KPMG

Private Banking
ABBL Cluster

Clarity on performance of Luxembourg private banks

2022 — 2nd edition

kpmg.lu

Foreword

For the second consecutive year, KPMG Luxembourg and the Private Banking Cluster of the Luxembourg Bankers' Association (ABBL) have joined forces to produce another edition of this study which aims at providing a State of the Nation report on the private banking industry in Luxembourg.

As we were writing these lines last year, we were barely recovering from 18 months of a Covid crisis that had forced us all to completely rethink the way we live, the way we work and the way we interact with one another, both privately and professionally. The situation was of course no different for Luxembourg private banks, which were compelled to concomitantly face multiple challenges: to continue providing high-quality customer service, to support their employees in unprecedented working conditions, to face an increasing shortage of talent and to manage the unavoidable flow of regulations, just to name a few.

And yet, as the figures presented hereafter will show, the year 2021 was a very good year for the Luxembourg private banking sector, with an increase of 18% in total AuM, to almost reach the significant threshold of EUR600 billion.

Admittedly, much of this increase was due to the robust health of the financial markets in 2021, rather than just to client acquisition, and there were — as always — a number of M&A deals reinforcing the consolidation trend observed in previous years among the smaller structures. In addition, some private banks urgently need to restore and improve their profitability — and certainly competition with other offshore and onshore financial centers is as fierce as ever — but at the end of the day, the Luxembourg private banking sector seems to be successfully pursuing its transformation process toward enhanced professionalization, even better customer experience, more automation and digitalization, more skills and capabilities, more innovation and more of the essential human touch that makes a private bank not just any bank.

But, as we all know, 2022 unfortunately started differently, in a far gloomier manner, with another major crisis the negative consequences of which we are currently witnessing on the economy as a whole and on the financial markets in particular. This reality check compels us to restrain our enthusiasm and to remain focused on the hard facts and figures.

All in all, in this volatile, uncertain, complex and ambiguous world, we felt that this second edition of the study was more important than ever, in order to shine an additional light onto the development, the challenges and the ambitions of the private banking sector in Luxembourg.

Finally, similarly to last year, we thought it would make sense to follow up on the development of our private banking neighbors — so we also include the main findings of the annual private banking study Clarity on Swiss Private Banks, produced by KPMG Switzerland in collaboration with the University of St. Gallen, which was released in August 2022.

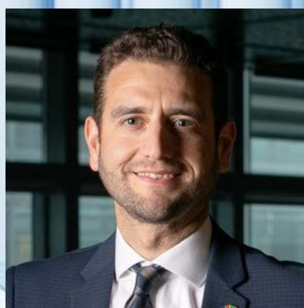
We would of course like to extend a warm thanks to all the members of the Private Banking Cluster for their contributions and openness, and we hope that the information provided in this report will provide you, the reader, with some useful insights.

Jean-Pascal Nepper

Partner, Head of Banking
KPMG Luxembourg

Pierre Etienne

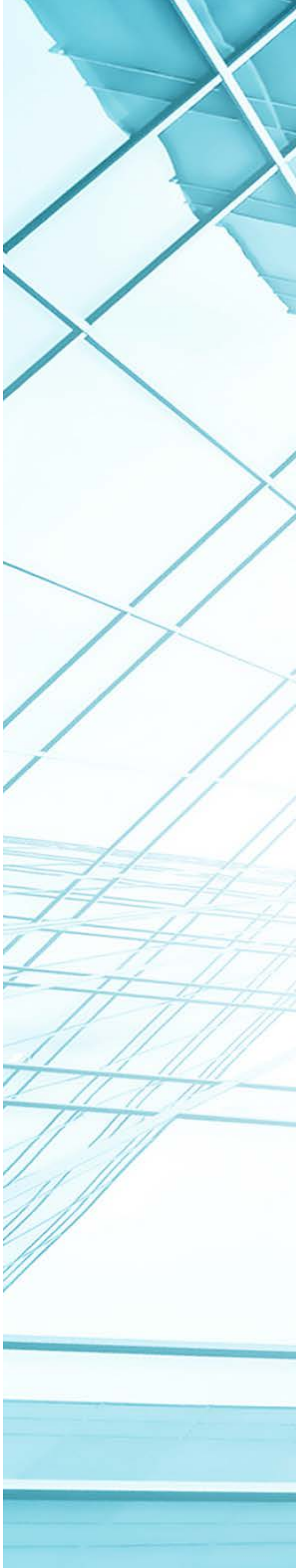
Vice-Chair of the ABBL Board
Head of the Private Banking Cluster



Fabio Mandorino

Senior Adviser - Private Banking
ABBL Member Relations

The Luxembourg Bankers' Association (ABBL)



The Luxembourg Bankers' Association (ABBL)

The ABBL is the oldest and largest professional association in the financial sector, representing the majority of financial institutions as well as regulated financial intermediaries and other professionals in Luxembourg, including law firms, consultancies, auditors, market infrastructures, e-money and payment institutions. The ABBL counts over 220 members, who represent the financial center as a whole and in all its diversity, which is key to shaping the financial sector's future and speaking with one voice.

The ABBL is an association with a long history of promoting, defending and defining the banking sector in Luxembourg. It gives its members a common voice, providing a platform for the exchange of ideas and keeping them informed of industry trends and regulatory developments. Its mission is to promote, for and on behalf of its members, the sustainable development of regulated, innovative and responsible banking services.

The ABBL is organized around Clusters, Committees, Forums and Working Groups, which reflect the banking sector interests as of today and ensure that it is active in the right areas. To channel common issues and challenges of each domain and focus on the most strategic priorities for the members, its Clusters represent the main business lines of the financial sector:

- Corporate & Investment Banking
- Depositary Banking
- Payments
- Private Banking
- Retail Banking

The Luxembourg Private Banking Group (PBGL)

The Private Banking Cluster regroups professionals active in private banking and wealth management and has as its primary objective to advocate for and promote the private banking industry, both within Luxembourg and abroad. In a fast-changing market and regulatory environment, the PBGL strives to promote private banking industry positions on key banking developments and issues within Luxembourg and internationally.

About this research

The Private Banking Cluster and KPMG Luxembourg joined forces for the second time to carry out a study assessing the development of the private banking industry in Luxembourg and the performance of Luxembourg-based private banks.

Similarly to last year, the objectives of the study were threefold:

— To give a contextualized view of the development of the private banking sector in Luxembourg with regard to key data — such as the number of institutions, assets under management, client origins, wealth bands or numbers of employees.
— To provide an overview of the business and operating models of private banks in Luxembourg.
— To highlight the main drivers of financial performance for these banks.

May-June 2022
data collection

In terms of methodology, our analysis was based on a detailed questionnaire sent in May-June this year, through the CSSF, to the senior executives of the financial institution members of the Private Banking Cluster.

The questionnaire, addressing 130 data items, covered the following categories in relation to the 2021 financial year:

1. Clients and assets
2. Assets and liabilities distribution
3. Service offering
4. Income and costs structure
5. Financial indicators
6. Human resources
7. Operating model and sourcing

130
data items related to FY21

45 private banks took part in the study and submitted their answers, accounting for a 94% participation rate and 99% of the total AuM of the private banking market in Luxembourg.

For data confidentiality, all individual questionnaires were anonymized before being shared and analyzed by KPMG.

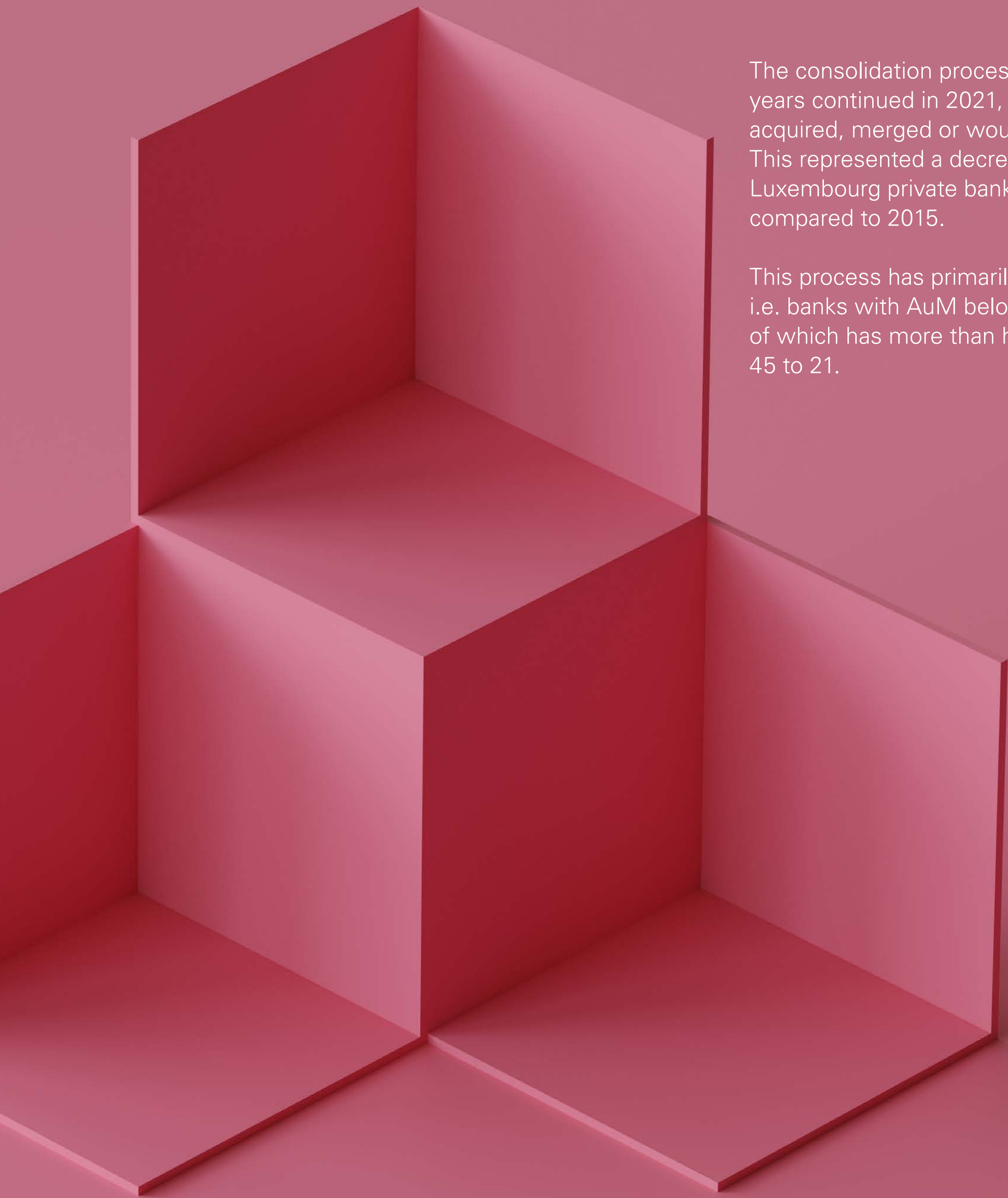
Lastly, it is important to note that, while we did our best to neutralize and homogenize the answers we received, the analyses presented in Part 02 (Business and operating models) and Part 03 (Understanding industry performance) should be read in the light of the great heterogeneity — both in terms of governance/group structure and operating models — of the Luxembourg private banking market, where certain activities are often shared, either with a parent group outside Luxembourg or with other Luxembourg entities active in different domains such as asset management or asset servicing.

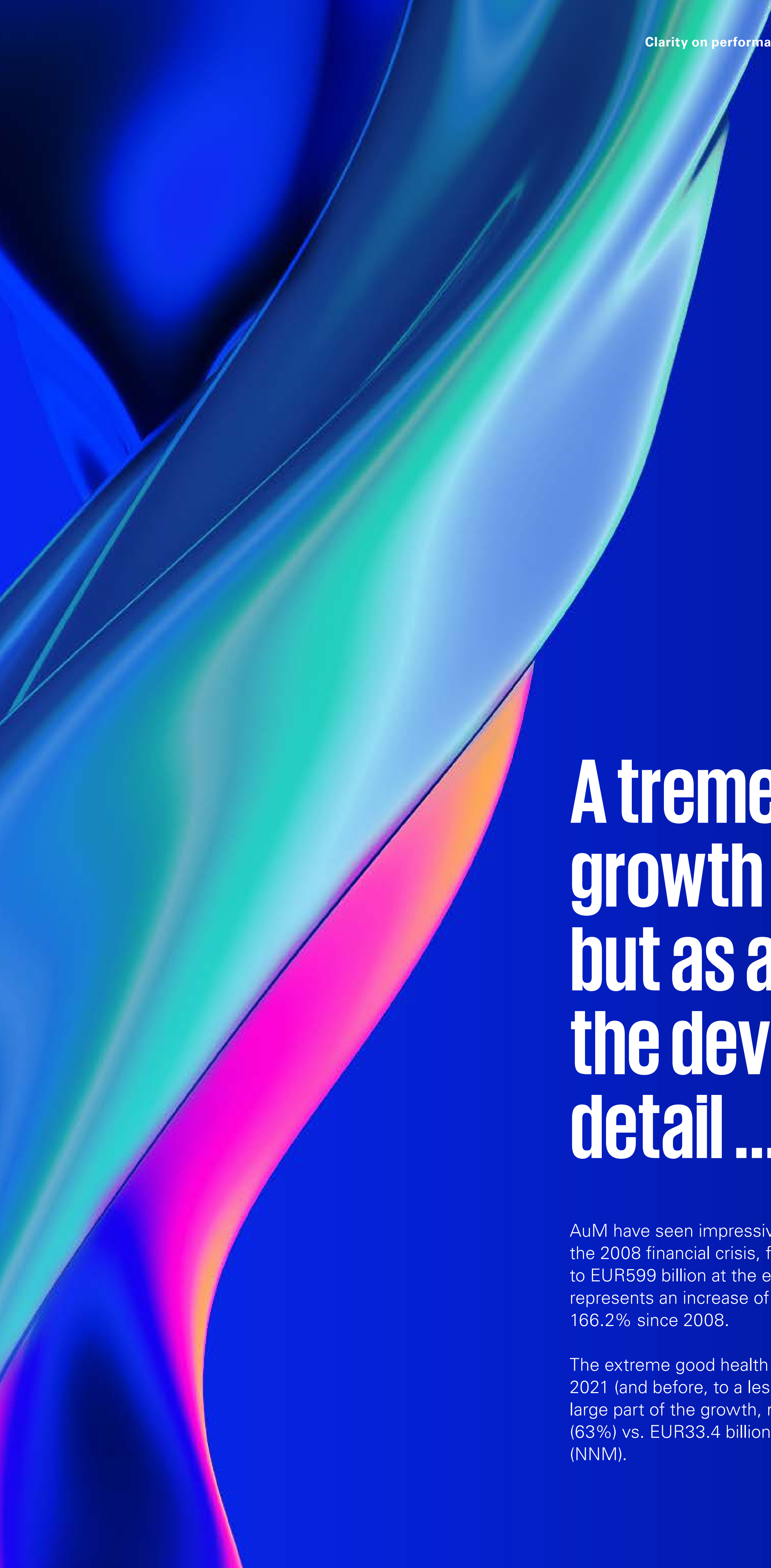
45 banks
99% of Luxembourg private banking AuM

The consolidation process continues within the private banking sector in Luxembourg

The consolidation process initiated over the past few years continued in 2021, with another six private banks acquired, merged or wound down during the year. This represented a decrease of 11% in the number of Luxembourg private banks relative to 2020, and of 27% compared to 2015.

This process has primarily affected the smaller players — i.e. banks with AuM below EUR5 billion — the number of which has more than halved since 2015, falling from 45 to 21.





A tremendous growth in AuM, but as always the devil is in the detail ...

AuM have seen impressive uninterrupted growth since the 2008 financial crisis, from EUR225 billion in 2008 to EUR599 billion at the end of 2021. The 2021 total represents an increase of 17.9% over 2020 and of 166.2% since 2008.

The extreme good health of the financial markets during 2021 (and before, to a lesser extent) accounts for a very large part of the growth, representing EUR57.3 billion (63%) vs. EUR33.4 billion (37%) of net new money (NNM).

The clientele remains very European

The distribution of client origins changed very little in 2021 compared to the previous year.

While Luxembourg private banks originally built their client bases in the immediately neighboring countries of France, Belgium and Germany, they have been pursuing diversification efforts ever since. But these efforts have so far mainly been oriented toward other European countries: figures clearly show that Europe remains the core market of the Luxembourg private banking sector, accounting for 86% of total AuM, with the remaining 14% allocated to the “rest of the world”.

The HR challenge

The number of staff members in private banks didn't change significantly during 2021, totaling c. 5,700 when taking into account only Luxembourg-based personnel, and reaching up to c. 6,700 when including staff from branches and subsidiaries.

But at the core of the development of the private banking industry in Luxembourg lies the vital need to attract, motivate, train and retain the right talent. The financial industry as a whole is experiencing significant difficulties in this regard and there is now an urgent need for innovative and sustainable approaches. Unsurprisingly, the need for resources in compliance, risk management and internal audit functions is still very much present, as is that for front office and relationship management positions.

Almost 74% of industry players grew their operating income baseline in 2021

Overall, income growth accelerated in 2021, with almost 74% of the banks under study increasing their income. The vast majority of the growth was fueled by a simultaneous increase in revenues and costs. However, the growth in revenue surpassed the growth in the cost base. Compared to 2020, only a handful of banks enjoyed both increased income and a reduced cost base.

A very heterogenous cost-income ratio picture

If the median cost-income ratio of large banks remained rather stable in 2021 (67.29%, +0.29pp compared to 2020), and slightly reduced for medium banks (76%, -2pp), it dramatically increased for the smaller entities to 84.87% (+8.35pp).

All in all, 14 banks reported a cost-income ratio above 80%, and above 90% for 11 of them. While there might be conjunctural explanations for some of these entities, others are facing more structural challenges.

01
Luxembourg market analysis

Evolution of the number of private banks

The consolidation process continues

The consolidation process initiated over the past few years continued in 2021, with another six private banks acquired, merged or wound down during the year. This represented a decrease of 11% in the number of Luxembourg private banks relative to 2020, and of 27% compared to 2015.

This process has primarily affected the smaller players — i.e. banks with AuM below EUR5 billion — the number of which has more than halved since 2015, falling from 45 to 21, while the number of medium-sized and large banks has remained relatively stable or increased, probably also because a few of these have acquired some of the smaller entities.

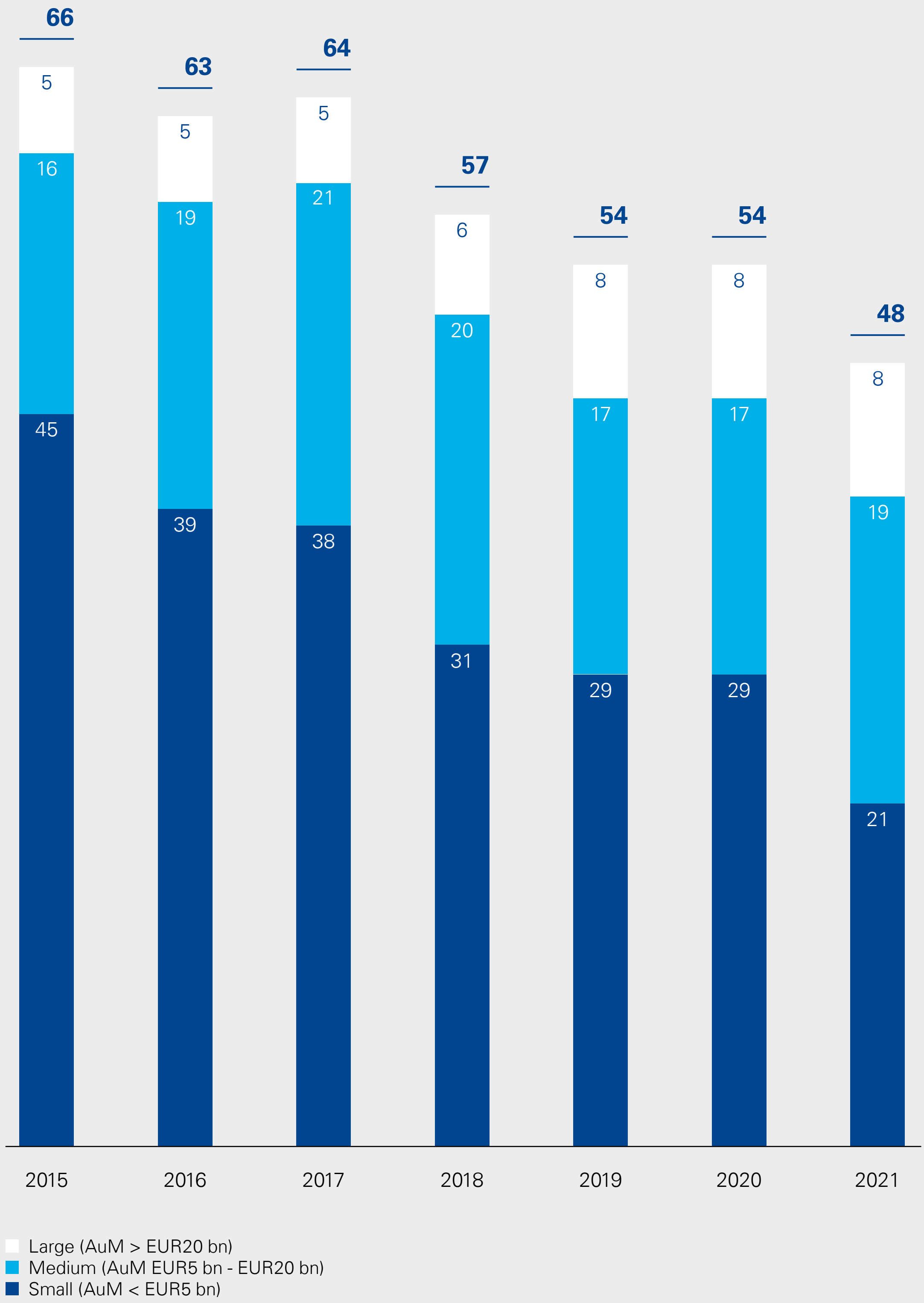
Again, this statement of fact does not come as a surprise. It is common knowledge that the costs of running a private bank have only been increasing over the past few years and that the challenges the banks are facing today are onerous rather than merely demanding — the continuous regulatory pressure, the race to enhance legacy IT systems to cope with the digital age, the war for talent in an extremely stretched labor market, the competition introduced by new, possibly more agile, banking and non-banking entrants — just to name a few.

Living up to the expectations of all these challenges hence requires a solid critical mass in terms of AuM. If, a few years back, a figure of EUR5 billion was considered the "magic number", i.e. the minimum AuM needed to survive and be reasonably profitable, today this minimum threshold is more in the region of EUR10–12 billion. But the figure remains rather theoretical since much depends on the private bank's actual cost and revenue structure (e.g. the level of support provided by its parent company, the maturity of its IT platform, its HR costs, the profitability margins on its customer base, the level of penetration and industrialization of its asset management offering, etc.).

It is interesting to note that the very same pattern of consolidation trend has been observed in the Swiss private banking market, as demonstrated by some of the extracts from our Swiss report in Part 04.

Number of private banks in Luxembourg, grouped by AuM size

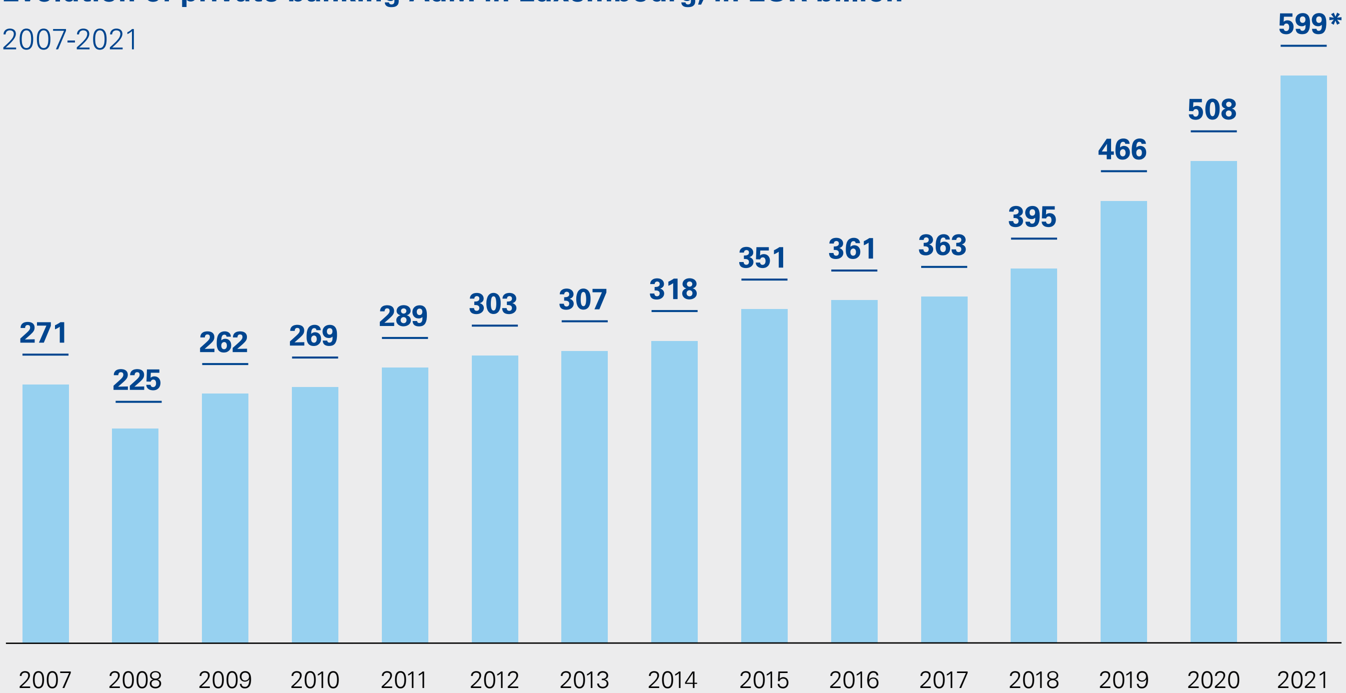
2015-2021



Assets under management

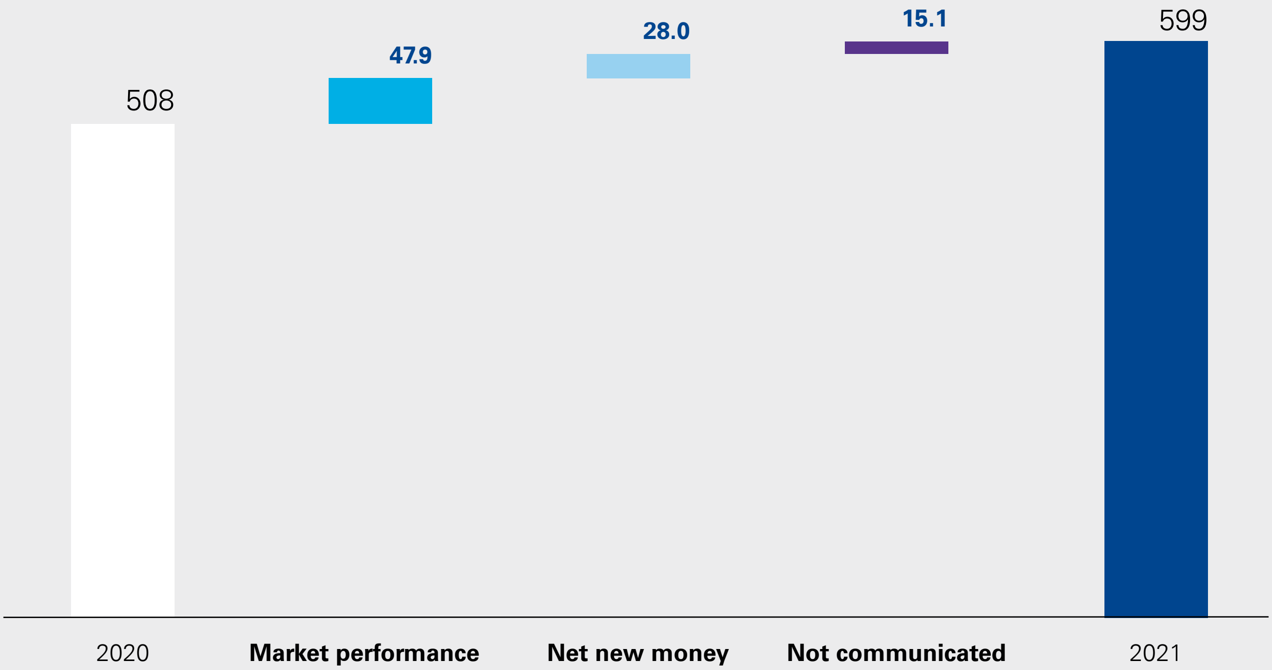
Evolution of private banking AuM in Luxembourg, in EUR billion

2007-2021



Asset growth components, in EUR billion

2020-2021



*Of the 48 private banks, 45 provided us with an answer. The AuM of the remaining 3 banks were estimated at EUR1-EUR1.5 billion, bringing total AuM for the country to just over EUR600 billion

A tremendous growth in AuM ...

The evolution of AuM graph speaks for itself: AuM have seen impressive uninterrupted growth since the 2008 financial crisis, from EUR225 billion in 2008 to EUR599 billion at the end of 2021. The 2021 total represents an increase of 17.9% over 2020 and of 166.2% since 2008. The average annual growth in AuM since 2008 has been 12%, but accelerated significantly over the past four years.

... but the devil is in the detail

It is however essential to note that, when it comes to the reasons underlying this impressive growth rate, especially over recent years, the extreme good health of the financial markets during 2021 (and before, to a lesser extent) accounts for a very large part of the growth. Indeed, given that, for example, the EURO STOXX 50 index increased by 20.4% and the S&P 500 by 26.9% in 2021, it is only logical that AuM would increase in parallel.

In our analysis we have therefore tried to separate the effect of market growth from that of AuM growth to determine the increase exclusively linked to new client and new AuM acquisition as a whole, i.e. net new money (NNM), as this better demonstrates the commercial dynamism of Luxembourg private banks and their ability to hold firm and continue growing when markets are less favorable.

As shown in the Asset growth components graph, the 2021 growth in AuM breaks down as follows:

— NNM: EUR28.0 billion (37% of the growth, ignoring the “not communicated” (NC) growth component)

— Market performance: EUR47.9 billion (63% of the growth, ignoring the NC growth component)

As a consequence, if we extrapolate the same ratios to the EUR15.1 billion for which the NNM breakdown was not communicated by participants, we can infer that, out of the EUR91 billion (17.9%) increase in AuM from 2020 to 2021, EUR33.4 billion constituted NNM, which would imply that the growth in AuM linked to NNM alone over the past year was 6.6%.

Looking a bit closer into the figures broken down per private bank size cluster, the figures are slightly different:

Small banks (AuM < EUR5 bn)	**Growth components** (EUR bn)	**Growth components** (%)
2020	36.0	-
Net new money	**3.2**	**37.6%**
Market performance	**5.3**	**62.4%**
2021	44.4	-

Medium banks (AuM between EUR5 bn and EUR20 bn)	**Growth components** (EUR bn)	**Growth components** (%)
2020	175.8	-
Net new money	**9.4**	**28.1%**
Market performance	**24.1**	**71.9%**
2021	209.3	-

Large banks (AuM > EUR20 bn)	**Growth components** (EUR bn)	**Growth components** (%)
2020	295.9	-
Net new money	**20.9**	**42.8%**
Market performance	**27.9**	**57.2%**
2021	344.7	-

However, as we are writing these lines, many asset managers are putting in long days and long nights, and many relationship managers are having difficult conversations with their clients, at a time when the EURO STOXX 50 has lost up to 21%* and the S&P 500 up to 22%* in 2022 to date, somewhat offsetting a part of 2021’s growth.

* as at 26 September 2022

Mergers and acquisitions

M&A continues to reshape Luxembourg's private banking environment, as banks dispose of non-core activities and consolidate by acquiring smaller entities to build scale.

Consolidation continues

Over the years, there have been several waves of sustained M&A activity in the Luxembourg private banking market, with some players consolidating their market positions and building scale through acquisitions, and others choosing to exit as they adjusted their strategies. There has also been sustained interest from potential new entrants looking to establish themselves in Luxembourg through the acquisition of an existing player.

Strategic rationales for banking M&A activity

Transactions in the private banking sector remain driven by three factors: economies of scale, a refocusing on core activities and, for new entrants, geographical expansion.

— Economies of scale are achieved by expanding the customer base and thereby diluting the cost base, which is increasingly being impacted by the evolving regulatory framework, as well as by changing customer expectations. Local private banking and wealth management businesses that have Luxembourg as their core market strive to achieve a critical mass in order to benefit from further economies of scale.

— International banks continue to refocus on their core activities, such as retail banking in their home markets — divesting Luxembourg operations that do not have synergies with their core businesses. Local banks are also persisting in trimming their customer portfolios and service offerings in order to focus on what they consider to be their own core strategic areas.

— At the same time, we continue to observe strong interest in entering the Luxembourg market from several foreign players. This would primarily be to extend the core services they are already offering in their home markets to Luxembourg, often with the intention of using the Luxembourg bank as a platform for further eurozone expansion.

Regulators favoring consolidation

The European and Luxembourg banking supervisory bodies have both indicated that they expect increasing banking consolidation — locally and cross-border — to promote banking efficiency and technological innovation, and to reduce risk-taking by subscale banks. The European Central Bank (ECB) has gone so far as to indicate that it is willing to relax the current regulatory framework and key constraints that have been created by the differences in national regulations, in order to favor cross-border deals.

Small-size private deals

We expect the strong M&A market to persist within the Luxembourg banking sector, including within private banking, despite potential future economic headwinds. In fact, a decrease in asset prices, or further increases in costs due to inflation, would only serve to intensify the rationales for private banking deals, so long as there is visibility on the future development of the sector.

In particular, we expect to continue to observe transactions involving smaller-sized private banking players or portfolios, as well as to see management companies or institutional business portfolios being carved out of private banks. It is also possible that we will experience a few larger-scale mergers of complementary private banking businesses. However, the market will remain highly selective and will continue to seek profitable, quality assets with attractive clients and an impeccable compliance track record — such that less attractive businesses will be difficult to monetize.

Selected recent transactions involving Luxembourg banks

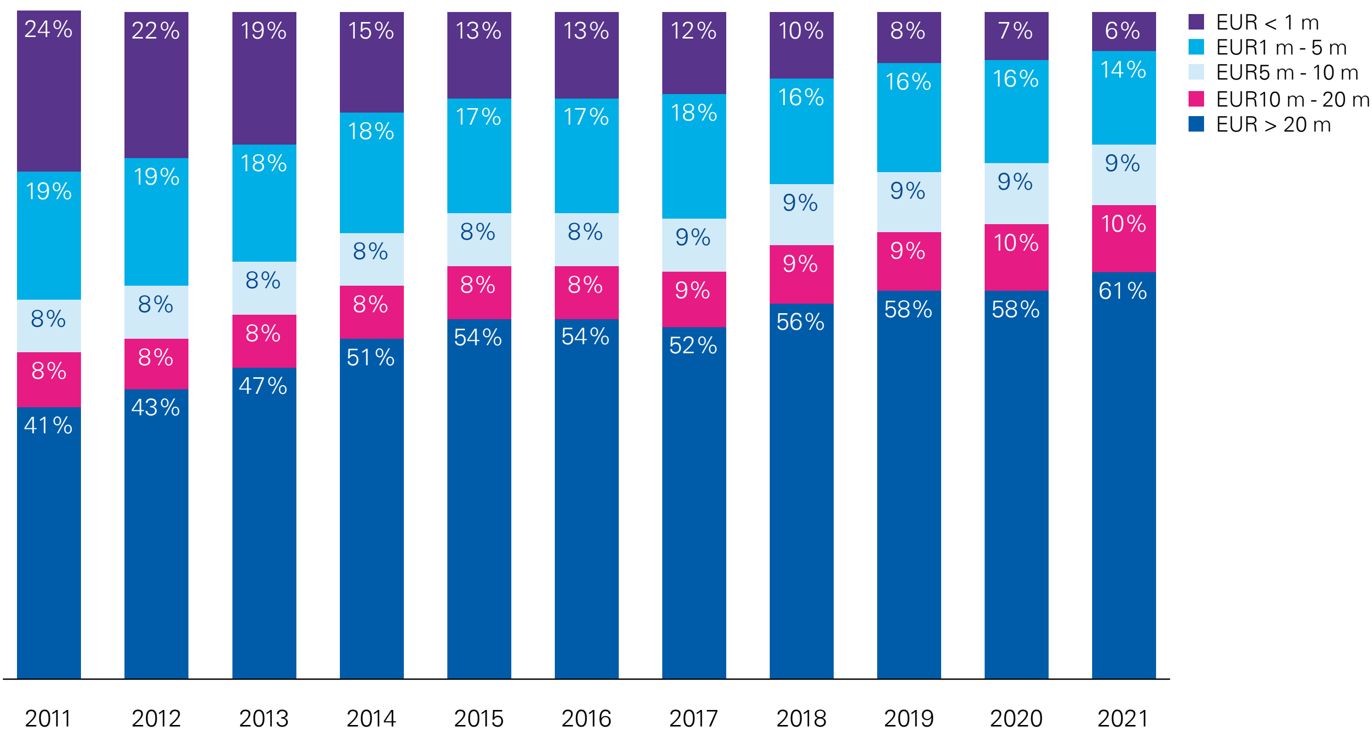
2021-2022

Target	Acquirer	Seller(s)	Completion date
European Fund Administration S.A.	Universal Investment Group	Banque de Luxembourg, Banque et Caisse d'Épargne de l'État, Oddo BHF, Quintet Private Bank (Europe) S.A.	Pending
Banque Fortuna customer portfolio	Banque et Caisse d'Épargne de l'État	Individual shareholders	Aug-22
Compagnie de Banque Privée Quilvest S.A. (CBPQ)	Fideuram Bank Luxembourg S.A.	Quilvest Wealth Management and private shareholders	Jul-22
SEPAexpress (b4payment GmbH)	Banking Circle S.A.		Apr-22
Danske Bank International S.A.	UBP (Luxembourg) S.A.	Danske Bank A/S	Jan-22
Keytrade Bank Luxembourg	Swissquote Bank Europe	Crédit Mutuel Arkéa S.A.	Jan-22
BIL Danmark	Ringkjøbing Landbobank	Banque Internationale à Luxembourg S.A.	Oct-21
EFG Fund Management S.A.	KB Associates S.A. (now part of Waystone)	EFG Bank (Luxembourg) S.A.	Aug-21
International affluent client book of Deutsche Bank Luxembourg	Nordlux Vermögensmanagement S.A. (Nordlux)	Deutsche Bank Luxembourg S.A.	Aug-21
Öhman Bank S.A.	VP Bank (Luxembourg) S.A.	Öhman Group	Jan-21

Client type distribution

Evolution of the distribution of client wealth bands, % of total AuM

2011-2021



The client type distribution has continued to polarize over the years

The proportion of UHNWIs has increased from 41% of total AuM in 2011 to 61% in 2021, while the proportion of affluent clients has decreased from 24% to 6% over the same period. It is interesting to note that, throughout the years, the proportion of HNWIs has hardly changed, while affluent clients are slowly disappearing from the map — a very different situation to that seen in the early days of Luxembourg as a nascent private banking center.

From a social type of perspective, (U)HNWIs also tend to follow and be inspired by one another. The progressive transformation of Luxembourg into a highly skilled and professional onshore center over the past 10 years has drawn the eye of more (U)HNWIs who, in turn, have advocated for Luxembourg, thereby attracting other (U)HNWIs, in a form of virtuous circle.

Beyond growth, a profitable growth?

On the downside, it has to be noted that this situation, while stimulatory, also creates a form of dependency of private banks on a more limited number of their clients. This then requires enhanced efforts from the banks to provide these clients with the best level of customer service in order to avoid attrition which could result in severe and immediate consequences.

Similarly, beyond the workload and associated costs that are needed to serve (U)HNWIs in the best possible way, the fierce competition among private banks in our globalized world, along with a higher level of "banking maturity" of this client type today, can also make it difficult to truly charge the right fees for the right service — and maintaining (U)HNWIs with high AuM does not necessarily always mean maintaining profitable AuM. As always, growth makes sense as long as it is profitable.

The clientele remains very European

The distribution of client origins changed very little in 2021 compared to the previous year: 19% of clients came from neighboring countries (vs. 17% in 2020) and 48% from other European countries (vs. 47% last year).

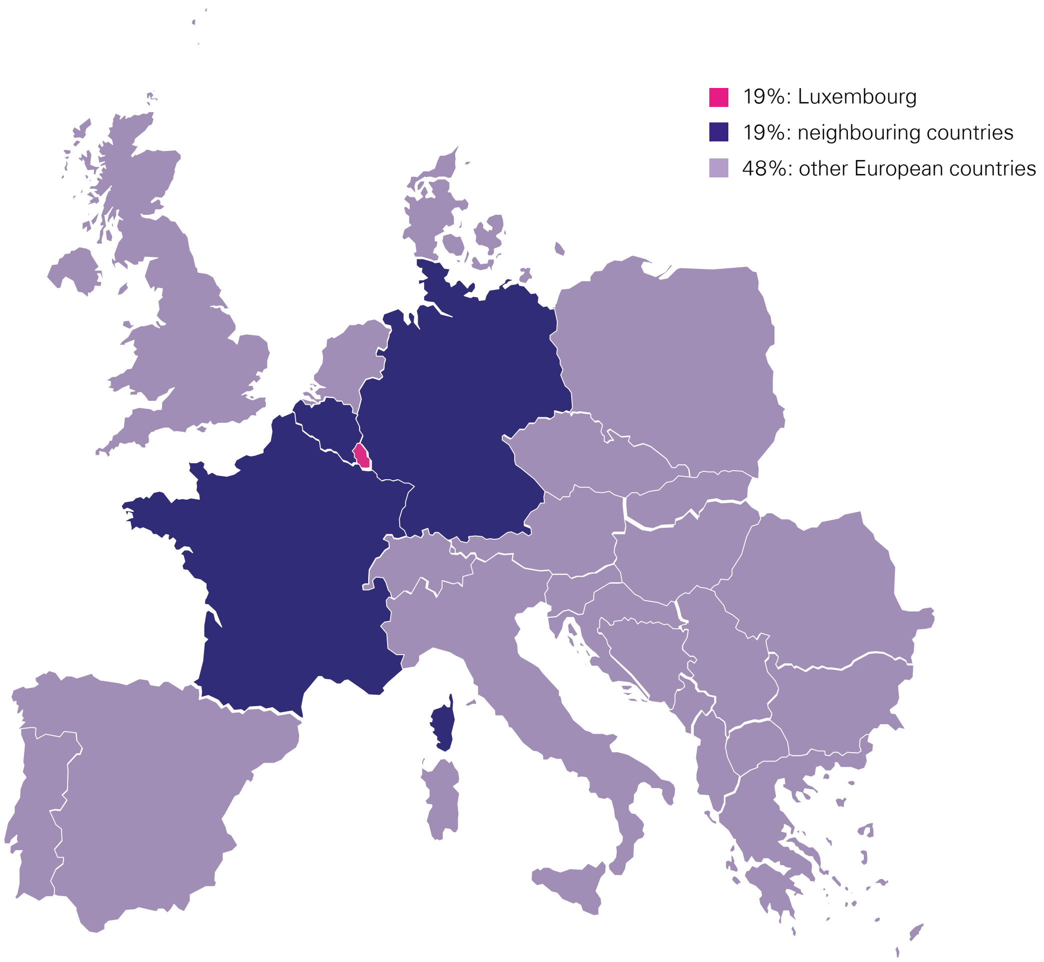
It is true that, while Luxembourg private banks originally built their client bases in the immediately neighboring countries of France, Belgium and Germany, they have been pursuing diversification efforts ever since. But these efforts have so far mainly been oriented toward other European countries: figures clearly show that Europe remains the core market of the Luxembourg private banking sector, accounting for 86% of total AuM, with the remaining 14% allocated to the "rest of the world".

It is also clear that, to provide their clients with a superior quality of service, and to be able to abide by their regulatory obligations (AML & KYC requirements among other things), private banks need to have a sound and proven understanding of the constraints and realities of their clients' countries of residence. It is therefore quite an investment to try to further develop less "mainstream" markets such as Latin America, China, the Middle East, etc. when one needs to master the language, be familiar with the local economic context, understand the tax environment, and so on.

Having said that, can we though, as a major international financial center, do without the "rest of the world"? Probably not. And this might be the next move for Luxembourg to spread its wings further and reach the symbolic EUR1,000 billion threshold in the next 10 years. As demonstrated by a few recent analyses, the rest of the world is undoubtedly worth our interest:

— Out of the estimated 22 million individuals worldwide with net assets of at least USD1 million, 7.9 million reside in North America, 7.2 million in Asia and 5.7 million in Europe.

— Similarly, out of the estimated 610,000 individuals worldwide with net assets of at least USD30 million, about 233,000 reside in North America, 170,000 in Asia and 155,000 in Europe.*

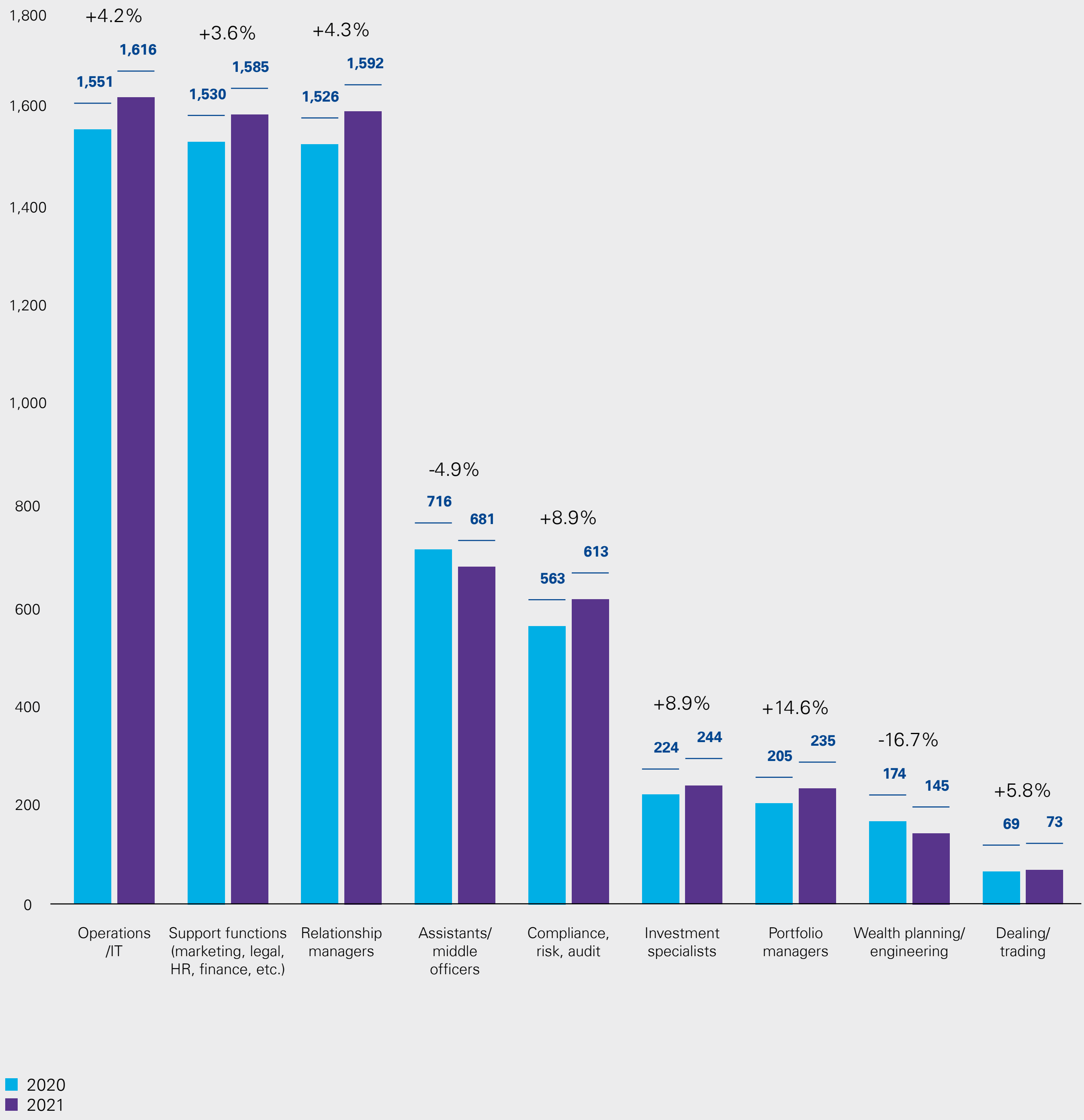


*Source: Statista, Investments of high net worth individuals, 2022 (2021 data)

Evolution of employment in the private banking sector

Number of FTEs by role — all personnel (Luxembourg-based and branch/subsidiary)

2020-2021



A stable workforce

The number of staff members in private banks didn't change significantly during 2021, totaling c. 5,700 when taking into account only Luxembourg-based personnel, and reaching up to c. 6,700 when including staff from branches and subsidiaries.

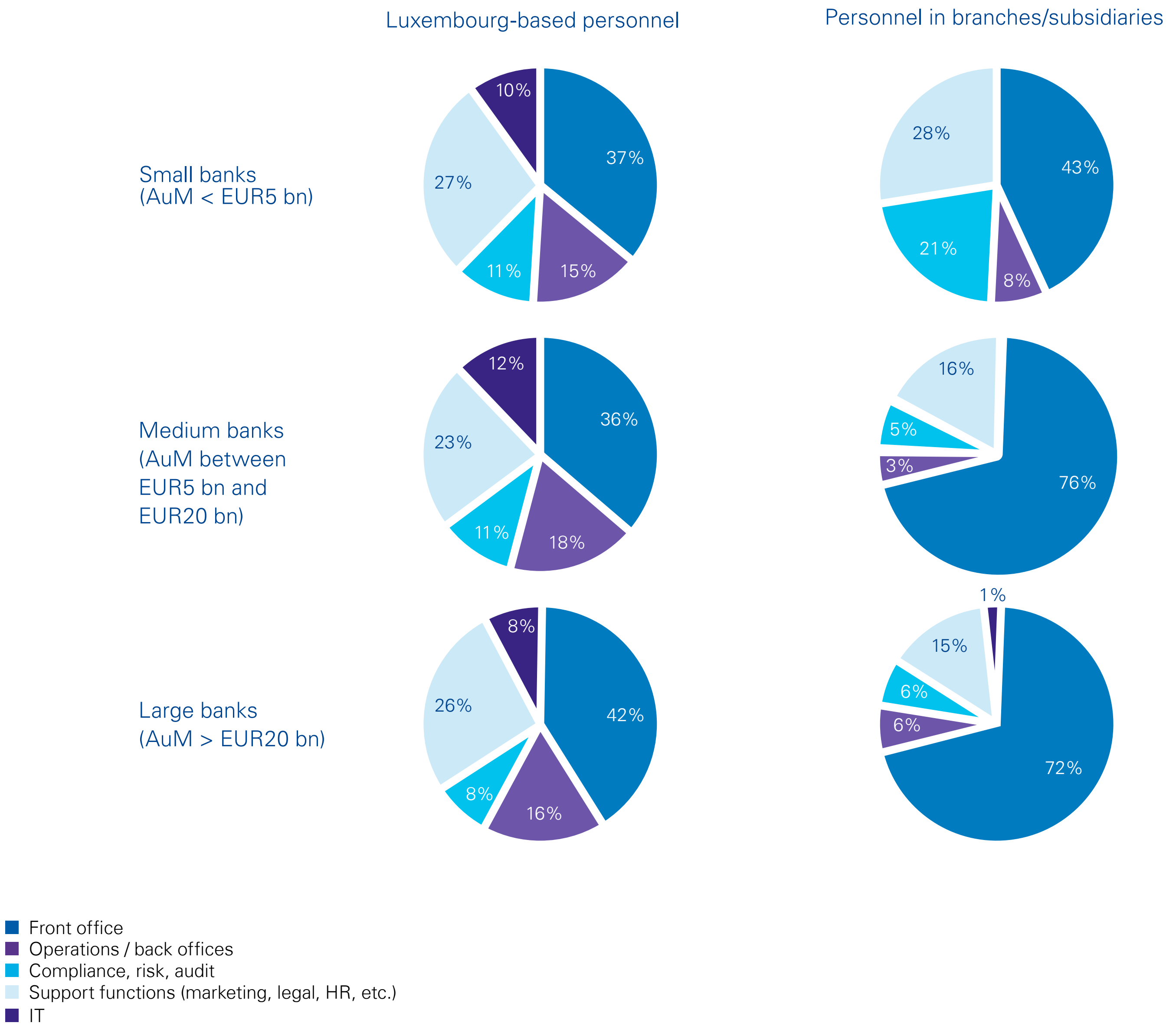
Unsurprisingly, the need for resources in compliance, risk management and internal audit functions was still very much present. As in 2020, these areas accounted for about 10% of the workforce in 2021.

Interestingly, there was a noticeable increase in the number of positions for investment specialists and portfolio managers, confirming once again the trend toward enhanced quality service in advisory and discretionary management among Luxembourg private banks.

When it comes to branches and subsidiaries abroad, the focus is of course mainly on front office personnel, as IT, operations, support functions and some elements of the control functions are as a rule centralized at the level of the Luxembourg-based entity.

Break down per role and per cluster

2021

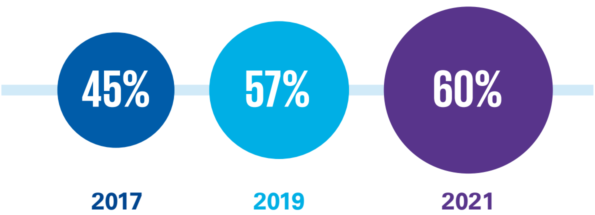


The HR challenge

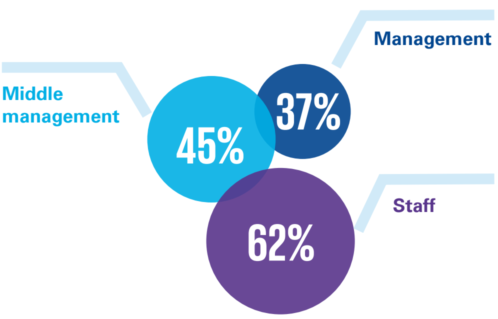
At the core of the development of the private banking industry in Luxembourg lies the vital need to attract, motivate, train and retain the right talent. The financial industry as a whole is experiencing significant difficulties in this regard and there is now an urgent need for innovative and sustainable approaches.

Recruitment difficulties

While for a multiplicity of reasons (openness of the population to foreigners, attractive pension system, health and social security system, quality of life, etc.), Luxembourg generally seems to maintain a rather strong attractiveness to potential talent, there is a real lack of availability of professional and technical skills, and this situation is likely to hinder the further development of the country in general and of the financial sector in particular. As demonstrated in the KPMG Luxembourg 2021 Remuneration Survey, the difficulties in recruiting suitable profiles are certainly increasing.



In 2017, 45% of financial sector survey participants experienced difficulties in recruiting; 57% in 2019. In 2021, this figure continued to rise, reaching 60%. The most difficult levels to recruit into were staff (62% of participants experienced difficulties), middle management (45%) and management (37%).

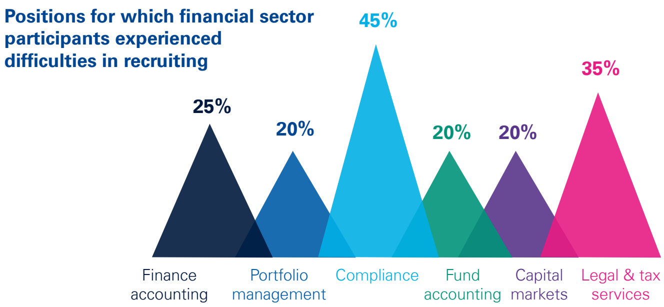


This trend underscores the banking industry's difficulties in recruiting new talent.

Talent gap

According to the financial sector survey participants, the recruitment difficulties are mainly due to a lack of qualified candidates (stated by 41% of participants), a lack of package competitiveness (18%) and the languages required (11%).

Further, the difficulties in recruiting mainly concern the following profiles:



The Luxembourg employment agency (ADEM) corroborated these trends and findings for the finance sector.

For example, when looking at the top 20 most in-demand jobs in the banking sector (using ADEM's role classification model), "Know Your Customer - KYC analyst" (KYC analyst / officer, AML analyst / officer / specialist, compliance officer / analyst / manager) was the most advertised position for banks, with 240 vacancies declared to ADEM, an increase of 52% over the previous year.

Similarly, in fifth place we find "Chargé / Chargée de clientèle bancaire" (account manager, relationship manager, business developer in private banking, wealth manager) with 131 positions advertised, up 56% on the previous year.

So, what is keeping qualified talent from coming to work in Luxembourg and, more specifically, in the Luxembourg banking sector?

From the employee's side

From an employee's standpoint, according to the 2021 Quality of Work Index produced by the Chambre des salariés (CSL) and published in January 2022: "24% of workers intend to leave their job in the near future". The pandemic has highlighted the desire for a better work–life balance. Among other things such as career management, perspective, training, etc., many employees are now looking for more flexible work patterns where they can more easily balance their private and professional lives. And this is of course even more true for commuters who face boredom, delays and fatigue in traffic.

From a business perspective

On the employer's side, solutions are emerging to meet these new challenges. Banks are now able to set up and encourage new ways of working such as remote or hybrid and digital nomad models. Nevertheless, it is more difficult than elsewhere to deploy teleworking in Luxembourg.

According to a study by the Luxembourgish thinktank IDEA Foundation, the presence of state borders between the workplace and home, for almost one employee in two, constitutes the most difficult brake on teleworking in Luxembourg. Currently, Belgian cross-border workers can telework for 34 days a year, French workers 29 days and German workers 19 days. There is an obvious imbalance and a real disparity with the situation for Luxembourg residents, which needs to be redressed. Negotiating with neighboring countries to achieve an equitable distribution of the taxes levied on the teleworking of cross-border workers is certainly part of the solution.

Companies can also use new technologies, and redefine roles, responsibilities, work processes or communication guidelines, etc., in order to meet workers' expectations.

To improve employee well-being, banks have various possibilities for innovating their offerings, such as cultivating a positive corporate culture, designing inspiring offices, or offering empowering packages and reward plans with greater flexibility.

From a country perspective

According to the 2022 Global Financial Centres Index (GFCI), which provides evaluations of financial centers' future competitiveness and ranking, Luxembourg dropped four places from 23rd to 27th in the world. At a European level, it was only in 10th position, somewhat behind its close geographical neighbors of London, Paris and Frankfurt, which took the top three places.

In the context of the attractiveness of Luxembourg as a financial center, the question of the cost of housing and living is also raised. Even if housing price rises slowed down slightly in the first quarter of 2022, they have nevertheless risen by 10.5% over one year in Luxembourg, and even more in the years before. Additionally, more and more French cross-border employees are being tempted to quit their jobs in favor of employers located in Paris, which is after all not so far away from their home — all the more so if the Paris-based employer offers a flexible working pattern. On the German side, the same phenomenon is starting to spread with the competition from Frankfurt.

From an employer branding perspective

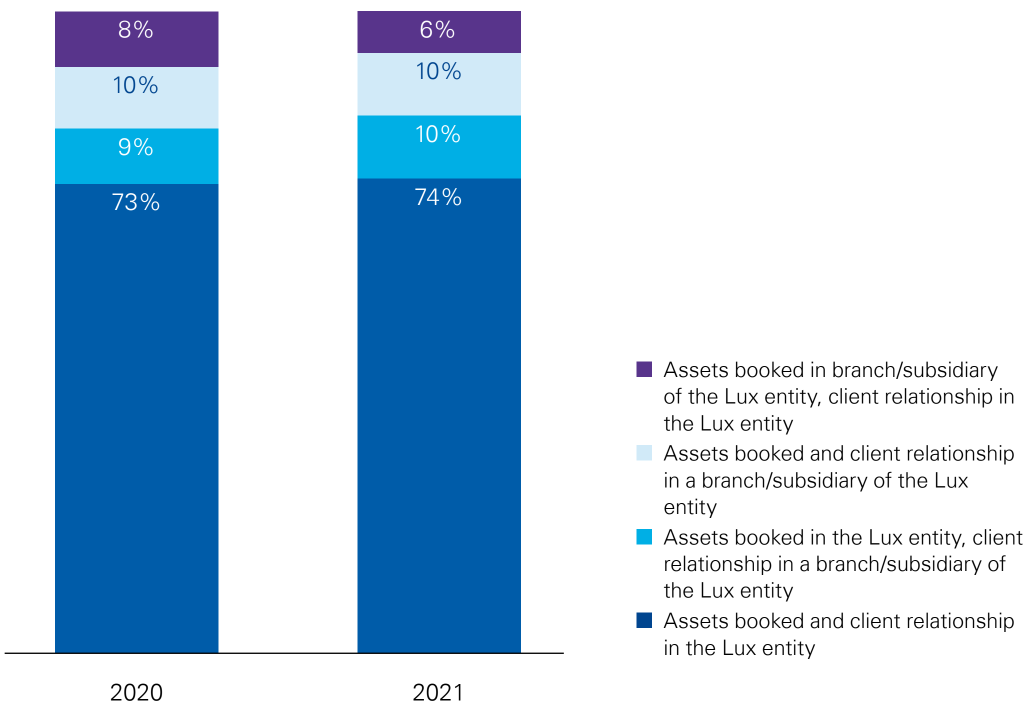
Finally, the banking sector also needs to work on its branding, as it is not always regarded as the most attractive employment sector, especially by the younger generations. There are plenty of innovative and creative things to do within a Luxembourg private bank, but these are probably not sufficiently marketed and known by potential candidates in Luxembourg and abroad.

02 Business and operating models

Booking centers

Booking center distribution, as a percentage of AuM

2020-2021



Luxembourg remains the European hub for major private banks

As can be seen in this graph, the distribution of booking centers barely changed between 2020 and 2021. While the vast majority of clients remain booked and managed from a Luxembourg entity, the number of models where the booking centers and the relationship managers are in different locations has become fairly common.

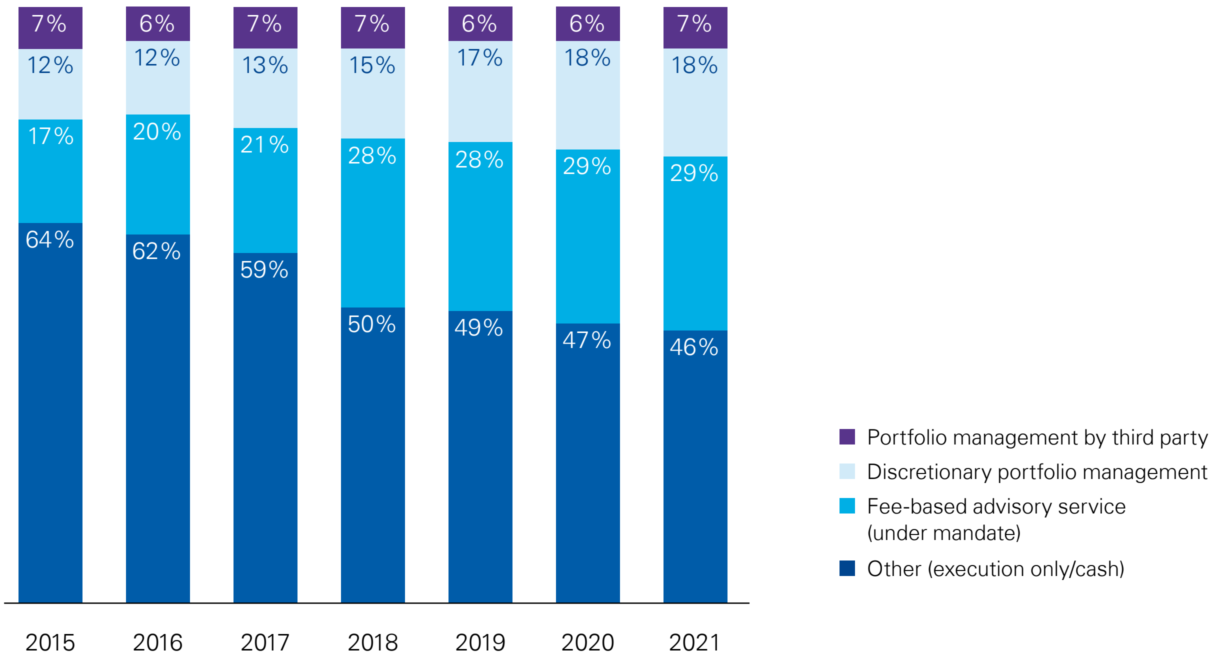
For multiple banks with non-EU parent companies, Luxembourg has become a form of EU headquarters from which a series of branches are deployed across Europe. In doing so, these banks benefit from access to EU markets while streamlining their processes, centralizing their IT, back office and support activities and de facto optimizing their cost structures. At a time when, as mentioned earlier, the cost of doing private banking business has only been increasing, innovative, agile and flexible models are key to accompanying growth in a cost-effective manner.

Ultimately, the important element remains staying close to the customer, whatever the model retained. While digital innovations have made it easier for clients and relationship managers to interact, the physical presence of a bank in the clients' country of residence is a significant advantage and sends them a clear signal. On the one hand, it allows the bank to better understand the realities, difficulties and constraints of its clients, hence making it easier to propose suitable products or services; on the other hand, it also demonstrates a strong commitment on the part of the bank to remain and invest in this particular market, which can undoubtedly reassure its clients.

All in all, the model of the pure offshore bank, whose Luxembourg-based relationship managers would circulate around Europe in search of clients, has clearly evolved into a more balanced and structured offshore/onshore model.

Investment service offering

Investment service offering, as a percentage of AuM
2015-2021



A form of plateau in the penetration rate

As discussed in last year's report, since 2015, the industry has been trying to shift toward a fee-based model where private banks charge clients directly for investment advice. This service was historically free, or quasi-free, as revenue was mostly transaction-based and therefore generated from commission and execution fees.

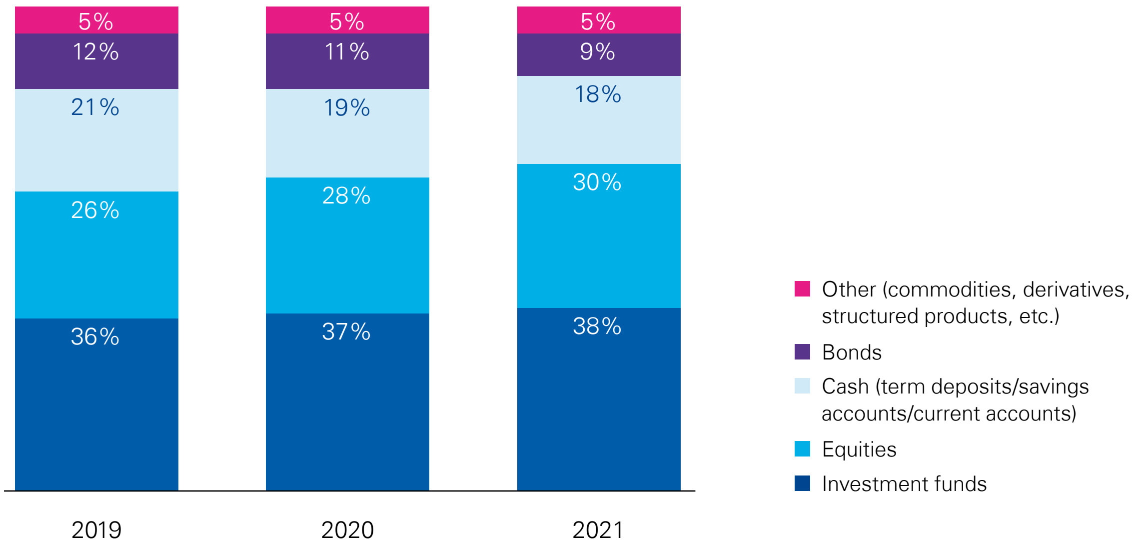
In this regard, the two main service offerings that have grown significantly since then are discretionary portfolio management (DPM) and advisory mandates. While the former had increased from 12% of AuM in 2015 to 18% in 2020 and the latter from 17% to 29% over that period (accounting for almost half of AuM in 2020 vs. less than a third in 2015), we note no evolution whatsoever in 2021, as if there was a sort of plateau in their penetration rates. Moreover, the proportion of cash remained very high in 2021, at 18% (c. EUR100 billion) of AuM.

This may come as a surprise as, in 2021, not only were interest rates very low or even negative for clients, discouraging many from remaining in cash, but at the same time financial markets were flourishing. One might have expected the conjunction of these two elements to result in an increase in the development of DPM and advisory mandates.

Conversely, and paradoxically, one could also argue that the financial markets were booming to such an extent that investors might have been under the impression that they didn't really need tailor-made, personalized advice and that any investment they made would be profitable… If that was the case, 2022 could provide a tough wake-up call, reminding us all that wealth management is indeed a profession in its own right.

Composition of client portfolios, by asset type (all service types together)

2019-2021



Assets under management vs. assets under custody

For many years, there has been an endless debate as to what proportion of assets were actually managed by private banks and what proportion were deposited with private banks but managed by "third-party" or "external" asset managers.

As a reminder, in Luxembourg, an external asset manager would be a regulated Professional of the Financial Sector (PSF) supervised by the CSSF, entrusted with the mandate for managing a client's assets deposited in an account with a custodian bank, in a triangular relationship setup.

While this debate continues, it is not without merit, as custody fees are of course significantly lower than management fees. Additionally, a proper understanding of the true value of the assets under custody (AuC) within the sum of AuM in Luxembourg would make it possible to better assess the average profitability of assets actually managed vs. those that are only deposited, as well as to avoid double-counting of assets by both private banks and asset managers.

To add another layer of complexity to this issue, the fact is that, within a private bank, the activities of custody and support to third-party asset managers sometimes lies with the private banking department, and sometimes with the institutional or corporate banking department.

This can make it difficult for our survey respondents to provide suitable figures, thereby significantly hindering our data collection exercise.

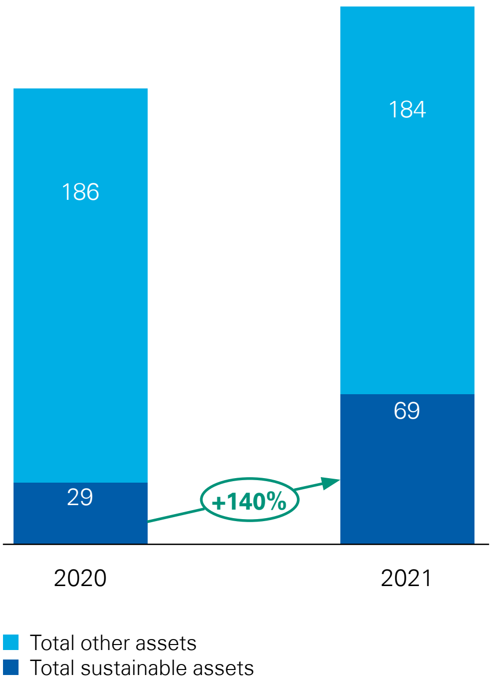
That said, in order to somehow try to compute an approximate figure that is as close as possible to reality, if we apply the 7% of "portfolio management by third party" answers to the EUR599 billion of total AuM, we obtain a figure of EUR42 billion. This seems in line with other similar studies available on the market, with the additional nuance that this figure also includes asset managers that are not based in Luxembourg.

When it comes to the profitability of AuM vs. that of AuC, this is further discussed in Part 03.

How is ESG currently changing the investment product landscape amongst private banks?

Evolution of sustainable assets in EUR billion

2020-2021*



* Only 17 respondents provided an answer to this question, hence the limited amount of assets

Introduction

Greenwashing risk has been at the top of the regulatory agenda for 2022 — especially after the entry into force of Level 1 of the Sustainable Finance Disclosure Regulation (SFDR) on 10 March 2021 — while sustainability reporting and disclosures have continued to be front and center for financial market participants. At the same time, the sustainable finance agenda for private banks remained full, with the publication of supervisory guidelines to clarify sustainability disclosure requirements (e.g. those from the European Securities and Markets Authority (ESMA) and European Supervisory Authorities (ESAs)), and especially with the implementation of new ESG-related MiFID II and Insurance Distribution Directive (IDD) requirements, which came into force on 2 August 2022. Financial market participants are continuing their sustainability and ESG transformations, with SFDR Level 2 to come into effect on 1 January 2023.

Although we observed that total sustainable assets under management increased by 140% in 2021 (compared to 2020), private banks face many challenges in ensuring that their promoted products qualify as sustainable. They must also strengthen their procedures to avoid the risk of greenwashing.

The current state of affairs

The key priorities of regulators are currently tackling greenwashing and promoting transparency. As such, on top of following the initial regulatory roadmap set up with regard to sustainability, regulators are undertaking additional initiatives based on practices observed in the market, feedback collected and remediation actions that have been identified as necessary.

Sustainability disclosure requirements under SFDR

Over a year after the application of SFDR Level 1, a compliance "health check" is necessary to factor in feedback provided by the regulators. Product manufacturers must apply more stringent rules in their disclosures, as clarified in recent publications from ESMA (Supervisory briefing: Sustainability risks and disclosures in the area of investment management, published 31 May 2022) and the ESAs (Clarifications on the ESAs' draft RTS under SFDR, published 2 June 2022). Private banks are also constantly monitoring the performance of promoted products to ensure alignment with their customers' preferences.

Furthermore, banks have been busy with the calculation of principal adverse impacts (PAIs) (where considered), which will have to be reported on an annual basis starting from 2023. Quarterly data collection on PAIs is already required from 2022, which will serve for the 2022 reference period reporting during 2023.

However, the different regulatory agenda for corporates' reporting obligations creates market uncertainties, with lack of accuracy and consistency seen in ESG data compiled by data vendors. This results in difficulties collecting the mandatory information to comply with the entity-level and product-level PAI reports for the first-year exercise. At some point, private bankers will discover the ESG impacts of their investments for the first time and will then have to define a clear strategy to reduce any negative impacts during the coming years.

Addressing customers' sustainability preferences under MiFID II and IDD

The ESG regulatory roadmap has driven private banking professionals to channel their efforts into implementing the MiFID II and IDD Delegated Regulations[1]. These new requirements have shaken the core business and operations of private banks which now need to comply with more stringent rules to qualify a financial product as sustainable (a minimum proportion of investments must be aligned with the EU Taxonomy, or with the definition of Article 2(17) of the SFDR, or should consider the PAIs on sustainability factors).

These new criteria emphasize even more the problems surrounding ESG data, as ESG data providers' labels and ratings will no longer suffice.

The limited ability to qualify a financial product as sustainable under MiFID II and IDD rules also creates difficulties in conducting ESG suitability tests against clients' preferences. The ESG questionnaire to be completed by customers was therefore at the center of discussions in recent months, to ensure not only that customers would understand the sustainability concepts and products offered, but also that banks would be able to address the preferences chosen by their clients in the questionnaire.

Integrating sustainability risks within risk management practices

From a risk management perspective, the focus has been on the definition and implementation of roadmaps to address the 13 supervisory expectations that the ECB set out for climate-related and environmental risks (C&E risks).

The 2022 ECB climate risk stress test results published on 8 July 2022 also provide private banks with a deeper analysis of how they incorporated C&E risks into their strategy, governance and risk management frameworks and the areas they need to improve on with this exercise.

Although most institutions have started integrating C&E risks into their credit risk management processes, they are still at an early stage of development. In particular, their portfolio monitoring and loan pricing processes and practices still need to integrate C&E factors in a deeper and more consistent manner.

These risk management aspects also affect banks' reporting obligations, as banks have to integrate ESG-related risks and their green asset ratio (GAR) as part of their Pillar 3 reports, in accordance with the European Banking Authority's (EBA's) implementing technical standards (ITS). This should also be incorporated into banks' current operating models and ESG data capture.

Specific considerations at local level

Although the European regulatory landscape around sustainability aims at standardizing the definition of sustainable products and improving transparency, there are also local specificities to take into account at national level. For instance, France's Autorité des Marchés Financiers (AMF) published its doctrine 2020-03[2] which includes more restrictions than the SFDR regarding information to be provided to retail investors in France at product level.

The additional layer of local rules, and the view as to what is considered to be an ESG investment, add complexity

1. Delegated Regulations refer to:
   a. The Delegated Regulation (EU) 2021/1253 amending the Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organizational requirements and operating conditions for investment firms
   b. The Delegated Regulation (EU) 2021/1269 amending the Delegated Regulation (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations
   c. The Delegated Regulation (EU) 2021/1253 amending the Delegated Regulation (EU) 2017/2359 as regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products.
2. Position - Recommendation AMF DOC-2020-03

for banking professionals in their sustainability journey, as they need to factor in these specificities based on the geographic localization of their operations and not only rely on the group's strategy and review.

Overall, the above regulatory context presents many challenges to the banking sector. Based on our experience and interactions with financial market players, we have identified that today's key issues lie in the following:

- **Collecting reliable ESG data** – Whether it is for the calculation of PAIs, classification of products as sustainable, or the integration of sustainability risks into risk management practices, it is still very difficult to obtain accurate or reliable ESG data at present. We can expect improvements in the quality and availability of such information through time, with the application of the European ESG Template (EET) from 1 June 2022, and the SFRD regulatory technical standards (RTS) from 1 January 2023. Intense and continuous scrutiny from regulators regarding ESG data will, however, keep putting pressure on banks regarding the reliability and accuracy of data used.

- **Upgrading existing systems** – The integration of ESG data needs into existing systems and processes requires extensive effort, and must be undertaken from an overall "ESG data strategy" view, rather than at the level of individual topics. Stringent IT implementation plans are essential to cope with such changes.

- **Managing reputational risks** linked to greenwashing – With greenwashing being one of regulators' top priorities, banking professionals must go beyond tick-the-box compliance exercises. They should conduct thorough due diligence analyses of investments, and product performance monitoring, to ensure that the descriptions of products classified as Article 8 or Article 9 under SFDR do not contain any misleading sustainability claims.

- **Training employees** – Training is an inherent corollary of the sustainability path and the significant changes occurring within the core functioning of banks, especially regarding front office teams that interact directly with clients. Maintaining adequate staff skills is not an easy task for financial players, as sustainability-related topics are very changeable and evolve rapidly.

What's next for private banks?

- **Continuously improving ESG data governance** – This will occur through constant work and discussions with ESG data providers to improve access to relevant ESG data.

- **Strengthening the control environment and governance around greenwashing** – Existing procedures for the selection, analysis and promotion of products with sustainability characteristics should be reviewed to ensure adequate governance and a strong control environment are implemented to reduce the risk of greenwashing.

- **Strengthening supply chain due diligence** – This is necessary to avoid financial and reputational risks, as there is increasing pressure for banks to perform an assessment of supply chain human and environmental risks, in addition to the due diligence for granting loans or when investing directly in companies.

- **Defining/reviewing long-term ambitions and product strategies** – The new "sustainability" outlook provides banking professionals with opportunities to review the ways in which they operate and to provide even greater value to their customers. Based on the returns from experience acquired so far, and further changes to be implemented in the coming months, operating models should be continuously reviewed to embrace ESG opportunities and enhance value. Private banks are also starting to sign the Net Zero Asset Managers initiative, as well as to join the Net Zero Banking Alliance for net zero emissions portfolios by 2050.

Sustainability preferences

EU Taxonomy

A financial instrument for which the client or potential client determines that a minimum proportion shall be invested in environmentally sustainable investments as defined in Article 2, point (1), of Regulation (EU) 2020/852.

Sustainable investments

A financial instrument for which the client or potential client determines that a minimum proportion shall be invested in sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088.

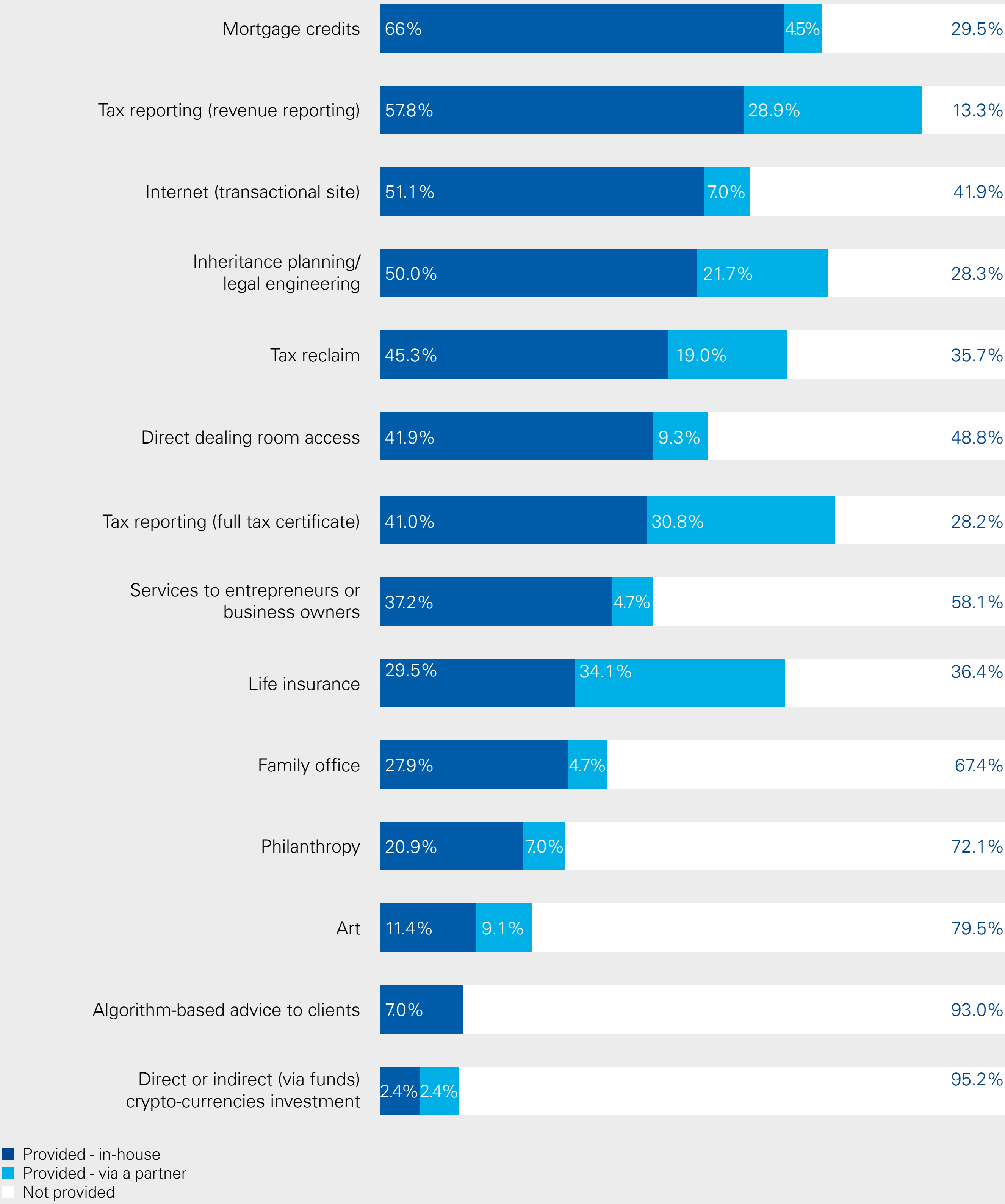
PAIs

A financial instrument which considers principal adverse impacts on sustainability factors, where qualitative or quantitative elements demonstrating that consideration are determined by the client or potential client.

Additional service offerings

Additional services provided by private banks, by % of banks

2021



Additional service offerings

A focus on...

Tax reclaim and reporting

Today's tax landscape is becoming more and more demanding, requiring timely and efficient implementation of ever-changing regulations in the private banking industry. Taxes are increasingly becoming a core topic for companies, and especially banks. New fiscal regulations issued by the EU, as well as by national and international bodies, lead to many challenges, but also opportunities, in the banking sector. As such, private banks are now under constant pressure not only from legislators, to comply with numerous tax provisions, but also from their clients, to offer new services and provide tax-efficient and digital solutions.

As a general market trend, it can be observed that private banks are tending to offer additional non-mandatory (tax) services that increase their attractiveness to clients and thus generate competitive advantages. At the same time, the mandatory compliance obligations private banks must meet — in particular in the field of operational taxes — whether regarding withholding taxes or regarding exchange of information (FATCA, CRS or QI), are only increasing.

Many private banks are demonstrating that they want to and can adapt to the new tax environment by offering new services. These include various tax reporting or tax reclaim/relief services in relation to withholding taxes on capital income. While detailed reports satisfy investors' thirst for more information, reclaim and relief services increase the cashflow of clients by reducing the actual tax burden. These advantages don't just benefit the banks' customers: offering new services also increases banks' attractiveness on the market and hence can even attract new customers.

At the same time, the mounting compliance requirements for private banks bring risks, as non-compliance or incorrect execution of requirements may lead to significant penalties and fines. Private banks are required to comply with a set of due diligence, withholding tax and reporting requirements. Rules in relation to FATCA, CRS or QI apply to financial and non-financial entities, including private banks; the applicable regime depends on the type and/or jurisdiction of their investors or investments. Given the increased risk of falling under the tax authorities' spotlight, financial institutions must, now more than ever, make sure that appropriate policies, controls, procedures, and IT systems are in place to meet their reporting and due diligence obligations.

This increasing complexity can be seen not only in operational taxes but also in the area of corporate taxes, where the requirements directed at companies in the context of tax returns are constantly growing due to, for example, ATAD1, ATAD2 or DAC6.

In conclusion, on a positive note, there is a trend toward more digital tax solutions and outsourcing of various activities, especially those that tie up resources, such as tax reporting or the filing of withholding tax reclaims or applications for relief at source. At the same time, there is greater scrutiny from the Luxembourg authorities (CSSF, ACD) regarding the conduct of tax audits, with particular attention being paid to tax procedures.

Moreover, we can observe a need to consolidate tax risk documentation in order to be prepared for tax audits and to guard against potentially severe financial or reputational risks. It becomes critical to satisfy the regulators' requirements with respect to documentation of procedures and the implementation and remediation of actions — and this will require appropriate internal safeguards and protective mechanisms, as well as the right governance, to be in place.

Life insurance

The results of our study show that many respondents seem to offer life insurance services to their clients via an internal brokerage department or via a collaboration with an external distribution partner. Life insurance products are a well-established wealth planning tool for (U)HNWIs, hence the reason why private banks and life insurance companies have historically had ties in Luxembourg for a number of years.

Based on the broad definition of insurance distribution that can be found in article 279 (16) of the Luxembourg Law of 7 December 2015 on the insurance sector, private banks have to be careful not to carry out insurance distribution activities without having the proper license delivered by the Luxembourg insurance regulator, the Commissariat aux Assurances (CAA). Insurance brokerage is a licensed activity subject to specific rules and regulations, and requires a professional setup and a perfect understanding of the entire life insurance ecosystem in order to act in the best interests of the client.

However, private banks can undoubtedly increase their revenue streams through insurance activities by multiplying the roles they take on in the life insurance ecosystem. The following activities can be carried out by a private bank or another entity of the group to which it belongs:

- Life insurance distribution by creating an internal brokerage department or by setting up an external brokerage firm
- Discretionary asset management activities for dedicated funds
- Custodian activities for the assets held by life insurance companies.

Insurance brokers can help clients analyze the advantages life insurance products can offer them in structuring their wealth, explain the different options that are available on the market and negotiate the contract with the life insurance company. Consequently, private banks may offer additional services to existing clients and thus increase their customer retention. Private banks with an internal brokerage department do not have to share revenue and client data with an external party, which constitutes a clear benefit.

Insurance brokerage can be an interesting activity for a private bank if it is part of a broader strategy of proposing additional value-adding products and services to its clients. The bank can become a one-stop shop for private banking and life insurance needs and so have the possibility of building long-lasting relationships with its clients.

Algorithm-based advice to clients

Back in 2019, KPMG Luxembourg and the PBGL published the findings of a joint research study on the digitalization of private banks in Luxembourg. As part of this study, private banks were asked whether they felt that robo-advisor solutions were really designed for typical private banking clients.

Only 15% of the banks surveyed replied that they were considering offering a business-to-consumer (B2C) robo-advisor solution to their clients, stressing the fact that clients primarily seek a privileged interaction with their relationship manager. A few banks felt there was some potential for this type of technology and offering, provided that it was only implemented in an internal setting — i.e. to support relationship and investment managers. This was reflected in the fact that 55% of banks surveyed were considering using robo-advisor technology in, effectively, a business-to-business (B2B) mode, to boost the efficiency of their advisory services.

As shown in the accompanying graph, the results of our analysis this year tend to confirm the trend observed in 2019, as only 7% of respondents said they currently offer algorithm-based advice to clients.

As we know, providing advisory services to private banking customers is not just a matter of portfolio optimization which can be standardized and automated. The human factor is also crucial, notably due to the complexity of the services provided, their significance for the client and the importance attributed to trust.

Rather than fully automating the advisory client journey, the digitalization of advisory services has taken two separate paths in recent years:

— Facilitating interactions with clients through virtual channels such as email, chat or video telephony

— Improving the tools made available to investment managers through the implementation of digital advisory platforms, which also provide opportunities to revisit advisory client journeys, leveraging new and advanced data analytics capabilities.

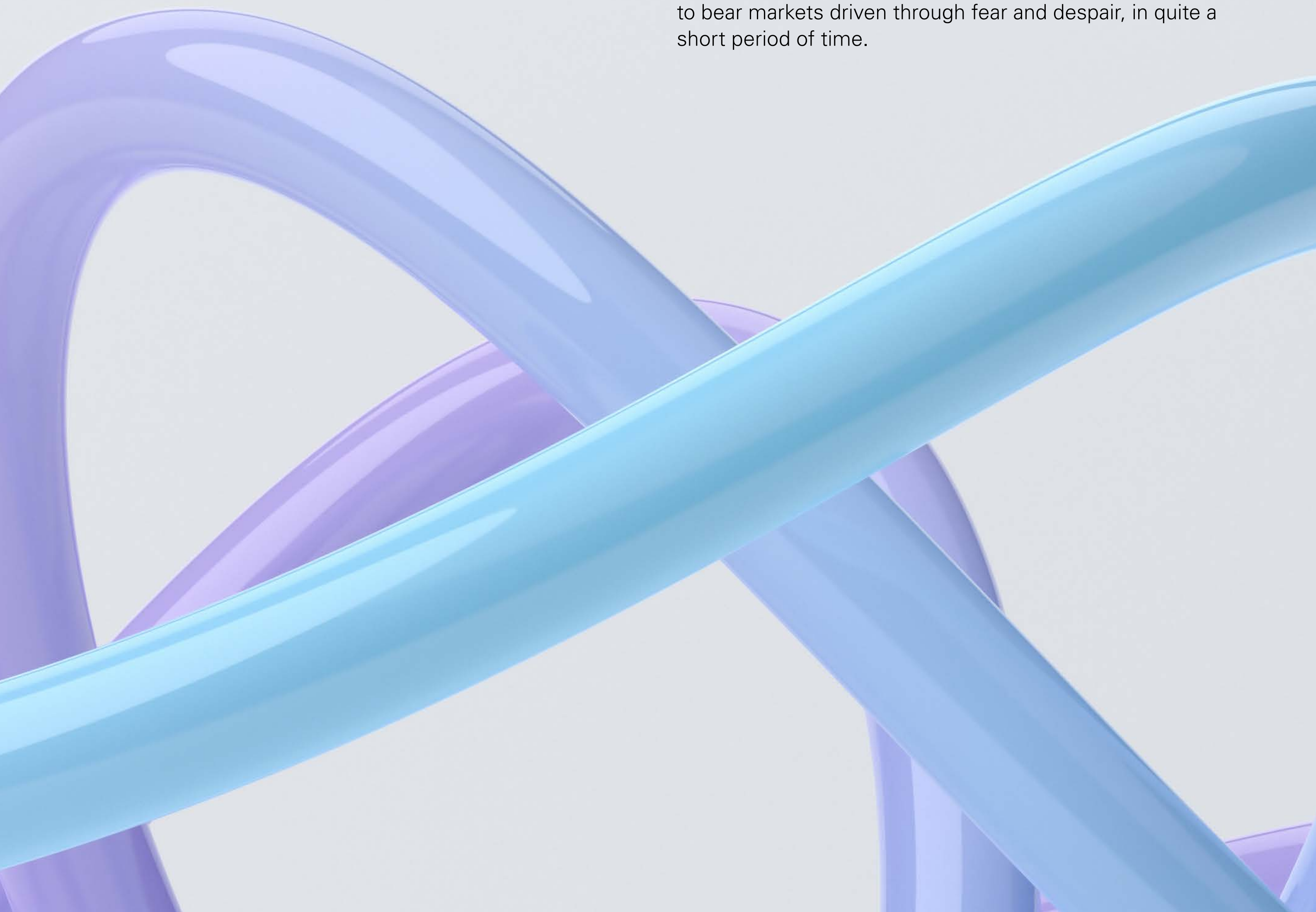
Some private banks have preferred to focus their efforts on the digitalization of their execution-only and discretionary portfolio management client journeys.

In conclusion, although B2C robo-advisory solutions remain a very valid offering, unsurprisingly they are more oriented toward retail or mass affluent clients, rather than toward private banks that focus on (U)HNWIs.

Crypto-assets

It has been fourteen years since the pseudonymous Satoshi Nakamoto published his white paper, “Bitcoin: A Peer-to-Peer Electronic Cash System”, which described the basic structure of the bitcoin network.

We’ve come a long way since 2008 and have witnessed the full gamut of classic phases of a disruptive technology: from a bull market driven through euphoria, to bear markets driven through fear and despair, in quite a short period of time.



While growth has been rampant, harmonization in understanding its implications is still in progress. There is significant information asymmetry, as well as a lack of understanding — and, as basic as it sounds, even the elementary terminology is not clear or agreed upon among market participants and regulators. For instance, the terms virtual assets, crypto assets, cryptocurrencies, digital assets, tokens, etc. are all used interchangeably.

Not surprisingly, crypto has different interpretations for different stakeholders: for some it is an investment asset class like commodities, while for others it is a currency; for some it is a venture capital investment, for yet others it is a bubble. Some value it as a medium of exchange, while others value it as an anonymous method of exchange and an immutable record of rights and ownership.

Nevertheless, with more than 20,000 crypto assets, USD1 trillion plus in market capitalization and over 500 crypto exchanges, crypto as an asset class simply cannot be ignored. Crypto assets continue to garner significant attention from the media, financial analysts, governments and regulatory institutions — more particularly in the last couple of years, for both good and bad reasons.

A tumultuous 2022 for crypto assets hasn't helped much either. From bitcoin's November 2021 peak to early August 2022, almost USD2 trillion was wiped off the crypto market. We have witnessed the collapse of the Terra ecosystem, the failure of the reputable hedge fund Three Arrows Capital, and multiple hacker attacks, among various negative events.

All hope is not lost though. There is a world beyond crypto speculation — and the underlying technology has massive benefits for the system. Crypto assets have multiple use cases and asset tokenization (security tokens and tokenized securities) is finally taking off. But to realize this potential, large scale institutionalization is the need of the hour.

There are many challenges facing organizations as they institutionalize crypto: formulating strategy, narrowing product–market fit, developing TOMs (target operating models), earning consumer trust, navigating regulatory challenges and bad press, etc. Nevertheless, institutional interest in crypto continues to rise at a very rapid pace. Some notable institutional strategic initiatives are definitely worth highlighting, including the following.

— Citigroup and Morgan Stanley now provide advisory services to HNW clients with crypto exposure.

— BNP Paribas entered the crypto space via a partnership with crypto custody specialists Metaco and Fireblocks.

— BlackRock, the world's biggest asset manager, has partnered with Coinbase to offer crypto to institutional investors.

— Commerzbank, Germany's fourth-largest bank, has applied for a local crypto license in order to offer digital asset custody and exchange services to clients, focusing initially on institutional customers.

— LGT has partnered with SEBA Bank to offer cryptocurrency custody and brokerage services to private clients.

— Fidelity Investments is launching a product that will allow bitcoin investments in 401(k) managed accounts.

From a products and services perspective, there are multiple ways to capitalize on the availability of this new asset class. Without going into the demerits of volatility and nascent valuation models, the most familiar case is providing access to cryptocurrency for clients who seek exposure to this new asset class. This can be done standalone, as well as on a partnership basis with an exchange. Additionally, providing access to crypto funds and crypto ETFs could also be of interest for clients who seek more diversification and management expertise.

As tokenization of assets is increasing at a rapid pace there could potentially be an opportunity in providing safekeeping and custody services for virtual assets. In the context of crypto this primarily refers to the management and safekeeping of the cryptographic private keys that virtual asset owners use to execute virtual asset transactions.

In Luxembourg, both the above services — crypto trading and custody — are possible by virtue of acquiring a VASP (virtual asset service provider) license. With the launch of the EU's announced digital finance package, and more particularly the MiCA (markets in crypto assets) and MiDLT (market infrastructures using distributed ledger technology) regulations to come, we are now moving toward harmonization of an effective regulatory framework which will boost the growth of this asset class.

As a new world of finance emerges, private banks have the potential to adjust their strategies, rethink their business and operating models and leverage impending regulatory changes so as to capitalize on the multiple upcoming opportunities for meeting consumer demands — or they may simply choose to ignore these. The choice is theirs.

Private banks' increasing appetite for private funds

Democratization of private funds

A key opportunity for private banks lies in the democratization of private funds, with retail investors being given access to private investments previously reserved for institutional investors. The market now offers retail investors semi-liquid products such as "evergreen" funds, and alternative investment platforms are starting to grow in Europe. The challenge of getting individual investors into private asset classes is spurring plenty of innovation, but the market has yet to identify a single best solution. In fact, the highest priorities of private banks are to expand their private funds offerings to their own clients, as well as to develop new private funds for clients via partnerships with external "general partners" (GPs).

Interest in collaborating with big private funds players

Private banks recognize that big-name private funds firms and large global asset management firms with alternative platforms have accumulated significant expertise and have established networks that allow them to identify the most attractive deals. They understand the benefits of using fund managers that have a broad range of expertise and platforms, and which can offer new private market products and raise enough assets relatively quickly.

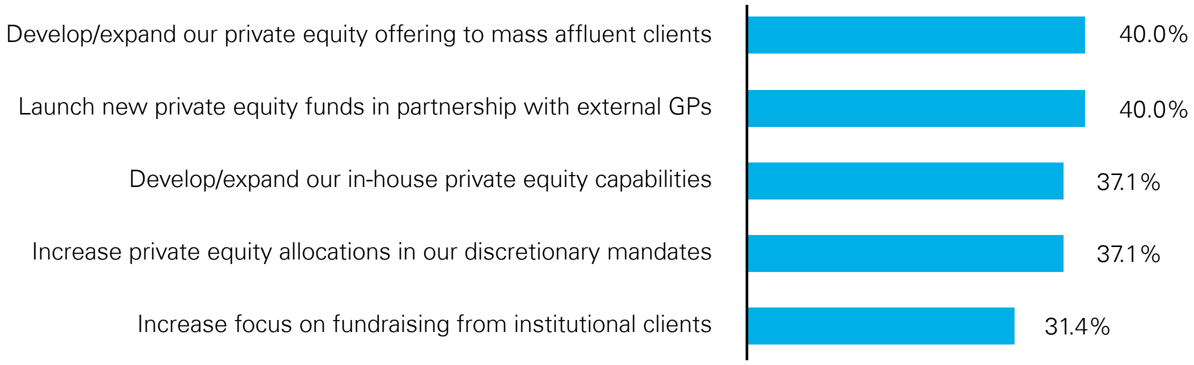
Private banks among the top distribution channels

A Cerulli Associates analysis ranked private banks and wealth managers as the fourth most important distribution channel for private market products in Europe — it found that, in 2021, 43% of asset managers considered that private banks and wealth managers represented a "high" distribution priority for private funds over the next one to three years and the remaining 57% said they represented a "medium" priority. On the other hand, some fund managers do not see any immediate need to promote mass market channels, given that retail investors represent only a small fraction of their revenue streams.

Client education will be crucial

Private banks should be aware that, given the variety of vehicles used to deliver private funds investments and the complex nature of the underlying strategies, educating clients about these investments will be crucial, with asset managers passing information to private bankers and private bankers passing information to their clients.

Private banks: priorities for private funds business in Europe



Source: Cerulli Associates, European Alternative Investments 2021

Attraction of private funds

Private banks have also begun to be attracted by illiquid assets. About 48% of the European private banks surveyed by Cerulli in 2021 planned to increase their recommended strategic allocations to private funds over the following 12 to 24 months, and 36% planned to increase their recommended allocations to infrastructure investments. Only 20% planned to increase strategic allocations to real estate within their discretionary portfolios. Nearly 84% of the private banks surveyed planned to use external asset managers to source venture capital strategies; only around 17% of respondents had the expertise necessary to run such strategies in-house.

Private banks' investment strategies

A third of the private banks surveyed by Cerulli had acted to rebalance their clients' alternative investment portfolios over the previous 12 months; private funds and infrastructure were among the main beneficiaries of such coronavirus-driven portfolio rebalancing. However, some respondents said that Covid-19 had triggered only minor changes rather than significant rebalancing.

The private funds strategy in most demand by private banks for the following 12 months was the use of growth funds. Around a third of the private banks expected to increase their allocations to private growth funds over the following year. Around 70% planned to use external managers and around 30% said they would rely on in-house teams to increase their exposure to growth funds.

HNWI interest in private funds

Private banks should be aware that HNWIs' interest in private funds has grown substantially in recent years; this trend is expected to continue. Family offices and their UHNW clients typically allocate, on average, 20% of their total assets to private funds and hedge funds (excluding real estate). In comparison, HNWIs allocate only around 2% of their assets to alternative investments. Clearly, the majority of HNWIs are underexposed to private funds markets. In fact, the expectation is that HNWIs' allocations to alternatives will increase to 5% or more over the next three to five years (source: Cerulli Associates).

Moreover, private banks should also consider the challenges that private funds allocations might bring, such as lack of liquidity, dealing with client risk aversion and the complexity of the investments.

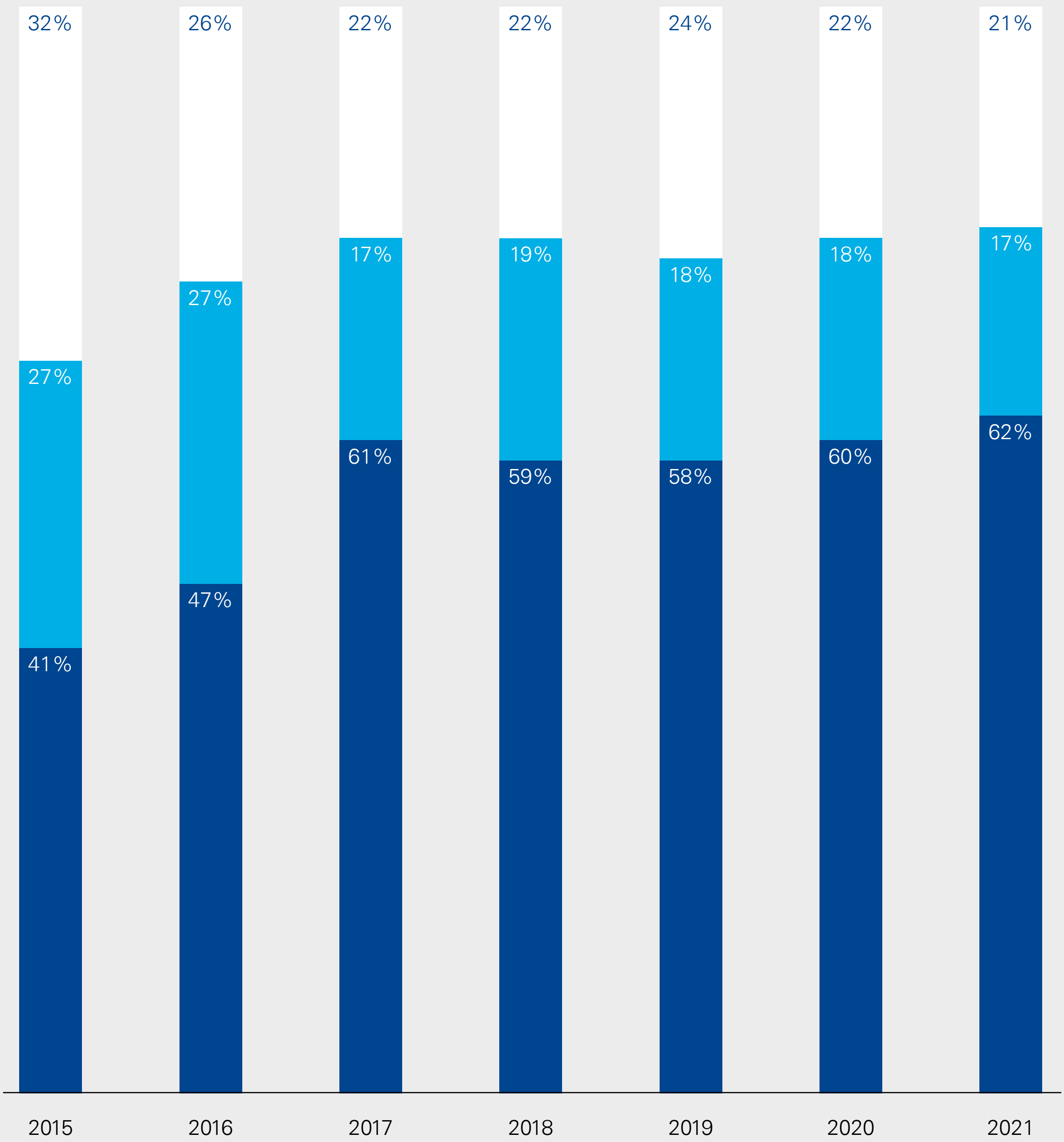
Private banks: main barriers to further increasing private funds allocations for discretionary mandates

Source: Cerulli Associates, European Alternative Investments 2021

Loan book

Composition of private banks' loan book, by loan type, in %

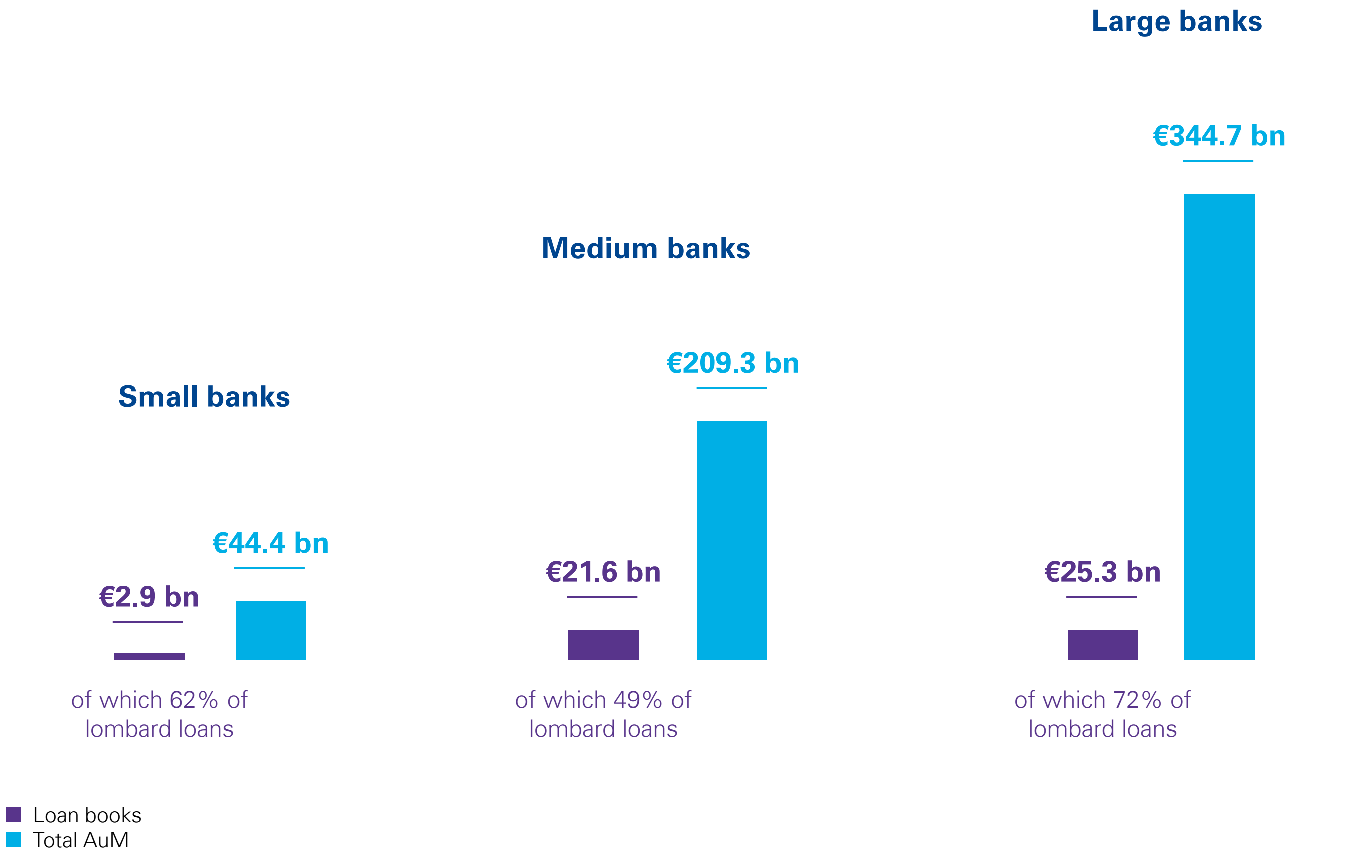
2015-2021



Off balance sheet engagements, consumption loans and multi-use credit lines
Real estate
Lombard

Private banks' loan book size vs. total AuM, in EUR billion, by cluster

2021



Loan book increase

The total amount of lending by Luxembourg private banks to their clients continued to increase in 2021, rising 12.4% from EUR44.3 billion to EUR49.8 billion. This followed an already significant 9.6% increase in 2020. When comparing the banks by size cluster, however, we note considerable differences in growth rates, with the minimal (0.5%) growth within the smaller banks cluster standing out as significantly lower than for the larger clusters:

Cluster	Lending growth
Small banks	0.5%
Medium banks	12.4%
Large banks	14.1%

Lombard loans accounted for almost two-thirds (62%) of the total loan book at end 2021. This is not surprising as, on the one hand, they remain the number one financing product offered by Luxembourg private banks and, on the other hand, the excellent performance of the financial markets in 2021 undoubtedly encouraged some private clients to increase their investments, with some therefore requiring additional leverage.

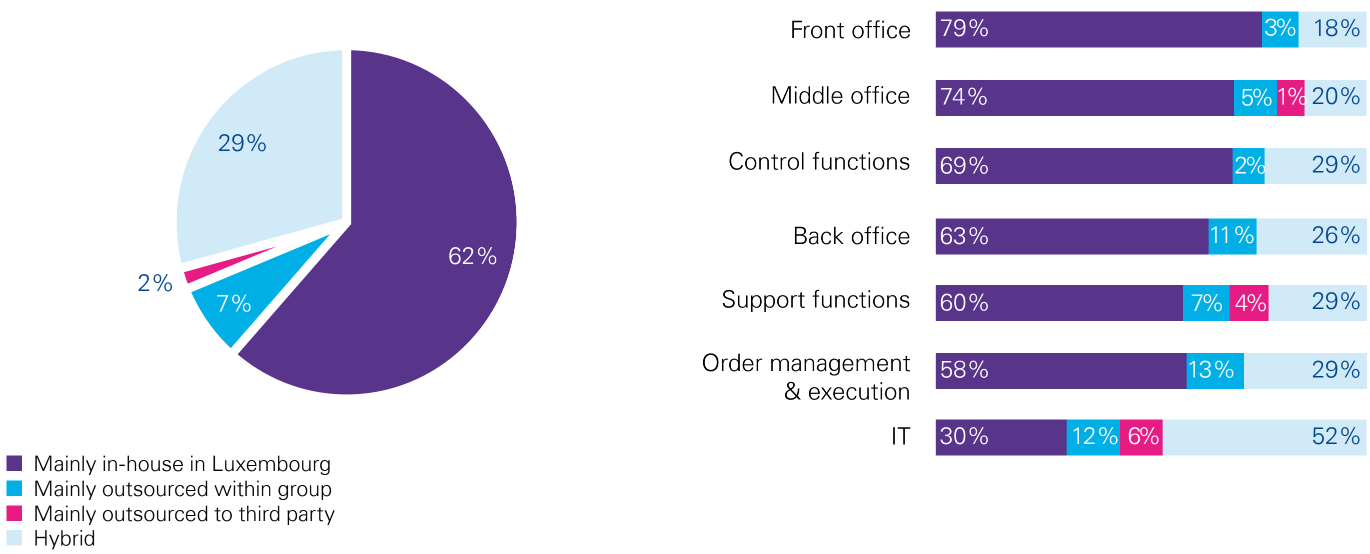
When it comes to the ratio of the loan book to total AuM, by cluster, the proportions are somewhat closer to one another, varying between 6.5% and 10.3%.

Cluster	Loan book as a proportion of total AuM
Small banks	6.5%
Medium banks	10.3%
Large banks	7.3%

Operating models

Proportion of total activities undertaken in-house/outsourced/hybrid

2021



Activities remain very much performed locally, with a fair level of leverage on groups

Just as in 2020, the majority of private banks' activities (62%) are operated mainly in-house, and the share of activities mainly outsourced to the group (7%) or to a third party (2%) remains limited, while a significant proportion of activities is operated in a hybrid mode (29%), i.e. with a mix of in-house and outsourcing within group or to a third party.

Activities that are mainly operated in-house are still the ones related to front and middle office, while activities mainly outsourced within the group are those related to IT, back office and order management & execution.

Those activities that are mainly outsourced to a third party are concentrated in the IT and support functions.

This reflects the trend observed over the past few years, whereby most private banks with an international footprint are trying to optimize the way they operate, centralizing teams and activities across locations, leveraging unified IT platforms, transforming some subsidiaries into branches, and potentially rationalizing their booking centers' organization.

Proportion of activities in-house/outsourced - front office

Front office

Within front office activities, the main activity that leverages intra-group outsourcing through a hybrid model is discretionary portfolio management. In fact, harmonizing the way clients of the same group are served across locations is becoming more and more important, not only from a client experience perspective but also to increase operational efficiency and ease the monitoring of compliance with applicable regulations.

Proportion of activities in-house/outsourced - middle office

Middle office

Middle office activities remain mainly operated in-house. However, client tax operations is the activity that is the most outsourced within the group or even to a third party. In fact, this activity requires a broad expertise across various markets and jurisdictions, and the sharing of competences, or outsourcing to a third party that can provide this range of expertise, can make a lot of sense for many banks.

- Mainly in-house in Luxembourg
- Mainly outsourced within group
- Mainly outsourced to third party
- Hybrid

Proportion of activities in-house/outsourced - order management & execution

Order management & execution

A significant part of order management and execution activities remain outsourced within the group or to a third party, as only a limited number of private banks have a dealing room in Luxembourg. These activities are therefore often shared at group level.

Regarding funds order execution, we have also seen several banks changing their setup and moving to a funds trading platform over the past few years. This is mainly done to increase the level of automation and reduce operational workload on the banks' side, especially regarding due diligence on transfer agents and other KYC and administrative tasks, while possibly optimizing the management of trailer fees.

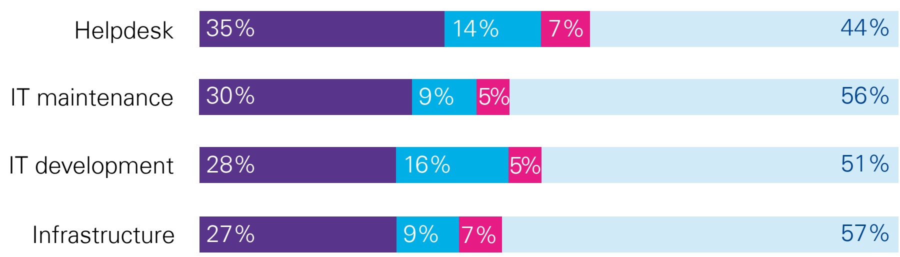
Proportion of activities in-house/outsourced - back office

Back office

Within back office activities, securities operations have always been the ones that can really benefit from a centralization of activities, as long as banks can harmonize their brokerage and/or custody setups across their locations. Unsurprisingly, it is these activities that leverage more within group outsourcing through the hybrid model.

- Mainly in-house in Luxembourg
- Mainly outsourced within group
- Mainly outsourced to third party
- Hybrid

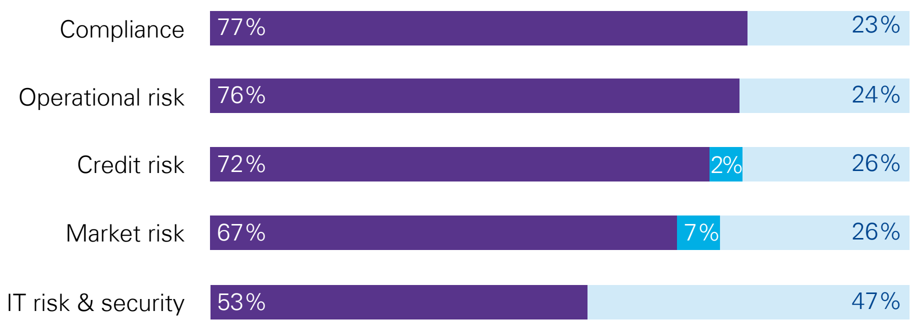
Proportion of activities in-house/outsourced - IT



IT

Banks have always tried to centralize IT activities within their groups in order to harmonize the way in which they operate and serve their clients across locations, and thus reduce cost-to-serve. All types of IT activities therefore rely significantly on outsourcing within the group, with part of these activities also outsourced to third parties. In fact, the majority of banks that are currently replacing some of their IT systems are now opting for a software as a service (SaaS) operating model, whereby most IT-related tasks are outsourced to a third party, allowing banks to focus more on their core activities.

Proportion of activities in-house/outsourced - control functions



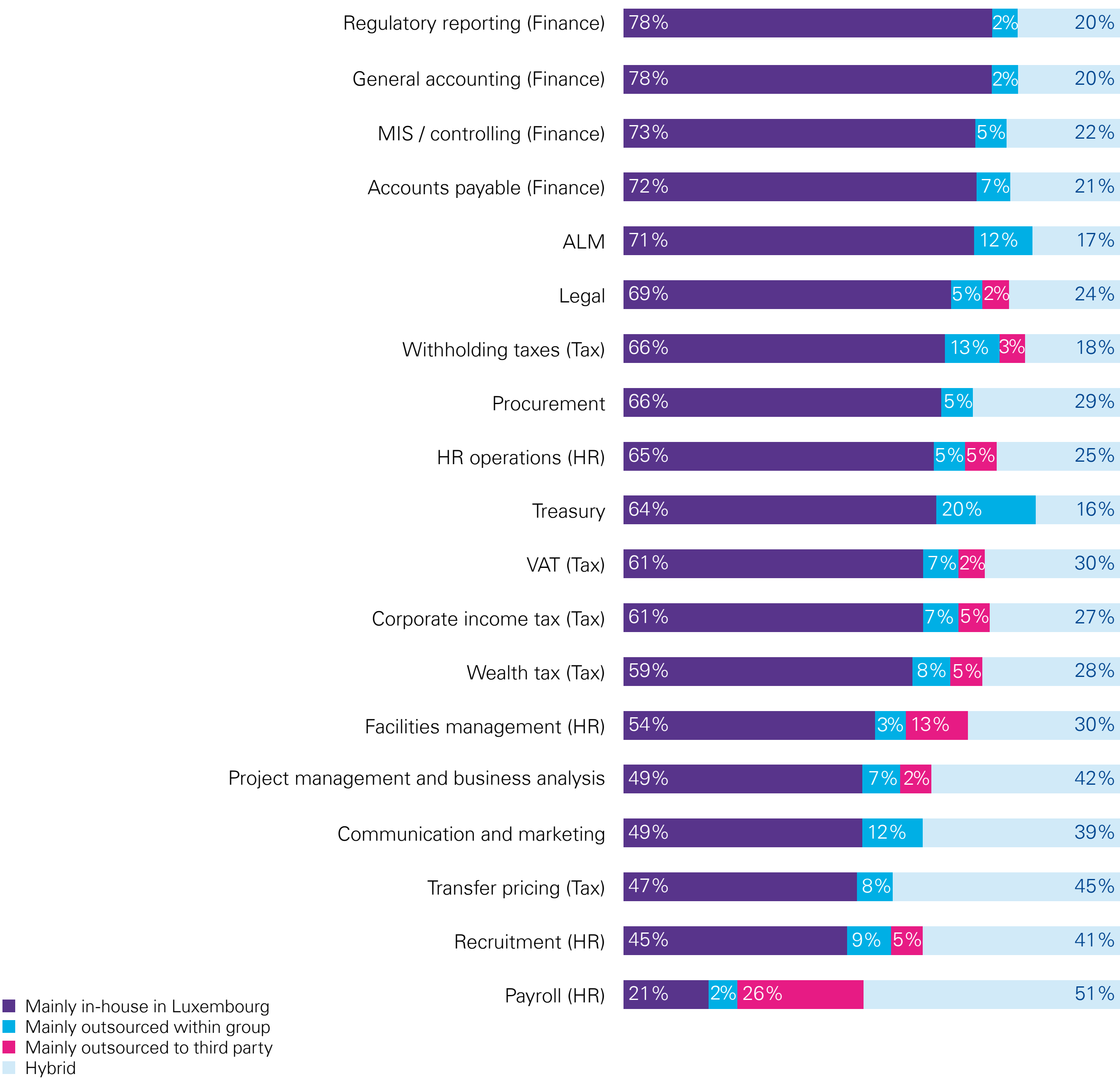
Control functions

Within the control functions, the activity that is the most operated in a hybrid mode is IT risk & security (47%), as it is of course closely connected to IT.

When it comes to risk management, credit risk and market risk activities are the ones for which banks tend to leverage their group more, which can be explained by the fact that the activities they monitor are often managed in a centralized manner at group level.

- Mainly in-house in Luxembourg
- Mainly outsourced within group
- Mainly outsourced to third party
- Hybrid

Proportion of activities in-house/outsourced - support functions



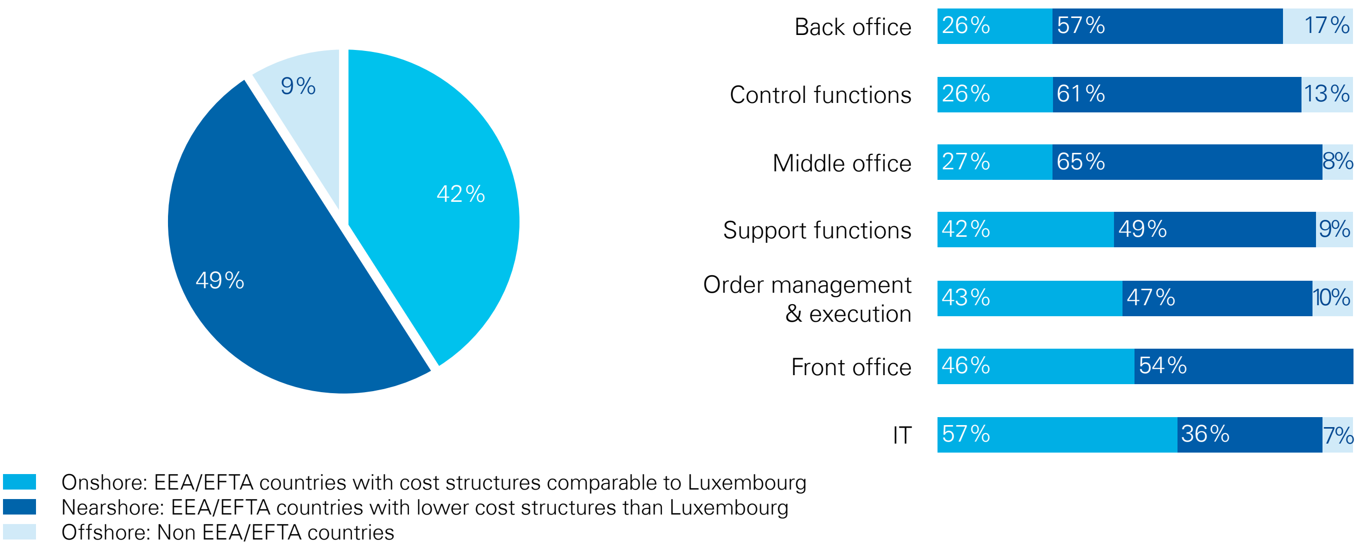
Support functions

The support activities that are the most outsourced to a third party remain HR activities such as payroll or recruitment, for the same reasons as in 2020 — i.e. the limited size of banks' HR teams in Luxembourg, the cost of maintaining in-house payroll services and the difficulty of attracting new talent in the current market.

Tax activities are the ones that rely most on outsourcing within the group or to a third party through hybrid models, as these activities typically require a high level of expertise in various markets and tax disciplines, which makes them difficult to maintain locally.

Type of sourcing for activities outsourced within the group

2021



For this year's survey, we have for the first time collected data related to the type of sourcing for activities that are outsourced within the group — notably to understand to what extent private banks leverage competence centers or delivery centers that are located in countries with lower labor costs.

The main observations here are that almost half of activities outsourced within the group are operated nearshore (49%), while 42% are operated onshore and only 9% offshore. This indicates that several banking groups are leveraging nearshore centers to serve their various entities at a lower cost. Notably, we have observed such a trend in the domain of KYC, where many banks are centralizing operational and IT resources in "KYC factories" operated nearshore.

Activities that rely more on offshoring tend to relate to back office and support functions such as finance and HR. More surprisingly, control functions are also among the activities that rely on offshoring, which tends to demonstrate that several banks have tried to optimize the ways in which they control their activities and reduce the cost of their risk and compliance functions.

Regulatory update on outsourcing

The long-awaited circular transposing the revised European Banking Authority (EBA) Guidelines on outsourcing arrangements (EBA/GL/2019/02) into Luxembourg regulation was finally published in April 2022 as Circular CSSF 22/806.

Scope of application

While the EBA Guidelines only apply to credit institutions, investment firms, and payment and electronic money institutions, the CSSF circular has a wider scope — notably it also applies to professionals of the financial sector and, as regards information and communications technology (ICT) outsourcing, to investment fund managers.

By enlarging the scope of application, the CSSF aims to introduce a harmonized framework and to promote convergence at a national level.

An integrated framework

The circular aims to gather all supervisory requirements on outsourcing arrangements in one document. It amends the governance framework around outsourcing, provides supervised entities with a reminder of their specific responsibilities — in particular those of the board of directors and the authorized management — and mandates the creation of an outsourcing function or the appointment of an outsourcing officer.

The circular further defines a specific outsourcing process to be followed by supervised entities and highlights the importance of identifying, monitoring and managing risks — especially those operational risks generated by the externalization of certain functions — as well as conflicts of interest.

Another key point of attention throughout the outsourcing process is the security of data.

The circular also provides the criteria for identification of “critical or important functions” that shall be subject to more stringent requirements. In this regard, the circular goes beyond the EBA Guidelines and identifies as critical or important functions, with some exceptions, the externalization of operational tasks related not only to internal control functions, but also to the financial and accounting function.

Moreover, the circular mandates a minimum content for outsourcing agreements, and the creation and maintenance by supervised entities of a detailed outsourcing register, to be provided to the CSSF upon request.

Entry into force

The circular entered into force on 30 June 2022. By that date, institutions were to have implemented their governance frameworks. All existing outsourcing arrangements will have to be reassessed and potentially remediated before 31 December 2022 (see additional details on opposite page).

Implications for the banking industry

Despite the new constraints introduced by Circular CSSF 22/806, it is important to note that banks are still permitted to use outsourcing to a significant extent and can still externalize a substantial portion of their day-to-day activities that are not “critical or important”.

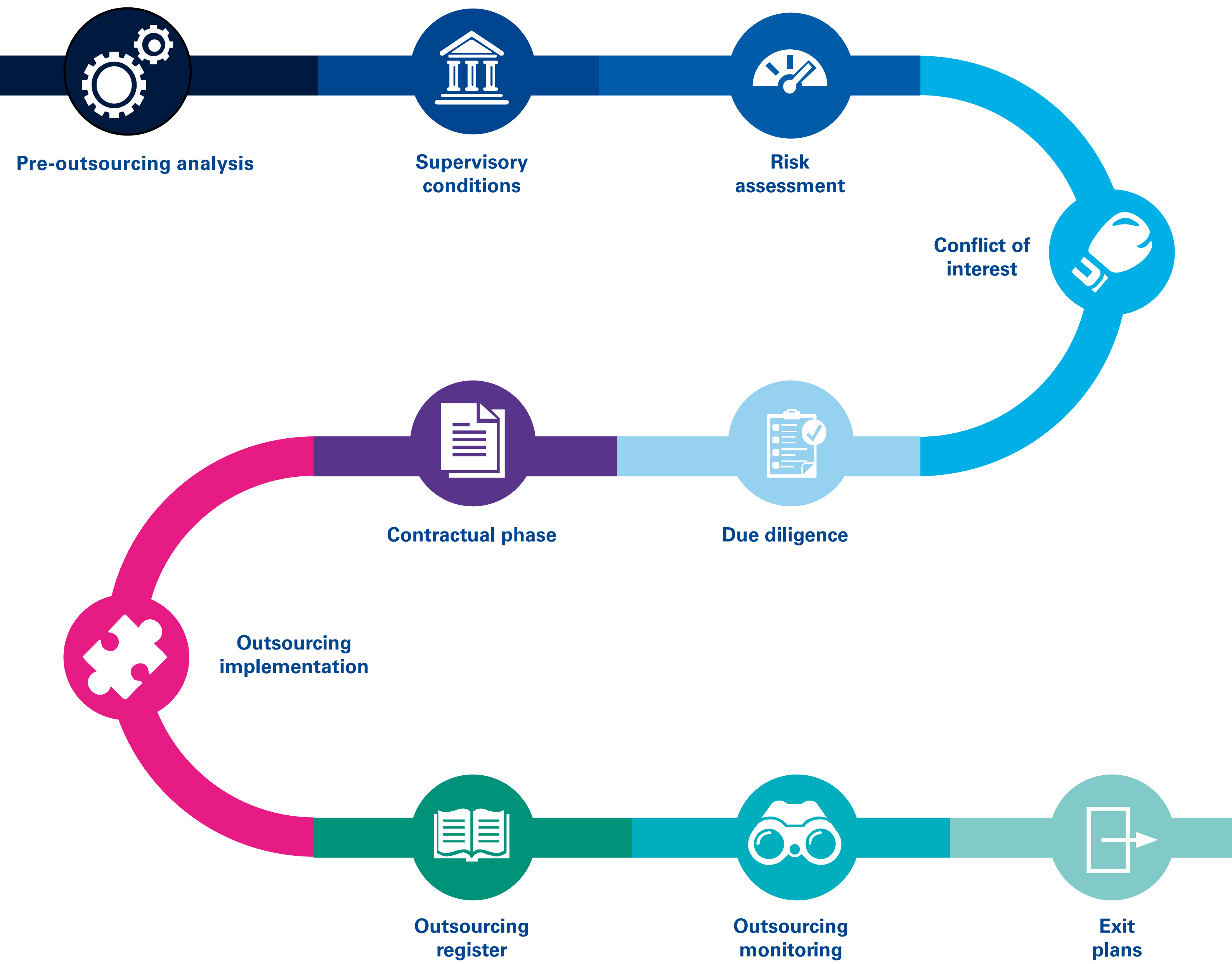
In order to do so, banks will have to ensure that they implement both a robust governance framework around outsourcing and effective oversight of service providers.

To successfully leverage outsourcing arrangements, banks should define a clear outsourcing strategy by identifying those processes and tasks they want to focus on and those processes and tasks that can and should be delegated (to third parties or to the group they belong to). This will lead to a review of operating models in order to focus investment and effort on core strategic activities.

Outsourcing process

As previously noted, existing outsourcing arrangements need to be reassessed and potentially remediated according to the requirements applying to each outsourcing arrangement. These requirements address every step of an outsourcing arrangement's lifecycle. The process is risk-based in the sense that the number of requirements to be considered will generally be dependent upon the criticality of the outsourcing arrangement.

Criticality is the new terminology replacing the old concept of materiality: "critical or important" arrangements have more requirements, while other arrangements have fewer.

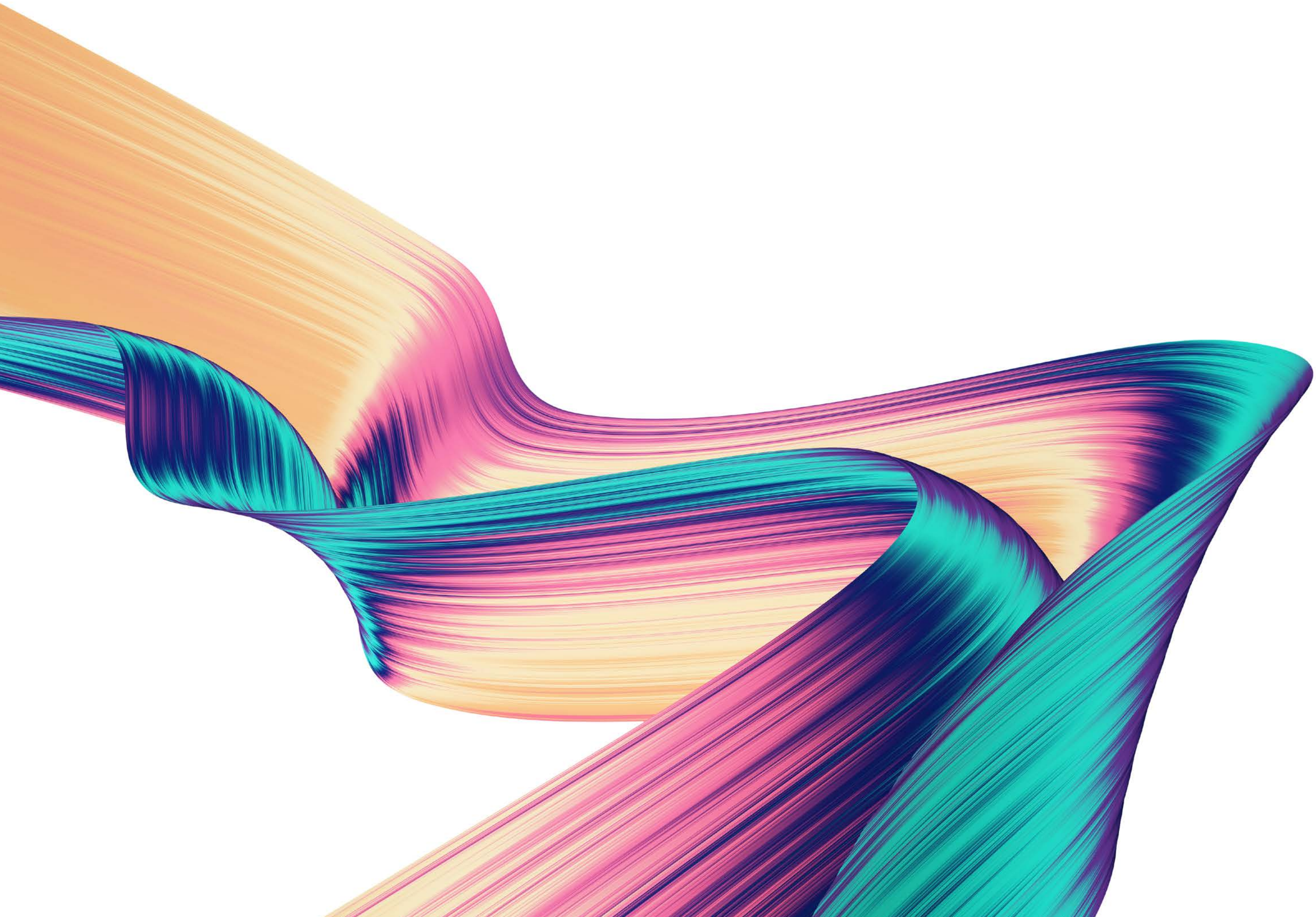


03 Understanding industry performance

Industry performance overview

This section focuses on the analysis of private banks' profitability with regard to a number of key performance indicators (KPIs).

As a reminder, the figures and KPIs presented below are based on the answers provided by the participating banks to our questionnaire. To facilitate the analysis, we also chose to regroup the respondents into three groups — large, medium and small — based on the size of their assets under management.



Large banks (AuM > EUR20 billion)

Despite a multitude of macroeconomic challenges, recessionary fears and increasing complexities, the large banks cluster witnessed very strong growth in AuM. As mentioned earlier, the strong performance of the financial markets in 2021 accounted for the major part of this growth.

By strategically repositioning themselves, large banks were able to perform beyond expectations in all key growth and profitability metrics. The growth was fueled primarily by the increase in net interest income (+17.76%[1]) which, combined with the increase in net commission income (+5.93%), resulted in a healthy growth in operating income (+8.98%) compared to 2020.

Large banks were pragmatic with their cost structures. As indirect costs increased (+15.0%), large banks balanced this off by simultaneously reducing some fixed costs, e.g. staffing costs (-6.10%). This balancing phenomenon led to a modest overall increase in operating expenses (+3.23%).

On average, large banks realized a sizable growth in gross operating profit (+23.87%).

Large banks (sum of 8 entities) EUR million		**2020**	**2021**	**Change**	**Number of respondents**
Net interest income		255.91	301.35	17.76%[1]	8/8
Net commission income		736.87	780.59	5.93%	
Operating income		**992.77**	**1,081.94**	**8.98%**	
Staff expenses		338.80	318.15	(6.10%)	
Indirect costs[2]		274.77	315.98	15.00%	
Other direct costs		102.36	104.90	2.48%	
Operating expenses		**715.93**	**739.03**	**3.23%**	
Gross operating profit		**276.84**	**342.91**	**23.87%**	
KPIs					
AuM	25th percentile	24.13	28.14	16.62%	8/8
	Median (EUR bn)	**27.86**	**32.91**	**18.13%**	
	75th percentile	58.32	65.55	12.40%	
FTEs	25th percentile	221	223	0.90%	7/8
	Median	**404**	**379**	**(6.19%)**	
	75th percentile	575	538	(6.43%)	
Cost-income ratio	25th percentile	57.36%	49.46%	(7.90pp)	8/8
	Median	**67.00%**	**67.29%**	**0.29pp**	
	75th percentile	87.20%	89.19%	1.99pp	
Return on AuM	25th percentile	0.54%	0.48%	(0.06pp)	7/8
	Median	**0.60%**	**0.56%**	**(0.04pp)**	
	75th percentile	1.24%	0.92%	(0.32pp)	
Return on AuC	25th percentile	0.11%	0.10%	(0.01pp)	6/8
	Median	**0.17%**	**0.15%**	**(0.02pp)**	
	75th percentile	0.35%	0.28%	(0.07pp)	

[1] One bank reported extraordinary interest revenues. If we exclude this bank, the variation in net interest income amounts to +4.21%

[2] Indirect costs refer to internal local rebilling costs and intra-group/headquarters rebilling costs

Medium banks (AuM between EUR5 and EUR20 billion)

Unlike for the larger banks, the key driver for overall operating income growth for the medium banks was net commission income (+13.59%)

The increase in operating income (+9.84%) was well able to offset the growth in operating expenses (+5.44%).

Hence, on average, medium banks were able to grow their gross profit (+18.86%).

Compared to the large and small banks, medium banks reduced their cost-income ratio by 2 percentage points (pp) (median), but just like the other clusters, they were not able to maintain their return on AuM.

Medium banks (sum of 17 entities) EUR million		**2020**	**2021**	**Change**	**Number of respondents**
Net interest income		313.61	318.95	1.70%	17/19
Net commission income		681.42	774.01	13.59%	
Operating income		**995.03**	**1,092.96**	**9.84%**	
Staff expenses		322.82	341.49	5.78%	
Indirect costs		253.40	267.56	5.59%	
Other direct costs		92.10	95.61	3.81%	
Operating expenses		**668.33**	**704.66**	**5.44%**	
Gross operating profit		**326.70**	**388.30**	**18.86%**	
KPIs					
AuM	25th percentile	5.37	6.37	18.62%	19/19
	Median (EUR bn)	**8.38**	**8.95**	**6.80%**	
	75th percentile	12.21	16.74	37.10%	
FTEs	25th percentile	94	109	15.96%	17/19
	Median	**144**	**150**	**4.17%**	
	75th percentile	264	303	14.77%	
Cost-income ratio	25th percentile	58.37%	64.45%	6.08pp	13/19
	Median	**78.00%**	**76.00%**	**(2.00pp)**	
	75th percentile	101.05%	96.49%	(4.56pp)	
Return on AuM	25th percentile	0.57%	0.50%	(0.07pp)	15/19
	Median	**0.62%**	**0.60%**	**(0.02pp)**	
	75th percentile	0.77%	0.69%	(0.08pp)	
Return on AuC	25th percentile	0.11%	0.11%	-	6/19
	Median	**0.21%**	**0.20%**	**(0.01pp)**	
	75th percentile	0.29%	0.27%	(0.02pp)	

Small banks (AuM > EUR5 billion)

Despite strong growth in AuM, the small banks were unable to capitalize on their income growth. Operating income declined (-0.93%), primarily as a result of significantly lower net interest income (-20.96%).

However, it is worth noting that small banks, on average, were able to optimize their cost structures and thus reduce overall operating expenses (-3.37%). Despite the decline in operating income, the small banks as a group were thus able to increase their overall gross operating profit (+9.31%).

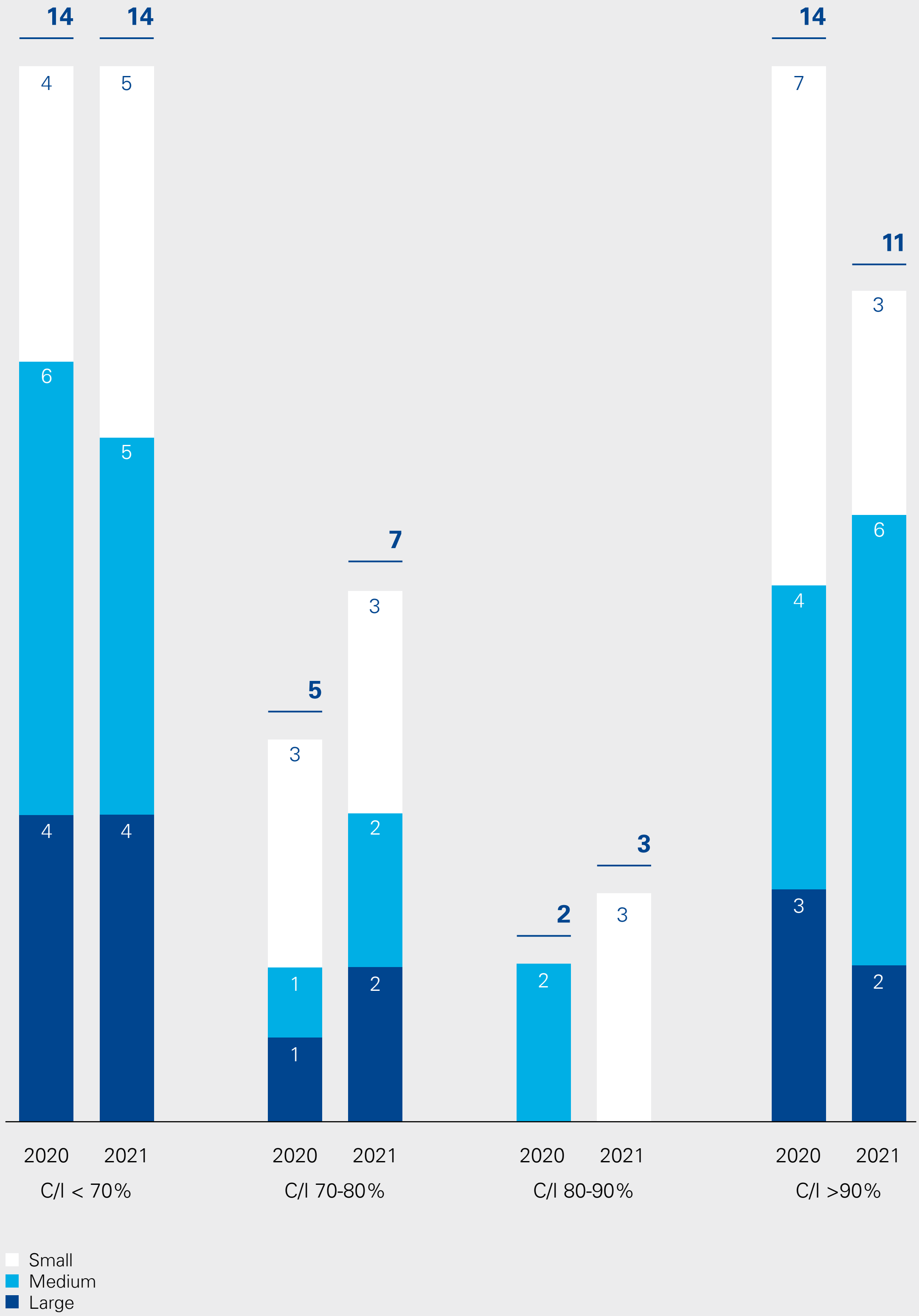
Cost optimization was only able to marginally offset the declining operating income in proportional terms. Hence small banks increased their cost-income ratio by the rather large margin of 8.35pp (median).

Small banks (sum of 17 entities) EUR million		2020	2021	Change	Number of respondents
Net interest income		60.36	47.71	(20.96%)[1]	17/18
Net commission income		160.61	171.20	6.59%	
Operating income		**220.97**	**218.91**	**(0.93%)**	
Staff expenses		92.86	93.40	0.58%	
Indirect costs		52.70	50.87	(3.47%)	
Other direct costs		32.87	28.15	(14.36%)	
Operating expenses		**178.43**	**172.42**	**(3.37%)**	
Gross operating profit		**42.54**	**46.50**	**9.31%**	
KPIs					
AuM	25th percentile	1.03	1.23	19.42%	18/18
	Median (EUR bn)	**1.90**	**2.47**	**30.00%**	
	75th percentile	3.56	3.84	7.87%	
FTEs	25th percentile	22	22	-	16/18
	Median	**34**	**37**	**8.82%**	
	75th percentile	56	59	5.36%	
Cost-income ratio	25th percentile	57.04%	56.53%	(0.51pp)	14/18
	Median	**76.52%**	**84.87%**	**8.35pp**	
	75th percentile	91.26%	93.98%	2.72pp	
Return on AuM	25th percentile	0.36%	0.34%	(0.02pp)	13/18
	Median	**0.53%**	**0.49%**	**(0.04pp)**	
	75th percentile	0.68%	0.75%	0.07pp	
Return on AuC	25th percentile	Not communicated			N/A
	Median				
	75th percentile				

[1] Significant heterogeneity of data induced large variation ranges

Cost-income ratio, by banks' size*

2020-2021



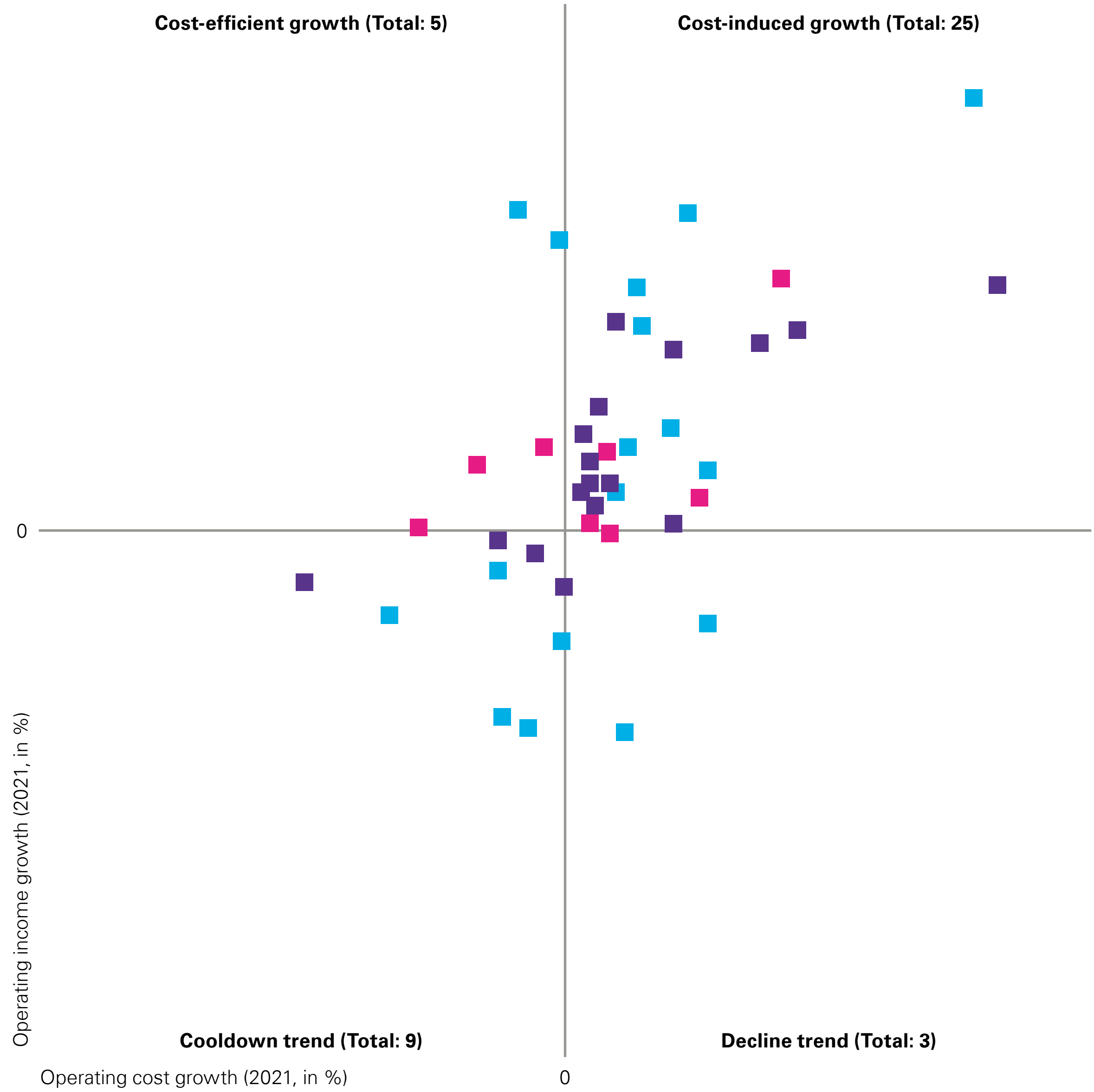
*35 respondents provided an answer to this question

Performance clusters

Almost 74% of industry players grew their operating income baseline in 2021

Overall, income growth accelerated in 2021, with almost 74% of the banks under study increasing their income. The vast majority of the growth was fueled by a simultaneous increase in revenues and costs. However, the growth in revenue surpassed the growth in the cost base. Compared to 2020, only a handful of banks enjoyed both increased income and a reduced cost base.

In the representation below, we have grouped the banks analyzed into four performance clusters by plotting their operating income growth against operating cost growth. A notable feature in the cost-induced growth group is that the performance is particularly clustered for many participants, while for the remaining clusters it is much more dispersed.



Quadrant definition

Cost-efficient growth: income increase and cost decrease
Cost-induced growth: income increase and cost increase
Cooldown trend: income decrease and cost decrease
Decline trend: income decrease and cost increase

Bank cluster

- Large banks (8)
- Medium banks (17)
- Small banks (17)

Beyond the financial figures, client centricity remains a must

A people-to-people business

In the previous version of this report we highlighted that, despite the incredible rise of digital, private banking remains an activity very much centered on people and on relationship management. Today's empowered clients want companies to know them and to create tailored experiences that provide relevant solutions for their evolving needs.

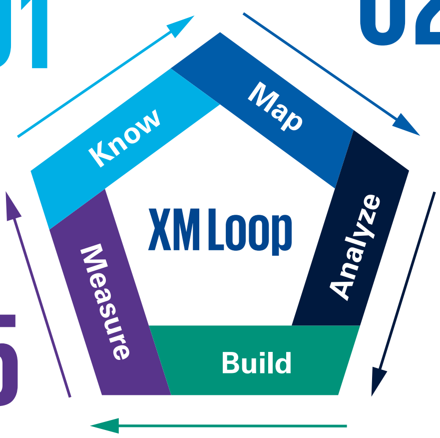
According to a 2022 Forbes study, 58% of customers will pay more for a better service. And this rises to 70% if they know they will receive a convenient experience. Positive experiences lead to trust, which leads to satisfaction and loyalty.

For years, the financial sector has outperformed other sectors in Luxembourg when it comes to delivering a great customer experience[1]. However, all banks are not equal. This is for a simple reason: a good experience does not happen by accident — it must be managed.

The XM loop

Experience management (XM) is about having an excellent understanding of customers' expectations and behaviors. These factors should be documented, updated on a regular basis and monitored by an operational team who can identify pain points and improvement areas. Private banks can rely on their mastery of agile methodologies to drive the initiatives that will change their brand perception. This is a continuous process.

Customers' behaviors and expectations change over time, based on factors businesses don't necessarily have control over: the customers' surrounding environment, their state of mind or their past experiences (whether with your organization or with another business in a completely different sector). A bank's ability to rapidly adapt to the new realities will give it a big advantage over the competition.



01 Get to know your customer

Observe, collect feedback (unsolicited and solicited), conduct research, combine and structure your customer data

02 Document the experience

Define your customers' personas, build experience maps and add as much information as possible

03 Identify pain points and improvement areas

Document problems and elements to improve, propose solutions, structure and prioritize these in an agile backlog

04 Deliver solutions

Use agile methods to optimize changes: define success factors and metrics in advance and ensure your organization adopts new behaviors to better address customers' needs

05 Monitor the experience

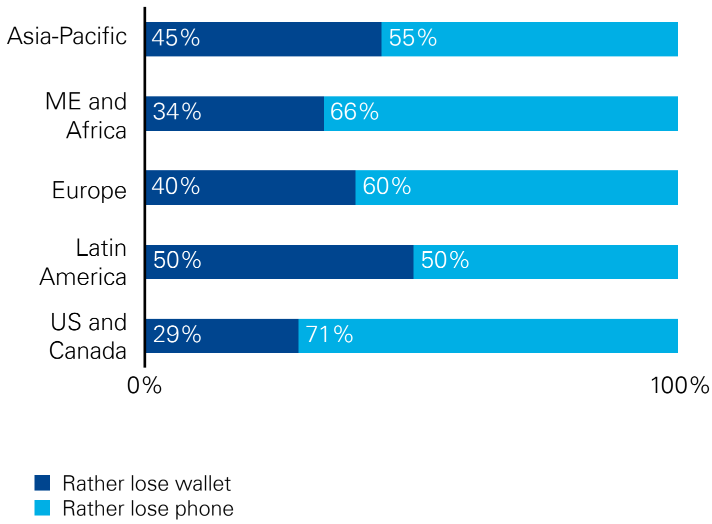
Measure the impact of your initiatives at a global level (NPS, C-SAT, CES...) and at more specific levels (targeted business metrics to assess each initiative's success)

The phygital balance

Two years of the Covid-19 pandemic have demonstrated how digital solutions facilitate our lives in all kinds of situations. Private banks, just like most organizations, have had to review their processes and adapt to the new normal. Not all clients will now want to take the car to attend a yearly meeting with their relationship manager when a videoconference call, coupled with a trusted digital signature solution, can save them hours. Client expectations are high and, beyond the simple supply of a digital process, attention should be paid to the robustness of the tools and the quality of the user experience provided. There will be less and less tolerance for digital inconvenience.

While 40% of European customers are saying that they would rather lose their wallet than their mobile phone[2], one size does not fit all and it might be a mistake to bet on a digital-only approach. The key to success is in the phygital (physical–digital) balance, which takes into consideration multiple factors such as age, geographic location, time and, again, customer expectations.

Would you rather lose your wallet or your phone?



Data is a treasure

If the first decade of the century was that of the rise of technology, and the second was the age of customer experience, this third decade we have entered is unquestionably that of data.

In 2021, the overall amount of data generated worldwide was estimated at 79 zettabytes (79 x10^{21} bytes), and this is expected to double by 2025[3]. In a contradictory twist, while customers emphasize the importance of data security and the privacy of their information, they are demanding hyper-personalized experiences. Organizations are expected to use their customer data for the benefit of their customers. Finding the balance between being irreproachable in protecting customers' data rights and leveraging data via profiling or AI-based predictions is not straightforward.

This paradigm obliges companies to pay considerable attention to the data they are using and the way they use it. Not all data sources are equal. First-party data is what is directly collected by the bank when it interacts with the customer. Second-party data is similar data shared with the banks by other companies, and third-party data corresponds to aggregated data about the customer from public and non-public sources. The use of second and third-party data is sensitive, as these are more exposed to an absence of direct or contractual consent. Hence the use of first-party data became a best practice.

Organizations are now working on collecting zero-party type data: that shared actively and freely by the customer with the bank. From a technological point of view, customer data platforms and customer relationship management systems are good allies for achieving this goal and getting the full potential from information collected.

[1] KPMG Luxembourg *2021 Customer Experience Excellence Report*
[2] KPMG *Me, my life, my wallet* report, 2021
[3] Source: Statista.com

04
A view from Switzerland

KPMG Switzerland — *Clarity on Swiss Private Banks*, August 2022 (extracts)

The number of Swiss private banks continues to fall

Fifteen M&A transactions announced in 2021 were followed by ten in the first quarter of 2022. This strong deal momentum stalled, however, due to uncertainty arising from the Russia-Ukraine war, rising inflation and interest rates, and fear of a looming recession. The result was a sluggish M&A market in the second quarter of 2022.

The number of private banks in Switzerland dropped from 99 at the end of 2020 to 92 by June 2022.

Large banks drive strong M&A activity

Large banks were involved in 22 of the 27 M&A deals since January 2021 as they sought to streamline their global operations. The remaining transactions were mostly consolidation deals among smaller players.

UBS was particularly active in the past 18 months. It announced four cross-border and one domestic transaction, exiting selected markets and consolidating ownership. The largest acquisition was of Wealthfront Inc., a US-based Fintech offering automated investment services and managing AuM of CHF 27bn. Divestments included UBS's Spanish wealth management business of around CHF 15bn AuM to Warburg Pincus-backed Singular Bank, and an SEC-licensed investment advisor with around CHF 7bn AUM servicing US clients booked in Switzerland, which was sold to Vontobel.

The past 18 months also saw a rare transaction for the past decade – a foreign acquirer buying a Swiss private bank – when Gibraltar-based Trusted Novus Bank announced the purchase of Kaleido Privatbank.

Number of banks declines further

The number of private banks in Switzerland fell to 94 by the end of 2021 and to 92 by the end of June 2022.

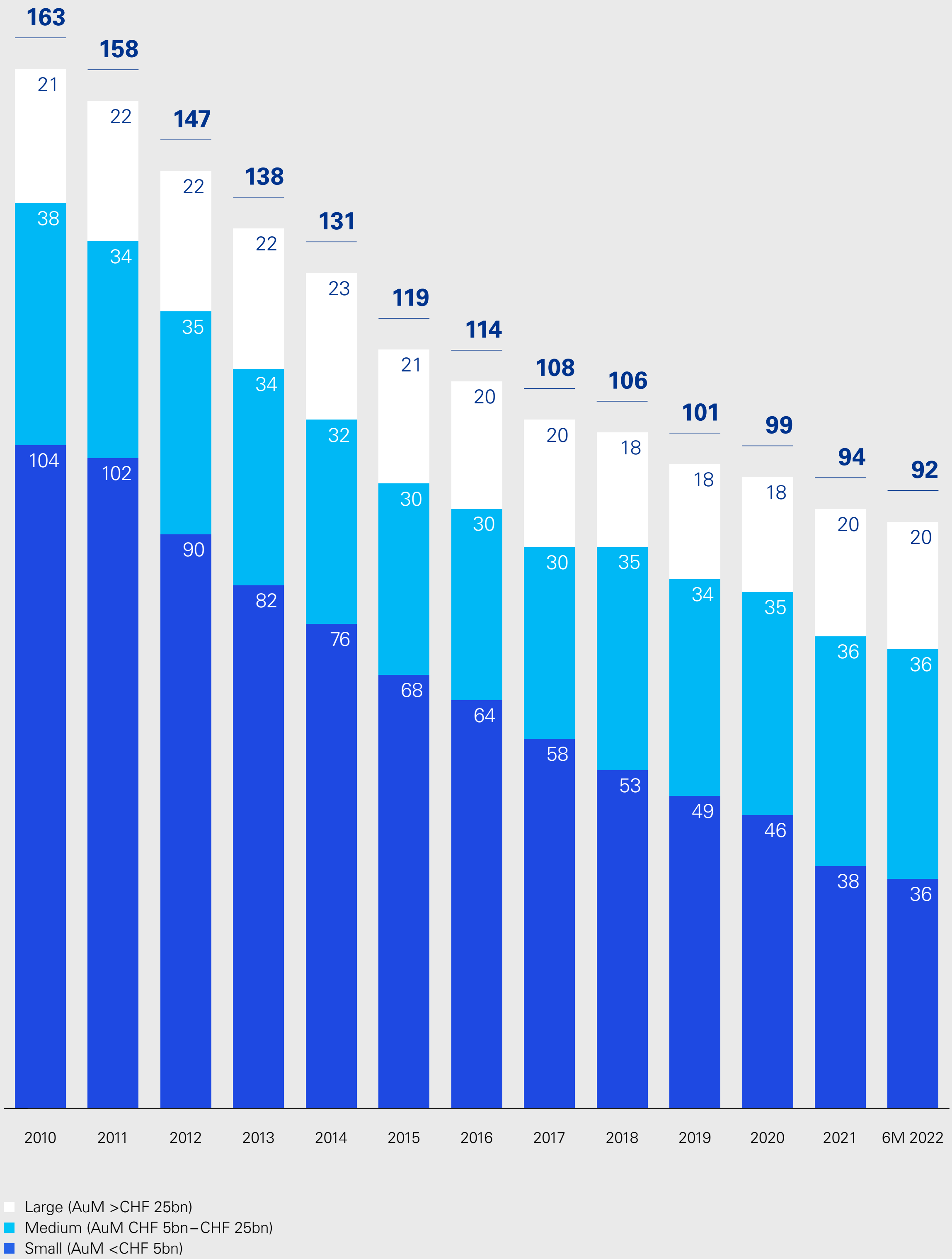
The number of large banks grew by two in 2021. Rothschild & Co. passed the CHF 25bn threshold thanks to its acquisition of Banque Paris Bertrand, as did Citibank.

A new banking license was granted to Cité Gestion, a large independent asset manager in Geneva with AuM of CHF 7bn in June 2022.

More deals involving independent asset managers

Swiss private banks were also involved in transactions with independent asset managers. These were Syz's acquisition of BHA Partners, Cornèr's acquisition of a 30 percent stake in Finpromotion, Reyl's acquisition of a 40 percent stake in 1875 Finance – one of the largest IAMs in Switzerland with AuM of more than CHF 11bn – and two management buy-outs of independent wealth managers owned by Julius Baer, Wergen & Partner Wealth Management and Fransad Gestion.

Number of Swiss private banks by AuM size
2010 – 6M 2022



AuM hits a record high

A golden year for AuM growth among the 76 banks in our analysis, 2021 ended on a new high of CHF 3,263bn. Positive equity and foreign exchange markets combined with record NNM to generate a 12.9% rise in industry AuM – over four times that of 2020.

Extremely encouraging for Switzerland's private banking industry, 2021 was the third consecutive year of increasing NNM. Three out of four banks saw NNM grow, with industry-wide NNM reaching a record CHF 131bn, being 4.5% of the year's opening AuM.

AuM in 2021 was boosted by NNM and supercharged by performance

The combined AuM of the 76 banks grew by CHF 373bn or 12.9% to CHF 3,263bn last year. This was driven by NNM of CHF 131bn (4.5% of the year's opening AuM), supercharged by CHF 234bn in performance (8.1% of opening AuM) on the back of favorable equity and foreign exchange markets.

AuM rose at 91% of banks in 2021, with median bank AuM growth hitting a record 13.7%.

AuM grew by 47% over the past six years

Industry AuM has grown from CHF 2,220bn to CHF 3,263bn – or CHF 1,043bn – over the past six years, which is a healthy 47.0% (annual rate of 6.6%). This growth was driven by CHF 583bn performance from robust equity markets; CHF 330bn NNM, of which 68% was in the past two years; and CHF 141bn from acquisitions.

NNM grew 38% in 2021 to a record CHF 131bn

2021 was the third consecutive year with very strong and increasing NNM. Banks achieved record NNM growth with a median bank NNM growth of 4.3% of opening AuM. The number of banks with positive NNM growth rose to a record 74%.

We believe this outstanding organic growth is a vote of confidence in Swiss private banking by the world's wealthiest.

Equity and foreign exchange markets drove 2021 performance

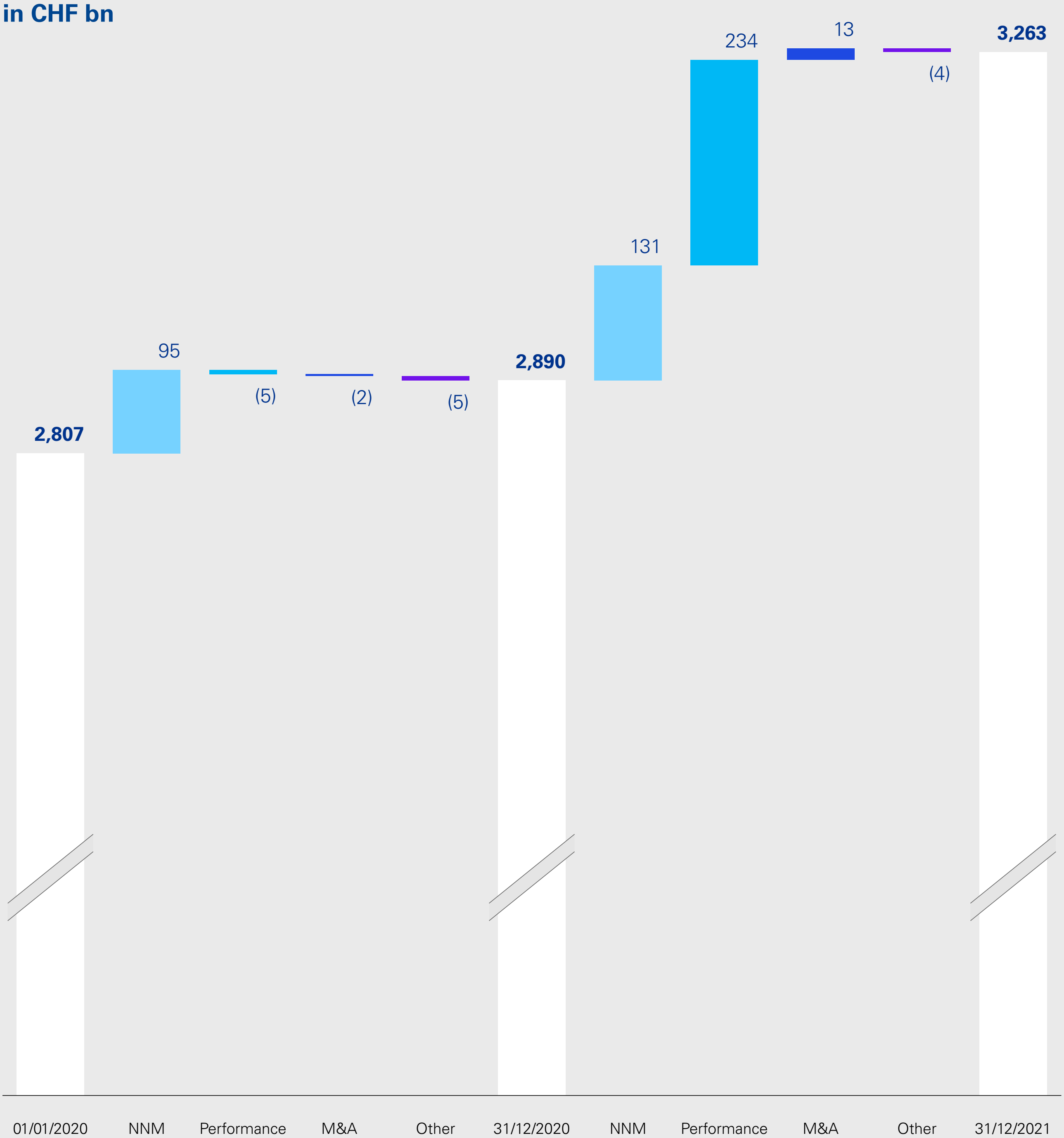
AuM performance benefited from the rare simultaneous occurrence of strongly rising equity markets and USD/CHF strength to grow by CHF 234bn in 2021. These forces produced compound industry performance growth of 8.1% on opening AuM. They enabled 96% of banks to increase AuM from performance.

With around 50% of the industry's AuM denominated in USD, AuM is impacted by foreign exchange fluctuations regarding the CHF. The 9% USD/CHF weakness in 2020 negated equity market gains. In 2021, however, USD/CHF strength provided a performance boost.

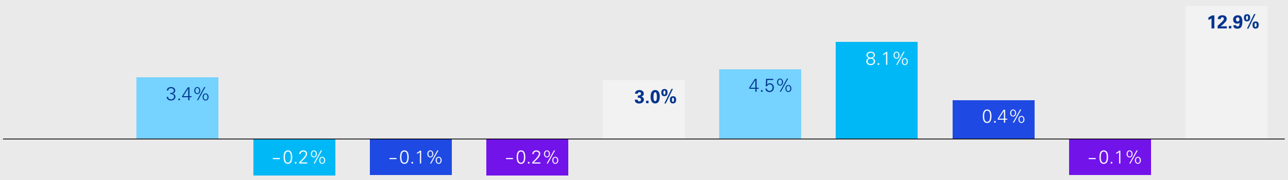
Smaller M&A transactions led to little 2021 AuM growth

Considerable M&A activity last year yielded a net increase of only CHF 13bn AuM. The largest deal that closed in 2021 was Rothschild & Co Bank's acquisition of Banque Pâris Bertrand, which added CHF 7bn in AuM.

AuM development
1 January 2020 – 31 December 2021
in CHF bn



AuM development
1 January 2020 – 31 December 2021
Change in %



The gap between Strong and Weak banks becomes wider

At the top end of the industry, 16 banks that were Strong in both 2021 and 2020 improved their median C/I significantly to 60% in 2021. By contrast, 18 banks that were Weak in both 2021 and 2020 were unable to improve their median C/I ratio of around 99% despite favorable market conditions.

Cost-income ratio (C/I) as a profitability metric

Cost-income ratio (C/I) is our key profitability metric to determine the performance clusters. C/I has the advantage of being less affected by exceptional profit items and differing size. This makes it a useful level-playing-field profitability metric.

Performance clusters are grouped by C/I:

- Strong <70%
- Upper Mid 70%-80%
- Lower Mid 80%-90%
- Weak >90%.

An elite core of Strong banks is emerging

Of the 19 Strong banks, 16 (or 84%) were Strong in both 2021 and 2020. This core's median C/I improved from 64.3% in 2020 to 59.6% in 2021.

The best performer was a small bank that improved its C/I by 5.5 percentage points to the lowest we have seen historically at 44.1%. The lowest large bank's C/I in 2021 was 53.8%.

More difficult for banks to enter the Strong cluster

Favorable market conditions enabled a net of seven banks to break into the Upper Mid cluster. However, only three banks were able to migrate into the Strong cluster. It appears to be more difficult for banks in other clusters to reduce their C/I below 70% and become Strong.

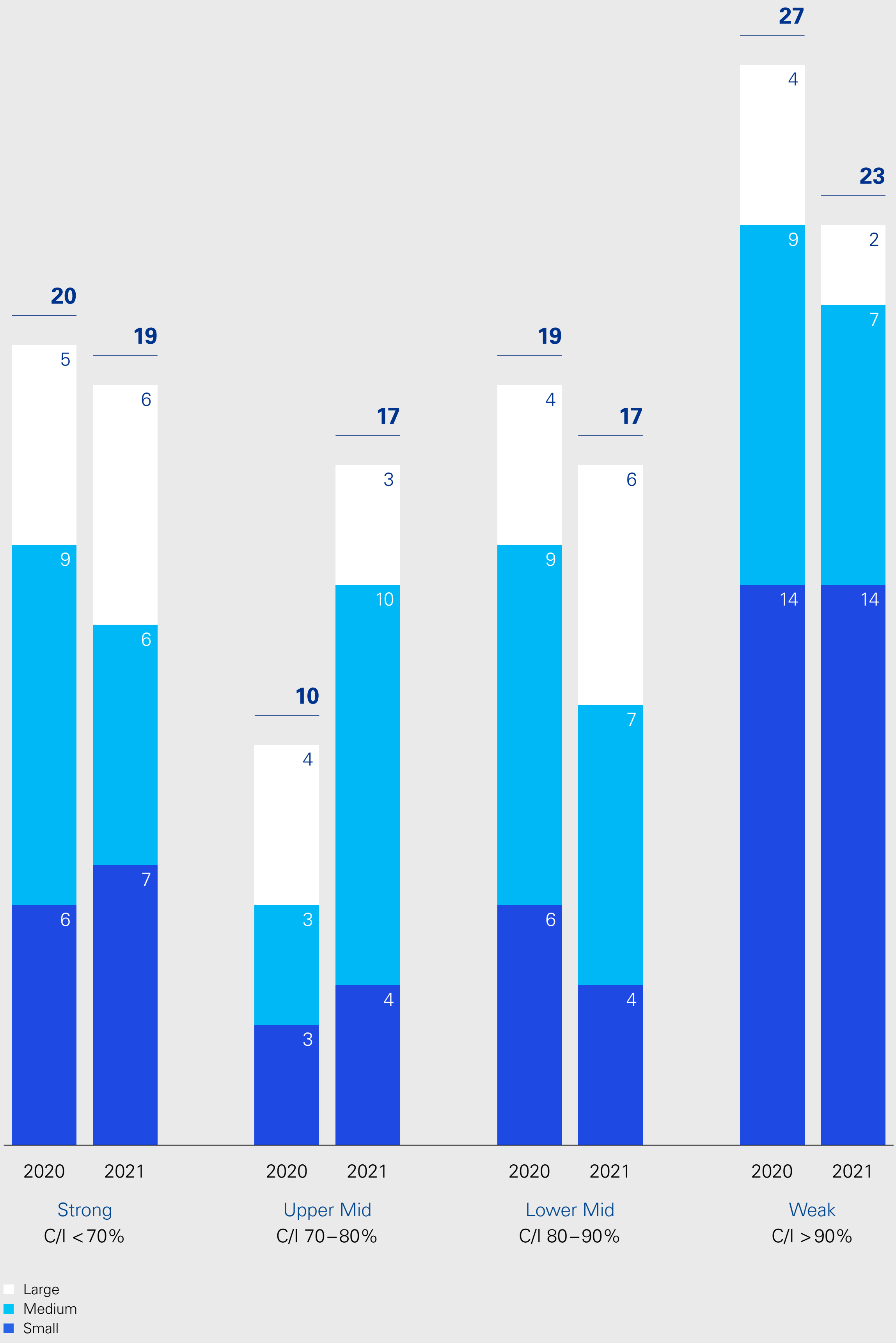
Poorly performing Weak banks unable to improve C/I

Eighteen of the 23 Weak banks (78%) were Weak in both 2021 and 2020. These banks' median C/Is stagnated at around 99% in these two years as they were unable to capitalize on 2021's beneficial market conditions. There is a risk that the next market downturn may push their median C/I deeper into operating loss territory.

Nine banks had C/I above 100%, which means operating losses. Eight of these were small banks.

The largest performance cluster remained Weak, with 23 banks or 30% of our sample.

Number of private banks by performance cluster 2020 and 2021



Jean-Pascal Nepper
Partner,
Head of Banking
T: +352 22 51 51 - 7973
E: jean-pascal.nepper@kpmg.lu

Stanislas Chambourdon
Partner,
Head of Markets
T: +352 22 51 51 - 6206
E: stanislas.chambourdon@kpmg.lu

KPMG Luxembourg,
39, Avenue John F. Kennedy
L-1855 Luxembourg

T: +352 22 51 51 1
F: +352 22 51 71

www.kpmg.lu