical for enabling private banks to withstand pressures. We use evolution

of the cost-to-income (C/I) ratio as a proxy for assessing profitability and resilience, as it tests for a bank's response to changes in both AuM and revenue margin. Over the last five years, nearly two-thirds of European private banks failed to improve C/I ratios, despite relatively healthy asset growth driven by market performance and net flows. Absolute costs in the industry have been steadily rising and pose a much graver threat to these banks if the anticipated slowdown materializes.

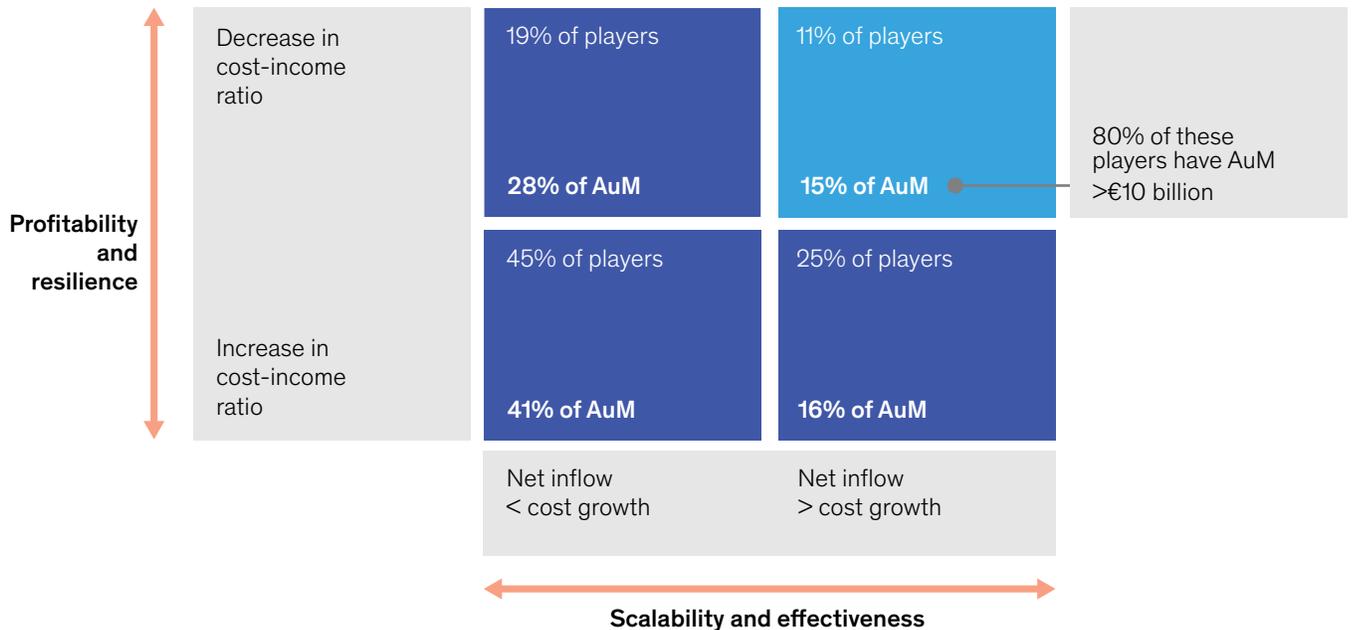
We also tested whether the growing cost base is actually generating ROI and if the industry benefits from operating leverage. Over the last five years, only 36 percent of European banks were able to grow net flows at a rate higher than cost growth, demonstrating scalability in their operating model.

Putting these results together, we believe that only a small fraction of banks is well positioned to navigate a potentially tougher economic environment and achieve profitable growth as opportunities arise. These are represented by the 11 percent of banks that both managed to decrease their C/I ratios and achieve a net flow rate higher than their cost growth (Exhibit 7). Of these banks 80 percent have

Exhibit 7

Only 11 percent of firms have sustainably improved performance over the last five years.

Western Europe, 2014-18



Source: McKinsey 2019 Private Banking Survey

AuM greater than €10 billion, reemphasizing the importance of scale.

Large banks—those with AuM greater than €30 billion per booking center—have consistently performed better than banks with AuM less than €10 billion each across nearly every parameter (Exhibit 8). Nearly 30 percent of European private banks in our sample are subscale, in the under-€10 billion category. They have an average C/I ratio of 98 percent, which is nearly twice that of their larger peers. We believe these players will find it difficult to thrive in a challenging economic climate and could be willing (or unwilling) candidates for further consolidation.

MIFID II further aided growth of contracted mandates, requiring focus on developing scalable and standardized investment propositions

The year 2018 saw a further shift in private-banking assets, away from execution-only services to

contracted, discretionary and advisory mandates. This was likely further fueled by investor protection provisions of Markets in Financial Instruments Directive (MiFID II), as the impact of regulatory change started fully coming into effect.

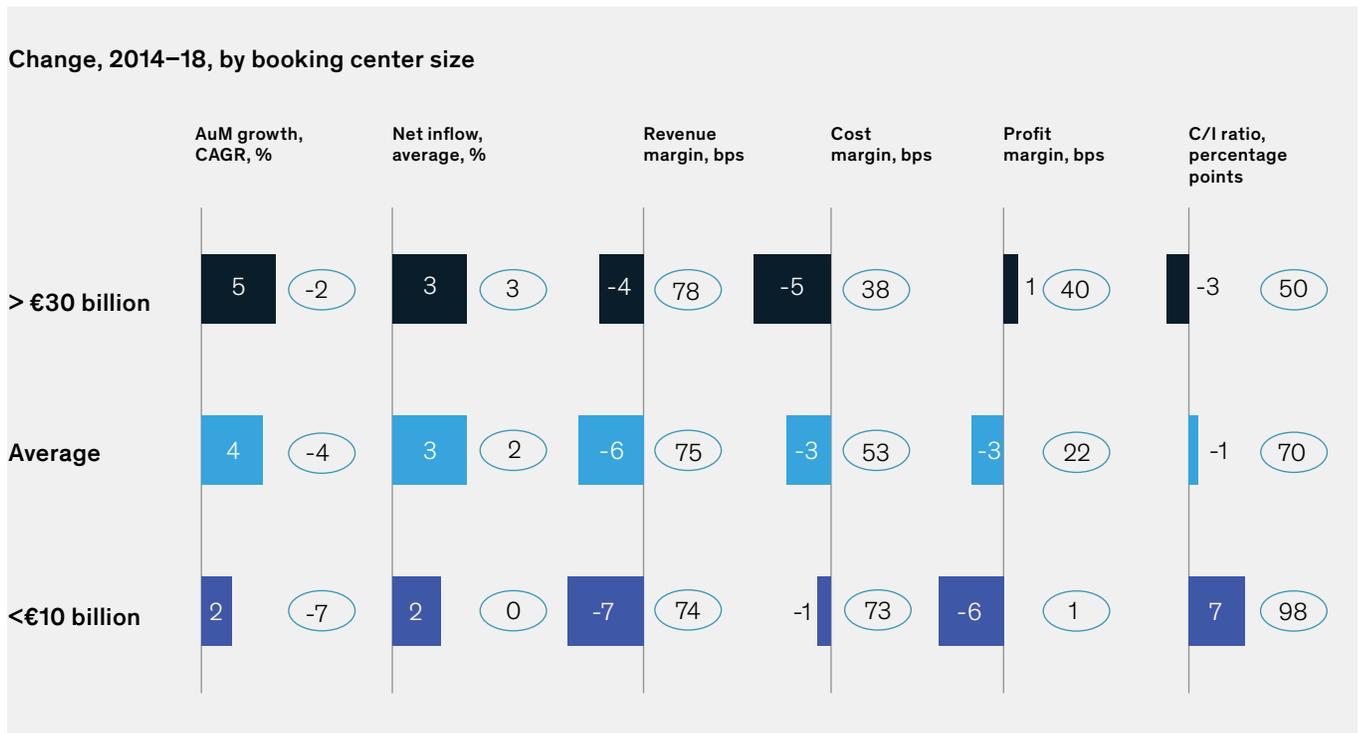
There has been a further shift of two percentage points in the share of assets from execution-only services to contracted mandates, resulting in 47 percent penetration of discretionary and advisory services at the end of 2018. While the penetration of contracted mandates had been gradually increasing over the last five years (41 percent in 2014 to 45 percent in 2017), the shift was more pronounced in 2018. A similar acceleration also occurred in the United Kingdom, after the implementation of Retail Distribution Review (RDR) recommendations, which have similar investor protection provisions as MiFID II. Share of discretionary mandates in the United Kingdom grew from 34 percent in 2013 to 38 percent in 2016,

Exhibit 8

Scale important for multiple dimensions.

Western Europe

○ 2018



Source: McKinsey Private Banking Survey

during implementation of RDR provisions.

These movements resulted in share of discretionary mandates growing to 28 percent (versus 27 percent in 2017) and share of advisory mandates to 19 percent (versus 18 percent in 2017). Onshore private banks continued to have significantly higher penetration of discretionary mandates, at 30 percent versus 22 percent for offshore private banks.

As was the case in 2017, investment performance of discretionary mandates outperformed that of advisory mandates by three percentage points. This highlights the value of scalable and standardized investment propositions that are supported by a strong, centralized investment office.

Given these shifts, private banks will need to continue investing in strengthening their discretionary and advisory capabilities, especially in the following ways:

- *Strengthen the investment office with standardized and industrialized approaches.* The industry has already been on a path toward standardizing investment models. Private banks believe that currently 65 percent of their total discretionary assets are already within standardized models (as opposed to 25 percent for advisory mandates). Given the regulatory risk and cost challenges the industry faces, private banks that are yet to make this shift will need to turbocharge their efforts toward standardization. This will require investment in their investment office, evolution of their front-office and risk management model, and careful management of the changes required in client portfolios.
- *Leverage technology.* A fully automated portfolio management system that supports management of standardized models and allows for tailoring of client portfolios (within preset guidelines) is critical for private banks. Outdated portfolio management systems and the use of “spreadsheets” to manage portfolios, although still prevalent in some small and midsize banks, is no longer sustainable in today’s environment.

Banks will need to fundamentally transform their business and operating model to thrive in the new environment

Industry headwinds have resulted in a rather challenging year and have highlighted the need for fundamental transformation. A high potential of a global slowdown further adds to the urgency. In recent years, most private banks have focused their investment in adapting their systems and processes to comply with the new regulations. Some have undertaken tactical measures like selective digitization of the service model, introduction of new investment themes (e.g., ESG), or targeted automation of processes. However, this will no longer be enough. Private banks will need to reconfigure their business model to operate in a market with flattening asset growth and ever-decreasing margins.

We suggest a three-part call to action. First is to improve client experience by doubling down on creating digitally enabled, exceptional client experience, substantially improving front-office effectiveness, and considering new service value proposition models (e.g., partnerships) to drive growth. Next is to update technology by adopting a next-generation operating model that is akin to operating like a scalable technology platform. Finally, private banks can benefit from structural shifts, including driving consolidation and sharing costs by creating or participating in industry utilities (e.g., shareable technology platforms for mid- and back-office functions).

1. *Create exceptional client experience and drive front-office effectiveness.* The private-banking industry has lagged the evolution in client expectations that has been driven by clients’ experiences in other industries. The service model has remained largely unchanged, with overreliance on skill of the individual private bankers, rather than building institutional capabilities and processes. Clients can no longer be classified into preferring a single channel (face-to-face or digital) for all their needs, nor they can they be bucketed in terms of wanting a standard packaged proposition. For banks to build flexibility and substantially improve client experience, we recommend the following actions:

- a. Reinvent client journeys end to end, paying careful attention to what influences client experience and enable overall efficiency in delivery of service to reduce costs.
 - b. Build omnichannel capabilities that enable clients and their RMs to engage across multiple channels in a seamless manner. Allow clients to use digital interfaces for some of their needs while focusing face-to-face time on client's most pressing issues and life events.
 - c. Proactively measure client experience and understand the voice of the customer to continuously learn and deliver superior improvements over time while making clear choices on where to differentiate versus competition.
 - d. Substantially improve front-office effectiveness and ignite growth by improving sales culture and enhancing performance discipline. Invest in learning programs and tools that enable relationship managers (RM) to be more effective and instill a significantly greater performance mind-set. Measure RM performance across a broader range of drivers, including client experience. Aspire to achieve a set change in RM loadings and profitability, including the use of technology enablement.
 - e. Build internal capabilities or partner to offer a competitive PE/Alternatives proposition given the barbell of client portfolios towards passives on one end, and alternatives/PE/Private companies on the other
 - f. Consider new models and innovate to drive growth. Technological evolution is resulting in greater interconnectedness among clients' various service providers across all their needs. Explore potential new partnerships to become further entrenched in clients' daily life (e.g., leveraging private investment and alternative investment platforms to expand investment universe). Continue innovating on the core investment proposition to meet emerging themes (e.g., ESG).
 - g. Align pricing strategy to perceived value by the customer and value for the bank to enhance client experience and salesforce effectiveness
2. *Adopt a next-generation operating model.* So far, banks have adopted largely tactical initiatives to better manage their cost base. There has been targeted replacement of specific platforms, automation of some of the manual processes, and some effort at simplification of the product and operating model. However, given the recent and anticipated pressures, a more transformational approach will be necessary. Banks will need to adopt a "digital first" approach that enables them to become more like a tech platform by undertaking the following actions:
 - a. Focus sales and client service where you have a natural right to play, rather than taking a broad-brush approach, catering to large parts of the market. This will help in simplifying the business and focusing investment in areas that would generate the highest returns.
 - b. Streamline the product suite substantially, focusing on propositions and products where a bank can truly generate some scale. Consider divesting noncore businesses to more scalable players.
 - c. Adopt a digital-first approach as you transform end-to-end client journeys, aspiring to eliminate all manual and algorithmic activity across the bank.
 - d. Automate at scale where a full digital transformation is unlikely to generate ROI. Build an internal engine that identifies the highest-value use cases and delivers capability quickly. Automation can go a long way in reducing costs and risk without necessarily requiring large-ticket investments.
 - e. Leverage advanced analytics and deliver high-impact use cases to drive sales and client experience. Advanced analytics can enable RMs to deliver "bespoke experiences" at a much lower operating cost.
 - f. Implement agile practices across the bank to become faster, more productive, and more responsive to customer needs
 3. *Benefit from (or drive) structural shifts that support the broader industry.* The private-banking industry is highly fragmented, and as highlighted earlier in this report, small and midsize players have continued to experience

profitability challenges. In fact, profitability of private banks with less than €10 billion in assets per booking center has declined over the last five years, despite strong market performance and steady net flows. Given these structural challenges, small and midsize players will need to consider more structural moves to fundamentally lower their cost structure and improve performance. They should consider these options:

a. Pool capabilities to create or participate in industry utilities that allow you to share your cost base. If private banks simplified their operating model and drove greater standardization, they could potentially come together to create or leverage a industry utility that allows them to share costs with other similar private banks. This could be targeted at specific back-office functions like compliance, know your client due diligence (KYC), trade reconciliations, or the utility could become a full-fledged platform that provides all core

services, leaving a private bank to focus on clients, solutions, and front-office functions. A version of this has already been achieved in the UK wealth management industry via FNZ, which has become the core platform utility for majority of the mass and affluent adviser market.

b. Drive consolidation to build scale. Banks that adopt the next-generation operating model described in this report are going to be better positioned to acquire other private banks or capture value from being acquired by a competitor. Traditionally, consolidation has sporadically created value in the industry, given the differences in propositional, pricing, and operating models, as well as cultural differences, of the two banks coming together. Adoption of next-generation operating model, building on an existing platform that can be scaled up rapidly, could enable unlocking value from consolidation.

Methodology

McKinsey's annual Private Banking Survey, launched in 2002, provides comprehensive knowledge of the private-banking industry. The survey is a global effort comprising most relevant markets: Western Europe, Central and Eastern Europe, Asia, Middle East, Latin America and North America. For Western Europe, a new high of 113 banks participated in the survey this year.

The participating banks in Western Europe cover a range of sizes and business models. Around one-third of total participants (32 percent) were private-banking units of universal banks, 27 percent were offshore private banks, 24 percent private-

banking units of foreign firms, and 18 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 2019 survey, which have enabled a better understanding of the economics of wealth management.

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