cutting through complexity

FINANCIAL SERVICES

Spotlight on Hong Kong's private banking sector

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There is solid growth potential for private bankers who can innovate to overcome service, regulatory and operational challenges.

Perched strategically on the shore of a nation with exponential, long-term potential for wealth creation – and comfortably positioned as a natural and storied commercial hub for the Asia Pacific region – Hong Kong remains a magnet for the private banking industry.

In pursuit of a lucrative share of the sizable and growing population of high-net-worth (HNW) and ultra-high-net-worth (UHNW) investors in Hong Kong's Special Administrative Region and across Mainland China, the crowded private wealth marketplace has seen continuous change.[1] Some long-established global banks have closed or restructured their operations, consolidation is a threat for smaller niche firms, and numerous Mainland Chinese banks are actively launching private banking offices.

The frenzy of activity hints at the difficult operating conditions faced by the local private wealth sector as the banks seek profitable growth. Although many of their issues are global in nature, including worldwide regulatory change, volatile capital markets and continued low interest rates that impact deposit product profitability, other root causes can be traced to Hong Kong's unique local characteristics, including cultural nuances, distinct client tastes and business practices among the private banks.

1. We define HNW as clients with at least assets of US$1 million with an institution and US$3 million in total investable assets, and UHNW as clients with greater than US$10 million in investable assets.

Examining the drivers of private bank growth

To provide perspective into the dynamics of the Hong Kong market, partners from KPMG's Banking group interviewed senior leaders from a number of private banking institutions that span a range of business models, from global banks to local boutiques and regional institutions.

Through in-depth conversations between December 2013 and February 2014, we gathered the candid viewpoints from private banking executives on their organisations' strategic priorities, opinions on key market opportunities, their principle revenue drivers, cost pressures and client and human resources challenges.

"We envision this publication as a thought-provoking review of the current market, to help our clients better understand how they may be positioned strategically among their peers. It's an opportunity to compare shared or distinct challenges they face in this evolving marketplace and support strategic decision-making," observes Paul McSheaffrey, Head of Banking for KPMG in Hong Kong.

Strategic priorities

Private banks may consider:

- Constructing leaner, more efficient organisations and harvest cost and structural efficiencies in the post-acquisition phase
- Applying D&A to measure client profitability improve segmentation and price/discount strategically
- Focusing on deepening relationships with existing clients through increased contact and target organic growth through expanded cross-sell and asset building campaigns
- Building out revenue through expansion into key markets within Asia, including Mainland China and India.

Continued business growth over next two years

When asked about their strategic priorities over the next two years, private bankers interviewed expressed consistent optimism in Hong Kong's market potential, despite acknowledging that there remains flux among industry players and surviving firms must confront challenging competitive conditions.

"Growth is definitely a priority, because most multinational banks still see Asia as a high promise market, particularly when compared to North America or Europe," observes Isabel Zisselsberger, Partner, KPMG in China. "Their challenge, in part, is where will that growth come from? For example, in recent years, the private banks have focused on adding net-new assets to their portfolios. Now, they need to deepen those client relationships."

A number of banks alluded to more focused, selective growth, as opposed to aggressive expansion. Several banks anticipate significant growth in two to three years, but concentrated within Hong Kong serving North East Asian clients, without immediate extension into new markets including opening offices in Mainland China. While they foresee substantial mainland growth, and may operate representative offices in Mainland China, it is a secondary priority.

The mainland Chinese banks also appear focused on controlled local growth to complement their increasing onshore private wealth services to China's burgeoning HNW population. While they are eager to follow their clients to Hong Kong, they appreciate that their aspirations will require a patient, gradual development of staff and product capabilities.

Improving profitability through data and analytics (D&A)

While there may be M&A opportunities in Hong Kong, the banks recognise the need to focus on immediate organic growth and direct their attention to improving internal efficiencies, optimising sales channels and refining their client segmentation.

After several years of aggressive client acquisition, the banks need to determine which clients are profitable, in order to either increase their share of wallet or exit those unprofitable relationships. KPMG sees a need among the banks to invest in D&A capabilities to better segment client portfolios, refine account thresholds, adapt pricing criteria and elevate cross-sell efforts.

"At present, a number of banks have limited analytical capability to capture information and understand their clients better, to supplement the role that has been a primary accountability of personal Relationship Managers (RMs)," notes Isabel Zisselsberger. "Data analytics holds vast potential to bolster the quantity and quality of data to anticipate client needs and service them better."

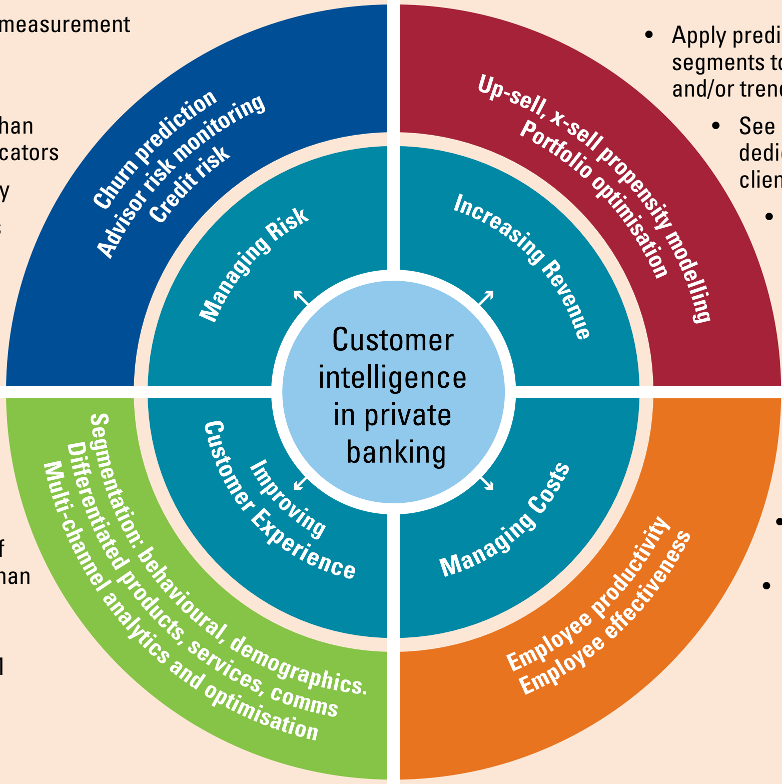
The private banks also highlighted the need to implement group-wide service standards or simplify their organisation, through process improvements, technology centralisation or enhancement, or legal entity restructuring.

Leveraging D&A should be a priority for private bankers.

The incredibly rich data available can be leveraged to uncover fresh client and business insights which will help drive increased profitability.

- Enhance staff performance measurement across balanced scorecard
- Identify underperformance;
- Reveal preventative rather than detective fraud and risk indicators
- Support cross border activity
- Identify client risk scenarios (e.g. data inconsistencies).

- Apply predictive analytics on customer segments to identify investment habits and/or trends
- See new client opportunities via dedicated industry targeting and client segment targeting
- Enable prospect tracking and follow through for events or thought leadership
- Create cross line of business contact and opportunity tracking.



- Identify certain market events or trigger events (e.g. customer events) to shape customer interaction
- Provide an understanding of portfolio movement rather than pure status quo reporting
- Support the interaction and relationship between an RM and client.

- Perform process-level and individual productivity analysis
- Track efficiency and effectiveness metrics
- Conduct cost trend analysis Customer profitability analysis.

Source: Data and Analytics, It's everything we do, 2014

Revenue growth

> "Private banks may alter their sales operating model by putting more product specialists in front of the client to help expand their product offering."

Turning the spotlight on key revenue drivers, private bankers continue to witness strong client appetite for more sophisticated asset classes, particularly in private equity, real estate and holistic tax planning services.

"There is a shared sense among private bankers that their clients are highly sophisticated investors with continuously rising expectations," opines Isabel Zisselsberger. "However, they also realise the need to ensure that their RMs can speak knowledgably to each product, both in terms of features and risks, in light of today's more vigilant regulatory oversight."

"This may prompt private bankers to alter their sales operating model for these product offerings," adds Arend Oldenziel, Partner, KPMG in Hong Kong. "They may introduce more product specialists who can supplement the RM and deliver niche expertise as required in areas such as credit, individual asset classes or tax. By doing so, they can simplify sales and service for their employees, provide better access to technical expertise for clients, and improve their ability to meet changing conduct and compliance rules."

"This approach would also enable a private bank to strengthen its 'institutional relationship' with the client, by creating more contact points and reducing the risk of asset attrition if an RM switches firms," adds Paul McSheaffrey.

Gradual rise of discretionary services

A number of private banks have set targets to increase their percentage of discretionary mandates, but the trend is not particularly strong. This may reflect cultural nuances and the fact that many Asian clients are savvy, hands-on investors who prefer to keep greater control of their portfolio than wealthy clients in other markets.

There is also growing demand among sophisticated Hong Kong clients for self-service delivery channels without advisory support from a RM. This trend may accelerate as the next generation of wealthy Asian families inherits considerable assets in the coming years. With this is mind, many of the private banks have specific campaigns or initiatives to target the next generation.

Stable but inflexible pricing landscape

When queried about price sensitivity or fee negotiation pressure from clients, private bankers report limited pricing concern among the HNW segment. In this highly-competitive market with many local players, and a traditionally transparent, disclosure-oriented regulatory regime, there is a commercial barrier for private bankers to set higher fees, as institutions may risk being priced out of the market. As well, most clients prefer transactional services, in which charges are presented up-front.

"We do see a common practice among banks of discounting fees for new relationships when clients bring over additional assets," notes Paul McSheaffrey. "We also observe that UHNW clients are more likely to be price 'makers' – leveraging their portfolio size to attain better fee pricing – whereas HNW clients are generally fee 'takers'."

These factors again highlight the potential opportunities to enhance pricing sophistication to ensure fee structures are optimised. Profitability could be maximised by implementing better client data systems, analytics capabilities and profitability modeling.

A clear delineation of HNW from UHNW clients can enable the banks to better tailor their offering to each distinct segment, and provide more strategic discounting. While some bigger players have performed careful client segmentation exercises, the mid-tier and smaller private banks could also benefit from this process.

New client acquisition strategies

During our discussions with private bankers, most stated their new client acquisition was focused on external 'net-new' assets, rather than internal referrals from other parts of their institution. Several private banks acknowledged that any referral structures or processes with other divisions of their bank were neither well developed nor effectively utilised.

This environment may be partly attributed to an intended strategic preference by private bankers to build distinct brands or cultures from the group, which do not foster cooperation or connectivity between the separate bank business lines. To remedy this situation, several bankers stated that they plan to improve cross-bank collaboration and create or revamp referral networks between the private wealth division and their commercial, institutional and investment banking counterparts.

Strategies to attract net-new assets seem to follow the traditional model, encompassing a non-aggressive approach. Several banks admitted that their RMs are not encouraged to hunt for new clients, nor do they accept walk-ins. They often indicated a preference for referrals exclusively from current clients or through newly-recruited advisors who bring over their previous clients.

In this era of greater competition for new assets, the private banks may consider more assertive client acquisition strategies, and increased marketing and branding to differentiate themselves from the crowd. However, any changes must be carefully considered to ensure they do not harm a private bank's brand or run contrary to client preferences.

Private banks may consider:

- Adapting the service delivery model with additional internal specialists to satisfy client needs and supplement RM capabilities
- Offering hybrid discretionary/transactional account services to suit Hong Kong's more confident, control-minded investor
- Creating intra-bank group referral processes and shared incentive programs to reduce client ownership issues
- Increasing external client acquisition strategies or increased brand promotion
- Developing strategies to engage and retain second generation wealth, beginning with data collection into their behaviours, attitudes and needs.

Cost pressures

> "By supporting employees in skills training and certification programs, the banks can improve RM loyalty and reduce costly turnover."

While they look favourably upon their revenue-building potential, private bankers acknowledge the need to address high cost income ratios, which generally range from 70 percent upwards. Since high ratios are a worldwide phenomena among private banks, averaging 75-88 percent[2], this is a universal issue not exclusive to Hong Kong institutions.

Elevated staffing costs

Most banks point to human resources expenses as the principal cause of their elevated cost structures. In recent years, a shortage of top talent drove salaries to new heights in this market. While salaries are now stabilising among new hires, the banks remain saddled with the salary commitments they made while they grew their capacity.

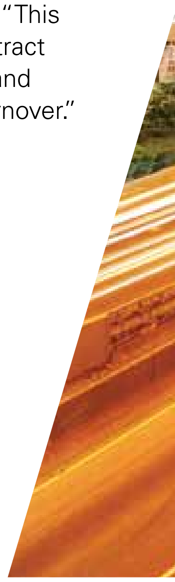
There is also the serious challenge of equipping their client-facing employees with adequate skills and training to deliver the level of advice demanded by both clients and regulators. The private banks will increasingly feel pressure to ensure that staff meet the principles introduced in the Treat Customers Fairly Charter issued by the Hong Kong Monetary Authority (HKMA), in addition to more detailed guidelines for suitability assessments, client disclosures and communications.

Private banks will inevitably need to accelerate their internal training programs to ensure that employees can fulfill their duties.

The industry's recent move to create a wealth management qualification, under the auspices of the Private Wealth Management Association (PWMA), is an important step to bring added professionalism to the private banking sector and its advisors. However, the PWMA initiative creates a baseline in training and qualifications and private banks must ensure that their employees' skills and knowledge are enhanced and maintained through regular, core and specialised training.

"Although bonus payouts have fallen in tandem with declining revenues, we are likely to see the banks move increasingly to more balanced pay models, if it can be done without impacting client service or triggering employee turnover," observes Paul McSheaffrey.

"The banks could also benefit by actively supporting their employees in meeting these new performance standards and by introducing curriculums that provide private bankers with a clearer career path," adds Isabel Zisselsberger. "This may build RM loyalty and help attract the next generation of bankers, and potentially reduce costly staff turnover."



2. Scorpio Partnership, *Global Private Banking Benchmark Report*, 2013.

> "Banks can prioritise quick-win process changes that remove complexity, improve efficiency and support customer pricing strategies, in order to lower costs and boost revenues."

Regulatory demands impact costs

The second most quoted cause of high cost structures among the banks was regulatory expenses. Bank executives repeatedly cited new global and cross-border standards, including anti-tax avoidance measures such as FATCA and the Dodd-Frank consumer protection safeguards.

They also pointed to perceived stricter enforcement of existing regulations by the HKMA and the Securities and Futures Commission (SFC), regarding anti-money laundering and Know Your Customer guidelines, suitability standards and risk management practices. Indeed, the banks stated that they will incur significant costs to upgrade their current compliance measures, including technology, processes and data collection, in response to more intense regulatory enforcement.

Adding to the detrimental impact of new regulations, some banks may be restricted from on-boarding new clients until their prescribed remediation is complete.

Resistance to technology investments

Private bankers anticipate making strategic changes in the coming years to improve their cost structures. Under consideration are investments in technology to enhance delivery platforms, increase client self-service and outsource support functions.

While banks recognise the need to make up-front investments, they admit to the challenge of balancing priorities and are reluctant to make the investments at this time. Some banks have embarked on mini-transformational projects, in which they focus on a specific product or service and aim to streamline end-to-end processes to achieve quick wins and targeted savings.

In response to these issues, KPMG emphasises that banks should prioritise process change initiatives to remove costs and complexity from their operations. Through a combination of efficiency measures and enhancements to client pricing strategies mentioned above, the banks should be better able to achieve the dual objectives of boosting revenue and lowering costs.

Rising client expectations

Private bankers reported that their clients' expectations continue to rise, particularly in terms of technology to improve client access to information, execution and personalised service.

Often, the banks noted that innovative high tech functionality, from online tools to social media engagement, was critical to build loyalty among the next generation of Hong Kong wealth, particularly as inter-generational wealth transfer occurs. Unfortunately, in the last few years most banks have concentrated their technology spending on urgent regulatory compliance matters. As a consequence, developing new online services has taken a back seat.

Although the multinational banks offer an array of online services, private bankers opined that their clients are often unimpressed by the current technology options and they are hesitant to promote these services with clients. This elevated level of sophistication in the market suggests that Hong Kong clients may require more customised technology choices, including increased web access to product documentation, multilingual capabilities, more detailed portfolio analysis and greater online interaction with their RMs.

Technology enhancements could also help private bankers better manage the ongoing challenge of complying with local marketing rules when travelling to meet and serve cross-border clients.

In this area, the global banks have the ability to leverage their economies of scale and multi-country technology platforms to distinguish their technology offerings.

Clients demand speed and service quality

The private banks reported that their clients are particularly sensitive to any perceived downgrade in service, as demonstrated by the recent outcry after several institutions reassigned unprofitable customers to the retail bank, or curtailed their exclusive banking privileges. As there is a desire to increase the thresholds for HNW and UHNW, the re-segmenting approach needs to be managed with sensitivity to ensure the client relationship is maintained.

There is also a high frustration level with new in-depth, time consuming client on-boarding processes since the quantity and detail of information required of clients has increased significantly. RMs also find it is difficult to satisfy heightened anti-money laundering requirements to identify the source of client wealth. The banks describe how new accounts have been lost during the onboarding process since clients objected to the seemingly intrusive legal and compliance requirements.

Upgraded internal training will be critical for the banks, in order to offset client impatience with regulatory processes and to polish their current client service levels. The banks acknowledge the need to do so, and they voiced their broad support for the Enhanced Competency Framework (ECF) by the PWMA. However, our interviews revealed that many banks were adopting a wait-and-see approach towards unfolding HKMA requirements and industry standards before they commit to PWMA membership or any specific training direction.

Private banks may consider:

- Ensuring client service technology is aligned with local market and cultural expectations, customised to support off-shore discussions and builds a brand advantage with a differentiated offering
- Streamlining new client onboarding process to ensure service excellence and efficiency
- Moving forward with upgraded employee training to distinguish service and reduce regulatory risk
- Further automation of compliance and internal controls to ensure adherence to established policies and procedures with respect to sales activities (including enhanced supervisory policies, procedures and activities).

What does the future hold?

Room to improve

In light of the points discussed, private banks may consider:

- Invest in technology to reduce costs, enhance service delivery in both the online and RM channels, and apply data & analytics to mine client insights.
- Clearly articulate your bank's points of differentiation from competitors in terms of service offering, expertise, etc.
- In light of continued M&A market, seek selective acquisitions of complementary operations or portfolios from departing firms.
- Perform rigorous due diligence to evaluate strategic fit of acquisition targets including synergies and culture-fit and develop comprehensive post-deal integration plans to ensure acquisition benefits are realised, cost efficiencies are achieved and to avoid client and talent attrition.

"Our survey highlights the importance of local service customisation and technology investment to lower costs and strengthen client relationships."

Based on this review of the challenges and opportunities in the Hong Kong private banking market, we share the view of our interview participants that there is considerable growth promise in this dynamic environment but the competitive landscape will continue to evolve in the next few years.

We anticipate continued M&A activity among the vast field of domestic and international private banks resulting in a regularly refreshed landscape of departing players and new entrants.

Although many institutions have made significant investments in the market over the past decade, some banks have realised that the infrastructure and staffing requirements and escalating compliance obligations have created an unpalatable cost base unless they can achieve sufficient scale. As a result we anticipate some consolidation among smaller players in the coming years.

With limited client movement between institutions, and difficulty differentiating themselves from other well-entrenched banking brands, the operating imperatives for this market may exceed some players' resources, patience and commitment.

Despite these high profile departures and consolidation activity, Hong Kong will remain highly competitive in light of the growing ranks of banks from Mainland China that are now ramping up their local presence.

"Following an extended era of regulatory change, and probable continued supervisory pressures, it will be important for the banks to embed compliance processes so they can refocus on their core business and target the growth opportunities in this market," observes Isabel Zisselsberger.

Concludes Paul McSheaffrey, "Although we observed a range of viewpoints and priorities, our survey highlights the importance of local service customisation and an increased focus on several global trends, particularly accelerated technology investment to lower costs and expand data and analytics. Good customer analytics create the ability to make existing client relationships stronger and grow a bigger share of their wallet. Knowing your customer better and anticipating their needs first, will create a competitive edge."

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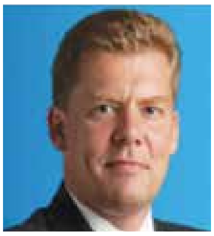

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