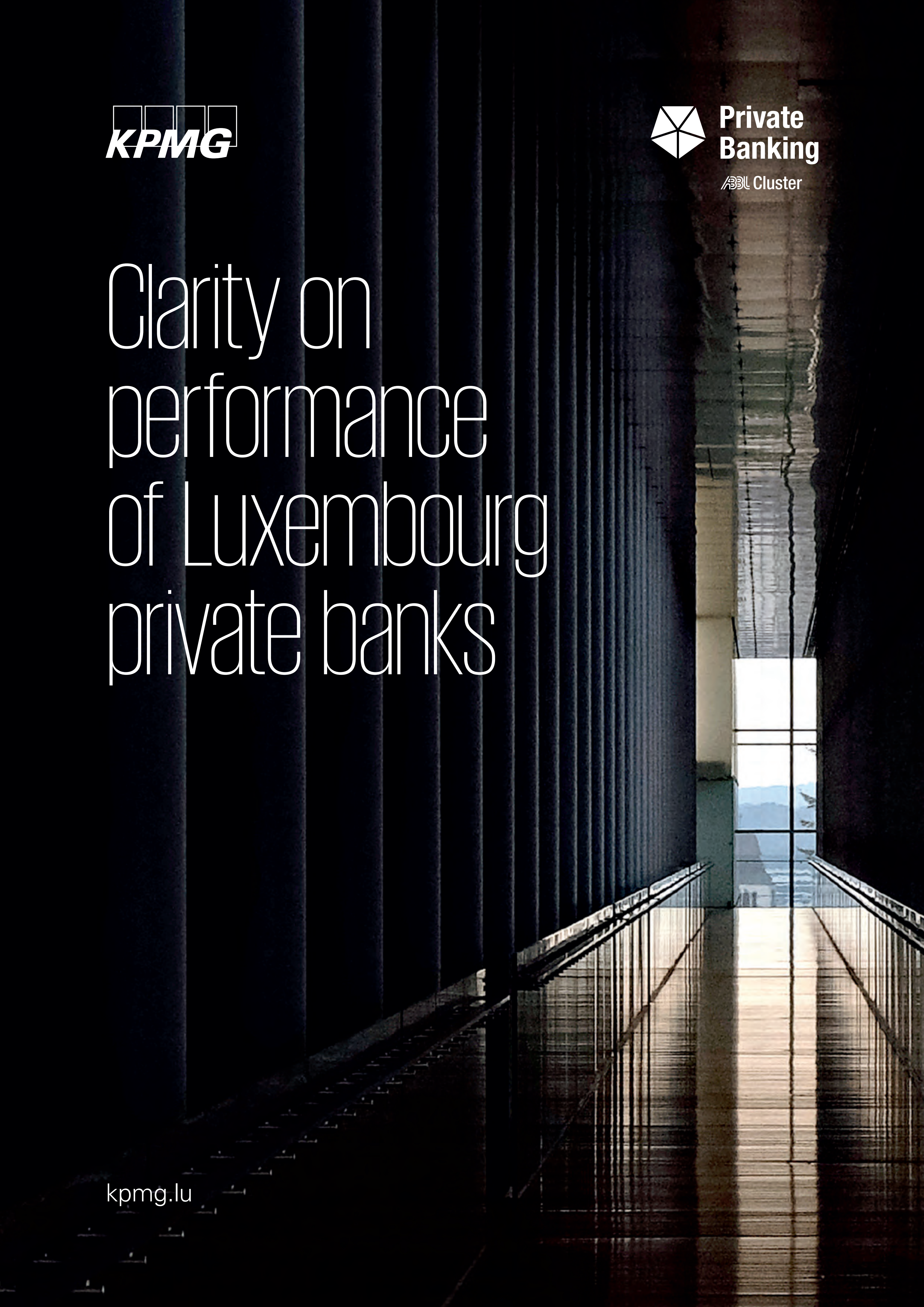

Clarity on performance of Luxembourg private banks

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Table of contents

Foreword

Private banking has been at the heart of the financial sector in Luxembourg for almost five decades. From the simple savings account and the first Eurobonds exchanged over the counter in the '70s to the most sophisticated financial products seen today, the private wealth management industry has grown relentlessly and in 2020 crossed the psychological threshold of EUR500 billion assets under management (AuM).

During these years, Luxembourg private banking has, of course, gone through a large number of transformations, all headed in the same direction of enhancing the professionalization of the sector. Among these transformations, a key milestone was undoubtedly the introduction of the automatic exchange of information a few years back. This repositioned Luxembourg as a financial center no longer just competing with a few isolated offshore financial locations but rather competing with all private banking players around the world — which de facto compelled the sector to raise the bar even higher in terms of product offerings, HR skills and competences, and customer experience.

Without doubt, the incredibly strong growth of the investment funds industry in parallel — which has seen Luxembourg become the largest fund domicile in Europe, with more than EUR5,500 billion AuM — has also been an important contributing factor to the Luxembourg private banking sector's growth, thereby providing an extended product offering to a greater number of institutional distributors.

In light of the significant development of the sector and the various transformations that have taken place, the Private Banking Cluster of the Luxembourg Bankers' Association (ABBL) and KPMG Luxembourg decided to join forces to produce this study, aimed at providing a form of a State of the Nation report on the private banking industry in Luxembourg.

In addition, as we live in a globalized world, and as it is always interesting to peek into our neighbors' backyards, we thought it would make sense to follow up on the development of another well-known private banking center close to us — that of Switzerland. So we also include here the main findings of the annual private banking study, Clarity on Performance of Swiss Private Banks, produced by KPMG Switzerland in collaboration with the University of St. Gallen.

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

We wish you a pleasant read.

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

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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 shape the financial sector future and speak with one voice.

The ABBL is an association with a long history of promoting, defending and defining the banking sector in Luxembourg. We give our members a common voice, provide a platform for the exchange of ideas and keep them informed of industry trends and regulatory development. Our mission is to promote, for and on behalf of our 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 we are active in the right areas. To channel common issues and challenges of each domain and focus on the most strategic priorities for the members, our 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 with the primary objective to advocate 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.

In total, the PBGL counts **61 members**:

- Private banks (48)
- Audit firms (5)
- Law firms (4)
- Investment firms (4)

About this research

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

The objective of the study was 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, their 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.

In terms of methodology, similarly to the previous editions of the Luxembourg private banking reports published by the ABBL, 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 2020 financial year:

- Assets and liabilities distribution
- Income and costs structure
- FTE allocation
- Service offering
- Operating model and sourcing
- Regulatory key performance indicators (KPIs)

40 private banks took part in the study and submitted their answers. While this accounts for a 74% participation rate, the AuM of these participating banks accounts for 94% of the total AuM of the private banking market in Luxembourg. For data confidentiality, all individual questionnaires were anonymized before being shared and analyzed.

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 II (business and operating models) and Part III (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.

May - June 2021

130 data items related to FY20

40 banks

94% of Luxembourg private banking AuM

More than a decade of AuM growth and an accelerating trend

As a result of 12 consecutive years of growth, Luxembourg private banking assets under management (AuM) reached a total of EUR508 billion at the end of 2020 — more than double their 2008 level.

Since 2008, the average annual growth in AuM has been 7.0% as, following a plateau between 2015 and 2017 (+1.7% p.a.), the rate of increase accelerated to reach 13.4% p.a. between 2018 and 2020.

Private banks saw their profitability increase in 2020, due in part to growth in AuM

On average, the Luxembourg private banks under review experienced a relatively strong AuM increase (+3.9%) to reach EUR11.6 billion despite the pandemic and its underlying impact on the economy. Moreover, operating revenues grew faster than costs, resulting in an overall decrease in the industry’s cost-income ratio (-2.4pp) to 66.1%, as two-thirds of banks increased their operating profitability.

Overall, 12% of all private banks analyzed — three-quarters of which belonged to the small cluster (AuM <EUR5 billion) — were unprofitable in 2020.

The shift toward a fee-based advisory model is ongoing...

The industry has been trying to shift toward a fee-based model where private banks charge clients directly for investment advice. This advice was historically free, or quasi-free, as revenue was transaction-based — generated from commission and execution fees.

This trend has been observed since 2015 in, among others, a MiFID II context, as two service offering types have grown considerably and now represent almost half of AuM: discretionary portfolio management (increasing from 12% of AuM in 2015 to 17% in 2020) and, to a greater degree, fee-based advisory services (from 17% to 29%).

...but not completed yet

Although the increase in discretionary portfolio management and fee-based advisory services over the past five years has been remarkable, 48% of 2020 AuM remained in cash or execution-only services, or was managed directly by the dealing room. If we disregard the latter, we can only assume that a considerable proportion of AuM is thus still in cash or serviced via execution-only means.

While, in this report, we are trying to analyze the profitability of private banks and identify the possible levers on both the revenue and cost sides, the transformation of the 19% of cash AuM and, say, 15% of execution-only AuM into fee-generating services is an obvious potential course of action that is already well-known to private banks.

The majority of the private banks' activities are operated fully or partially in-house

The main instances where private banks rely on their head offices relate to the provision of IT services, which 48% of banks either fully, or more usually partially, outsource to their head office. In direct connection with IT, head offices also provide support in project management and business analysis, as projects very often have IT impacts.

Beyond IT, among the key activities that are outsourced to head offices are market activities and their associated risk management tasks, ALM and treasury activities and their associated risk management tasks, and discretionary portfolio management.

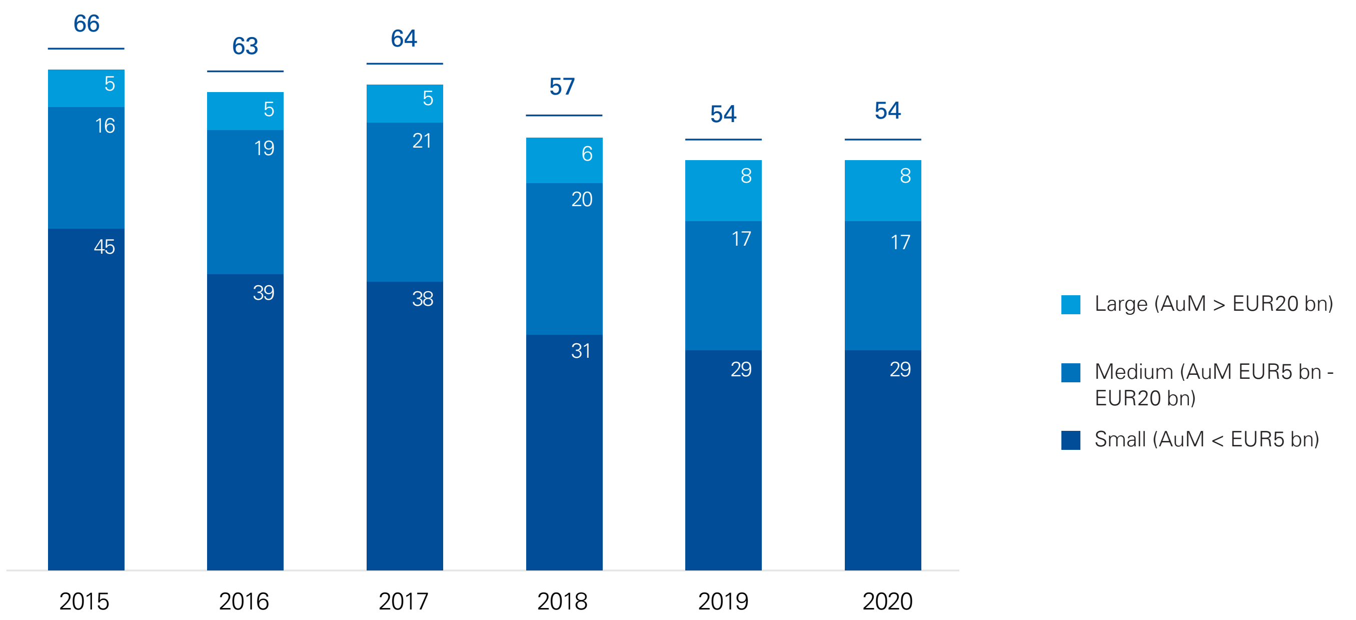
There are as many operating models as there are banks — and none guarantees a better financial performance

Overall, based on the data analyzed, we could not find any specific correlation between the sourcing model employed and the financial performance of the banks. Indeed, banks that tend to outsource more than others, be it to the head office or to a third party, have a similar cost-income ratio, on average.

Chapter I:
Luxembourg market analysis

Evolution of the number of private banks

Number of private banks in Luxembourg, grouped by AuM, 2015-2020



A consolidating private banking sector in Luxembourg

The net number of private banks in Luxembourg — taking into account mergers, wind-downs and new entrants — decreased by 18% between 2015 and 2020. While the total figure has been stable over the past two years, it is however very likely that this downward trend will continue in the future.

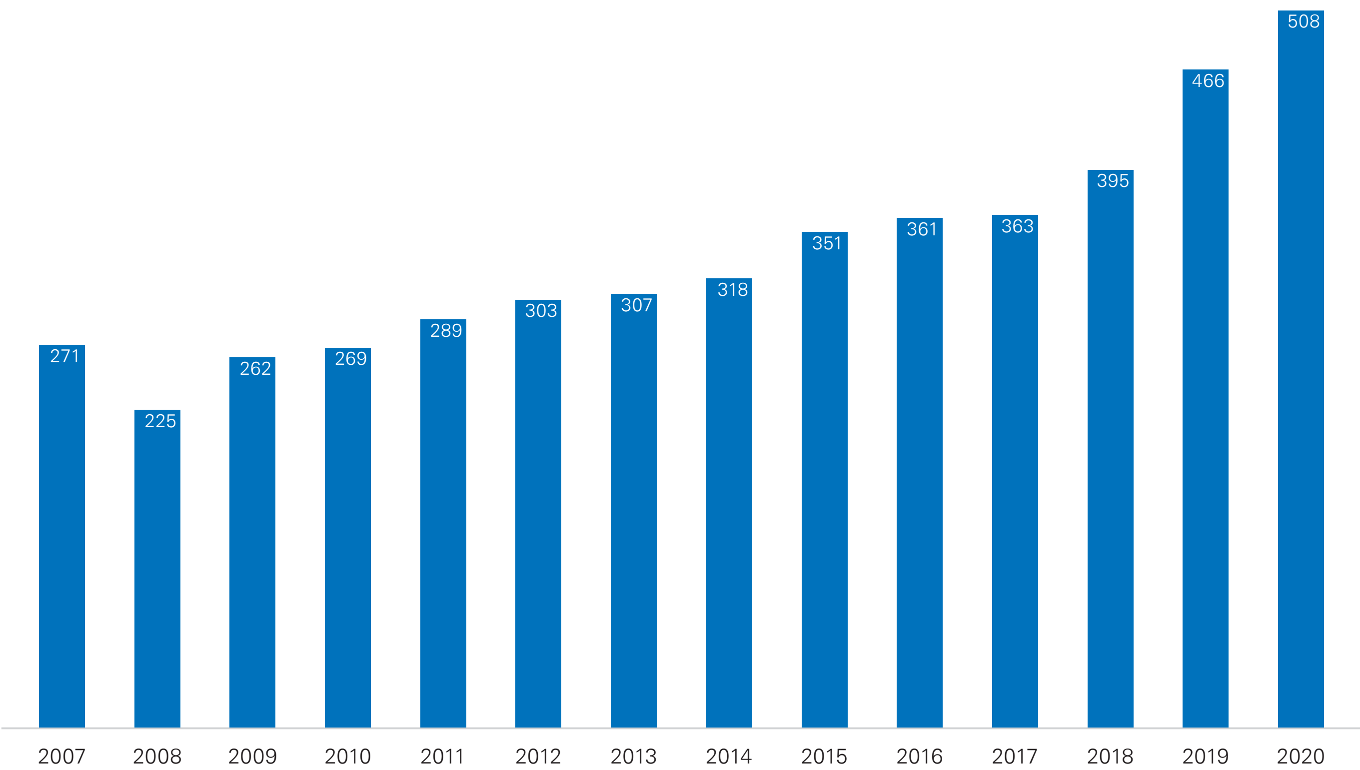
The decrease can be explained by a number of factors, all aligned and associated with the necessity for private banks to have a larger critical mass in terms of AuM and a leaner operating model allowing for a more balanced cost-income ratio and, hence, a sounder financial performance.

These factors include, among others: low interest rates on the financial markets, where every non-invested cent costs private banks money; the pressure of ever-increasing regulatory supervision over the past few years; legacy IT systems that often require significant investment to be transformed and adapted to the needs of the digital age; more informed, sophisticated and mobile clients demanding more complex products and enhanced customer experience; and reinforced competition imposed by new entrants that may sometimes appear more agile as they have no legacy burden to manage and tend to have fewer difficulties in recruiting, developing and retaining highly skilled individuals at a reasonable cost.

As a consequence, the net number of small private banks has, unsurprisingly, decreased by 36% since 2015 — from 45 to 29 — while the numbers of medium-sized and large banks have grown, organically and/or inorganically.

Evolution of assets under management

Evolution of private banking AuM in Luxembourg, 2007-2020, in EUR billion



More than a decade of AuM growth and an accelerating trend

As a result of 12 consecutive years of growth, Luxembourg private banking assets under management reached a total of EUR508 billion at the end of 2020 — more than double their 2008 level.

Since 2008, the average annual growth in AuM has been 7.0% as, following a plateau between 2015 and 2017 (+1.7% p.a.), the rate of increase accelerated to reach 13.4% p.a. between 2018 and 2020.

This impressive growth is of course linked not to just one but a number of factors:

- Since the introduction of the exchange of information, Luxembourg private banks have been accelerating their transformation processes and have heavily restructured their go-to-market capabilities, including upskilling and/or engaging more highly skilled front office staff with an enhanced sales mindset in order to reach a different, wealthier category of (U)HNWIs. Evolving from "farmers" to "hunters", private bankers have put more energy and dynamism into their business development activities.

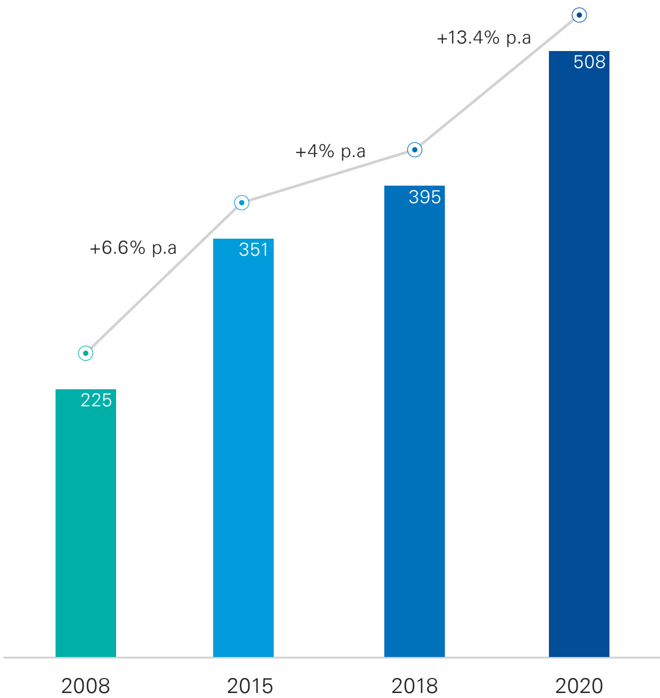
- As a result of Brexit, Luxembourg emerged as one of the favored locations of UK-based private banks. Brexit has indeed revitalized the private banking markets, bringing new players and increasing the competition level. This concentration of the best private banks in Luxembourg gives a real credibility to the financial center: the best attract the best and clients feel all the more secure. Since 2018, we have seen a certain number of private banks, such as J.P. Morgan Bank Luxembourg or Citibank Europe PLC, that have reinforced their private banking activities in Luxembourg and that significantly contributed to the AuM growth.
- The Covid crisis, beyond the dreadful health issues and consequences, has also created some instability in certain countries, as a result of which (U)HNWIs have viewed Luxembourg as potentially the stable and trustworthy safe haven they need in these troubled times.
- Finally, the favorable situation on the financial markets should not be overlooked, as it has clearly played a part in the growth in AuM. For example, on average, the EURO STOXX 50 Index increased by 3.6% per year between 2015 and 2020 and, similarly, a so-called "balanced portfolio" increased by 4% over the same period.

AuM growth led by the large financial institutions, as the number of private banks decreases

It is important to mention that, be it through organic growth or acquisitions, it is the large banks that have contributed most strongly to the growth in AuM, accounting for approximately 90% of the increase.

Indeed, in 2020, the largest private banks (those with over EUR20 billion AuM) represented approximately 47% of total AuM, while small banks (with under EUR5 billion AuM) only represented 9%.

A stronger AuM growth over the past two years (in EUR billion)



Mergers and acquisitions

KEY STRATEGIC DRIVERS FOR CONSOLIDATION IN LUXEMBOURG

Scale

The escalating costs of operating a private bank have, over the years, led to a rise in the minimum critical mass of AuM needed to operate profitably. Currently, this minimum threshold is deemed to be between EUR7 billion and EUR10 billion.

Regulatory pressure

Mounting regulatory pressures (ATAD 2, MiFID II, PSD2, GDPR, Basel, DAC 6, etc.) will continue to weigh on profitability margins and capital positions. The costs of supervision, risk management and regulatory compliance have also been important drivers impacting the banks' cost bases.

Refocus on core businesses

There is an established trend for global banking groups to refocus on their core businesses (frequently retail banking), and for private banking groups to divest their non-private banking operations (e.g. fund admin).

Refocus of Luxembourg private banking on (U)HNWIs

A refocus in Luxembourg private banking on the (U)HNWI customer segment sometimes leads to difficult operational transitions as the industry moves from a reliance on traditional relationship manager models to the structuring of teams able to serve sophisticated (U)HNW clients with services such as estate planning and transmission, tax structuring, funds structuring and inheritance, which require a different skill set.

EU hub for Switzerland and other non-EU countries

Consolidation in the industry is partly offset by new entrants from countries like China, Switzerland and Spain, all interested in setting up EU private banking hubs in Luxembourg. We also note the rise in new entrants operating an open architecture "endowment model" that is more appealing to (U)HNWIs, who want less reliance on in-house banking solutions.

MERGERS AND ACQUISITIONS WILL CONTINUE TO RESHAPE LUXEMBOURG'S BANKING ENVIRONMENT

European private banks had already felt pressure to revitalize their business models, but the pandemic precipitated many such changes, forcing the industry to accelerate its transformation.

The financial performance of banks in 2020 confirmed a decade-long pressure on profits and margins. The Luxembourg market was no exception, and its major banks had already long been anticipating the difficulties in maintaining a sustainable cost to income ratio.

The current challenges faced by the Luxembourg banking industry and the perception of "critical scale" have triggered a wave of consolidation which is currently reshaping this sector.

Banking groups that own Luxembourg private bank subsidiaries whose assets under management fall below critical mass have been exiting the market.

This withdrawal strategy is particularly notable among Nordic players, with groups such as Nordea Bank (January 2018), Banque Carnegie (May 2018), Catella Bank (October 2018) and Danske Bank (2021) all terminating their private banking operations in Luxembourg after executing a full or partial disposal of their respective Luxembourg-based businesses.

Further, private banks are increasingly refocusing their businesses to serve (U)HNWI, sometimes resulting in a restructuring of their traditional relationship management models.

Therefore, private banking groups are also moving to free up capital to reinvest in their core businesses by disposing of their non-private banking subsidiaries (e.g. fund administration and asset management companies). One successful example of this non-core asset strategy was put in place by EFG Bank (Luxembourg) SA. This subsidiary of a Swiss private banking group completed the sale of its in-house management company to KB Associates in mid-2021.

Covid-19 and the challenges that have evolved from the current low interest rate environment have contributed to an acceleration in the Luxembourg private banking market's consolidation trend, mainly led by a strong interest in client portfolios and acquisition of banking licenses.

Two Swiss banking groups announced the most noteworthy transactions seen in the last quarter of 2020 and during 2021. In December 2020, VP Bank acquired a EUR760 million portfolio of private banking clients from Öhman Bank S.A., while UBP Bank announced in July 2021 that it would be buying a portfolio of private banking clients from Danske Bank International S.A.

M&A OUTLOOK 2021-2022

Given the current banking environment in Luxembourg, we expect the M&A market will continue to be highly active, with the potential for opportunistic bidders to emerge.

We expect banks' M&A strategies to be influenced by four themes that will emerge in the short to medium term and reinforce each other: **consolidation, core portfolio optimization, new capabilities and digitalization, and the building of commercial relationships.**

We also note that regulators have an additional impetus to keep the consolidation trend progressing at a good pace. In order to favor banking efficiency and technological innovation, the ECB has stated its willingness to favor banking consolidation via cross-border mergers and to relax the current framework and constraints created by differences in national regulations. Additionally, the CSSF has expressed its positive view on the consolidation of the private banking industry in Luxembourg, thus paving the way for possible new transactions.

Consolidation

Given continued top- and bottom-line pressures, banks are likely to seek opportunities to consolidate in order to realise economies of scale. For their part, acquirers will try to achieve economies of scale by capturing divestitures arising from factors such as:

- the ripple effect of M&A or divestment decisions following financial distress in their domestic markets
- lack of scale
- groups refocusing on their core businesses
- pressure on offshore activities.

We expect to continue observing players from nearby countries, mainly Switzerland, entering and consolidating the Luxembourg private banking market. Further, certain other global players with an inorganic growth appetite, from e.g. Southern Europe as well as North and South America, will keep sounding out the current opportunities.

Portfolio optimization

The changing value proposition and a necessary refocusing on (U)HNWI customer segments anticipate potential new transactions in the short term.

Private banks will continue redesigning their value propositions, refocusing on their core businesses and implementing a restructuring of traditional relationship management models.

Those undertaking strategic reviews will most likely continue instigating the disposal of non-core assets (private or non-private banking businesses).

New capabilities, client expectations and digitalization

Prior to the emergence of the Covid-19 pandemic, the private banking industry was focusing on increasing front office effectiveness and optimizing value propositions and pricing.

Covid-19 caused clients' preferences regarding sales and advice channels to shift quickly, for reasons of health and safety, toward digitally enabled remote solutions.

The crisis has required the majority of clients to experiment with digital channels and it would be reasonable to expect heightened client expectations for digitally enabled private banking even after the crisis.

Further, the private banking sector is facing a progressive transformation of its client base due to generational change. Clients' expectations are evolving and the new generation of digitally savvy professionals, well-informed regarding online channels and investment tools, is becoming a highly profitable target group for private banks. Thus, banks are redesigning their strategies to remain attractive to this new generation of clients.

We also expect some M&A activity driven by the digitalization of the front office as well as by client satisfaction and the client experience.

Building commercial relationships

In divesting non-core assets, private banks will have to establish partnerships and future commercial relationships with acquirers in order to keep providing high-quality services to their clients.

We expect that private banks will try to broaden the horizon of value-creating opportunities through acquisitions, alliances and joint ventures in adjacent segments.

External asset managers (EAMs)

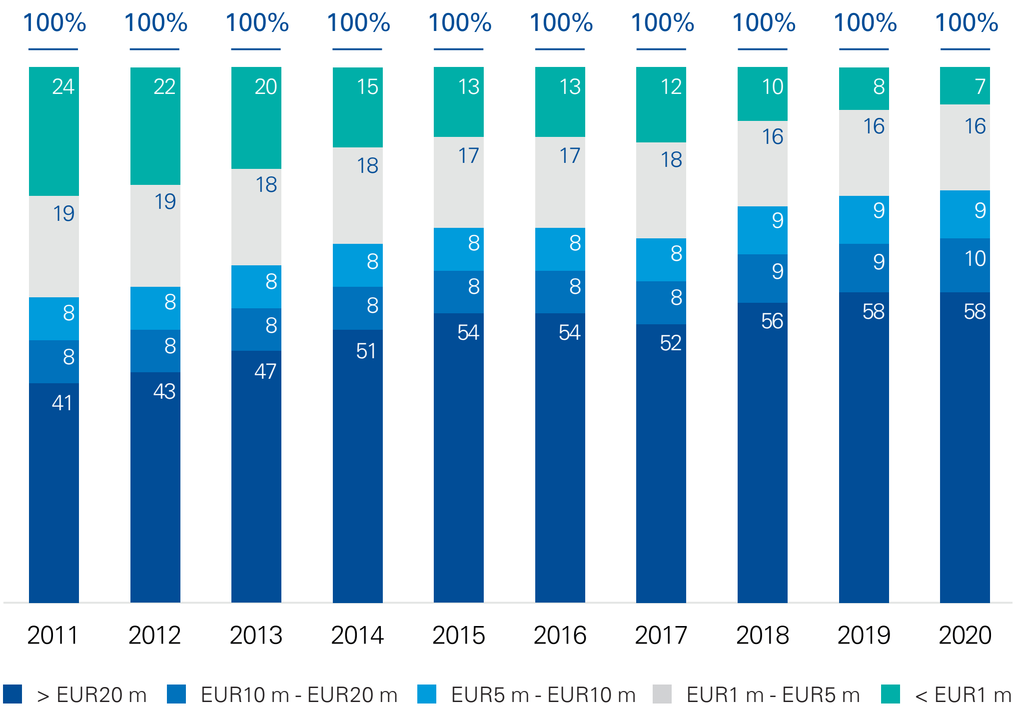
While our focus in this report was on the activity and profitability of private banks, it is however worth mentioning the continuous development of external asset managers, which are regulated Professionals of the Financial Sector (PSFs) supervised by the CSSF, and that also sometimes constitute a tempting path for some subscale private banks wishing to decrease their regulatory or capital costs.

Within this model, (U)HNWIs open and maintain an account with a custodian bank based in Luxembourg or in another country, and entrust the mandate for managing their assets to a third party — the external asset manager. In this triangular relationship, each party plays its part. The further development of the external asset managers market tends to create healthy competition between market players, which benefits the client, as well as the Luxembourg banking sector as a whole.

There were 98 external asset managers in Luxembourg as of end 2020, managing nearly EUR30 billion in client assets (AuM) and employing more than 1,900 professionals in the country.

Client type distribution

Evolution of the distribution of client wealth bands, % of total AuM, 2011–2020



The Luxembourg wealth management sector is a great fit for (U)HNWIs as the client type distribution continues to polarize

While the number of private banking clients has decreased over the last few years, total AuM has grown thanks to the intensifying focus on HNWIs and UHNWIs.

The proportion of UHNWIs has increased from 41% of total AuM in 2011 to 58% in 2020, while the proportion of affluent clients has decreased from 24% to 7% over the same period. The repositioning of Luxembourg private banks toward (U)HNWIs cannot be clearer.

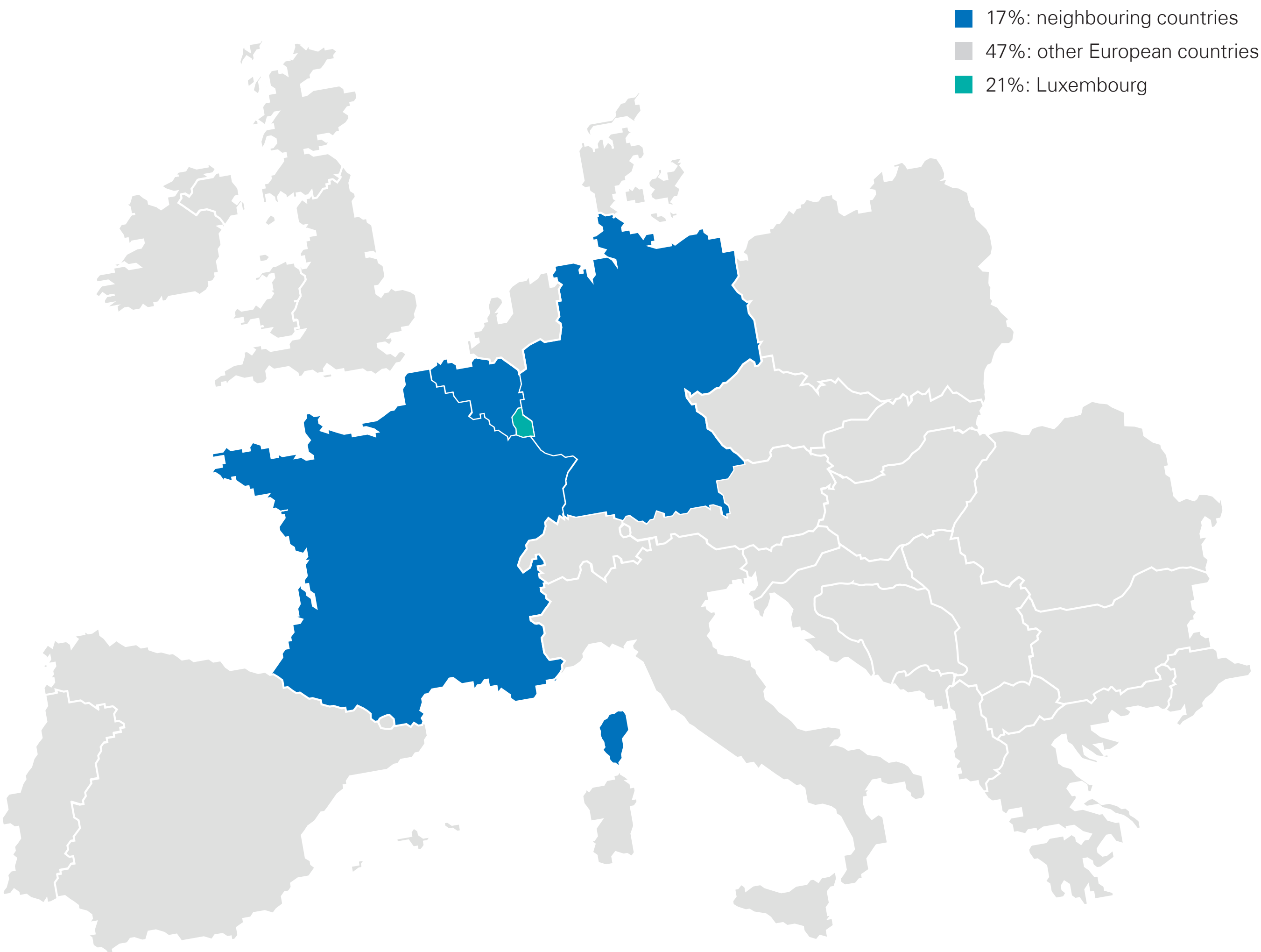
Of course, the number of (U)HNWIs globally has been increasing significantly in parallel, so the challenge for Luxembourg private banks is to take advantage of this surge by attracting these individuals as clients. And those banks have a great number of advantages that can be promoted in the chase for the wealthiest: a solid country reputation (Triple A rating), a qualified workforce, long-standing cross-border expertise, close connection with the investment funds industry and established links to satellite services in the Luxembourg ecosystem (family offices, lawyers, external asset managers, insurance companies, products, etc.), to name but a few.

But, as there is another side to every coin, to serve these clients well and remain attractive to them, private banks will also need to create a strategic shift in their offerings, with more complex products and value-added and bespoke solutions for tailor-made investment strategies, asset protection, and tax and succession planning. This may mean managing a lower number of clients, but of a far more complex and sophisticated nature, thus requiring additional skills and capabilities and a very pronounced form of agility.

Luxembourg as an international private banking center

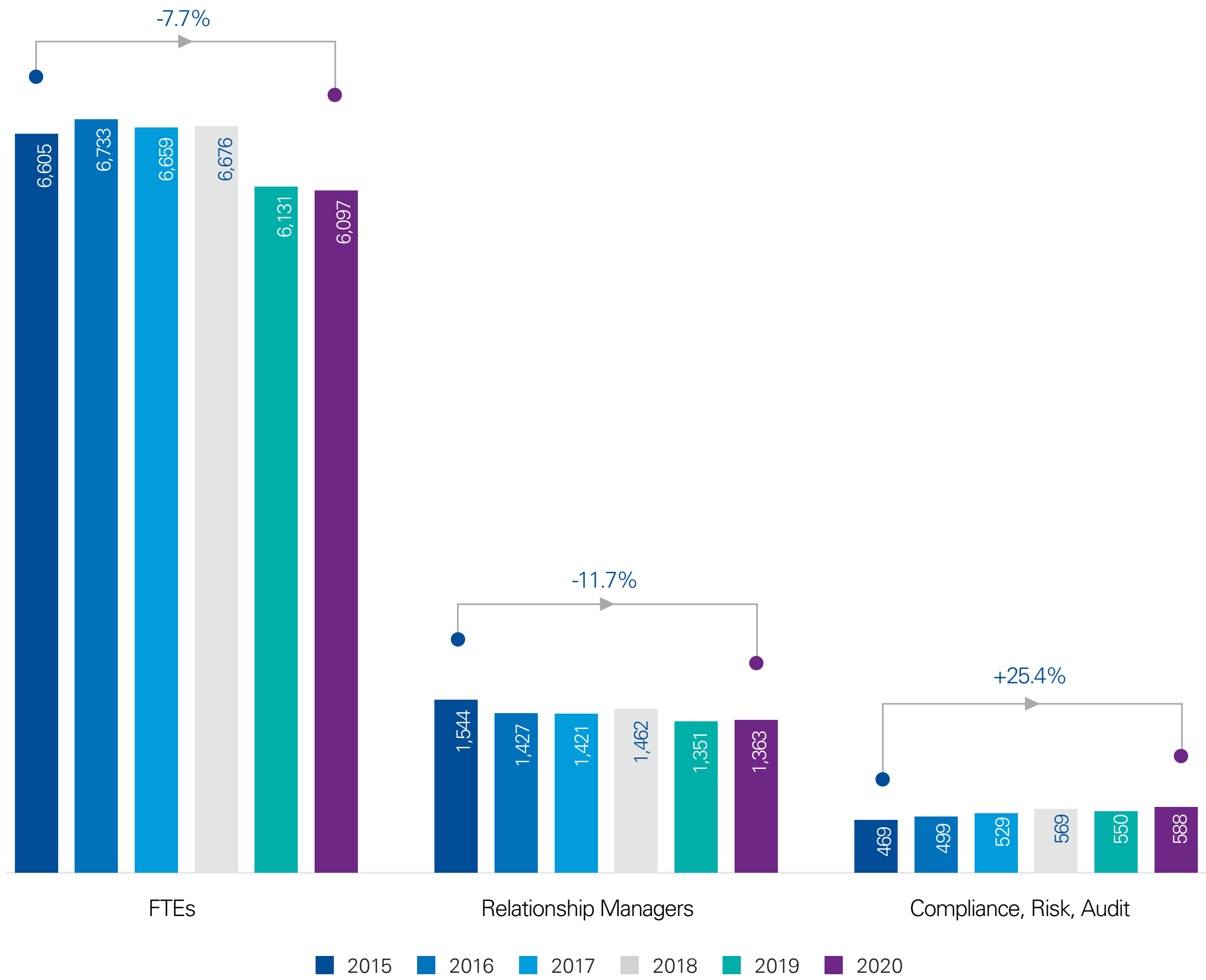
The Luxembourg private banking sector originally grew thanks to affluent customers residing in neighboring countries such as France, Belgium and Germany. As private banks have repositioned themselves toward another, wealthier, category of clientele, they have also been trying to better diversify their client bases and reach clients in other jurisdictions. As a result, the proportion of customers from neighboring countries has decreased to 17%.

Interestingly, the clientele does however remain very European, with 47% coming from other European countries. This is not surprising as, given the level of sophistication that (U)HNWIs require of their bankers, the capabilities of Luxembourg private banks to build and maintain the required skills in investment and wealth planning for a population of customers that might be deemed "exotic" from a Luxembourg standpoint are probably limited and/or not sufficiently profitable in the absence of a minimum critical mass. All in all, in terms of geographic origin of clients, Europe remains the core market, with 85% of total AUM.



Evolution of employment in the private banking sector

Evolution of the total number of FTEs and focus on client-facing and control functions*, 2015-2020



The number of private banking FTEs continues to decrease

Staff numbers in the Luxembourg private banking sector have decreased significantly since 2015 (down 7.7% overall). Moreover, this trend has accelerated since 2018 (falling at an average of 3% p.a.) after a period of stagnation.

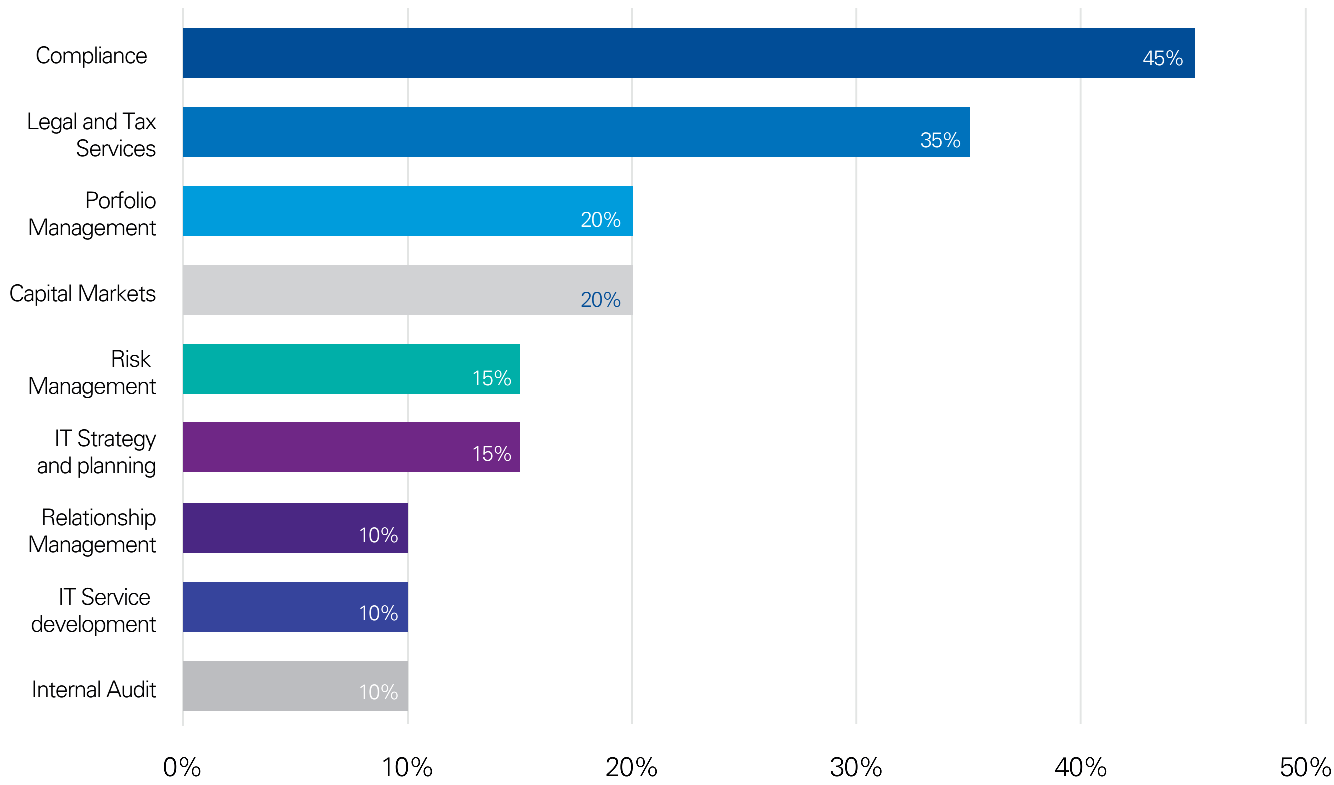
The fall in the number of affluent clients at the same time as the increase in a more limited number of (U)HNWIs, discussed earlier, means that fewer relationship managers (RMs), albeit more skilled, are now needed to serve clients — hence the reduction of almost 12% in this staffing group since 2015.

*Compliance, Risk Management, Internal Audit

Conversely, in the light of reinforced regulatory pressure, the need for resources in the fields of compliance, risk management and internal audit has only been increasing. And the growth here is impressive: up 25.4% over five years. Control function staff now account for almost 10% of the FTEs in a private bank, not far behind the proportion of IT staff. Further, with demand currently being greater than supply in these areas, the remuneration packages for these positions have been growing too. This adds up to double trouble for Luxembourg private banks' profitability: a greater number of control function staff, receiving higher compensation, weighs heavily on banks' cost-income ratios and confirms the importance of building and maintaining a critical mass in terms of AuM in order to be able to absorb and offset these costs.

It is also important to note that, while the number of relationship managers has been decreasing and the number of control function staff increasing, the optimization of operating processes — i.e. the automation and digitalization of processes — has brought about a decrease in the number of positions in back offices and operations departments, where the number of staff employed for routine, less value-added tasks has in fact been reduced.

Are you facing difficulties in recruiting? If yes, for which positions in particular?*



* KPMG Remuneration Survey, 2021 edition

The future of work

As has already been mentioned, Luxembourg attracts an active, mobile and demanding international clientele. To satisfy these clients, private bankers need to display a wide range of skills — in addition to providing investment advice, they need to have expertise in wealth structuring and planning, be able to support the client by considering international taxation and, above all, be able to ensure optimal management of the client relationship.

A new era of talent

Among the many challenges faced by Luxembourg private banks, the ability to attract, train, maintain and further develop highly skilled professionals is key and lies at the very core of business strategy.

While the battle for talent is nothing new, the transformation process private banks are currently going through — associated with rapidly changing technologies — makes it difficult to precisely predict today what skills will be needed tomorrow.

In this context, it is very likely that the employment market of the future will place a premium on broad "enabling" skills that can be adapted to a changing business environment, rather than more narrow, task-specific capabilities.

Employers need to ensure that employees' skillsets keep pace with evolving markets and that their workforces have the flexibility needed to adapt to the changes that lie ahead. Private banks cannot simply recruit new employees to cover skills shortfalls — first, as there are not enough suitable candidates available, and second, as the lifetime of a skill has shrunk considerably.

The notion that banking professionals can develop a skillset that will sustain them for 20 years is long outdated. There is a continual need to train — to learn, unlearn and relearn — as well as to foster a learning culture throughout the organization.

A new, skills-led approach to job design will also be required. The traditional role-based method will not be enough, as employees will no longer be seen primarily as relationship managers, risk managers, etc. Instead, they will be viewed in terms of their skillsets — i.e. as critical thinkers, analysts, project managers, and so on.

As the shape of the private banking industry evolves, a holistic understanding of the workforce will be critical to repurposing talent pools and leveraging skills. Ultimately, private banks will need to identify — and source — the combination of behavioral, leadership and technical competencies that will maximize the value that their workforces deliver.

Candidates in search of purpose-driven work

Aside from this, private banks must also attract the right talent. As the search for top talent becomes increasingly competitive and job seekers have much more control, employers have no choice but to stand out from the competition. Today's workers are looking for more from their jobs: they are looking for a way to make a mark on society.

For reasons ranging from generational priorities to personal preferences, the traditional driver of financial reward is no longer the best bait with which to lure top talent. Indeed, while competitive salaries can go a long way in helping to attract talent, much more goes into creating job satisfaction. More precisely, research has shown that almost half of today's workforce would take a 15% pay cut to work for an organization with an aspirational purpose.

Solving the multigenerational enigma

In the same way that private banks are considering how to remain profitably relevant in the future given the challenge represented by the great generational wealth transfer toward Generation Z and millennials, organizations should consider implementing or revamping their talent management programs to harness the specificities of each generation.

What's more, the workforce is becoming more diverse. As a result, the universal programs and tools made available by organizations for their staff have sometimes become obsolete and companies are starting to recognize that they need to tailor talent programs to specific audiences.

In a nutshell, sustaining success in the future will require the ability to: identify and source fundamentally different skills in order to leverage an authentic company brand, rapidly reskill the workforce, focusing on new and evolving roles, understand how talent can best be used in a changing business environment, and deliver competitive advantage through the employee experience in order to attract, engage and retain top talent across generations.

MULTIGENERATIONAL MINDS AT WORK

Below are some of the common differences across the four main generational groups at work:*

Baby boomers

- Value loyalty
- Possess a strong work ethic
- Want to move up the corporate ladder by proving themselves; likely to remain with the same organization
- Increasingly choose to remain in part-time roles rather than retire

Generation X

- Value flexibility and work/life balance
- Prefer an individualistic work style
- Want options to progress their careers and increase responsibility in their roles; likely to move between organizations for the right opportunity

Millennials

- Value purpose and meaning
- Work with others in a collaborative style
- Want to move through their career path very quickly; likely to move between organizations in order to gain experience

Generation Z

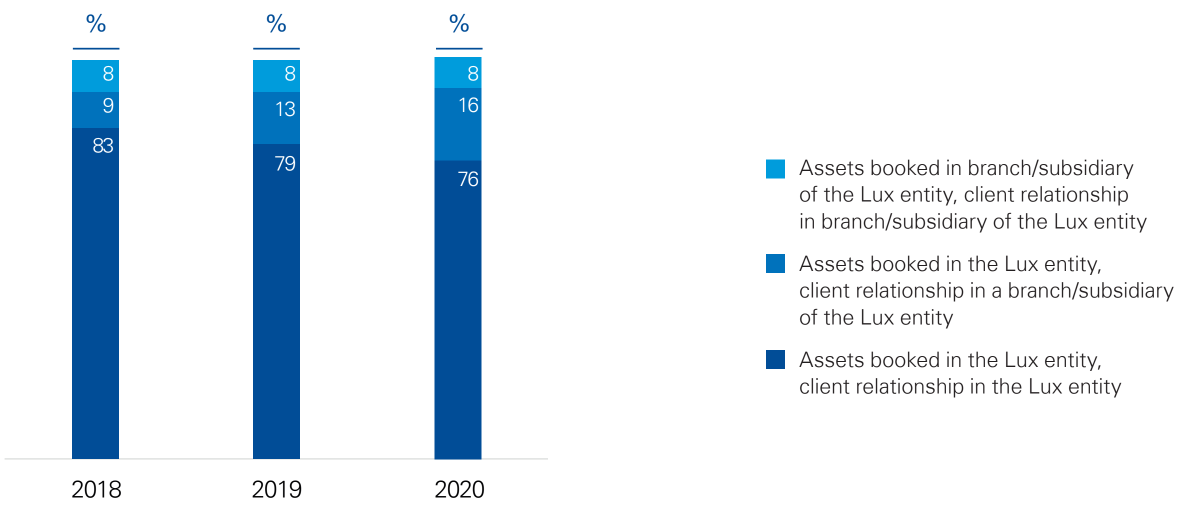
- Value earning power and job security
- Possess an entrepreneurial spirit
- Want to pursue multiple career paths at once; likely to move around within one organization with a lot of demonstrated opportunities
- Seek technological sophistication

*Generation Z talent - KPMG (2018)

Chapter II:
Business and operating models overview

Booking centers

Booking center distribution, as a percentage of AuM, 2018–2020



Luxembourg, the European hub for major financial institutions in private banking

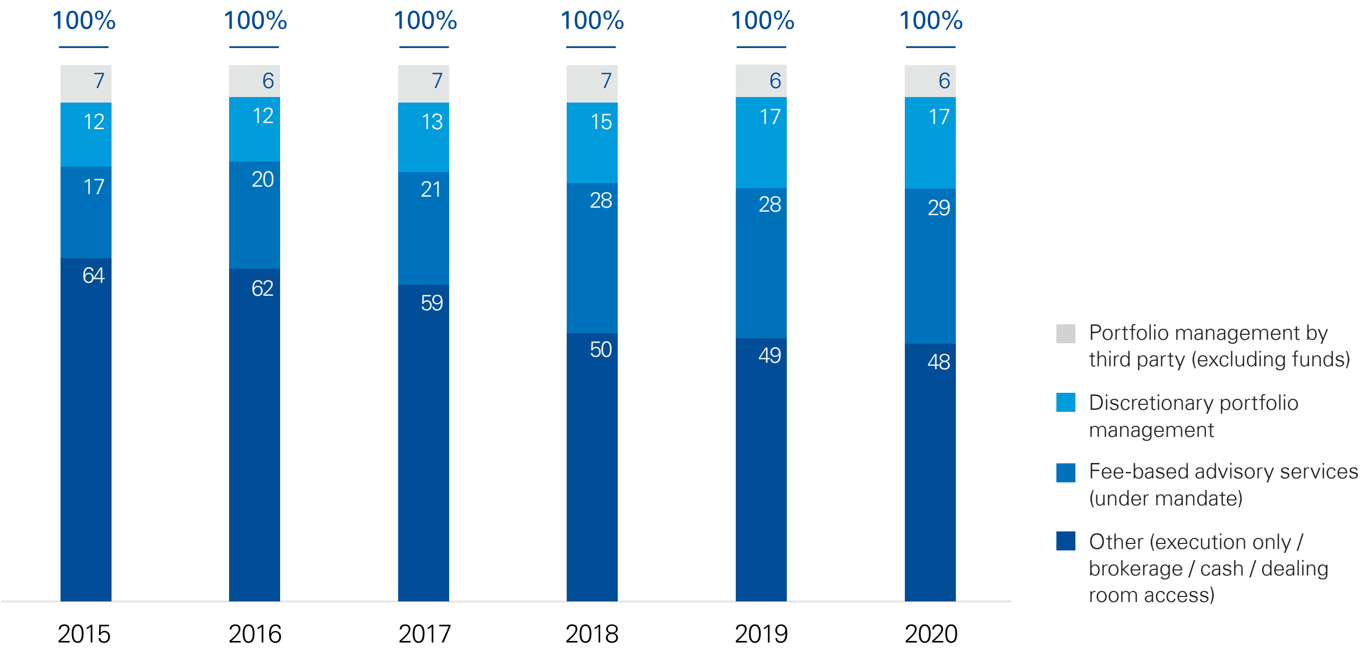
The Luxembourg private banking sector has found a successful way to remain relevant while adapting to changing group structures and governance issues in an onshore world where competition now has to be viewed from a global perspective. Indeed, banks that are licensed in Luxembourg generally operate across the European Union and can develop their activities through their branch or subsidiary networks while leveraging their Luxembourg platforms.

As a consequence, strong local operational competences associated with the capability to manage complex cross-border issues and constraints have made it possible for Luxembourg, where needed, to play the role of an asset booking hub, while relationship management is sometimes performed and maintained close to the clients, i.e. through branches or subsidiaries located in the clients' countries of residence.

As shown in the graph above, since 2018, the proportion of client relationships managed in a branch/subsidiary of a Luxembourg entity, with assets booked in the Luxembourg entity, has almost doubled. While this can certainly be explained in part by post-Brexit transformation processes at some UK-based groups, it is also a trend that we observe in other entities. This shift is very likely to continue as, the more integrated the banking groups are, the easier it is for them to build synergies and therefore optimize their IT, operational and, even more importantly, their regulatory costs.

A shift in the investment service offering

Investment service offering, as a percentage of AuM, 2015–2020



A shift toward a fee-based advisory model

As expected, the industry has been trying to shift toward a fee-based model where private banks charge clients directly for investment advice. This advice was historically free, or quasi-free, as revenue was transaction-based — generated from commission and execution fees.

This trend has been observed since 2015, as two service offering types have grown considerably and now represent almost half of AuM: discretionary portfolio management (increasing from 12% in 2015 to 17% in 2020) and, to a greater degree, fee-based advisory services (from 17% to 29%).

Multiple factors explain this shift:

- MiFID II introduced higher transparency requirements regarding costs and charges for both services and products, prompting banks to rely on contracted service offerings with tailored pricing, such as advisory and discretionary mandates.
- Clients' needs are evolving, driving them to seek advisory services for important variables in their investment decision making: cost and product transparency, tax implications, personalized services or positive ESG impact.
- New entrants from outside the industry (e.g. fintechs, robo-advisors) offer easy and cheaper solutions for self-directed and discretionary investing. While these cannot really compare with traditional, high-quality private banking services and are not intended for (U)HNWIs, they do induce a form of latent pressure on private banks in terms of service offering.
- (U)NHWIs are demanding tailor-made and personalized services from their relationship managers. As long as private banks target and shift toward this clientele, the demand for advisory and discretionary services will continue to grow.

But what about the remaining 48%?

Although the increase in discretionary portfolio management and fee-based advisory services over the past five years has been remarkable, it is important to note that 48% of 2020 AuM remained in cash or execution-only services or was managed directly by the dealing room. If we disregard the latter, even though we do not have precise figures we can assume that a considerable proportion of AuM is thus still in cash or serviced via execution-only means. As we know, in the current low interest rate environment, cash costs private banks a lot of money, while execution-only does generate limited fees — even more so with the parallel development of online brokers and robo-advisors.

In this report we are trying to analyze the profitability of private banks and identify the possible levers on both the revenue and cost sides. The transformation of the 19% of cash and, say, 15% of execution-only AuM into fee-generating services is an obvious potential course of action that is already well-known to private banks. To this end, relationship managers today have a strong incentive to reconnect with clients who — whether by fear, lack of knowledge or a desire to remain very much in control — have chosen to remain in cash.

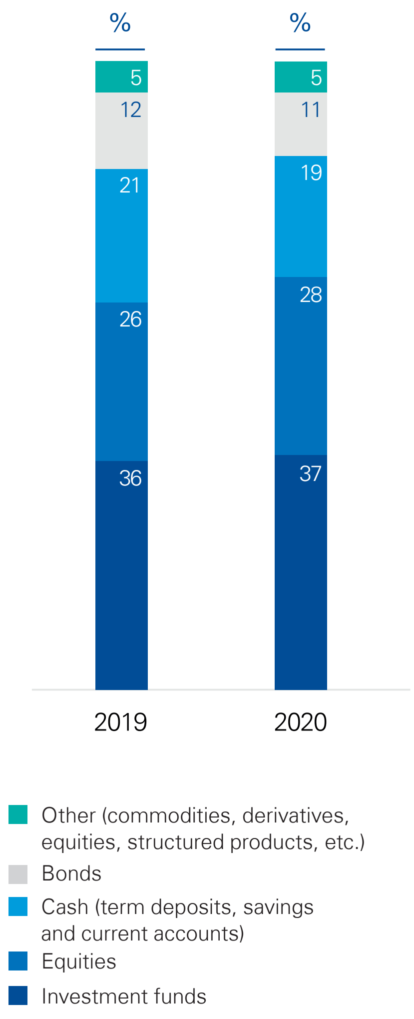
Tremendous progress for passive investing and ETFs

At a more global level, it is also interesting to note that some investors have been shifting their assets from active to passive investment management. This has, in part, contributed to the reshaping of the competitive asset management landscape, and this trend is set to continue.

While active mutual funds still account for the majority of the market (59%*) and represent a greater share than passive mutual funds (20%*) and ETFs (21%*) combined, their grip has weakened since 2009. Indeed, their share has fallen from 80% (-21%), while the combined share of passive mutual funds and ETFs has doubled.

The main driver of this boom for passive funds and ETFs is the demand, mainly from affluent investors, for cheap product. MiFID II has contributed to this shift, as it has enabled clients to compare costs and has pushed some cost-conscious investors away from active funds.

Composition of client portfolios, by asset type (all service types together), 2019–2020



*KPMG Research

Private banking and private equity: prospects for added value

Private equity held up more than well in 2020 and 2021, despite the Covid crisis, and is expected to continue growing significantly in the coming years, focusing still more attention on such investments.

For private banks, integrating private equity investments into their offer has become essential in order to meet clients' changing needs and expectations. In an environment of negative interest rates and low returns on investments in public equity and debt instruments, private equity is an opportunity for investors to diversify their portfolios and target higher returns. Customers' demands have also changed over the last few years, with sustainable and ethical investments, and investments focused on very specific sectors or startup companies, increasingly being requested. Investing in private equity enables clients to target companies or SMEs that they believe in, or investments in line with their own ethics and values. Last but not least, private equity has the advantage of being only weakly correlated with stock market developments. The low frequency of valuations makes it possible to silence the noise of daily valuation so that investors focus more on long-term returns.

That being said, private equity remains a complex and heterogeneous environment encompassing many different types of vehicles and investments — and inherently riskier than most standard investments. Private equity investments hence represent a unique opportunity for private bankers to further enhance the added value they offer their customers, by analyzing, selecting and structuring private equity investments and building solutions adapted especially for private banking customers. Private bank customers greatly appreciate support not only in gaining access to alternative investments but also regarding due diligence and advice on such investments: how they are priced, controlled, audited, monitored, diversified, etc.

Historically, one of the limitations of private equity has been that it was often limited to experienced professional and institutional investors. Leveraging their MiFID expertise and the relationships they have built over time with their clients, private banks are in the perfect position to open private equity investments to other market players, acting as a facilitator and an intermediary between private banking customers and external private equity vehicles or creating their own investment solutions.

Of course, this requires private banks to have the capability and willingness to build dedicated private equity teams with deep knowledge and expertise in all key aspects of the private equity spectrum — from investment sector knowledge and cross-border investments to tax topics and many others. As always, understanding the needs and expectations of customers is crucial here: expected returns on investments, risk appetite, investment perspectives, etc. The ability to stay in regular contact and properly communicate with clients is also key, especially in the current environment, in order to discuss their private equity investments, new opportunities and exit strategies. Digital solutions for interacting and for sharing investment materials with customers would undoubtedly help.

> Private equity investments represent a unique opportunity for private bankers to further enhance the added value they offer their customers, by analyzing, selecting and structuring private equity investments and building solutions adapted especially for private banking customers.

Obviously, building such teams and expertise in private equity is challenging, as private banks need to make significant upfront investments to identify and attract talent, identify intermediaries and relevant private equity (funds) investments, develop credible investment solutions and even, potentially, financially support their own investment vehicles during the investment phase. Some private banks have therefore decided not to spread their efforts in all directions but to focus on some very specific areas, such as infrastructure, real estate, green energy or fintech.

It is indeed a challenging area, but not participating in this market may expose private banks to growing competition, not only from other credit institutions but from non-traditional players as well. New fintech companies are currently developing solutions to directly connect potential investors with the private equity world without any bank acting as intermediary. Private equity is evolving … and not alone.

Demystifying ESG

Since the 10 March 2021 entry into force of SFDR Level 1 — the first step in the rollout of the Sustainable Finance Disclosure Regulation (SFDR) — we have observed an increasing demand for additional sustainable and responsible financial products. Banking professionals have put sustainable finance at the top of their agendas and are now moving from defining their environmental, social and governance (ESG) ambitions to the operationalization process.

The types of challenges and drivers that banking professionals are facing in the context of sustainable finance are varied and interlinked.

The market started to move around end 2020, with a first regulatory driver that mainly impacted product manufacturers. It became mandatory to consider sustainability risk in investment decision-making processes and to assess and categorize investments as per the SFDR articles, from non-ESG products to sustainable investments.

In recent months, banks have been busy assessing their current consideration of climate and environmental risks in credit decision-making processes and defining their roadmaps for addressing the ECB's own expectations. Up until spring 2021, only a limited level of ESG awareness was detected in the boardrooms of Luxembourg private banks. This may have been partly due to the complexity of the regulations, making it difficult to draw out and decide on concrete actions to be deployed.

Awareness became a little clearer and moved up private banks' agendas on 21 April 2021, with the publication of a set of directives through delegated acts amending, notably, the MiFID II Directive. Under these new requirements, investment firms will need to adapt their established discretionary portfolio management and advisory services to incorporate new sustainability-related considerations along their service offering cycles.

The next milestone is therefore to define and integrate ESG ambitions into long-term strategy and to identify ESG products attractive to the new generation of investors, while mitigating any possible impact from sustainability risks. Banking professionals will have to update their MiFID questionnaires to capture clients' ESG appetites.

Taking a closer look at the MiFID amendments, investment firms have until 2 August 2022 to integrate sustainability risks, factors and preferences in their MiFID II processes.

Overall, the main challenges will lie in dealing with the flow of non-financial information and having to implement a strong ESG data management system, along with the related governance. There will be a need to understand clients' demands and to translate them into concrete investment decisions.

Bank managements undoubtedly need to consider the sustainable finance challenge as an opportunity to reinvent their business models and create societal value alongside their provision of financial support to clients.

In the context of this report, focusing on private banking in Luxembourg, we analyzed the public communications of a sample of 10 private banks relating to ESG topics. The following trends are derived solely from information available to a broad audience and published on the banks' websites.

- Education on sustainable finance and demystification around the perception that ESG products may produce weaker performances are at the heart of most communication strategies. However, this is not based on facts and data but focused more on the importance of becoming responsible investors.
- Some key players are already promoting investment strategies and products which embed ESG criteria, while recognizing the complexity and challenges they face in selecting, categorizing and then measuring ESG achievements. They are therefore quite transparent in explaining and sharing their methodology and approach, and even refer to academic research.
- For the vast majority, engagement remains at the level of establishing key guiding principles and on committing to listen to client expectations.

What's next on private bankers' agendas?

- Upscaling "ESG knowledge" across front office teams to ensure bankers can interact at an appropriate level with clients.
- Contributing to the ESMA's call for feedback on the success of MiFID II in guaranteeing retail investor protection, by 2 January 2022. One of the key concerns the regulator wants to address relates to information overload or the provision of overly complex information to clients.
- Defining communication plans to adequately educate clients on sustainable investment while ensuring investors do not end up overwhelmed.
- Defining long-term ambitions and product strategies, and assessing capabilities to upgrade operating models in order to embrace ESG opportunities.

What's new for private banks and investment firms?

Conflicts of interest

Conflicts of interest that arise in the course of providing investment and ancillary services should consider clients' sustainability preferences

Sustainability risks

Investment firms shall take into account sustainability risks (investment firms need to establish, implement and maintain adequate risk management policies and procedures which identify the risks)

Investment objectives

Investment firms need to select products for clients that meet the investment objectives of the client in question, including the client's risk tolerance and any sustainability preferences

Sustainability factors

Investment firms shall provide a description of the sustainability factors taken into consideration in the selection process of financial instruments

Sustainability preferences

An investment firm shall not recommend financial instruments or decide to trade such instruments as meeting a client's or potential client's sustainability preferences when those financial instruments do not meet those preferences. The investment firm shall explain to the client or potential client the reasons for not doing so and keep records of those reasons.

Where no financial instrument meets the sustainability preferences, and the client decides to adapt their sustainability preferences, the investment firm shall keep records of the decision of the client, including the reasons for that decision.

Understanding sustainability

Investment firms need have in place policies and procedures to be able to prove that they understand sustainability factors / preferences

Investment advice

When providing investment advice, investment firms shall include clients' sustainability preferences in the report they provide to retail clients

The new client investment objective scope

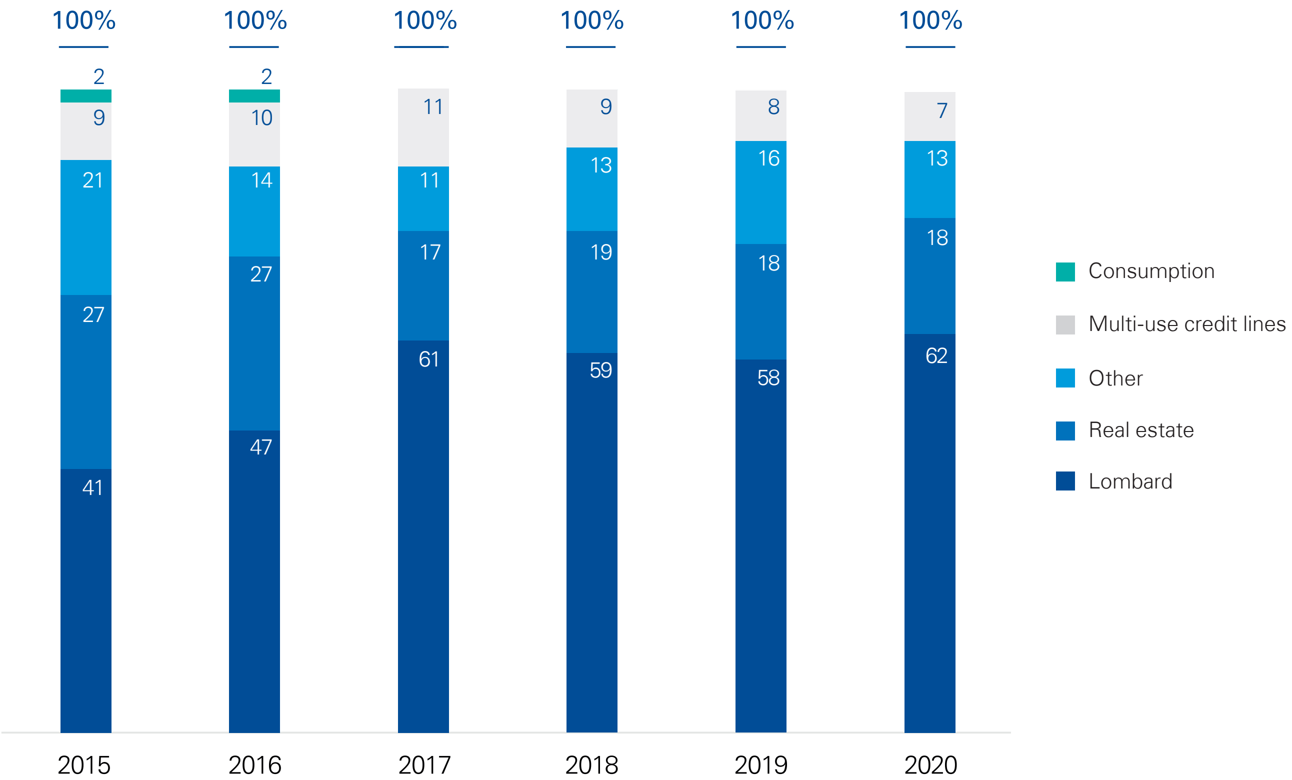
The information about the investment objectives of the client or potential client shall include:

- information about the length of time for which the client wishes to hold the investment →
- their preferences regarding risk taking →
- their risk tolerance →
- the purpose of the investment and →
- their sustainability preferences

Sustainability preferences will impact the client profile: the client needs to be educated on sustainability to be able to select their preferences.

Loan book

Composition of private banks' loan book, by loan type, in %, 2015–2020



Banks' loans to clients increased

The total amount of lending by private banks to clients increased significantly in 2020 (+9.6%), mainly via Lombard loans. This was probably due to the positive developments in the financial markets encouraging investors to increase their stakes.

This was welcome news for private banks, as income generated from loans accounts for almost a quarter of their total operating revenues, only just behind earnings from investment management fees.

This increase was supported by the rapid growth of both Lombard loans (+17% in 2020 in absolute terms), as already mentioned, and real estate loans (+11%), which compensated for the decline in other loan types (consumption, multi-use, etc.). The latter are, in any case, not the types of loans that private banks and their (U)HNW clients tend to seek.

Lombard loans: the favorite financing solution of private banks and their clients

Since 2015, Lombard loans have seen their share of the loan book increase dramatically (+51.2%) to reach almost two thirds of the total amount loaned to clients in 2020.

Both banks and clients see great value in Lombard loans, hence their being the financing solution offered by the largest share (86%) of private banks in Luxembourg, compared to real estate (57%) or consumption loans (17%).

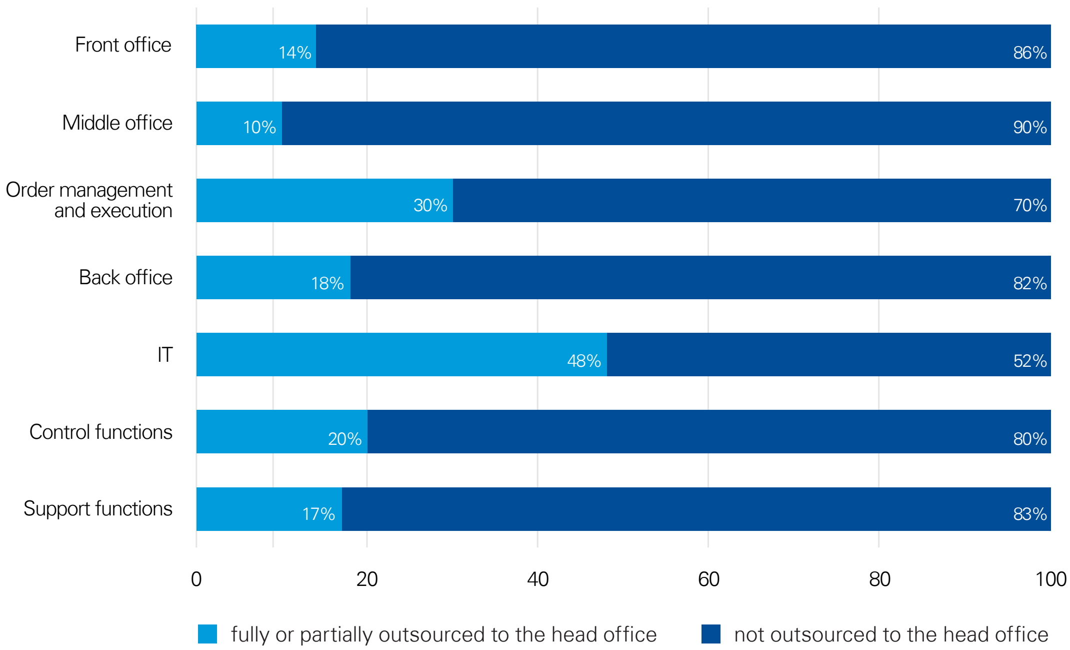
For clients, Lombard loans are an attractive financing solution as they allow them to, for example, invest in new opportunities (financial markets, real estate, etc.) without having to sell their assets or restructure their whole investment portfolio.

For banks, the gain in revenue is twofold: the interest from loans to (U)HNWIs is highly profitable and, if invested, the collateral provided by clients boosts the management fees earned, due to the inflow of AuM.

Operating models

Links with the head office

Proportion of activities outsourced to the head office, in %, 2020



Private banks' operations are very much performed locally

Most of the private banks' activities are operated fully or partially in-house, naturally with a strong focus on front and middle office. Managing client relationships and providing excellent service offerings are at the core of any private bank's strategy and ambitions.

Even though Luxembourg is known as a so-called "country of subsidiaries", the figures shown above illustrate that Luxembourg-based private banks do maintain a meaningful substance in Luxembourg and that they leverage their head offices less than might be expected, in order to operate, and rely on third parties even less.

The main activities that private banks rely on their head offices for relate, unsurprisingly, to the provision of IT services, which 48% of banks either fully, or more usually partially, outsource to a head office.

In fact, many private banks have tried to optimize their IT setups by adopting the same IT platform or core banking system across their different European entities, centralizing the management of this platform in one country, usually that of the head office.

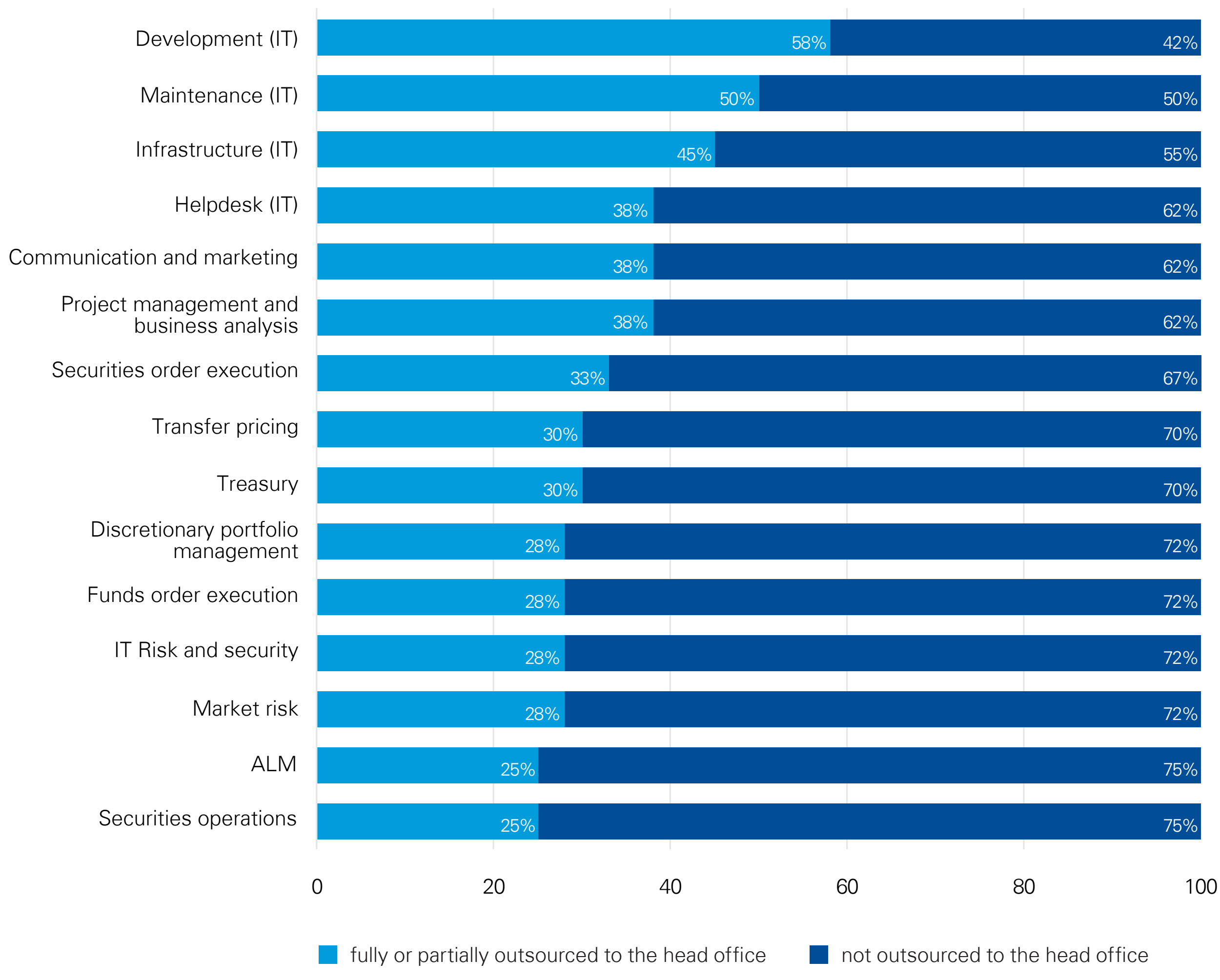
In direct connection with IT, head offices also provide support in project management and business analysis, as projects very often have IT impacts. Moreover, we have witnessed that some larger banking groups have also set up internal project or consulting teams to lower their dependence on external consulting firms — and these teams are, more often than not, located at head office level.

Beyond IT, among the key activities that are outsourced to head offices are:

- Market activities: only a limited number of Luxembourg private banks have a dealing room in Luxembourg, as market activities are often centralized at head office level and partly outsourced to brokers and/or funds trading platforms.
- Asset and liability management (ALM) and treasury activities: in direct connection with market activities, these are also typically outsourced to head offices, as most banks manage their cash positions and their assets and liabilities centrally.
- Discretionary portfolio management: many banks have tried to combine their investment organization and processing as much as possible, and portfolio management is one of the few front office activities that can benefit from centralization, not only from an operating cost perspective but also in terms of consistency in the management of client assets.

When it comes to control functions (risk, compliance, internal audit) — apart from IT risk and security, which is very much connected to IT, and market risk, also linked to market activities — most are located locally but with some support from the group.

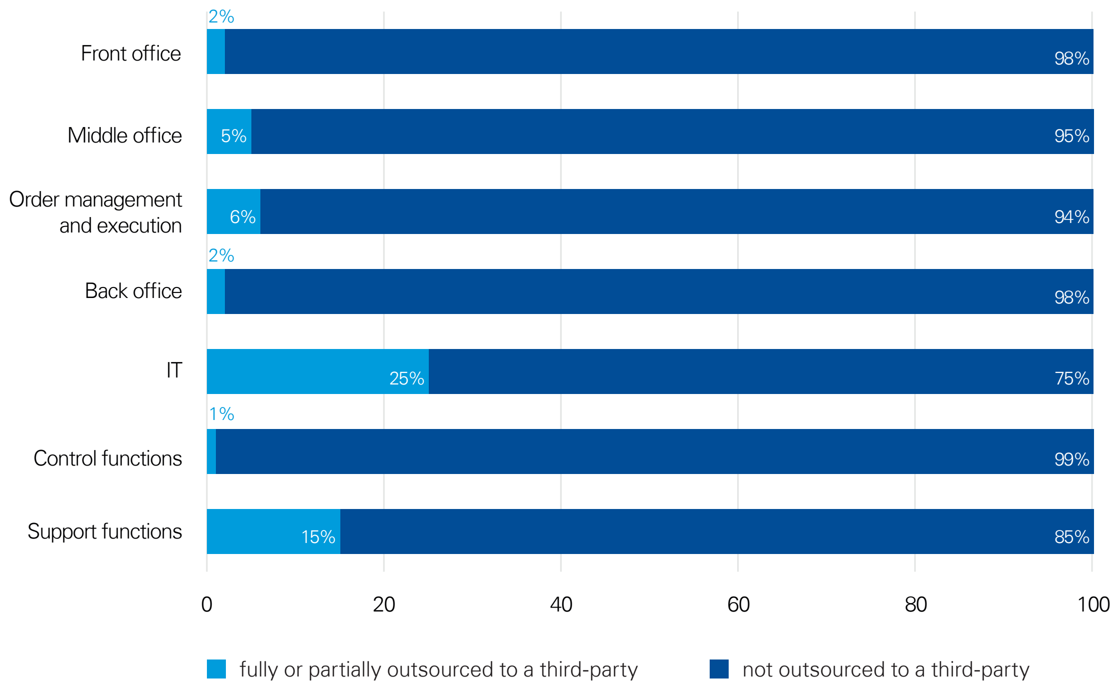
Top 15 activities outsourced to the head office, in % of banks, 2020



Operating models

Outsourcing to a third party

Proportion of activities outsourced to a third party, in %, 2020

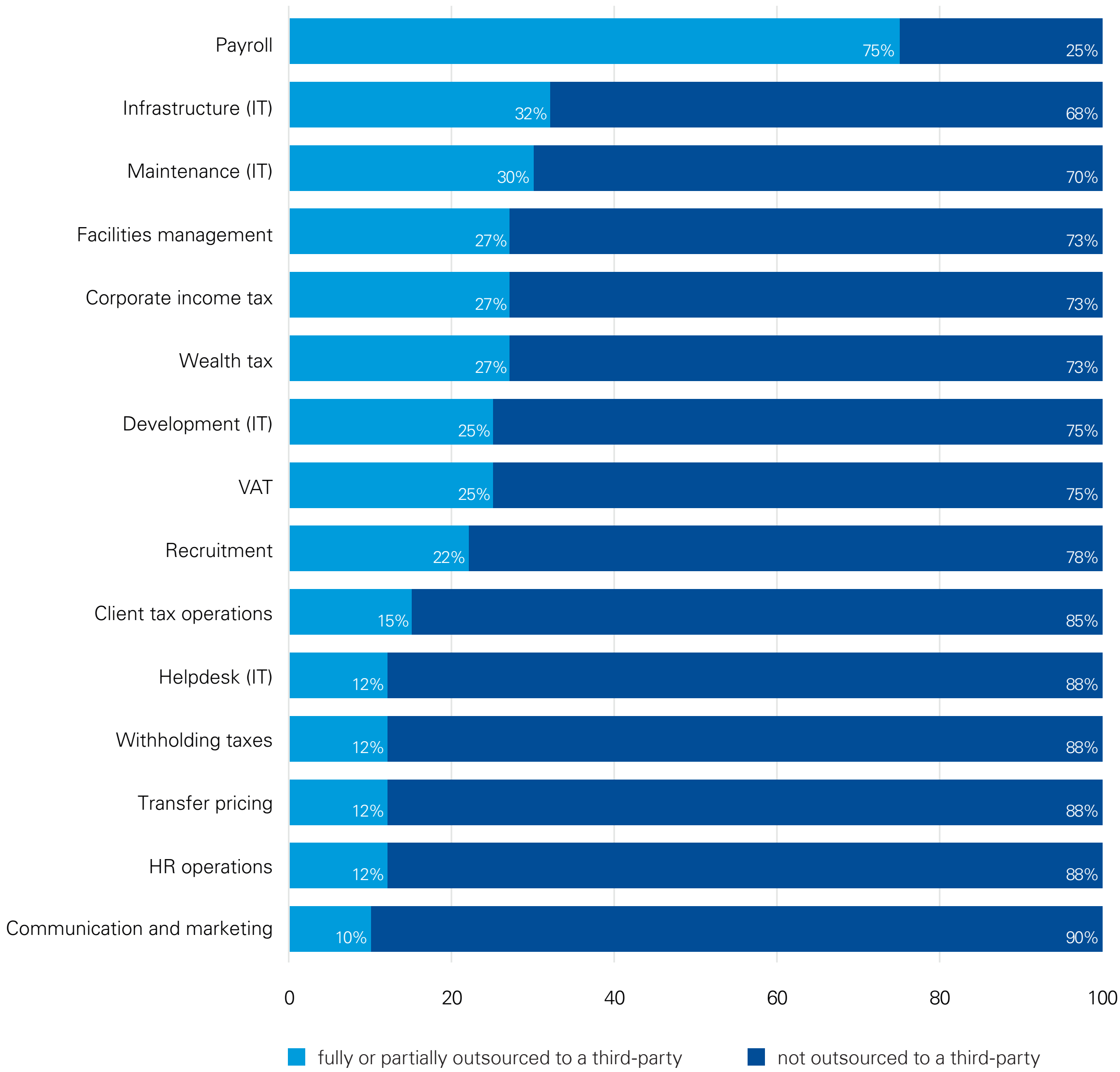


Apart from certain IT services and support function elements, some of which are outlined below, very few private bank activities are being outsourced to third parties.

- IT infrastructure is the IT activity that is the most widely outsourced to a third party, with 32% of surveyed banks fully or partially outsourcing elements of this activity externally. This is not surprising, as many Luxembourg-based private banks will not run and maintain their IT servers internally, but will rather rely on a local infrastructure provider or a cloud provider, while also taking into account all relevant regulatory constraints.
- In addition, 30% of private banks fully or partially outsource the maintenance of their IT systems to a third party. Again, as the vast majority of private banks in Luxembourg are operating third-party core banking systems, the necessary accompanying maintenance is more often than not managed by the system provider.

- Payroll is the support activity that is the most widely outsourced to a third party, with 75% of surveyed banks fully or partially outsourcing it. This is mainly due to the fact that the average number of employees in Luxembourg private banks remains low and that this activity requires a sound knowledge of local labor law. The latter makes it difficult to scale or to centralize payroll at head office level, whereas there are several mature payroll outsourcing offerings available on the Luxembourg market today.
- Recruitment is the other HR activity that is to some extent outsourced to a third party (22% of banks), as private banks, like many organizations in Luxembourg, are currently competing for resources and therefore rely on recruitment firms to help them source and recruit the right talent in this particularly challenging labor market.

Top 15 activities outsourced to a third party, in % of banks, 2020



Operating models

Regulatory updates on outsourcing

When it comes to outsourcing, certain rules and guidelines have long existed in the various EU countries, including Luxembourg, in order to provide credit institutions with a secure and structured framework for this process. Among these, the European Banking Authority (EBA) has recently published the final version of its revised guidelines on outsourcing arrangements — these aim to provide a more harmonized governance framework for outsourcing within the EU.

The guidelines underline that responsibility for outsourced activities always remains with the management body of the financial institution. To this end, and to preserve adequate substance, the management body should ensure that the institution allocates sufficient resources to adequately manage those responsibilities, especially regarding oversight of all risks and management of outsourcing arrangements. Oversight should be allocated to business functions, but management, the risk committee, and the board of directors should also have a role in ensuring appropriate governance of the processes and their alignment with business strategy and risk appetite.

As regards service providers located in third countries, the guidelines require financial institutions to ensure compliance with EU legislation and regulatory requirements (e.g. professional secrecy, access to information and data, protection of personal data) especially when outsourcing relates to critical or important functions.

Finally, the guidelines require competent authorities to identify and assess any outsourcing risk concentrations with individual service providers that could pose a risk to the stability of the financial system. In order to meet these needs, financial institutions have to compile comprehensive documentation on outsourcing arrangements in the form of a standardized register to be provided to the authorities.

The guidelines entered into force on 30 September 2019 and apply to outsourcings concluded, reviewed or amended after that date. Compliance of existing outsourcing arrangements with the guidelines should be ensured by 31 December 2021.

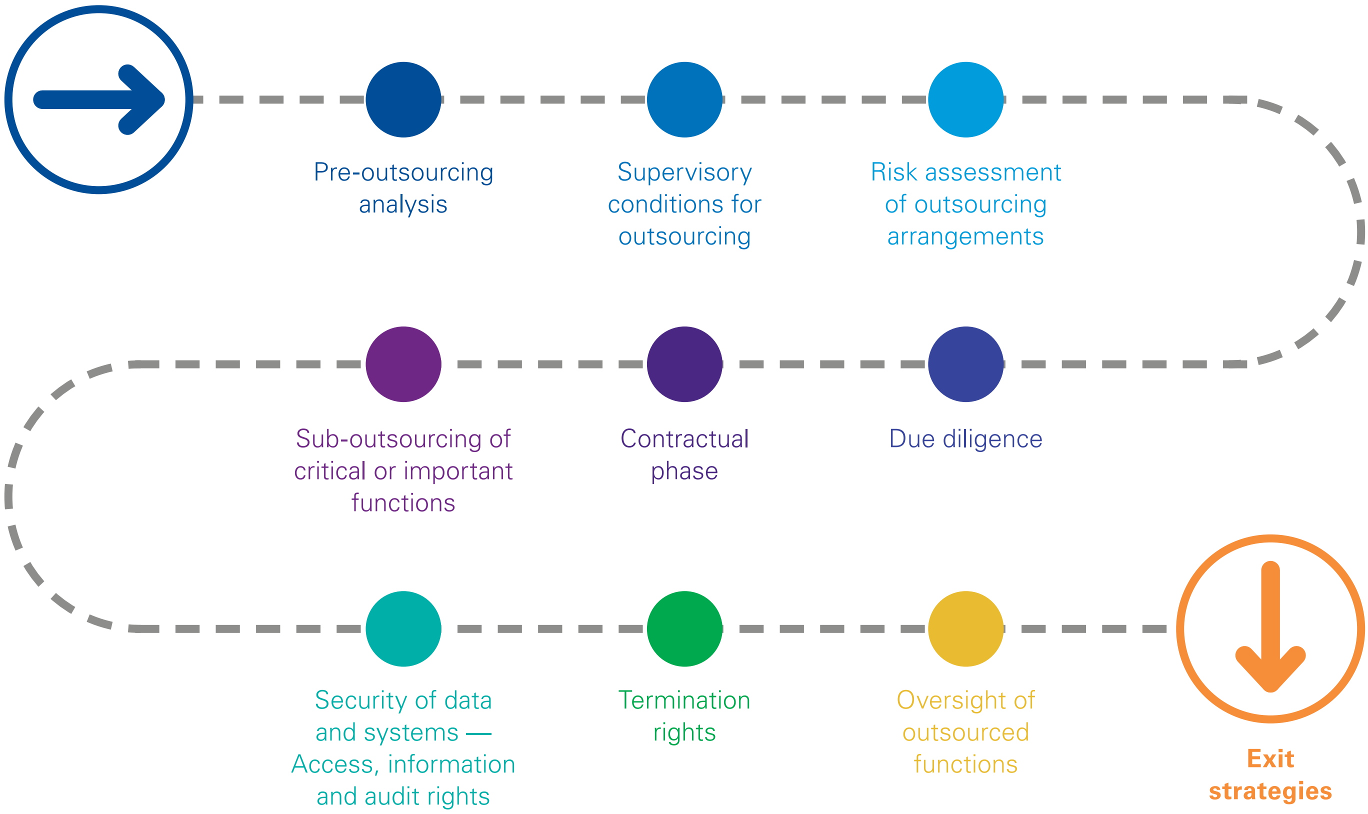
By this date credit institutions must perform a comprehensive review of their outsourcing processes, operational structures, and IT systems, as well as their internal guidelines and contract documents — and must have adapted them to the new requirements.

The CSSF will soon publish a new circular implementing the EBA Guidelines in Luxembourg, but these may be already considered as applicable.

Challenges with regard to the EBA Guidelines

- Existing contracts
- Criticality
- Monitoring
- Understanding & identification of outsourcing
- Outsourcing register(s)
- Internal organization
- Resources
- Third-party risk management

Optimal outsourcing process



While it finalizes the implementation of the EBA guidelines, the CSSF has published Circular CSSF 21/785, bringing in "interim" changes to existing requirements. The most important change concerns a relaxation which replaces the prior authorization requirement with a prior notification in the case of material IT outsourcing and a risk-based treatment of these notifications. Notifications must be provided at least three months before the planned outsourcing becomes effective; in case of recourse to a "support PSF", this period is reduced to one month. In the absence of reaction from the CSSF, financial institutions may implement the material IT outsourcing after the expiry of the three-month period (or one month, if outsourcing to a support PSF).

However, the CSSF highlights that it remains the sole responsibility of the entities to comply with all relevant laws and regulations regarding their planned outsourcing projects. Therefore, a lack of reaction from the competent authority during a notification period is without prejudice to any supervisory or enforcement measures that may be required at a later stage within the framework of the permanent supervision in case of non-compliant outsourcing arrangements.

Chapter III : Understanding industry performance

Industry performance overview

This section focuses on the analysis of the profitability of private banks with regard to a certain number of key performance indicators (KPIs).
As a reminder, the figures and the KPIs presented below are based on answers to the questionnaire sent to the participating banks.* To facilitate the analysis, we also chose to regroup the sample into three groups based on the size of assets under management: large, medium, small.

Large banks (AuM > EUR20 bn)

Overall, large banks saw a strong growth in AuM (+6.5%) despite the macroeconomic uncertainties and the headwinds created by the pandemic.

Large banks were able to offset challenges posed by a low interest rate environment and a decrease in net interest income through healthy growth in net commission income (+11%).

The growth in operating income (+4.5%) surpassed the increase in operating expenses (+1.4%) thus leading to a healthy growth in overall gross operating profit (+11.1%). Banks were cautious with their cost structures and repositioned quickly. The combination of revenue growth and low cost bases contributed to decreasing the overall cost to income ratio (2pp), and toward a marginal increase in gross operating profit margin (-2pp).

It is very important to note that the AuM data that was collected did not make it possible for us to differentiate the part of AuM growth linked to Net New Money (NNM) from the part due to market performance.

Large banks (7) EUR m	2019	2020	Change
Net interest income	216.30	188.76	(12.7%)
Net commission income	572.60	635.58	11.0%
Operating income	**788.90**	**824.34**	**4.5%**
Staff expenses	313.28	322.97	3.1%
Indirect costs	121.83	128.68	5.6%
Other direct costs	105.35	96.61	(8.3%)
Operating expenses	**540.46**	**548.26**	**1.4%**
Gross operating profit	**248.44**	**276.08**	**11.1%**

KPIs			
Average AuM (EUR bn)	31.44	33.49	6.5%
Average FTEs	326.3	318.6	(2.4%)
Gross operating profit margin	31.5%	33.5%	2pp
Average cost-income ratio	68.5%	66.5%	(2pp)

* 33 questionnaires were retained, to ensure an enhanced data consistency

Medium banks (AuM between EUR5 and EUR20 bn)

Overall, the banks in the medium cluster improved their overall financial performance and profitability. While net interest income declined (-4.2%), growth in commission income (+7.5%) was one of the prime drivers for growth in operating income offsetting the decline from net interest income.

Banks in the medium cluster had only a marginal increase in operating expenses (+1.2%), and thus had gross operating profit growth of 6.5% and an overall reduction in the cost-income ratio of 1.2pp.

Medium banks (10) EUR m	2019	2020	Change
Net interest income	280.50	268.74	(4.2%)
Net commission income	458.83	493.23	7.5%
Operating income	**739.33**	**761.97**	**3.1%**
Staff expenses	236.15	240.88	2.0%
Indirect costs	184.02	185.78	1.0%
Other direct costs	61.73	61.08	(1.1%)
Operating expenses	**481.90**	**487.74**	**1.2%**
Gross operating profit	**257.43**	**274.23**	**6.5%**

KPIs			
Average AuM (EUR bn)	10.84	11.08	2.2%
Average FTEs	215.4	208.0	(3.4%)
Gross operating profit margin	34.8%	36.0%	1.2pp
Average cost-income ratio	65.2%	64.0%	(1.2pp)

Small banks (AuM < EUR5 bn)

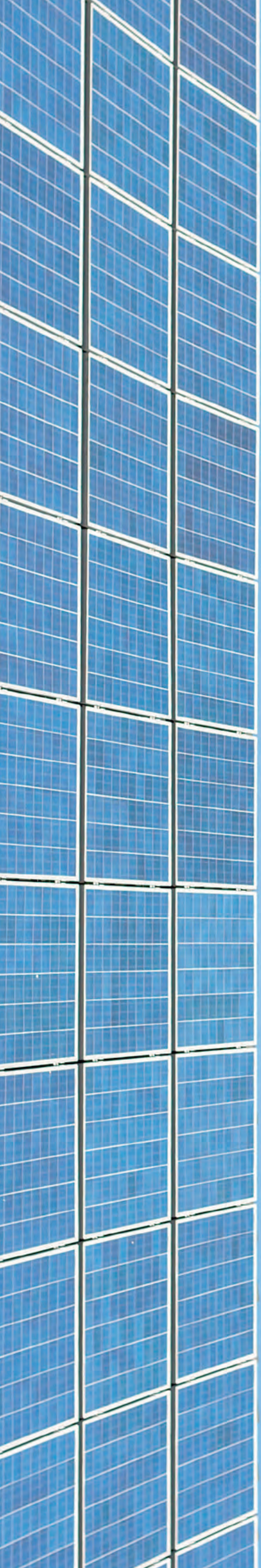
Compared to large and medium banks, small private banks appear to have had an overall decrease in AuM (-5.5%). However, this reduction had limited impact on their overall performance as, driven by a strong growth in commission income (+12.0%), small banks showed an overall increase in operating income of 7.5%.

On the expenses side, it is to be noted that other direct costs, i.e. mainly IT, rocketed to a 33.6% increase. This was probably partly due to the Covid crisis, where many of the smaller banks had to urgently and significantly invest in their IT infrastructure simply to be able to continue to operate. Despite this increase though, and further supported by reductions in staff expenses (-10.9%) and indirect costs (-7.6%), small banks were able to lower their overall operating expenses by 3.5%. The impact led to a notable gross operating profit margin improvement of 8.2pp.

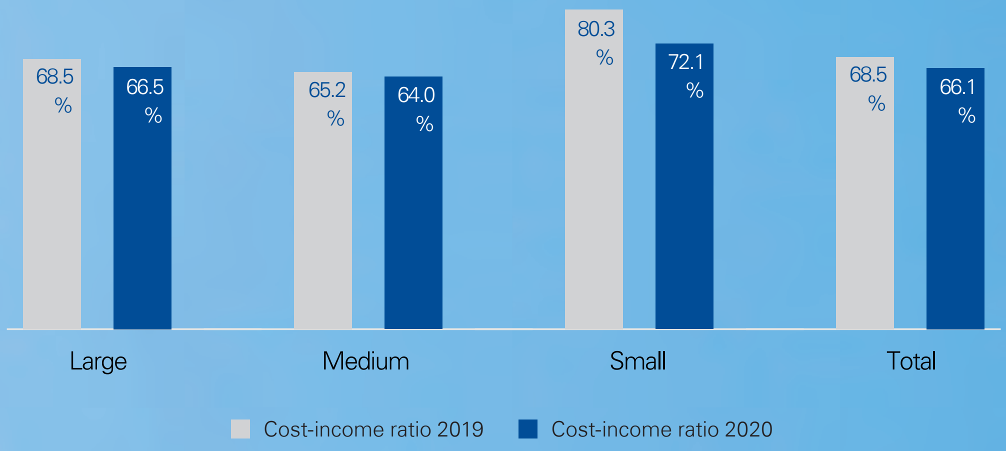
Consequently, the cost-income ratio decreased to 72.1% from 80.3%.

Small banks (13) EUR m	2019	2020	Change
Net interest income	64.87	63.63	(1.9%)
Net commission income	136.18	152.46	12.0%
Operating income	**201.05**	**216.09**	**7.5%**
Staff expenses	89.15	79.42	(10.9%)
Indirect costs	48.98	45.24	(7.6%)
Other direct costs	23.24	31.05	33.6%
Operating expenses	**161.37**	**155.71**	**(3.5%)**
Gross operating profit	**39.68**	**60.38**	**52.2%**

KPIs			
Average AuM (EUR bn)	2.54	2.40	(5.5%)
Average FTEs	55.7	53.8	(3.4%)
Gross operating profit margin	19.7%	27.9%	8.2pp
Average cost-income ratio	80.3%	72.1%	(8.2pp)



Cost-income ratio, by banks' size, 2019–2020

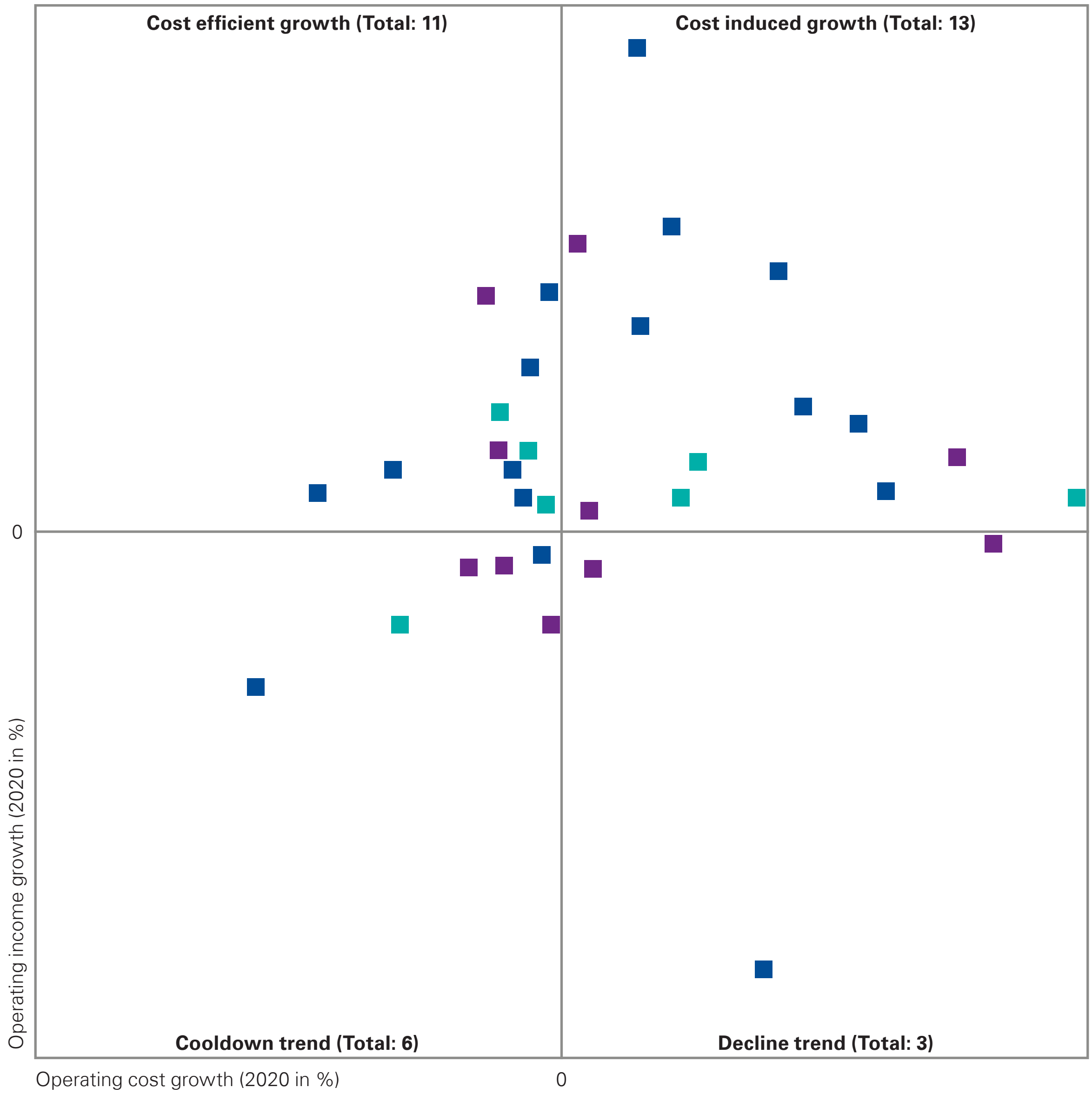


While increases in AuM and net commission income were the main factors fueling operating income growth, banks were able to keep costs under control due to greater operating efficiency and flexible working. Notably, small banks enjoyed the largest decline in cost-income ratio (from 80.3% to 72.1%) — fueled by a significant reduction in staff expenses (-10.9%), whereas staff costs at the medium and large banks rose last year (by +2.0% and +3.1%, respectively).

Approximately 73% of the industry grew their operating income baseline in 2020

Overall, income growth accelerated in 2020, with almost 73% of the banks studied increasing their income, while 33% of banks enjoyed not only increased income but also 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-efficient growth group is that the performance is particularly clustered for most participants, while the cost-induced growth group is much more dispersed.

Performance clusters



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

Small banks (16)
Medium banks (10)
Large banks (7)

Average bank performance

Private banks saw their profitability increase in 2020, due in part to growth in AuM

On average, the Luxembourg private banks under review experienced a relatively strong AuM increase (+3.9%) to reach EUR11.6 billion despite the pandemic and its underlying impact on the economy. Moreover, operating revenues grew faster than costs, resulting in an overall decrease in the industry's cost-income ratio (-2.4pp) to 66.1%, as two-thirds of banks increased their operating profitability.

Overall, 12% of all private banks analyzed — three-quarters of which belonged to the small cluster (AuM <EUR5 billion) — were unprofitable in 2020.

On average, the revenue of the private banks analyzed grew faster (+4.2%) than the costs (+0.7%) in 2020

Overall revenues grew in 2020, driven primarily by strong growth in commissions (+9.8%) and more specifically by rising transaction income (+26.3%). Indeed, transaction fees were the primary driver of commission-related income, with the highest growth percentage for all three AuM clusters.

However, given the interest rate environment, net interest revenues dropped (-7.2%), primarily due to a sharp decline in income from deposits (-22.6%), and the marginal increase in credit interest revenues (+2.5%) could not offset the decline. The reliance of banks on commissions to drive revenue rose in 2020 — total commissions now account for 71% of total revenues, with management fees being the biggest contributor to income (27.4%).

Overall, total costs increased only marginally (+0.7%), primarily due to the growth in indirect costs (+1.4 percent), as internal local rebilling increased (+4.3%).

Nevertheless, direct costs still account for more than two-thirds of total costs, despite the decrease in occupancy costs (-7.5%) probably brought about by the pandemic. In parallel, the latter had the exact opposite effect on IT costs which, unsurprisingly, increased significantly (+8%) to meet the IT infrastructure deployment needs during the various lockdowns.

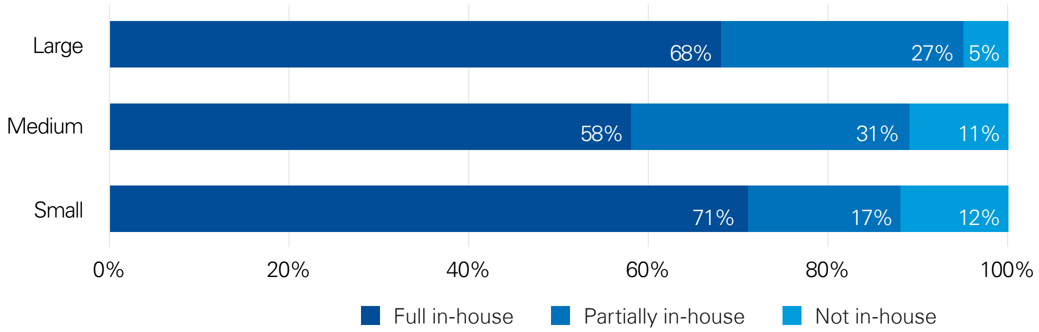
As anticipated, staff costs continue to remain the largest expenses pool, accounting for more than half (54%) of the overall cost baseline.

Average revenues EUR m	2019	2020	Change
Commissions (fees)	**35.38**	**38.83**	**9.8%**
Brokerage & Transaction	7.69	9.71	26.3%
Custody	4.10	4.24	3.4%
Management	14.23	15.01	5.5%
Retrocessions & Trailer	4.07	4.05	(0.5%)
Other revenues	5.29	5.82	10.0%
Net interest revenues	**17.02**	**15.79**	**(7.2%)**
Credits	10.44	10.70	2.5%
Deposits	6.58	5.09	(22.6%)
Total revenues	**52.40**	**54.62**	**4.2%**

Average costs EUR m	2019	2020	Change
Direct costs	**25.12**	**25.21**	**0.4%**
Staff	19.35	19.49	0.7%
IT	2.63	2.84	8.0%
Market data	0.99	0.90	(9.1%)
Occupancy	2.14	1.98	(7.5%)
Indirect costs	**10.75**	**10.90**	**1.4%**
Internal local rebilling	8.80	9.19	4.3%
Intragroup & HQ rebilling	1.95	1.71	(12.3%)
Total costs	**35.87**	**36.11**	**0.7%**

Performance & operating model

Proportion of activities managed in-house per cluster, in %, 2020



All clusters tend to operate their activities in-house rather than relying greatly on third parties.

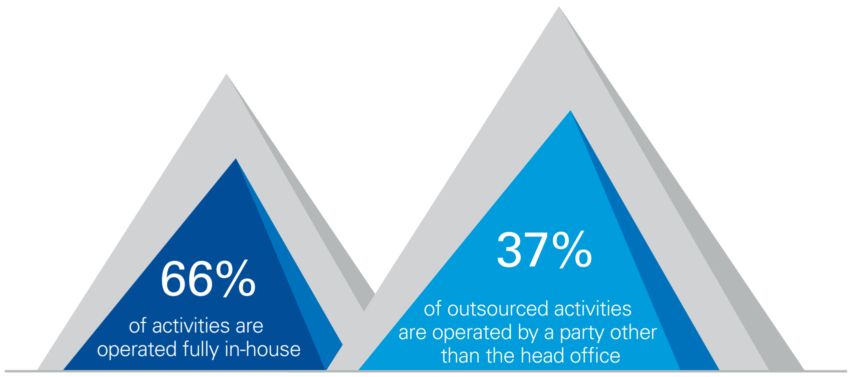
Overall, as mentioned in Part II, approximately 90% of activities are operated at least partially in-house by all three AuM clusters. However, small and medium banks, unsurprisingly, tend to outsource more activities (11%).

The activities most frequently operated in-house are, quite logically, the front-office (76%) and control functions (74%), due to their business importance and regulatory restrictions. On another note, the IT function (34%) is the most likely to be outsourced to the group or to a third party.

When banks decide to outsource, they usually prefer to do so intragroup — close to two-thirds of such activities are usually outsourced to head office. Activities that are more likely to be outsourced to third parties include IT and central services that are not fully operated in-house (here, 45% and 81%, respectively, are outsourced to third parties only).

There are as many operating models as there are banks — and none guarantees a better financial performance

Overall, based on the data analyzed, we could not find any specific correlation between the sourcing model employed and the financial performance of the banks. Indeed, banks that tend to outsource more than others, be it to the head office or to a third party, have a similar cost-income ratio, on average.



The "augmented" private banker in a post-Covid world

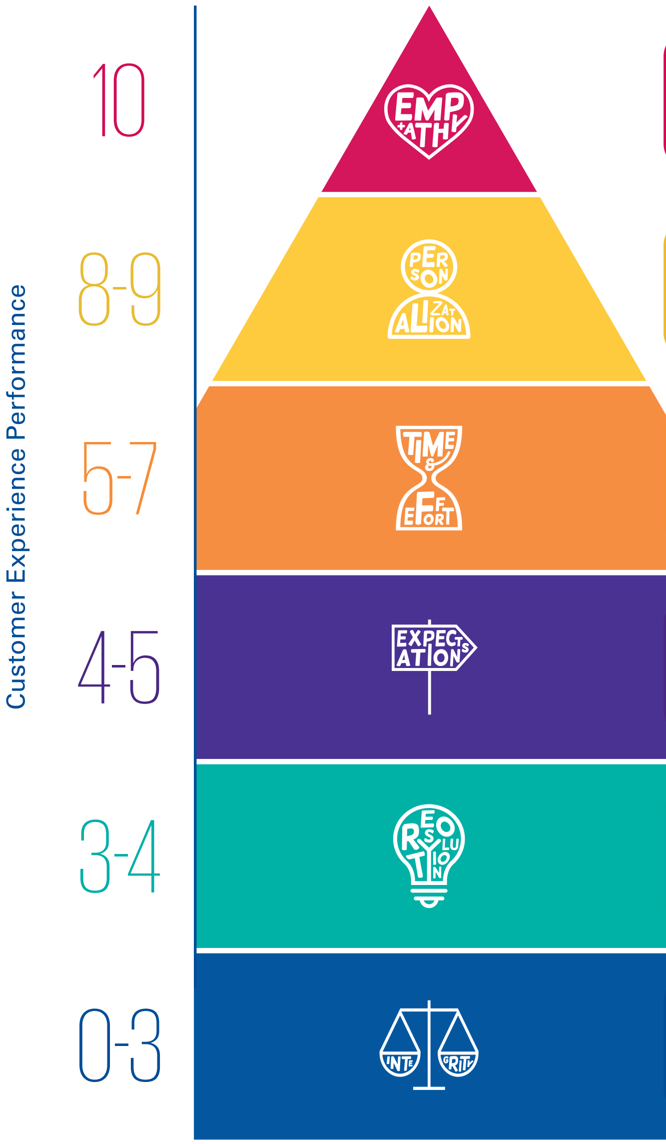
Faced with an unprecedented crisis over the past 18 months, private banks have been compelled to accelerate some of their digital projects that were silently waiting in their drawers. However, as we all know, private banking remains an activity very much centered on people and relationship management. As such, although digital can undoubtedly help, human interactions will remain more important than ever to maintain a customer experience of high quality, thereby ensuring strong client loyalty and advocacy in the long run.

In another joint KPMG-ABBL study released in 2019 on the maturity of digitalization in Luxembourg-based private banks*, it was made clear that, while almost all private banks considered digital as key to the development of the private banking sector in Luxembourg, they also felt that digital cannot — and will not — replace human interaction in a world where the private banker remains pivotal to the bank's relationship with the client. Digital was seen as a push toward "augmenting" private bankers — that is, helping them increase and improve client acquisition and retention through a better customer experience, reducing administrative workload for both the relationship managers and the clients, enhancing customer experience through better client data management or improving the means of communication.

Today, in a Covid / post-Covid world, even if the use of digital tools has accelerated, the importance of human interactions has certainly not changed. On the contrary, in a world filled today with digital, we need more of this human feeling and empathy, both at customer and employee level — as it goes without saying that to maintain a high-quality customer experience, a high-quality employee experience is a sine qua non.

* Beyond the Buzzword - Digitalisation and Luxembourg private banks, 2019.

The KPMG Nunwood Six Pillars of customer experience presented below provide a framework, i.e. a set of simple principles, that help navigate challenges by taking a "customer-first approach". It was really interesting to note that, as demonstrated by our recent research, in the past 18 months one particular pillar — empathy — played an even more important role than in the past. This demonstration of empathy, accompanied by a touch of humanity, significantly helps in establishing strong and long-lasting relationships with employees and customers.



Empathy
Showing that you care, choosing the right emotional response to meet the customer's circumstances.

Personalization
Understanding the customer's circumstances, prioritizing effectively, putting the customer back in control.

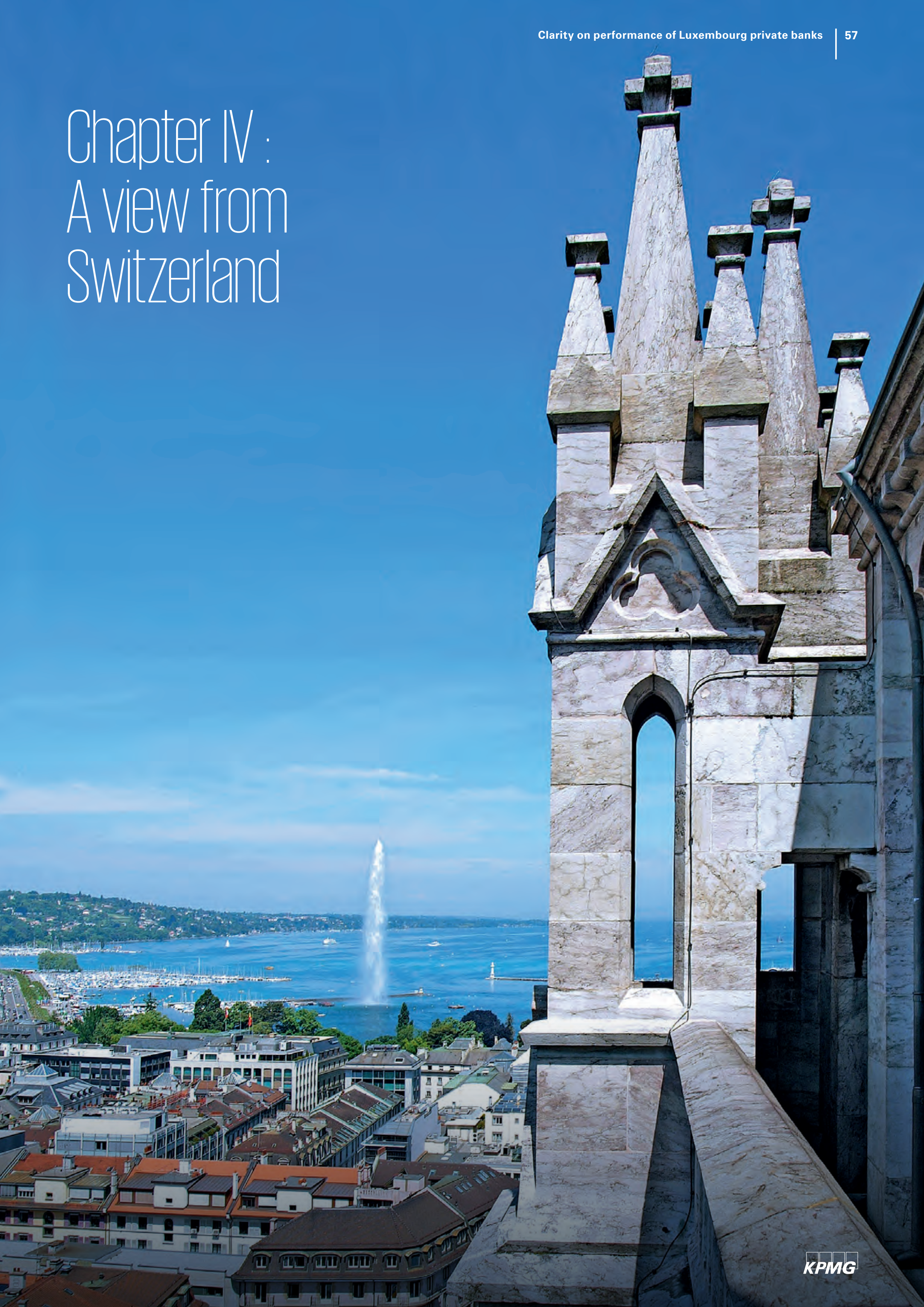
Time & Effort
Making it easy for customers to access information, get essentials, access customer communities and networks helpfully.

Expectations
Setting, managing and meeting customer expectations accurately in these difficult times.

Resolution
Responding rapidly to customer needs and finding solutions to new customer problems, accelerating innovation.

Integrity
Doing the right thing, ensuring the needs of the many are met, prioritizing safety, protecting the vulnerable, being seen to act fairly and in all customers' best interests.

Chapter IV : A view from Switzerland



Number of private banks and M&A

A slow start during the first lockdown in 2020 was followed by a burst of M&A activity with the announcement of eight consolidation deals by mid-2021.

With some of these deals now executed and closed, the number of private banks in Switzerland dipped below the hundred mark, to 96. Closing the remaining transactions will see this fall to 93.

Eight consolidation deals in 12 months

After a slow start during the lockdown in Q2 2020, M&A activity exploded from July onwards. Six consolidation deals were announced between July and December 2020, and two more in 2021. Consolidation deals almost reached 2015's record level, while the total number of deals in 2020 approached the highs of 2017 and 2018.

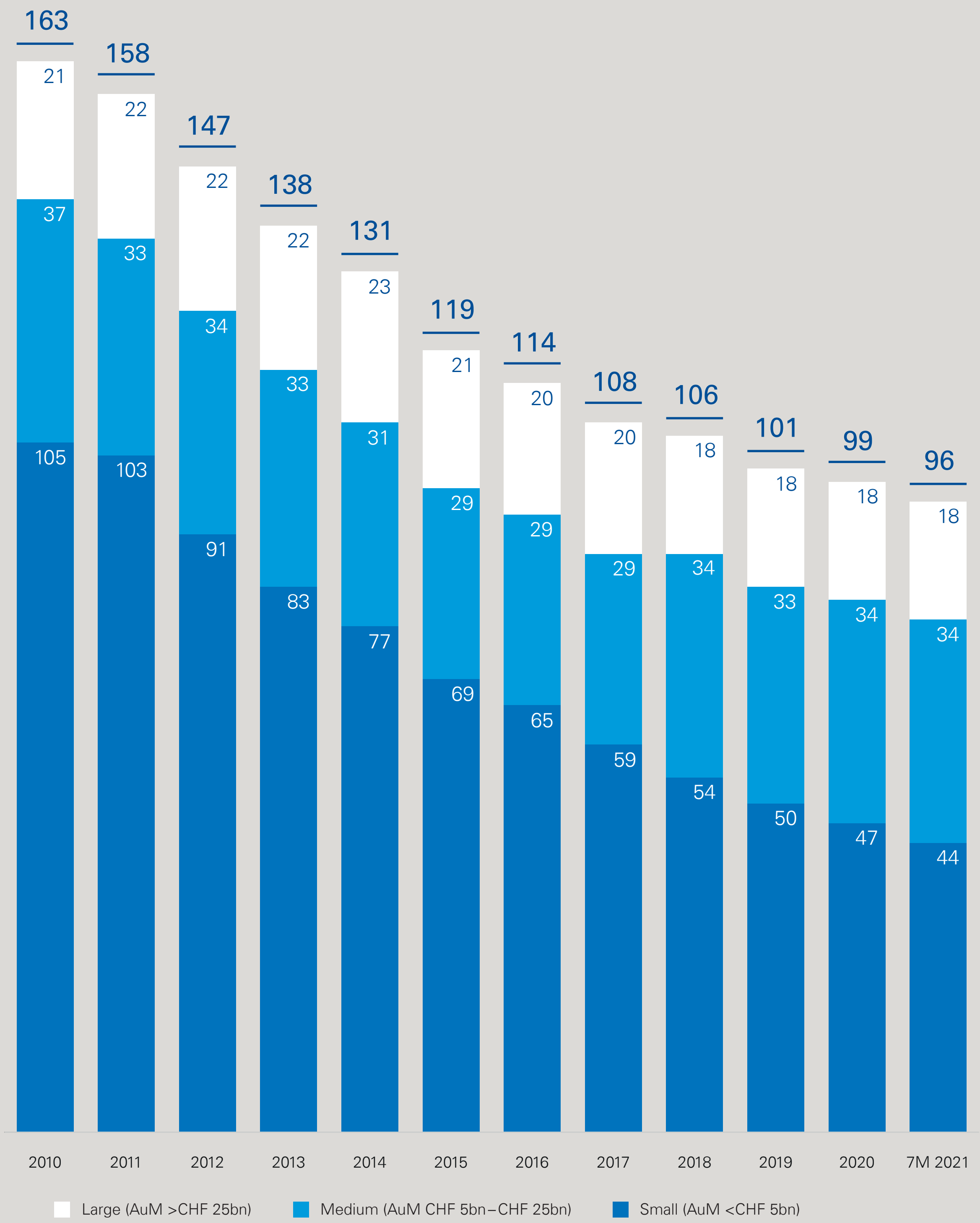
The largest of these consolidation transactions was Fideuram-Intesa Sanpaolo's acquisition of Reyl & Cie, which had CHF 13bn in AuM at the end of 2020. This deal demonstrated how Italy's largest private bank is continuing its inorganic growth strategy in Switzerland after merging with Banque Morval in 2019.

Number of banks falls below 100

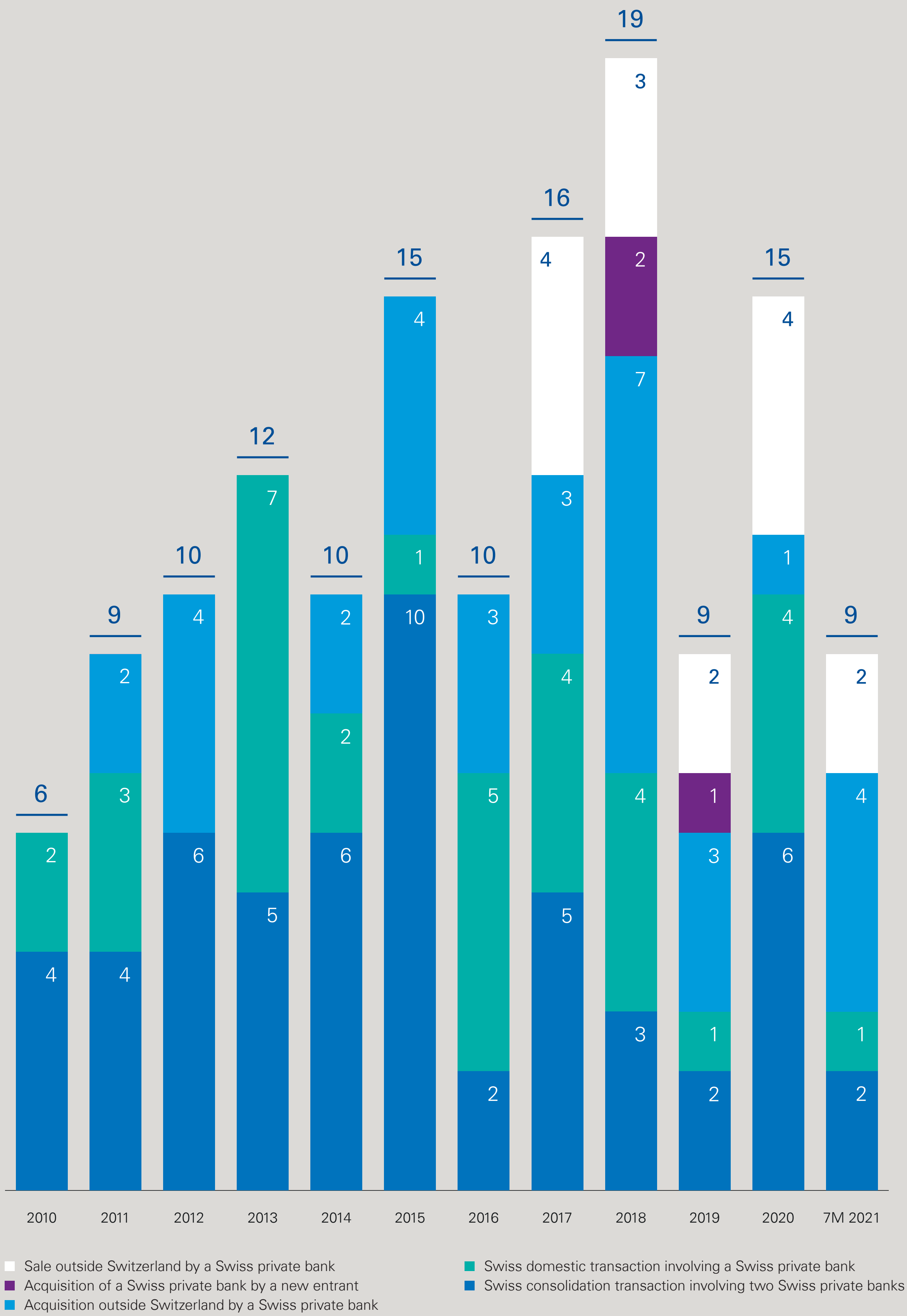
Driven by high M&A activity, the number of banks fell to 96 by 31 July 2021.

This excludes the following three deals that had been announced but not closed by 31 July 2021: Reyl & Cie, Banque Pâris Bertrand, and Millennium Banque Privée – BCP (Suisse). Once they close and the banking licenses are returned, the number of banks will fall to 93.

Number of Swiss private banks by AuM 2010 – 7M 2021



Number of announced M&A deals (buyer, target or seller is a Swiss private bank) 2010 – 7M 2021



Six exits abroad across four countries since February 2020

Banks continued to streamline their international setups by undertaking exits outside Switzerland.

Julius Baer and Financière SYZ exited their wealth management operations in the Bahamas; Financière SYZ sold their Luxembourg-based asset management business; UBS and Credit Suisse each sold parts of their wealth management businesses in Austria to Liechtenstein-based competitors; and EFG sold its remaining minority stake in a Spanish wealth manager.

Five acquisitions abroad over the past 18-24 months

Meanwhile, some Swiss private banks have been looking to expanding abroad. Over the past 18-24 months, they acquired businesses in Asia, South America, Germany and Luxembourg.

AuM development

As positive markets balanced out negative currency effects, performance was flat overall, with NNM of +3.3% in 2020 being the only positive contributor to industry AuM (Assets under Management).

Industry NNM hit a record high at CHF 94.5bn, with 95% generated by large banks (NNM of 3.6%) while small banks reported negative NNM of –2.9%.

AuM growth slowed significantly

AuM grew by 3% in 2020 compared to 14% in 2019, due to a lack of performance growth in 2020 against 10% performance growth the previous year.

Market performance gains offset by currency losses

On an industry-wide view, market performance rebounded well into positive territory after March 2020's drop, only to be offset by negative currency performance from the weakening USD. The result was that the year finished flat overall.

We estimate that the negative USD performance in 2020 was around CHF 100bn or –3.5%.

NNM driven mainly by large players

NNM of CHF 94.5bn, or 3.3%, in 2020 represents the highest NNM growth since 2010 in both relative and absolute terms.

Large players were responsible for 95% of this, or around CHF 90bn. NNM at small banks, which form the majority in our sample, turned negative following a positive 2019.

Overall, 48 banks (58% of our sample) reported positive NNM and 35 banks reported negative NNM.

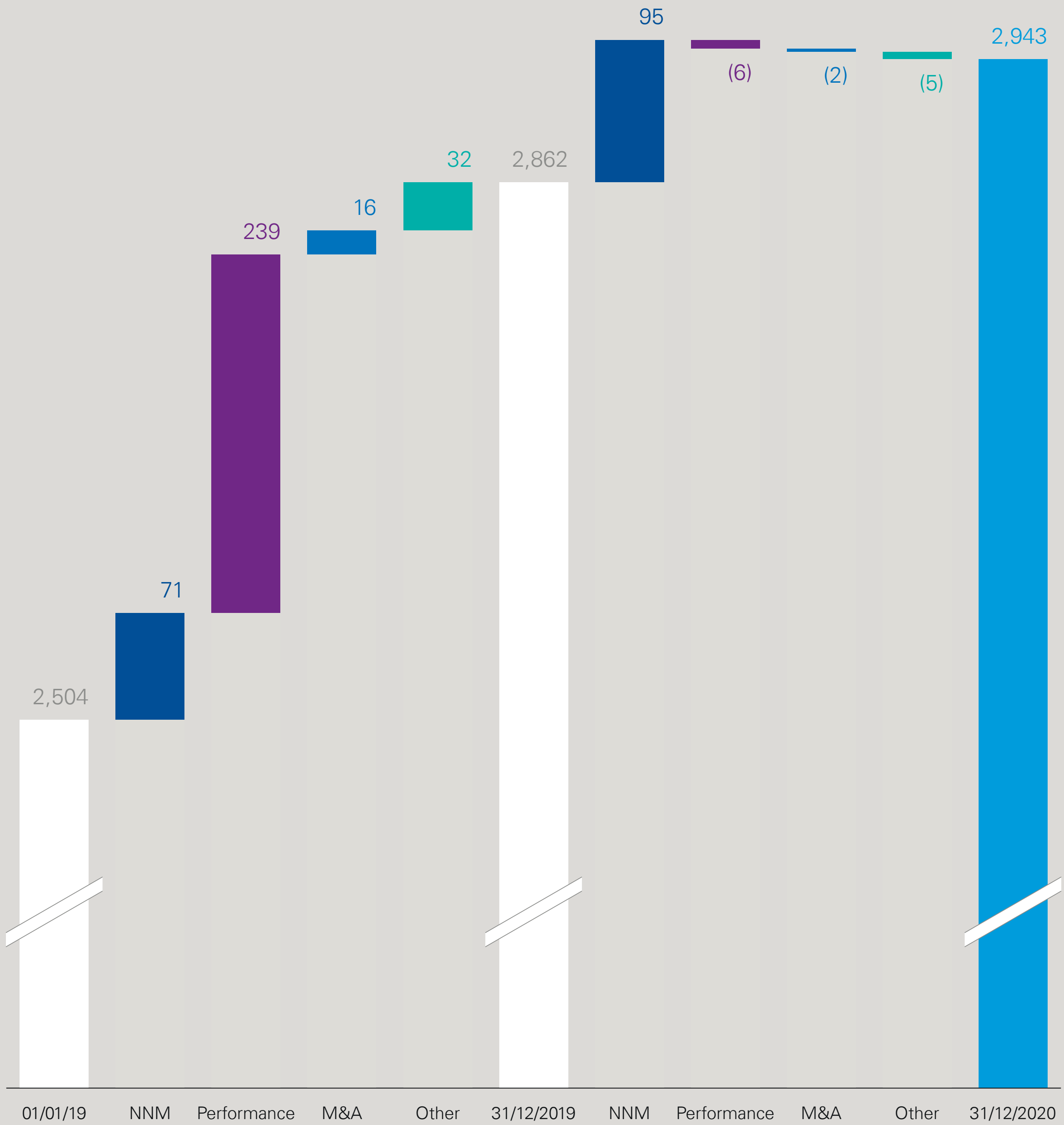
M&A had little impact on 2020 industry AuM

As some of the more sizeable deals announced in 2020 only closed in 2021, M&A did not have any significant impact on 2020's AuM figures.

AuM in CHF bn

31 Dec 2020	2,943
31 Dec 2019	2,862
31 Dec 2018	2,504

AuM development
1 January 2019 – 31 December 2020 in CHF bn



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