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Industry Challenges: New and Old

After years of persistently strong growth, driven in part by booming stock markets, the wealth management industry is emerging from the recent downturn. But it faces a series of huge structural challenges (see Figure 2.1). This chapter introduces these challenges, which form the backbone of the rest of the book.

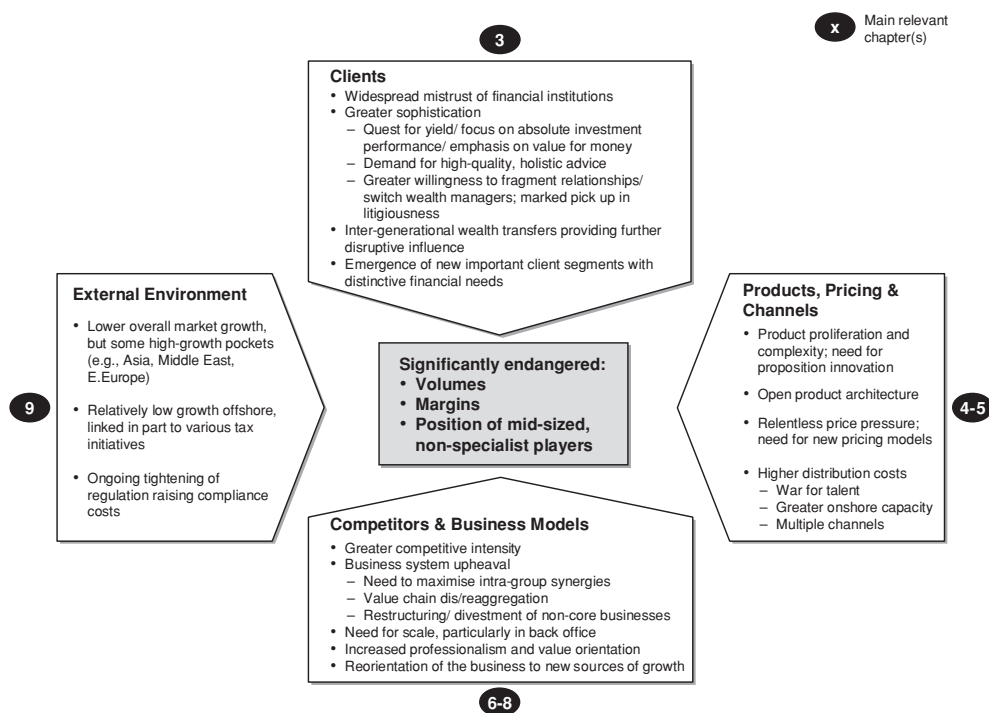


Figure 2.1 Key wealth management industry challenges
 Source: Author's analysis.

Of course, not all these challenges are new. Greater client sophistication, for example, has been an industry bugbear for well over a decade. It is the *confluence* of challenges – new and old – and the magnitude and speed of their combined impact that is unprecedented.

In an industry that has been accused of being sleepy, the challenges have been quite a wake-up call. One group of players – the ‘early risers’ (including the large Swiss banks and some of the brokerage houses) – was quick to spot the need for radical action and is now on the way to tackling the challenges head on. Another group of players (including some of the universal banks), linked to their better positioning or scale, has been content to take a more relaxed approach. But there is a further group of players (including some of the small/mid-sized players) – ironically, the very players that should be best placed to succeed in this business by

providing the truly personal service that wealthy clients crave – that has not yet fully come to terms with the new realities.

For all players, life will never be quite the same again. The overall impact is that, despite the recent pick-up in financial markets, high, sustained profit growth is no longer assured for all. Clearly, each of the challenges affects different players in different ways and some players are better positioned to deal with them than others. Mid-sized generalists, in particular, are likely to need to take the most radical action to secure a place in the new world.

2.1 CLIENTS

Arguably, the industry’s biggest challenge is the need to restore that most sought-after attribute: trust. In the wake of well-publicised scandals in other, related parts of the financial services industry (including equity research/investment banking and mutual funds), many clients remain wary of wealth managers, and there continues to be an environment of heightened scepticism and mistrust (see Figure 2.2). In particular, the majority of clients believes that the industry is motivated by greed and that relationship managers put their own interests first. Account churning is another notable perceived problem, a recent reported example being allegations by a former private banking client of the Spanish bank, BBVA.¹ Moreover, many clients do not believe the industry is prepared to put its house in order, by punishing transgressors or through tighter internal controls and greater disclosure of fees and risks.

Many argue that a broad pick up in financial market performance can be relied on to restore clients’ lost trust. But that would only postpone the day of reckoning. And, in any event, emboldened regulators and a more intrusive media mean that the issue is unlikely to go away.

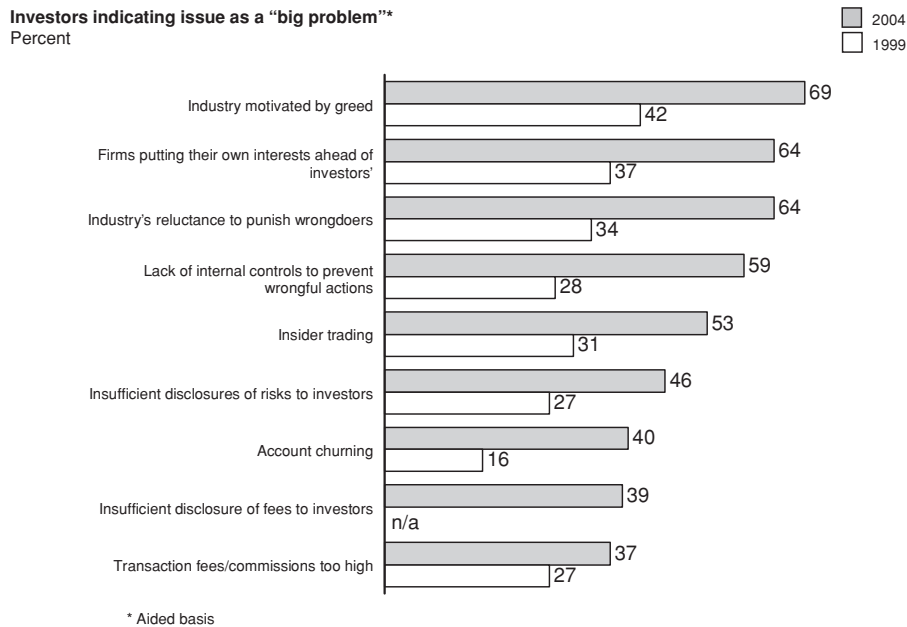


Figure 2.2 Clients’ ‘big problems’
Source: US Securities Industry Association annual investor survey, November 2004.

¹ BBVA has denied any wrongdoing.

Some firms have been vocal in their efforts to restore trust, a good example being Citigroup's 'Five Point Plan', which involves:

1. Expanded training for employees.
2. Improved internal communications.
3. Enhanced focus on talent and development.
4. Balanced performance appraisals and compensation.
5. Strengthened controls.

In the end, the key test is whether wealth managers can provide clients with high-quality, objective advice.

The composition of the client base is also becoming much more challenging. The well-known shift from old wealth to new wealth continues, and is now relatively evenly balanced in most mature markets. But the changes here go far deeper than that.

The sheer breadth and diversity of the client base is a challenge in itself. It now extends across entrepreneurs of various types, corporate executives, sports and entertainment stars, professionals, inherited wealth, retired people, and a host of niche groups such as lottery winners. Some players have made important strides in adapting their businesses to the needs of specific segments. But there remains a surprisingly large number of players continuing to use essentially a one-size-fits-all approach.

Clients are becoming ever more sophisticated, partly driven by the greater availability of financial news, data and analysis. That is clearly placing very strong product and service demands on wealth managers. The upside of this, however, is that wealth managers can, to some extent, do less in the way of basic 'hand holding' and are able to focus on sales and advice in more complex areas.

Clients are also seeking greater aggregation and control of their wealth. Most clients want to be more actively involved in their wealth management activities and often see their wealth manager as a partner with whom to validate their own investment choices. They are no longer content simply to hand over their wealth and wait for their annual portfolio review ('manage it *with* me, rather than *for* me'). Clients now have far greater demands than five years ago. They are more performance conscious and demand state-of-the-art products and services. At the same time, many clients are increasingly price sensitive and want more value for money.

Turning to investment preferences, the recent stock market downturn left its mark on clients, and many continue to seek guaranteed returns and (full or partial) capital protection. The low-inflation environment has also been influential, with clients increasingly focused on a quest for yield and delivery of absolute (rather than relative) investment performance, at least for a portion of their wealth.

Above all, clients are seeking consistent, high-quality, holistic advice and a means of navigating through the often bewildering array of products (in mutual funds alone, there are more than 54 000 products available globally). Given the greater financial market uncertainty, asset allocation services are in particularly strong demand.

Wealth management clients are complex and typically have international business interests and lifestyles. It is therefore quite typical for clients to have more than one provider, which can also be driven by diversification and secrecy considerations, the need to access specialist expertise and so on. Though some clients have been actively reducing their number of providers in recent years, many have shown an increasing desire to fragment their financial relationships where necessary, across both traditional and non-traditional providers. The IBM European Wealth and Private Banking Industry Survey 2005 found that 40% of clients use more than one provider. That, in turn, offers them a direct way of comparing providers. Indeed, it is increasingly

becoming the norm for clients to test out providers by giving them small amounts of wealth to manage. Clients then reward a provider's strong performance by committing more funds.

Clients are also far more prepared to go to law when they feel there has been wrongdoing by their wealth manager. In the United States, for example, the number of investment arbitration cases rose by more than 60% between 2000 and 2003, linked in particular to issues around the omission of facts and investment unsuitability.

IBM found that a client's principal provider typically manages 60%–70% of the client's assets. Client retention for such providers is therefore a key challenge, arguably the single most powerful value driver in wealth management. As a general rule, it costs wealth managers five times as much to add new clients as it does to keep the ones it already has, and every 2% of clients retained is equivalent to cutting costs by 10%. Wealth managers are having to step up their client retention efforts, not least because clients are showing a greater willingness to switch wealth-management providers. In many countries, intergenerational wealth transfer is starting to be a particularly strong disruptive influence in this regard. Wealth managers therefore need to strike early in forging relationships with the younger generation.

New client segments are emerging or are being recognised more explicitly by wealth managers. These include segments such as affluent women, divorcees, young people, sports professionals and various ethnic groups. To capture this new source of growth, the challenges are twofold: first, to acquire these clients, which can require new creative approaches and, second, to tailor existing (or design entirely new) propositions, given that many of these segments have very distinctive needs.

To deepen their overall understanding of client behaviour, satisfaction and the totality of individual situations, wealth managers need to become more systematic in their client learning through regular client surveys or focus groups and by capturing client feedback from relationship managers more comprehensively.

2.2 PRODUCTS, PRICING AND CHANNELS

To meet the needs of clients and strive for competitive differentiation, wealth managers are having to cope with a range of challenges that cut across products, pricing and channels.

2.2.1 Products

As noted above, clients are demanding a broader range of products than ever before. Product requirements span the client's entire balance sheet and beyond, also including non-financial products and services. The willingness of clients to diversify their asset allocation more broadly (across geographies and asset classes) is a further challenge, requiring wealth providers to broaden their product range still further in many instances.

Against this backdrop of product proliferation, it is unsurprising that wealth managers are under pressure to upgrade and renew their product ranges constantly. Thankfully, most private banks have long realised that some services – dog walking, school hunting, jewellery finding – largely destroy value. But the temptation to add products in an undisciplined manner, under the belief that product diversification alone will produce higher margins, is still there in many cases. Unwieldy product ranges increase costs and place a heavy burden on back and middle office infrastructure. Hence, product management discipline is becoming a key challenge.

Driven by commoditisation and shortening product cycles, wealth managers face pressure to develop more innovative propositions as a way of differentiating themselves. To some extent,

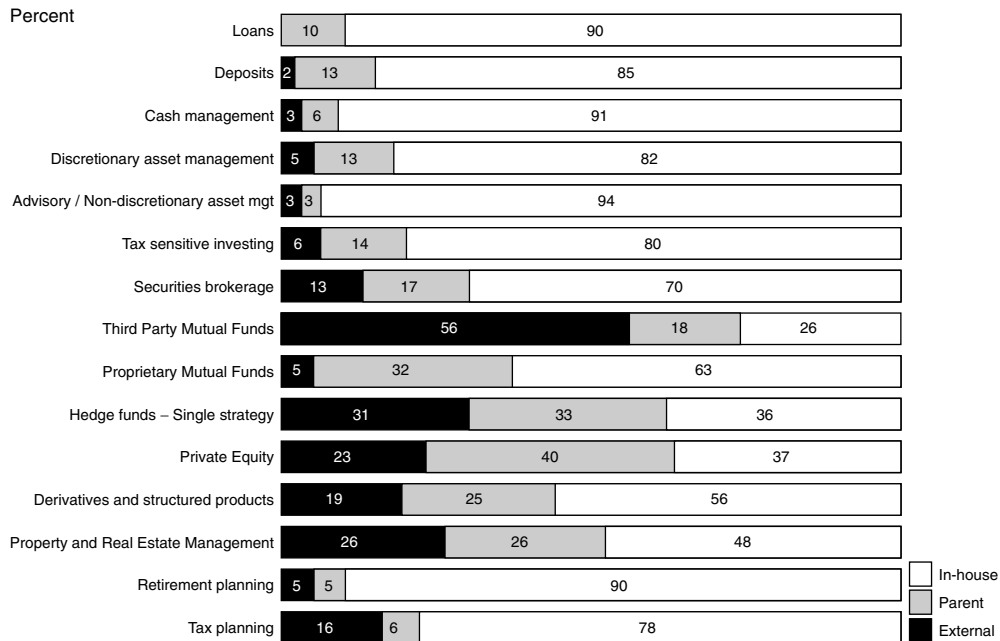


Figure 2.3 Wealth management product sourcing
 Source: PricewaterhouseCoopers, Global Private Banking/Wealth Management Survey 2005, p. 10. Reproduced by permission.

this means being able to secure cost-effective, preferential access to the top product providers (see below). It also requires more creative approaches to product structuring and proposition design and packaging.

The necessary modifications in product mix can be challenging to implement, requiring changes in investment policy, revenue-sharing arrangements and nothing short of a major cultural shift in some instances. The changes also require closer, two-way coordination between product development specialists and the front line. The new complex products often take relationship managers out of their comfort zones, and the front line needs specialist training in order to explain and sell these products effectively.

Open architecture is now a reality. Most players do, at least, talk a good game here: ‘some of our best clients have none of our products at all’. In practice, however, most wealth managers have not fully embraced the concept, or have done so half-heartedly, preferring to manufacture products either themselves or through their parent organisation (see Figure 2.3). One notable exception is mutual funds, but it is interesting that, in Europe at least, even in alternative investments, the general preference is to source internally where possible. Nevertheless, for those players that have genuinely embraced open architecture, the key challenge is to secure strong relationships and to manage the interface with the very best third-party product providers. That requires substantial resources and skill, and has become a value-added client service in its own right.

2.2.2 Pricing

Wealth managers, in common with players in most areas of financial services, are facing relentless downward pressure on prices across many product and service areas. That pressure

naturally increased during the recent market downturn, as clients paid much closer attention to fees in the light of poor investment performance. Pricing pressure also has a large structural element, linked, in part, to competitive intensity, HNW clients' willingness to play off providers against each other, and demand for transparency, which means greater scope for comparisons across providers.

Improving pricing practices is a major challenge but also a tremendous opportunity for most wealth managers. A clearly defined, well-implemented and followed-up pricing policy can create substantial value very quickly, typically to the tune of up to 10% of revenue, with negligible impact on client attrition.

The starting point for taking accurate pricing decisions is to ensure a deep and comprehensive understanding of (a) product and service costs; and (b) current pricing levels and practices, two things that many wealth managers currently lack clear sight of.

Given that negotiated pricing remains the norm in wealth management, a key focus area should be to develop tighter pricing discipline in the face of revenue leakage from discounting. Many wealth managers believe they have established rules to prevent excessive discounting and that, for any given client, a rebate on one revenue line is compensated for by additional revenue on another. However, analysis shows that, within wealth managers, there are surprisingly wide variations in pricing discipline across relationship managers. To counteract this, wealth managers need to establish clear rules, processes and incentive systems for granting waivers and discounts, and should install monitoring systems to ensure effective implementation.

A few players are going further and are actively experimenting with more sophisticated pricing models and a variety of new tactical and strategic approaches. These include value-based pricing and linking pricing to the performance of the client's entire portfolio. Pricing directly for advice has so far met with only limited success, at least outside the very top end of the market (i.e. family offices), with few clients currently willing to pay very much. This suggests that wealth managers seeking to go down that route need to be more forthright in demonstrating the benefits of such an approach to a broader range of client segments.

2.2.3 Channels

Wealth managers face a number of challenges across their distribution networks, which are raising costs.

Given the expansion of the industry, there is strong demand for high-quality relationship managers (RMs) – the so-called 'war for talent'. Nowhere is this battle more fierce than in Asia. To help meet that demand, new institutes are springing up to train private bankers, such as the Wealth Management Institute in Singapore. Players are also having to be more creative in their recruitment approaches, often looking outside financial services altogether, e.g. to other industries, the armed services and the professions. Like their clients, RMs are also more prepared to move firm.

Wealth managers also need to upgrade RM sales productivity using a variety of levers. For example, many players are well advanced in deploying team-based approaches to client coverage, by combining groups of RMs with product and other specialists. As Wells Fargo's Head of Private Client Services put it, 'This isn't about some hero salesperson, but rather the conductor of an orchestra.' Wealth managers are also thinking more carefully about RM roles (such as client 'hunters' versus 'farmers'), optimising client and asset loadings per RM, encouraging best-practice sharing, and providing RMs with dedicated support staff. Yet, despite these and other initiatives, analysis shows that many RMs spend less than half their time in

front of clients. It is important, therefore, for wealth managers to tackle the root causes of this problem. Smarter deployment of technology is a key enabler, but is only part of the solution.

Offshore-oriented wealth managers, in particular, face the challenge of securing onshore distribution capacity, through wider feeder networks, linked mainly to changes in the external environment (see below).

Though the RM will remain the dominant channel, wealth managers are also facing the challenge of having to develop and manage multiple channels – something that retail banks have struggled with for some years. This is largely client and technology driven. Online, for example, though very slow to get off the mark, is now a staple channel for some wealth managers, particularly useful for providing interactive consolidated reporting and for payments. But there is more to do here. In particular, mobile devices offer opportunities, and, moreover, there is a pressing need to exploit the full power of broadband technology, with experiments in video-based client consultation delivery now underway.

2.3 COMPETITORS AND BUSINESS MODELS

Competition within the industry is a key challenge, though it is far from new. There was a shake-out of some peripheral players during the downturn but, as the market recovery has gathered pace, competitive intensity has picked up, mainly among incumbents. All players are increasingly focused on growth. There is greater awareness that existing books of business offer a key opportunity at many banks: at least to some extent, much of the banks' 'wealth' will be inherited.

One key overriding theme – unheard of until recently in such a secretive, closeted industry – is collaboration:

- *Within integrated players*, as many large banks are actively seeking ways to maximise intra-group synergies. Key challenges here include breaking down product silos and developing effective interfaces and working arrangements with other parts of the group, whilst overcoming perceived conflicts of interest.
- *Among players*, across an increasing range of areas, driven by factors such as the growing importance of open product architecture, the trend towards operational outsourcing and the need to secure cost-effective onshore distribution.
- *Among clients* themselves, a more recent development that is occurring mainly at the top end of the market with some interesting peer-based models emerging. That is a key challenge for wealth managers because it shifts more of the bargaining power to the client and, particularly when combined with some of the other changes, raises the real threat of disintermediation.

Business system disaggregation is gathering pace, forcing hard choices on competitors as to where and how they should play in the value chain. Not least among them is whether to be a manufacturer, distributor or advisor. This pulling apart of the value chain is creating new roles for specialist players and raising the competitive bar (and IT and other investment requirements) for integrated players. But it also offers significant opportunities for players to reshape themselves in fundamental ways. For example, some players – large and small – have successfully hollowed themselves out through operational outsourcing and offshoring; many others, however, have yet to respond.

Driven, in part, by the downturn and by the need to reduce perceived conflicts of interest, many Swiss players in particular have been restructuring and divesting non-core businesses. The obvious candidates here are institutional brokerage and corporate finance, which are in

some cases barely profitable. It is possible that a sustained market recovery will be used to delay the need for radical decisions here. Brokerage houses are also restructuring and, like most other types of player, are converging on the holistic wealth management model. They are shifting away from traditional commission-based securities transactions, driven by slowing organic account growth, limited consolidation opportunities and the relentless decline in trade pricing. Their key challenge is to develop (a) greater advisory capacity and (b) broader product platforms (including asset management, banking and credit), in order to capture a greater share of wallet.

In principle, the high blocks of fixed costs mean that there should be economies of scale in wealth management. There should also be performance-related economies of scale: even without net new money, with the right investment platform, the performance of existing client assets will expand the revenue base and generate higher profits. However, as noted in Chapter 1, the benefits of scale in wealth management can sometimes be overstated. It has yet to be proven that size really does matter in the long term. There is, however, now a growing consensus on the need for scale in the back office, in particular.

Though scale can be achieved organically (albeit relatively slowly), given the industry's fragmentation, many are turning to the inorganic route. Indeed, most players have expressed a desire to make incremental acquisitions and the consolidation process is gaining momentum. One initial challenge here is the scarcity, and hence the high price, of available targets, which makes it difficult for many deals to create genuine value. But the fundamental merger and acquisition (M&A) challenge in wealth management – even more so than elsewhere in financial services – is integration execution: it is not unusual for 10%–15% of client assets (and quality RMs) to walk out of the door as a result of the associated client relationship disruption and cultural clashes. In short, M&A needs to be handled with care, given that client relationships and the personal touch are key in this industry.

As players become larger, small acquisition roll-ups are not enough to 'move the dials'. Meanwhile, revenue synergies can be hard to come by particularly when two large players combine, given the more limited scope for product complementarity. Moreover, it is important to note that consolidation in wealth management will, to some extent, be a by-product of – or, worse still, an afterthought within – the next wave of cross-border universal banking deals. Such deals are motivated by considerations that lie largely outside wealth management (typically by synergies in the broader retail and corporate banking areas). Hence, a key challenge will be for the relevant wealth management unit to fit into, and extract synergies from, the new organisation.

Bluntly, wealth managers need to become more professional in their management of the business. Once the preserve of gifted amateurs and the old-boy network, the quality of the top team has become more critical. Leading retail banking players have actively sought out management talent from other retail industries to enhance their expertise in areas such as pricing, marketing and branding. Similarly, wealth managers need to become less inward looking and more open to attracting talent from outside financial services, including the luxury brands, for example.

Wealth management requires a much more disciplined, value-oriented approach. There has been a shift, by many, away from the furious asset grab and revenue-at-all-costs approach that characterised the late 1990s. Serious long-term players are, at last, focusing firmly on the level and growth of net profit as their primary key performance indicators. The Pricewaterhouse-Coopers Global Private Banking/Wealth Management Survey 2005 found that over the next three years, wealth managers say they plan to focus particular attention on profit per client.

But many face a pressing need to upgrade the quality and sophistication of their management information systems.

Most wealth businesses need to reorientate themselves to capture new sources of growth from, for example, new geographies, client segments and propositions. That, in turn, will require greater flexibility, faster (and smarter) decision making and highly disciplined execution.

So, all in all, the wealth business model is very much in flux. Some have likened the business model challenges to those faced by the investment banks 20 years ago. At that time, investment banks were also struggling with value chain disaggregation, scale, complexity and cross-border expansion issues. Back then it was the US players that seized the initiative, with the emergence of the bulge bracket and an industry shakeout that continues to this day. It is conceivable that the wealth management industry is at a similar inflexion point.

2.4 EXTERNAL ENVIRONMENT

The industry consensus is for wealth market growth of around 6% a year over the next five years, well down on the double-digit levels seen during the late 1990s. In particular, overall net new money growth is low: McKinsey found that it accounted for less than one-fifth of overall AuM growth in 2003 and 2004, with the bulk of the growth being driven by market performance (linked to the stock-market recovery) and share-of-wallet expansion. Looking ahead, as noted above, there is even greater uncertainty than normal as to the direction of financial and other asset prices.

Regionally, there are some projected high-growth pockets (including Asia, the Middle East and Eastern Europe). But many established wealth managers are finding these opportunities difficult and time-consuming to access: they require a greater degree of onshore investment than in the past; cross-border banking is notoriously difficult to execute well; and there are cultural issues to overcome. In Asia, for example, it takes a particularly long time for foreign banks to gain wealthy families' trust – an issue that has been exacerbated recently by Citigroup's fall from grace in Japan. The key challenge is to develop, at speed, a local presence with the necessary critical mass. Collaboration and joint ventures with local players offer a way forward, but require careful handling, as some have already discovered.

Growth in offshore wealth management is expected to remain relatively low, linked in part to global, regional and country-specific tax initiatives. The most important recent one of these is the European Savings Directive, which went live in July 2005. But the imminent death of offshore banking – still projected by many – has been greatly exaggerated: offshore is down, but not out. In any case, there are signs that the 'reinvention' of offshore is underway. Offshore-oriented wealth managers are pursuing a range of strategies designed to defend their existing franchise and deliver growth onshore. And the rapid growth of onshore markets is forcing many players to raise their investments in new resources and distribution capacity and to develop new propositions.

Regulatory resurgence is continuing across a range of areas – from money-laundering to product regulation, and from accounting standards to capital rules. To implement the new regulations, players are having to overhaul their IT systems, adapt their products and, in some cases, rethink their entire strategic direction. Needless to say, this is raising compliance costs, which are up by more than 60% over the last three years. Smaller players are bearing the brunt of the impact, given their more limited resources. But the larger players are also feeling pressure here, given the breadth of their product ranges and greater scope for conflicts of interest.

The New York State Attorney General, Eliot Spitzer, has conducted investigations into investment bank conflicts of interest, illegal trading practices by mutual funds and bid rigging in the insurance industry – and has been a catalyst for industry-wide reforms. As some equity analysts have pointed out, a Spitzer-like investigation into private banking practices cannot be ruled out. For example, just as mutual fund firms have suffered from the fallout over market timing, the private banking industry could face a de-rating if a similar scandal erupted, and client confidence would suffer.

Analysts highlight two areas that could potentially come under scrutiny:

- *Rebates.* This is the industry practice of wealth managers receiving fees from product providers for selling their products. While this is a form of payment for distribution, it clearly creates a potential conflict of interest for wealth managers. Quotes like the following, which appeared in a *Euromoney* article (January 2004) on private banking, do not help the industry: ‘You get third-party fund manager A with a good track record, consistent performance, low volatility but that pays [the private client adviser] a rebate of only 20 basis points. Then you get fund manager B in the same strategy and style offering mediocre returns and high volatility but paying a 40 basis points rebate. And guess what? Somehow or other the client ends up with fund manager B.’
- *Fee levels.* Another possible area of concern is the high fees paid on wrap products such as multimanager funds. While the fees on the underlying products themselves are sometimes full, private banks go on to charge a further fee on top. Fees for certain structured products could also come under the microscope. There is nothing illegal here. But private banks’ unique pricing structure (where different-sized clients pay different prices for essentially the same service) leaves players open to criticism.

Greater transparency may provide one of the solutions. Initiatives along the lines of the ‘Schumer Box’, recently introduced (under Parliamentary pressure) in the UK credit card industry, could, at least in principle, be applied in wealth management.