TRANSACTION SERVICES

Hungry for more?

Acquisition appetite and strategy in the global private banking and wealth management industry

Global update 2005

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Introduction

There are ever more reports of consolidation in the global private banking market, but what is driving acquisitions? Asia-Pacific is 'the place to be' in terms of capturing a piece of this region's growth, but are potential acquirers reacting?

Following on from our 2004 survey "Hungry for more?", we address how acquisition appetite and strategy in the global private banking and wealth management industry has changed over the last year.

- Is more emphasis being placed on growth by acquisition rather than organic growth?
- Where are potential acquirers looking to buy?
- What are the key factors driving acquisitions?
- Is Asia-Pacific still the most promising region?

In addition to our survey, we have included articles on the opportunities and challenges in the private banking markets of China, India and Switzerland. We have also included an interview on a global wealth manager's view of this changing marketplace.

We assess whether private banks are still "Hungry for more?"

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Approach

This study was conducted in April and May 2005 through telephone interviews with respondents at 87 private banks around the world. All of the private banks included in this survey have either considered an acquisition in the prior three years, or plan to make an acquisition in the next three years.

The interviews were conducted by Consensus International Research Ltd, London. The confidentiality of individual responses was guaranteed as a condition of participation.

Reference is made throughout this study to the size of the respondents' private banking operations. Our classification is based on the number of full-time employees as follows:

- Small: fewer than 200
- Medium: 200 – 499
- Large: 500 or more.

Comparisons throughout this survey are to our previous 'Hungry for More?' survey, published in June 2004.

KPMG International (KPMG) would like to thank all respondents for their participation.

Definitions:

We would like to highlight that the definition of high net worth individuals (HNWIs) may vary throughout the survey reflecting differing definitions in the respective regions and organisations.

The terms "private banking" and "wealth management", and any derivations thereof, are interchangeable for the purpose of this document.

All statements and statistics included in this document relate to the private banking and wealth management sector, unless specifically stated otherwise.

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Key findings

Acquisition appetite

- The total number of transactions in the wealth management and private banking industry is up by 26 percent compared to the prior year.
- A significant increase in planned acquisition activity over the next three years was noted in all regions.
- Domestic deals continue to prevail, although 2004 saw an increase in cross-border transactions.
- The average publicly disclosed deal value was US$100 million (2004 average: US$140 million); only 15 percent were greater than US$250 million.
- Asia-Pacific was the most active region, with 38 percent of total transactions; deal volume in Europe continues to decline on a relative basis.
- Despite 37 percent of respondents indicating that Asia-Pacific was the region with most growth potential, and 14 percent indicating Eastern Europe, only 14 percent and 5 percent of respondents respectively indicated a desire to actually undertake an acquisition in Asia-Pacific or Eastern Europe.
- Respondents based in Japan, Hong Kong and Spain showed the greatest disparity between past acquisition behaviour (either considered or completed acquisitions) and future intention, with all three indicating a much higher appetite for future acquisition.
- Germany showed a greater propensity to acquire than last year; North America and Switzerland showed a continued high acquisition appetite.
- European banks noted legislative and regulatory changes as a motivation for acquisitions at a much higher rate than their North American and Asia-Pacific counterparts.

Growth strategies

- One in seven respondents indicated that they plan to sell or close some private banking or wealth management operations in the next three years.
- Respondents considering organic growth to be more important than growth by acquisition increased from 46 percent to 65 percent of participants.
- Organic growth is considered more important in emerging banking markets, such as Asia-Pacific, than in more mature markets such as North America.
- 51 percent of respondents indicated that the primary motivation to grow organically was the acquisition of new clients, with one-third of these respondents stipulating international clients.
- The number of large banks citing growth by acquisition as being more important than organic growth almost halved in 2005.
- 86 percent of North American banks cited the seller's price expectations being too high as the reason for breaking off a planned acquisition.
- One in six respondents cited anticipated post-acquisition integration problems as a reason for aborting a planned acquisition.

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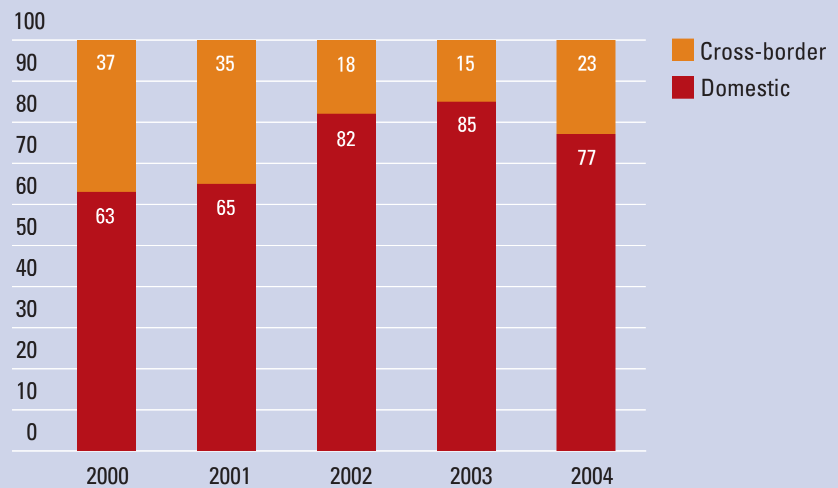
Acquisition appetite

Domestic deals continue to dominate

Although there was a marked increase in the number of cross-border deals in 2004, domestic transactions continue to dominate global private banking M&A activity. This was particularly the case in Europe, where intra-regional acquisitions as a share of all acquisitions fell by one quarter from 36 percent for the three years ended 31 December 2003, to 27 percent in the three years ended 31 December 2004. This may reflect the fact that small-to-medium sized banks do not necessarily have the resources to undertake cross-border acquisitions.



Source: Thomson Financial Data SDC, KPMG analysis 2005

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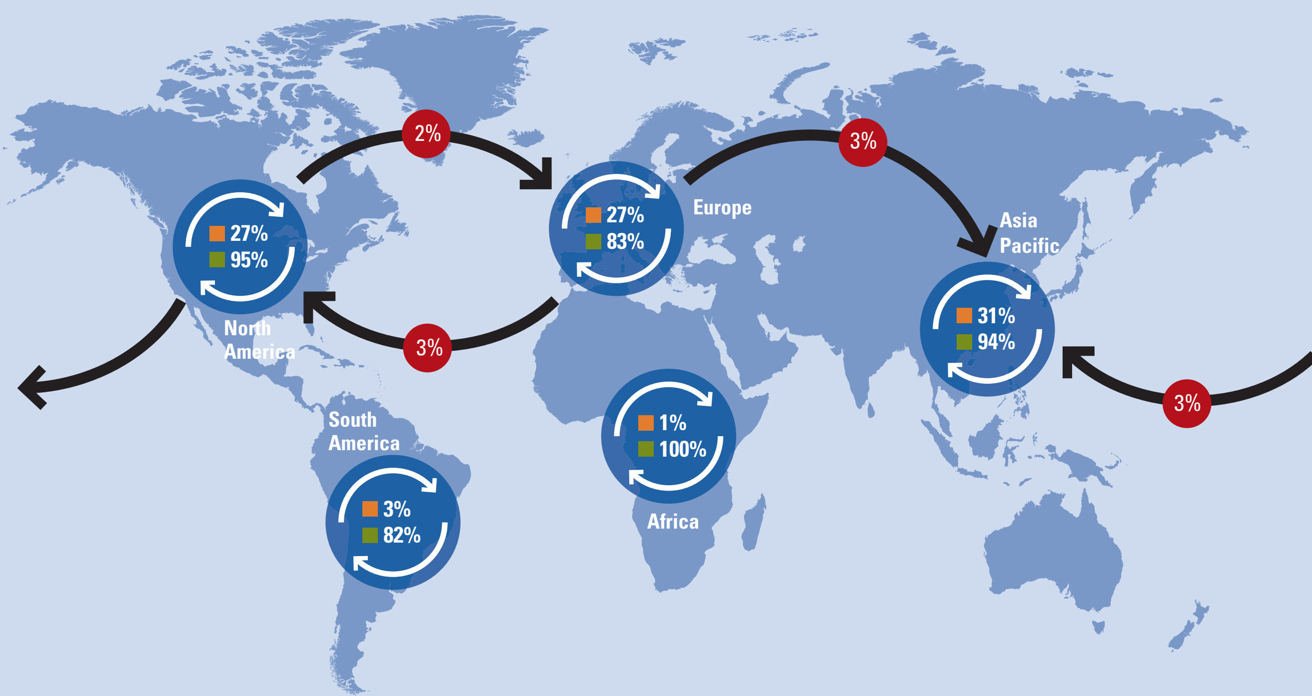
Trans-Pacific acquisition activity in particular increased last year. As shown in the chart below, the number of acquisitions between North America and Asia-Pacific increased to three percent of the global total from one percent in our 2004 survey. The purchase of North American banks by Europeans, however, has decreased from five percent of deals to three percent in this year's survey. This is surprising, given that foreign exchange movements have potentially made American targets more attractive to European acquirers, and may reflect a scarcity of appropriate acquisition targets.

Proportion of private banking transactions per region by volume (2002-2004)



- Inter-regional acquisitions (acquirer and target in different regions*)
- Acquisitions where acquirer and target are in the same region*
- Domestic acquisition

* Regions are defined as North America, South America, Europe, Africa, and Asia-Pacific

Source: Thomson Financial Data SDC; KPMG analysis 2005

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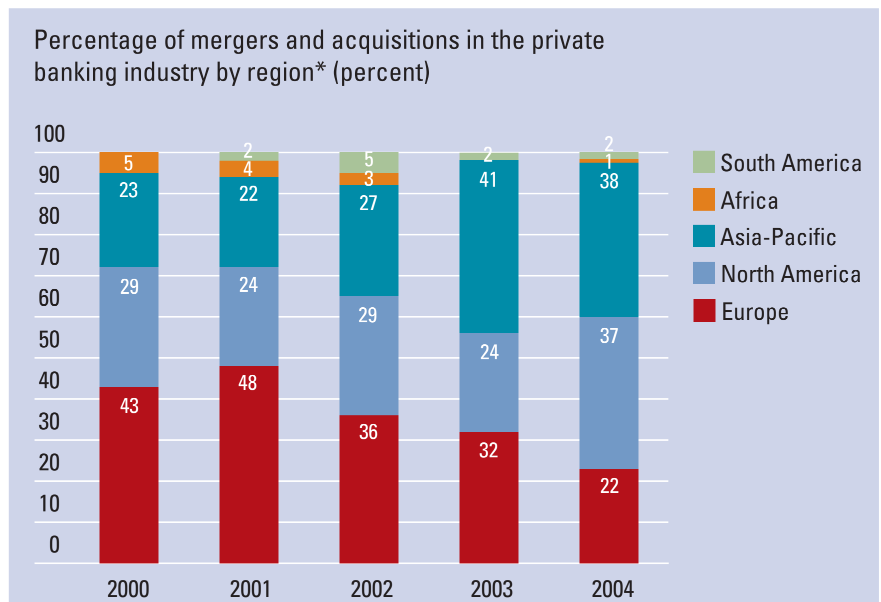
Deal volume up 26 percent – Asia-Pacific the most active

The total number of transactions rose by 26 percent in 2004 compared to 2003. Consistent with our findings last year, the chart below illustrates the continued importance of Asia-Pacific as a market for private banking transactions, accounting for 38 percent of activity in 2004. North America showed a markedly more robust acquisitions market in 2004.



The volume of deals in Europe as a percentage of total transactions fell for the fourth consecutive year. In absolute terms, the number of European transactions decreased by 11 percent in 2004. Our survey results indicate that the number of European banks considering, but not completing, an acquisition during the previous three years decreased to 71 percent from 82 percent last year, reflecting the general downturn in European transaction activity.

The average publicly-disclosed deal value globally in 2004 was approximately US$100 million, with only 15 percent of deals worth more than US$250 million. This is lower than the three-year average of US$140 million in last year's survey, and reflects the small size of most deals in this industry.

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Asia-Pacific most dynamic, but no plans yet

Our results show that Asia-Pacific is perceived as having the most growth potential, with 37 percent of respondents citing it as the most dynamic region and 75 percent naming it as one of the most dynamic. Within the region, China and India were the countries most often mentioned.

More than half of the respondents in the U.K. and Hong Kong identified China as having the most growth potential. A participant from the U.K. commented on China's, "immature product range at present and huge growth potential in terms of personal wealth."

An Italian participant noted that India is "a huge market with huge potential, which will play an increasingly big role. However, competition is tough; everybody wants to access these markets".

"New EU countries are a bit *terra incognita*" – France-based respondent

After Asia-Pacific, the region described as the most dynamic was Eastern Europe, by one in seven respondents. A participant from France noted, "It is where growth potential is higher – emergence of a middle class and middle management that did not exist before", but added: "Of course those who get there first will face more risks but also the best possible gains."

Thus far, however, this perceived dynamism has not translated into substantial plans to make acquisitions in these regions. Only 14 percent of respondents indicated the desire to undertake an acquisition in Asia, and only 5 percent in Eastern Europe.

Many Asian nations, including China and India, maintain restrictions on foreign ownership in the banking sector (please refer to articles later in this document). As these restrictions continue to be relaxed, it is reasonable to expect that acquisition activity will increase accordingly.

Part of the reluctance to enter or expand in these less developed markets is due to perceived integration issues. Of respondents who had considered, but not completed, an acquisition in the last three years, one in six indicated that integration issues caused the deal to be abandoned. This response was the second most common reason noted, after issues surrounding price expectations (mentioned by 29 percent of respondents).

Of respondents who cited integration issues, 45 percent specified cultural differences. Integration issues were mentioned more often by banks in Asia-Pacific, whilst North American banks focused on pricing issues.

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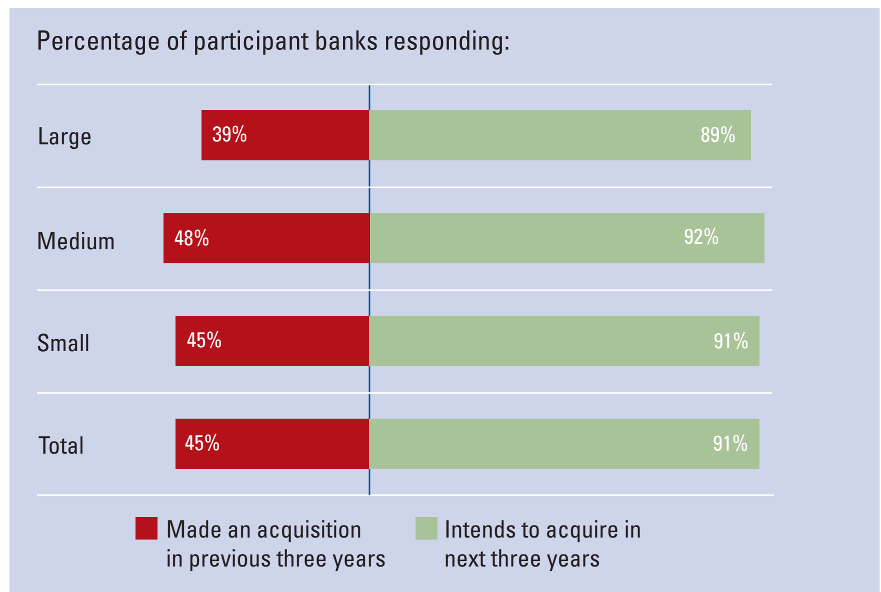
"World's third-largest economy and a need for more presence there."
– U.K. respondent on rationale for acquiring in Germany.

57 percent of respondents indicated they would like to undertake an acquisition in Europe. In keeping with the desire to minimise cultural integration issues, respondents tended to mention their home, neighbouring, or linguistically similar countries. Italy, Switzerland and Germany were the countries mentioned most often as locations of acquisition targeting.

Increase in planned activity

In both Europe and North America, an increase in the number of respondents intending to pursue an acquisition in the next three years was observed. In 2005, 90 percent of European and 87 percent of North American participants indicated that their business strategy assumed an acquisition in the next three years. In addition, although only eight percent of respondents from the Asia-Pacific region had made an acquisition in the previous three years, 100 percent indicated that their business plan anticipated one within the next three years. This disparity could reflect the difficulty of finding appropriate acquisition targets, restrictions regarding foreign ownership and easier organic growth opportunities in Asia.



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Respondents from certain countries showed a particular increase in acquisition appetite. More than 50 percent of respondents in Japan, Hong Kong, and Spain indicated that although they had neither completed nor considered a specific acquisition in the previous three years, they intend to acquire in the next three years. German organisations, which showed a low propensity to acquire in last year's survey, indicated a much greater amount of acquisition planning this year. North American and Swiss organisations continued to display a large appetite for acquisitions.

It was also noted that banks with plans to acquire in the next year were far less likely to be contemplating the closure or sale of a portion of their existing business. 93 percent of respondents who indicated that they did not plan any disposals intended to make an acquisition in the next three years, whereas only 75 percent of those planning to sell or close some operations also intended to acquire.

Increased European regulation driving acquisitions

Our results indicate that regulatory changes, including legislative and tax-related, were much more frequently cited by European banks as a significant factor driving acquisitions than for banks in North America or Asia-Pacific. 27 percent of European respondents named this as their primary motivation, versus 13 percent in Asia-Pacific and 8 percent in North America.

Asia-Pacific banks tended to indicate cost efficiencies and economies of scale as the primary factor driving their acquisitions, while North American banks indicated geographic expansion into new and existing markets.

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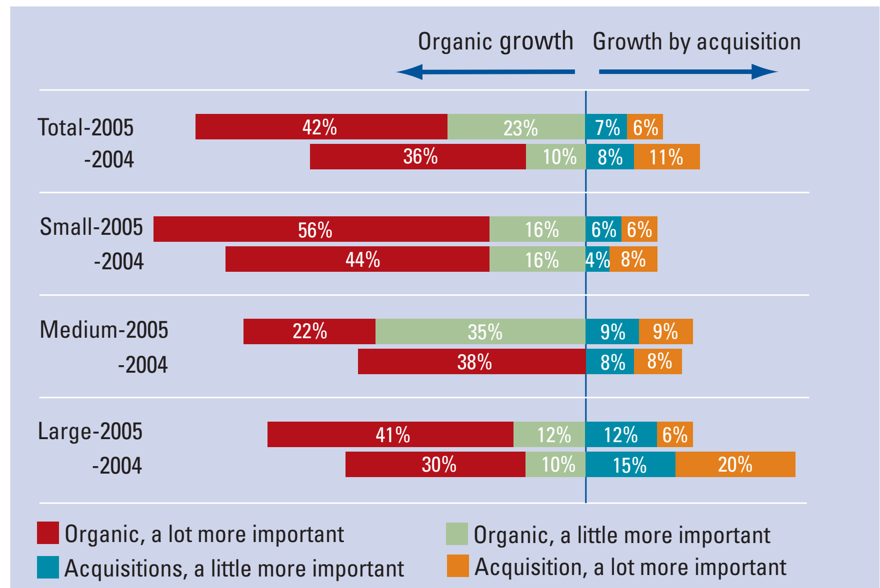
Growth strategies

"We are convinced that there is going to be a consolidation."
– Swiss respondent.

Increased focus on organic growth
Although market data shows a marked increase in transaction volume, and our survey results indicate an increased appetite for future transactions, the overwhelming majority of respondents indicate that organic growth is still more important to the strategy of their bank than acquisitive growth.

Our survey showed an increased focus on organic growth, with around two-thirds of respondents claiming organic growth to be more important than growth by acquisition. This was particularly noticeable in responses from large banks, where the percentage indicating that acquisition was more strategically important than organic growth almost halved from 35 percent in 2004 to 18 percent in 2005.

Mid-sized banks, however, did indicate a slightly increased interest in acquisitions, with the percentage of participants indicating that organic growth was much more important than acquisitions decreasing from 38 percent to 22 percent, and those indicating that acquisitions were more important increasing by 2 percent over 2004. This appears to be in line with market activity, which indicates the industry splitting into larger banks offering a broader range of services and smaller niche players who can offer a more personal relationship.



On a regional basis, North America showed the greatest affinity for growth by acquisition, with 27 percent indicating that it was much more important than organic growth. Europe and Asia-Pacific emphasised organic growth to a much higher degree. This is particularly true for Asia-Pacific, where 54 percent of respondents indicated that organic growth was much more important.

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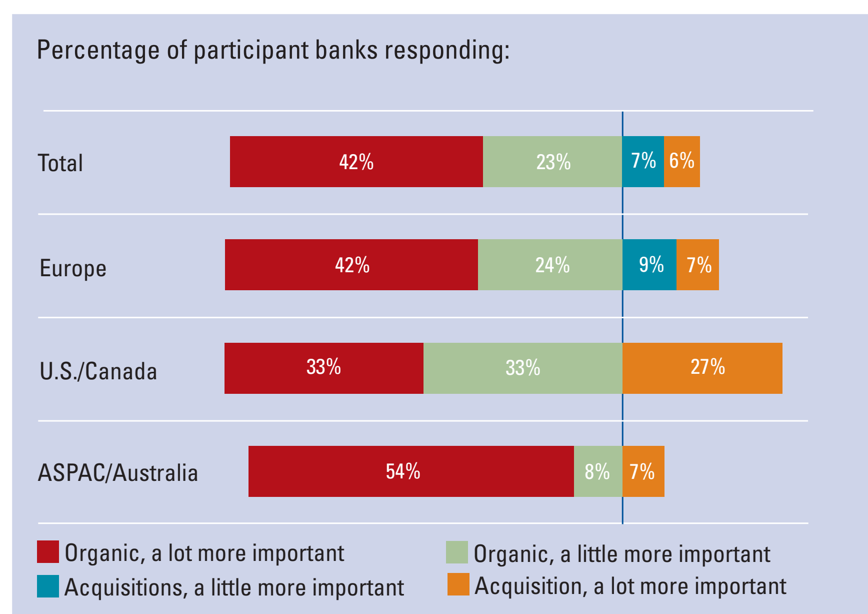
The focus on organic growth appears to correlate with the pricing multiples of potential deals and the maturity of the respective financial services markets. Only 33 percent of respondents from Asia-Pacific noted that the primary reason for a planned acquisition breaking down was that the seller's price expectation was too high. This contrasts with 86 percent of North American respondents who indicated that this was the case. This difference highlights that the Asia-Pacific market is less mature with greater scope for organic growth, thus implying lower pricing multiples. The prevalence of pricing issues for North American buyers indicates that the market is more saturated with less room for organic growth, which requires buyers to pay to acquire a competitor.



Components of organic growth

One-third of respondents stated that one of the two main components of their organic growth strategy is the acquisition of new domestic clients. A further 17 percent noted acquisition of new clients internationally (resulting in a little more than one half of respondents focusing on new client acquisition overall as being one of the two main components of their strategy). One German respondent noted its client acquisition strategy as being the "very selective and controlled expansion into new markets".

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Scaling back?

Our survey indicates that one in seven respondents intend to close down or sell some private banking or wealth management operations in the next three years. The countries most commonly indicated for planned sales or closures were France, Germany and Spain.

Although there was no predominant reason cited for discontinuing operations in a given country, the following were most commonly mentioned for scaling back:

- Lack of growth prospects
- Changes in legislation
- Client base does not fit strategic direction
- Centralisation of offshore operations
- Local players being more competitive.

Disposals may provide the sellers with an opportunity to redeploy resources in order to focus on their core strategy, and creates further opportunities for consolidation in existing markets.

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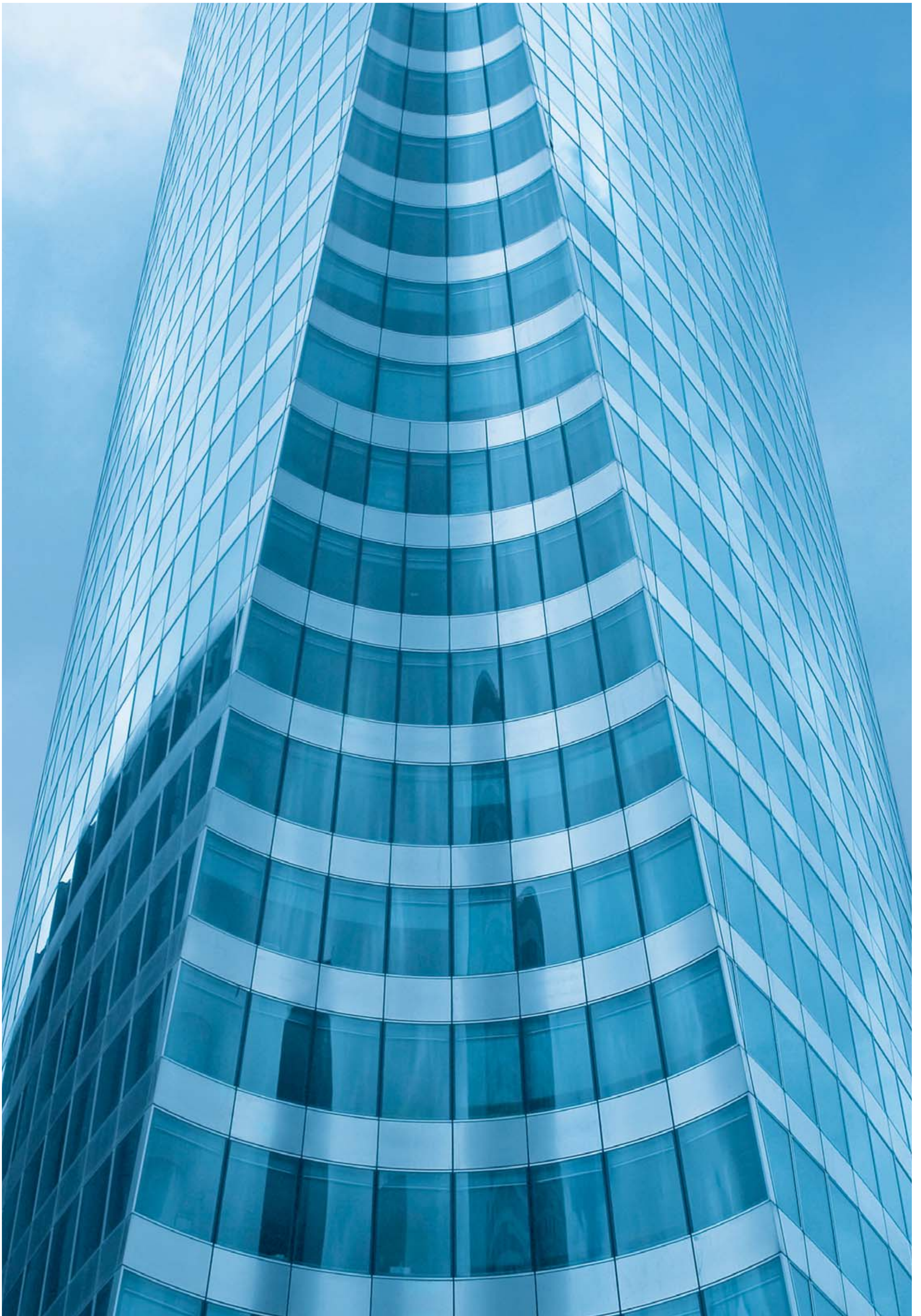

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China: breaking into the last frontier of banking

Increase in wealthy individuals

China's real GDP has continued to grow at a rapid pace over recent years. In 1998, just a year after the Asian economic crisis, the economy grew by 7.8 percent. In the first quarter of 2005, GDP grew by 9.5 percent year on year, the seventh consecutive quarter in which growth exceeded 9 percent[1]. Since mid-2003, the Chinese government has implemented tightening measures to curb the overheating economy.

This growth should be kept in perspective, however, China's per capita GDP of US$1,230[2] remains well below that in many other Asian countries. Hong Kong, for example, has per capita GDP of US$30,310[3].

Although the per capita GDP is low, income disparity in China is wide and there are a substantial number of wealthy individuals in mainland China. Total liquid assets held by wealthy individuals stood at US$1,228 billion at the end of 2003, an increase of 97.8 percent over 1998 representing a compound annual growth rate of 14.6 percent[4].

Between 1998 and 2003, the number of Chinese high net worth individuals increased rapidly at an annual average rate of 14.1 percent. The total number of wealthy individuals reached 4.3 million in 2003, compared with 2.2 million in 1998[4]. This represents a mere fraction of the total population.

Current investment channels

The size and rapid development of the Chinese market, make it a very interesting prospect for wealth managers. Some commentators, however, contend that there is still some way to go before there is a need for dedicated wealth management services.

Traditional products that are popular with the Chinese investor base are deposits and debt such as Chinese treasury bonds, followed by equity investments and lastly mutual funds. Non-liquid assets such as property and investments in unlisted companies are also popular. Going forward, offshore investment and investment in mutual funds are expected to be increasingly in demand, though regulatory restrictions apply.

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Debt

The domestic debt market attracts both foreign and domestic investors in plentiful supply. Over the last six years, investment in debt has increased strongly at 10.4 percent compounded annually. China is currently attempting to grow the domestic debt market in order to finance its development of domestic infrastructure, including building power plants and roads[4].

Equity investments

Direct equity investment in China has remained robust and as the country continues to develop, listed companies are likely to continue to enjoy revenue growth and thus fuel the market. Continued regulation of the markets and corporate governance reforms being implemented by listed companies is intended to improve investor confidence and sentiment over time, though additional reform is still required to bring this to international standards. In addition, as greater numbers of companies privatise, there will be more opportunities to invest in the equity market.

Mutual funds

One investment class gaining prominence is the Chinese mutual fund. China's investment fund industry emerged in March 1998 with the launch of two closed-end funds. At the end of 2004, there were 46 licensed fund management companies, of which 13 were Sino-foreign joint ventures. Together, these fund management companies manage 159 funds amounting to US$42 billion[6]. With the recent introduction of exchange-traded funds, Chinese investors can gain access to, and trade in, mutual funds more easily. This should provide an alternative route for investors to trade mutual funds at lower transaction costs than the traditional mode of subscription and redemption[4].

Non-liquid assets

Wealthy individuals in China hold a significant proportion of their wealth in non-liquid assets, including property and construction, non-floated equity stakes in companies (non-tradable shares of listed companies which are usually held by founders), investments in unlisted companies, loans to local authorities and other projects[4].

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Offshore investment channels

The tendency of Chinese investors to place their assets offshore or hold domestic assets through offshore companies is relatively high, partly because China is so close to two of the world's major offshore centres, Singapore and Hong Kong. Wealthy Chinese individuals have a propensity to place their assets offshore for the usual reasons, such as tax planning, financial and political security[4].

Personal taxation could be one reason for moving money offshore. China's tax system applies different tax rates and pre-tax deduction rates on 11 different types of personal income, including wages, salaries, return on investment, business profits and proceeds from property disposal[4]. Although China's stability has improved over the last two decades, wealthy individuals still wish to diversify their investment channels and tend to funnel more offshore for broader investment and currency diversification and higher returns.

The flow of funds to offshore centres such as Singapore, Hong Kong and the Bahamas indicates an opportunity for wealth managers to attract these assets and provide the services required by these investors. Many providers in the offshore jurisdictions are looking to gain distributional footprints in onshore markets around Asia for this very reason, and there may be a round of joint venture deals/partnerships struck with onshore retail banks[4].

Market dynamics

The Chinese banking market is gradually opening up to foreign investment. By the end of October 2004, 62 foreign banks from 19 countries and territories had set up 204 operating institutions in China, 105 of which can conduct local currency (Renminbi) business. Since last year, the China Banking Regulatory Commission has also authorised 24 foreign banks to trade financial derivatives. The total assets of foreign banks in China amounts to US$65.9 billion, accounting for approximately 1.8 percent of the total assets of Chinese financial institutions and 17.8 percent of foreign currency loans[5].

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Foreign banks have so far been allowed to provide services across several channels, including wealth management. As mentioned above, foreign institutions have set up fund management joint ventures with local parties to tap the domestic liquid funds. In this way, a number of the major financial institutions have made their way into the Chinese market. Local banks were not permitted to set up fund management companies, but recently a pilot scheme was launched allowing three of the state-owned banks to conduct fund management activities on a trial basis. There has been further relaxation of the regulatory regime to increase the competitiveness of the domestic banks as well as to tap the potential wealth management market.

Tapping the wealth management market

Foreign interest in the Chinese market remains high and there is no doubt that there are significant opportunities for wealth managers. However, the wealth market is still in a nascent state and there are very few wealth management offerings currently present. Foreign players have focused on retail and investment banking strategies and have established a presence in the market first before offering specialised wealth management services. Wealth management players looking to establish a presence tend to focus on the coastal areas around major cities. These areas are typically where the majority of foreign investment is concentrated and therefore is home to the majority of affluent individuals[1].

First step is to establish a presence

Foreign banks rely on both organic growth and joint venture/strategic investment stakes. In terms of organic growth, the remaining geographical restrictions which limit foreign banks from establishing operations in China, and also other restrictions on banking activities, will be lifted by the end of 2006, according to China's commitment on accession to the World Trade Organisation (WTO).

Foreign banks are hoping to gain a share in China as quickly as possible, with acquisition being considered a quick route. A small number of foreign investors have started to participate in the management of local banks in which they hold a stake.

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New opportunities for forming partnerships in retail banking operations are still available. State-owned banks, private commercial banks as well as city commercial banks are actively seeking foreign investors. Finding the right local partner and building trust and a long-term relationship with them as well as the regulators are critical factors to a successful investment.

The role of Hong Kong

Foreign banks are increasingly aware of the potential of Hong Kong as a springboard to the Chinese mainland. As a result, many are now seeking to incorporate their business in Hong Kong to take advantage of benefits from the Closer Economic Partnership Arrangement (CEPA) between Hong Kong and mainland China. CEPA makes it easier for banks incorporated in Hong Kong to apply for licenses to extend their business scope. This may not be the quick route into China that people hope, however, as the law requires a bank to have been operating in Hong Kong for some time before it can take advantage of CEPA.

1. China: More balanced, at least, Economist Intelligence Unit (EIU), Business Asia, 2 May 2005
2. Business Asia, EIU, 2 May 2005
3. Hong Kong: Economy: 5-year forecast, EIU Viewswire, 28 Apr 2005
4. Wealth Management in China 2004, Datamonitor, September 2004
5. Foreign banks set up 204 operating institutions in China, SinoCast China Business Daily News, 3 December 2004
6. 2004 annual reports of various funds, http://www.huaan.com.cn/fundinfo/fundBase/fundList.jsp?topcol=5

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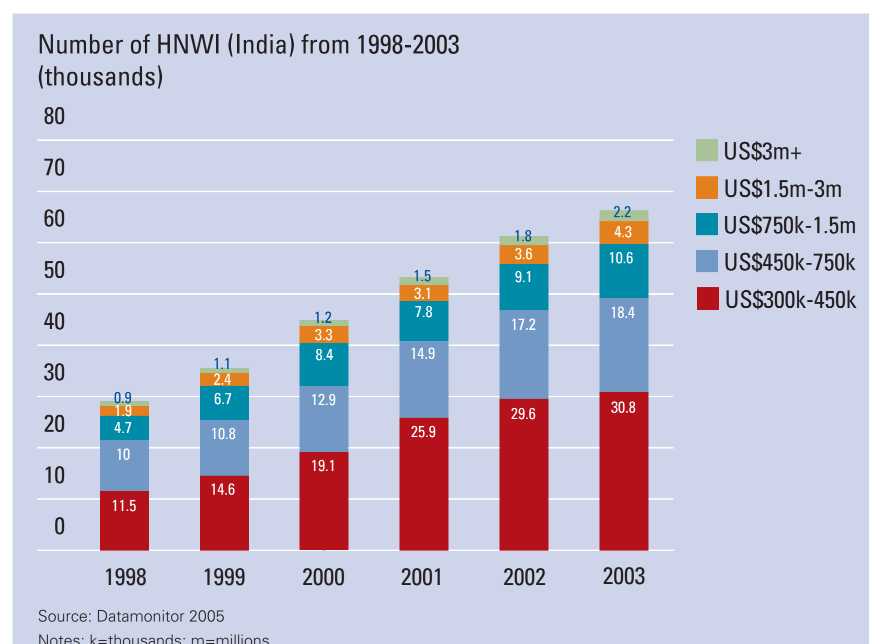
Indian wealth management industry poised for growth

Fuelled by strong economic growth, India's increasingly wealthy population is demanding more sophisticated products and services. Wealth managers with local knowledge, the right product mix and a clear distribution strategy are poised to reap substantial gains.

Wealth management grows in line with economy

India has come a long way – from a protected environment with a slow rate of growth to one of the world's fastest growing economies. India's GDP – presently at US$600 billion – is expected to grow at a rate of around 8 percent per annum, with strong foreign exchange reserves and increasing foreign direct investment[1]. At a deeper level, the fundamental factors which have enabled this growth – institutional reforms, financial liberalisation, opening markets to competition, increasing contribution of services and changing demographics – all indicate that the growth trend can be expected to remain stable.

Changing Indian demographics have clearly had a direct impact on the Indian wealth management industry. Demographic trends have led to an upward shift of income classes. As people have become better off, more income has moved into savings and investments. This movement, along with the liberalisation of the financial services industry, creates a fertile ground for wealth managers.



Source: Datamonitor 2005
Notes: k=thousands; m=millions

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Diverse market attracts new savers and new entrants

An important aspect of the Indian market is that it caters to a highly diverse range of consumers, from the upper-middle class mass affluent segment to the high and ultra-high net worth individuals, and all of these markets are growing. For instance, the number of individuals in the mass affluent segment grew at the rate of 17.5 percent annually from 1998 to 2003. Climb the income pyramid and growth rates are even faster. The number of high net worth individuals (HNWI)[2] grew at a rate of 18.1 percent, while the ultra high net worth segment[3] grew at 20.6 percent over the same period[3]. Banks are increasingly successful in targeting these markets.

This growth has led to a greater volume of wealth accumulation, with savings now accounting for nearly 15.1 percent of Indian GDP. Of the total annual financial inflows into savings of approximately US$70 billion, life insurance and pensions comprise 28 percent, while bank and other institutional deposits account for the majority, at 43 percent[4].

There has been a quantum leap in the inflow of funds to the mutual fund sector, with assets under management growing by 23 percent from 1999 to 2003. However, there is still great scope for future growth: assets under management as a share of GDP in India remain at just 4 percent, compared with up to 20 percent in some other emerging economies[5]. This potential has attracted a number of new asset management companies in the last few years.

Another important segment for the wealth management industry is non-resident Indians (NRIs), typically affluent people living abroad who remit significant sums to India. According to a report prepared by India's Department of Economic Analysis and Policy, NRI remittances – approximately US$15 billion in 2002-03 – were almost 3 percent of the country's GDP. A number of banks are becoming increasingly successfully at connecting both ends of this chain.

Furthermore, the imminent opening of the pensions market will bring new savings products, as well as a potentially large pool of funds to manage. Draft guidelines setting out the number of licences and the operational framework are awaited.

Competing for customers – the right business model

The size and growth potential of the Indian market is strategically important. The broad range of customers and needs presents players with a wide playing field. And in order to service these different segments, different business models will emerge.

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Among the various players vying for market share are large Indian domestic brokerage houses, professional portfolio managers, banks and even mutual fund houses. The market has traditionally been dominated by the large brokers, who can offer the sort of discretionary portfolio management services not permitted for banks. A key factor determining success in the Indian market is the ability to tap appropriate distribution channels. While the large brokerage houses rely on their direct relationships, banks – despite not being permitted to offer discretionary portfolio management – have a significant share of the market, due to ready access to their own customer base. Most banks have entered into strategic alliances to distribute insurance products, a strategy which is viewed as being increasingly successful. In addition, the creation of separate desks to service non-resident Indians is an indicator of how banks are moving quickly to segment and target customers.

Banks have additionally developed customer-oriented service offerings that cater to the mass retail and HNWI segments, including preferred and priority banking which deliver wealth management services of varied depth, but consistent quality, to customers across wealth levels. The business model adopted to provide these services is a key factor determining success in this market. Given the relatively small nature of deal/ticket sizes in the Indian market, it is critical that for players to deliver services through appropriate platforms, using the appropriate distribution channels and leveraging technology.

Recent studies suggest that different segments of the market are adopting the behaviours and demands of the group directly above it. For instance the lower wealth bands, which would typically include the mass affluent segment, are showing more interest in financial planning as is the case with HNWI.

HNWIs are diversifying into alternative investments that are now becoming their mainstream products. This used to be the domain for ultra HNWIs given the high minimum investments required. In pursuit of differentiating and expanding the services the private bankers are focusing on more “family office” service offerings such as accounting and reporting, fiduciary services, cash flow management, investment planning, legal advice, tax, trust and estate planning, some of which could be delivered through alliances. Ultra HNWIs are placing increasing importance on planning for future generations and charitable donations, resulting in many ultra HNWIs creating long-term plans in which family members are effectively embodied in legal vehicles and emphasis is placed on corporate inspired guidelines. This calls for more tailored services customised to every ultra HNWI customer’s needs and thus entails higher costs.

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What about future growth?

The future looks bright. At the upper end, the market for very high net worth individuals is expected to almost double in the next four years. The shift from bank deposits to alternative investment avenues will also drive growth in the middle and upper-middle income segments.

Most importantly, demographic change and further innovation by players will lead to a growth in the overall demand for wealth management expertise – firstly, from an upward movement of income classes and the consequent increase in wealth under management; and secondly, due to a movement towards more active financial wealth management as more options and avenues abound.

The industry's response to these changes in markets, product demand and service levels will determine who leads wealth management in the years to come.

This leads to the question of what can the Indian market gain from the overseas wealth management industry, and what role can foreign banks play in India.

Foreign investment in the Indian wealth management space

Foreign banks specialising in serving HNWIs can add value to the Indian market by bringing their products and service expertise, with appropriate tuning to the tastes and cultural aspects of Indian HNWIs. They may also provide a higher level of sophistication and impetus to the growing service needs of this sector. Some foreign banks operating in India have already made their presence felt by increasing competition in areas servicing HNWIs.

Despite current regulatory restrictions for new and existing foreign banks the Indian private sector banking space is clearly gearing up for foreign competition. The Reserve Bank of India (Indian central bank) announced in early 2005 the "road map for presence of foreign banks in India and guidelines on ownership and governance in private sector banks". Under the current guidelines, foreign banks are allowed to set up wholly-owned subsidiaries and are permitted to take over distressed private sector banks, as identified by the Reserve Bank of India. The protection afforded to healthy private sector banks from being acquired by a foreign bank will last only until 2009. The aggregate foreign ownership in Indian private banks is currently limited to 74 percent.

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Mergers and acquisitions (M&A) are not new to the Indian banking sector. At least 24[7] M&A transactions have been reported since the de-nationalisation of banks in India. However, most of this activity was a result of either bailing out troubled banks or of consolidation of the nationalised banks. Increased M&A activity led by foreign banks can clearly be expected post-2009.

The future trends in the wealth management sector in India may be summarised as follows:

- Appetite and demand of HNWIs is growing, driven by higher wealth creation. There is a clear opportunity to serve these individuals.
- There is a need for sophisticated and focused products to service niche segments.
- Regulatory environment changes will enable higher competition, leading to higher service levels.
- The Indian private sector must be ready to confront higher levels of foreign competition.

Given the significant market potential, the wealth management industry is gearing itself up to:

- Increase the range of services to customers, while containing service costs
- Enhance service delivery standards
- Build up a sound technology infrastructure platform
- Invest in the training of the advisers and relationship managers to facilitate greater proactivity.

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1. Source: Economist Intelligence Unit: Executive Briefing – India
2. "HNWI" defined as US$300,000+ in liquid assets
3. Assets of US$3 million
4. Source: Datamonitor 2005
5. RBI Annual Report 2004
6. Source: ICI.AMFI.2004
7. Source: RBI publication 29 November 2004: Trends and Progress of Banking in India

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Changes afoot for mid-tier Swiss private banks

Switzerland is traditionally regarded as the nerve centre of worldwide private banking. The past few years have continued to be prosperous for the private banking divisions at the two global Swiss banks and the country's numerous smaller niche players are also doing well. But what about the other private banks? Although their market still holds plenty of potential, the challenges are snowballing: increased domestic and international competition, pressure on margins, rising cost of regulatory compliance, ever increasing client expectations, and changes in taxation and the regulatory environment which threaten to cause a drift of business out of the country. This article presents an overview of current market pressures on the Swiss private banks, and explores how its players are reacting to the challenges facing them.

The Swiss private banking market

There are four main market segments:

- Two global universal banks carry out private banking activities as one business segment alongside other traditional operations like investment banking, asset management and retail banking.
- Large private banks – approximately ten – offer a wide range of private banking services, and sustain the related costs of research with their own analysts and researchers.
- Foreign subsidiaries of international banks, which compete directly with mid-tier and large Swiss banks and can profit from the critical mass and infrastructure provided by their parent company.
- Small private banks, including "boutiques" and product specialists.

According to an analysis by Scorpio Partnership (May 2004), in 2003 the two global Swiss banks held 31 percent of the world's US$4.6 trillion private banking assets.

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The competitive position

Current market and operational challenges include:

- Intense competition and high fee pressure
- Need for critical mass/capital strength to grow
- Challenge of hiring/retaining key employees, e.g. client relationship managers
- Pressure to develop new products and services
- High infrastructure costs/IT systems
- Increasing scale of regulation and regulatory compliance costs
- Limited foreign operations
- Pressures on the demand side, e.g. tax amnesties in other countries and new, more demanding, generation of investors.

The good news

The Swiss private banking market remains highly attractive, both for clients as well as those seeking M&A opportunities. With over a third of the world's private banking assets being held by Swiss banks, Switzerland is the traditional headquarters of international private banking, and despite a deterioration in market conditions recently, it remains a highly profitable business sector. The banks' solid reputation for stability and discretion is highly valued, and with banking being one of the country's major industries, there is ready access to a large pool of talented, highly-qualified and experienced people.

Acquisition opportunities

Our survey last year indicated that Swiss banks had completed a significant number of acquisitions during the preceding three years, and that they have one of the highest appetites for acquisitions in the future. With merger activity in this sector remaining intensive, the resulting consolidation is predicted to improve market performance in the long run. Both the large and medium-sized Swiss banks have openly stated that they are pursuing growth strategies, not only in Switzerland and Europe (which are now sellers' markets) but also in ASPAC, Eastern Europe and Latin America.

The results of our survey this year show that in terms of preferred locations for acquisitions, almost half of Swiss respondents named Switzerland as their first choice if they were to undertake an acquisition, while about one third regarded the ASPAC region as the most attractive location for their own growth purposes.

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Some slightly less good news

The small and medium-sized banks in particular tend to suffer from a comparatively high cost base. This will be exacerbated by the increasing costs of complying with tightening international regulations: it is estimated[1] that the cost of compliance amounts to approximately 8 percent of total costs for banks with fewer than 100 employees and 3.7 percent for larger organisations. Some of the main historical comparative advantages of Switzerland, such as complete client confidentiality, are under threat following pressure by the EU and OECD. Regardless of this unique competitive proposition, many banks are already reevaluating their approach to show new, clearly visible benefits – for example, enhanced customer service and/or an impressively wide range of specialist advice.

Developments in international and domestic regulation (including tighter tax regulation) may impact the Swiss industry's current perceived competitive advantages. In response to this, some Swiss banks are establishing centres of excellence in Asia (e.g. Singapore) to attract clients based in this region and fully exploit their relative legal and regulatory flexibility. They are also strengthening onshore operations in order not to lose repatriated funds.

Declining personal tax rates and amnesties in Europe have now made Swiss accounts less attractive. Demographics also play a role: younger, more sophisticated and more demanding inheritors do not necessarily share the loyalty of the current generation of investors. They may well decide to take their money elsewhere, unless the banks can persuade them to stay or offer onshore facilities in their own countries.

Pricing multiples for acquisitions in Switzerland are very high and, ironically, some of the same banks which have been talking about pursuing strategies of growth by acquisition could find themselves to be potential acquisition targets in the near future.

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Remaining strong

As market conditions tighten, how can Swiss private banks maintain their strength and influence? What strategies are they using to maintain profitability and achieve growth?

Tackling costs

New technologies have become a driving force for dramatic efficiency gains and cost reductions. One may expect to see further IT-based rationalisation, both at the front-end (customer-friendly investment strategy tools, Web-based interactive communication platforms with clients) and in the middle and back-office (ranging from simple IT streamlining to increase flexibility and reduce costs, to outsourcing of entire IT processes). Back-office and middle-office operations may expect headcount reductions as a consequence. Many Swiss private banks are facing a dilemma over outsourcing, with a need to balance cost-cutting with continued client discretion and trust.

Other measures are likely to include greater focus on performance-related remuneration for relationship managers. At a broader level, we are likely to see more organisational restructuring and focusing on core competencies.

Clear product strategy

Banks are assessing which are their most profitable products, and how they can improve sales by more precise targeting of clients. There are also decisions to be made on whether banks continue to sell their own products or focus on streamlining their offering of third-party products to maximise client satisfaction.

Knowing the customer better

Clients' needs are changing and additional pressure is developing from their shifting demands. More and more high net worth individuals have come to expect comprehensive, harmonised and sophisticated financial and tax advice. 'Traditional' family wealth requirements are declining in importance as a younger, more demanding generation assumes responsibility and seeks out more lucrative investments (e.g. hedge funds). Banks are beginning to pay closer attention to what clients (and particularly future clients) perceive to be the most important products and services. This encompasses high value-added services by tax and financial planning specialists, as well as advice on sophisticated products to clients from Asia-Pacific, Eastern Europe and Latin America. The new generation of clients is in general less risk-averse, less loyal and more performance focused.

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Attracting new clients

Banks are applying a variety of measures to attract new clients, ranging from outright acquisitions or setting up new operations abroad, through alliances, to recruiting customer relationship managers who will leverage existing client relationships or acquire new clients abroad on the bank's behalf.

Establishing new operations abroad or undertaking acquisitions are both risky and costly options, especially for medium sized banks which may not have the financial critical mass to expand into foreign markets such as Asia-Pacific or Latin America. Initial investment often requires additional resources to be spent subsequently on infrastructure (e.g. back office/middle office) or, in the case of acquisitions, in the integration issues arising from cultural differences or new regulatory environments.

It takes a great deal of capital strength to break out of the Swiss/European market and into faster growing regions, given the high investment required and the relatively slow payback that can be expected. Alliances are proving successful, as they involve considerably less strain on resources and usually provide a faster pay-off than outright acquisitions.

The less costly option is to recruit specialists to acquire new clients in other – mainly emerging – markets. A mid-sized Swiss private bank may be able to build upon its image and long-standing reputation abroad, and can offer a whole range of private banking services which are often quite unknown to clients in emerging markets, combined with tax and other "family office" specialist advice.

Strategic re-assessment

Ultimately, there may come a time when, for whatever reason, it makes more sense to sell. This may include situations where owners are unwilling to undergo necessary restructuring; an attempt to rationalise the client/activity portfolio by selling non-core operations; a situation where alliances or acquisitions are not deemed possible in the short to medium term; or perhaps when a new owner generation prefers a "cash-out" instead of continuing to run the family business. In this situation, it becomes crucial for banks to make a precise assessment of when is the best moment to sell, so that attractive deals can be achieved in the home market.

1. *Working Paper No.37 (Ivo Huebli), University of Zurich, 2004*

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An interview with Merrill Lynch

Merrill Lynch's Global Private Client business provides wealth management products and services, including financial, retirement and generational planning, to its high net worth clients worldwide. James E. Hays, Head of the U.S. Private Banking and Investment Group and Ausaf Abbas, Head of Global Private Clients in EMEA, discuss their approaches to acquisitions and growth.

Q: Our survey revealed that wealth management organisations tend to favour organic growth over growth through acquisitions. Is this Merrill Lynch's preference too?

A: In EMEA we're looking at both routes. The organic route is clearly one we continue to pursue – we have been hiring, growing assets and building revenue at an organic level fairly consistently. However, one of our strategic objectives internationally is to build market share. In a private client world which is consolidating, we want to be one of the consolidators. We already have the products, systems, processes, technology and compliance infrastructure set up, so we can buy assets and enhance value quickly. We don't need to buy businesses to fill in gaps: it's simply that we believe offering scale helps clients.

In the U.S. there are significant opportunities for organic growth, as well as select opportunities for acquisition. Organic growth comes from leveraging existing relationships with individuals and institutions. We will continue to grow organically by leveraging scale – for example our advisory services, our capital markets business and our foreign exchange businesses. Our greatest domestic opportunity is continuing to make our distribution more productive. Productivity differences between banks can be as high as 50 percent: our advantage is the competency and skill set of our advisers and our ability to provide a broader product offering.

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Q: What motivates you to pursue acquisitions?

A: It's not necessarily about geographic expansion: our private client operation already spans the world. Our ability to create products and provide global research ideas is at the forefront of current practice, so we don't particularly need to buy in skills. Our main motivation is that, having been through a period of restructuring, we now want to grow our international private client business to a level commensurate with our achievements in the U.S. Our U.S. domestic business currently accounts for some 90 percent of our global private client revenue. As a large institution, we have increasing ability and flexibility to pursue this goal by investing organically and in acquisitions.

Of course, the performance of the market is highly relevant to the inflow of new capital. The market has been flat recently, but we still expect to have revenue growth. Important factors in our success have been the right size of our organisation and the fact that we have confronted the realities of the business market. That has allowed us to do better in terms of profitability. Banks that have their internal organisations in order are also those that are better equipped when it comes to M&A.

Obviously, cultural fit and reputation risk are concerns when we're looking at an acquisition: certain of the more aggressive institutions have more reputational risk, so the process necessarily involves additional due diligence to find out what we are buying tangibly and intangibly.

Q: Can you comment on related growth strategies, such as lift-outs and strategic alliances?

A: Whether you go for a strategic alliance or choose to go into a new market alone really depends on the domestic circumstances: the state of development of the local economy, the state of local securities laws and the general view towards foreign investment. Joint ventures can provide some great opportunities. Take our joint venture in India, DSP Merrill Lynch Ltd, which has been running since the mid 80s. It began as a capital markets organisation, then developed an asset management business in the late 90s; we then launched our private client business two to three years ago. Current estimates of the potential HNW market are some 400,000 individuals with over US$1 million, so this enterprise has given us a local presence in a rapidly growing economy full of potential. We're also very excited about our new Sino-foreign securities joint venture with Huaan Securities in China, where the potential market is also growing rapidly.

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Lift-outs are not that common in EMEA, but in the U.S. where the M&A market has not been that active, private bankers are looking at lift-outs as a way to increase revenues. Merrill Lynch has been very successful using this strategy: we can buy the competencies and relationships but don't have to buy the infrastructure, so we pay a lower multiple. Valuations are sometimes three to four times revenues for an entire company: lift-outs cost a fraction of that. The only drawback is that you may not be able to achieve the scale you want as quickly as you want.

Q: According to our survey, domestic deals appear to be more popular than cross border deals. Is this true for Merrill Lynch, and do you see this trend continuing in the private banking sector?

A: It's certainly true in EMEA: there tend not to be that many firms which operate on a pan-European basis, but it's more a question of activity being restricted by domestic regulations, than a cultural issue. From our perspective we may well make acquisitions in certain countries, and the U.K. would be of particular interest to us, but in the majority of cases there are no international cross-border firms to buy. The other point is that domestic European players are fiercely protective of their own territory and will do everything they can to limit foreign competitors in their markets.

From the U.S. point of view, the regulatory environment and recent investigations have not had a significant effect on M&A domestically or internationally, but it has resulted in much greater due diligence and much greater scrutiny of non-core issues.

Q: Which geographic regions do you see as offering particular growth opportunities?

A: Everybody sees Asia-Pacific as the hottest area: the Chinese wealth management market, for example, is growing at 10-12 percent a year. Coming out of the Asian financial crisis, the region has seen period of considerable stability. With China becoming the manufacturing centre of the world, other Asian countries are able to act in a peripheral capacity and grow on the back of China's success, so the wealth generated is quite significant. In addition, lower rates of tax mean clients are able to keep more of their wealth, and there tend to be fewer restrictions on investment outside the country, so people are able to invest their capital around the world with relative ease.

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Q: Are Asian customers open to a global brand?

A: We think so. A lot of people in the emerging economies of Asia are looking to American companies as aspirational models, so having a relationship with Merrill Lynch is something they are quite comfortable with.

Q: How do you see the impact of demographic and economic trends globally on the growth prospects for private banking? Do areas where wealth is increasing offer the most opportunities, or are other factors also relevant?

A: The Middle East is enjoying a huge wealth boom, with hundreds of billions of dollars of extra money flowing into those economies as a result of oil prices being well above US$50 a barrel. As we've discussed, the Asian economies are growing and benefiting after four or five years of considerable pain, including Japan, which has finally come out of its long recession. The economies of Europe don't offer such significant or spectacular growth prospects, but there is a lot of difference between stock and flow: obviously the Asian and Middle Eastern economies are currently growing faster, but from a relatively small base, whereas in Europe there is a great deal of existing wealth that can be deployed and re-deployed. The fact that the population rates are growing slower in Europe than in Asia means that individuals have a lot more wealth in their personal name, whereas in Asia population growth is faster and saps per capita wealth.

The other interesting trend in global private banking is the onshore shift, meaning a preference for local private banking providers. As local financial services providers become more sophisticated, particularly in locations like Southern Europe, domestic banks are becoming increasingly popular choices for local high net worth individuals. These local entities are now quite adept at managing significant wealth and can offer services that challenge the traditional value propositions offered by centres of expertise like Switzerland.

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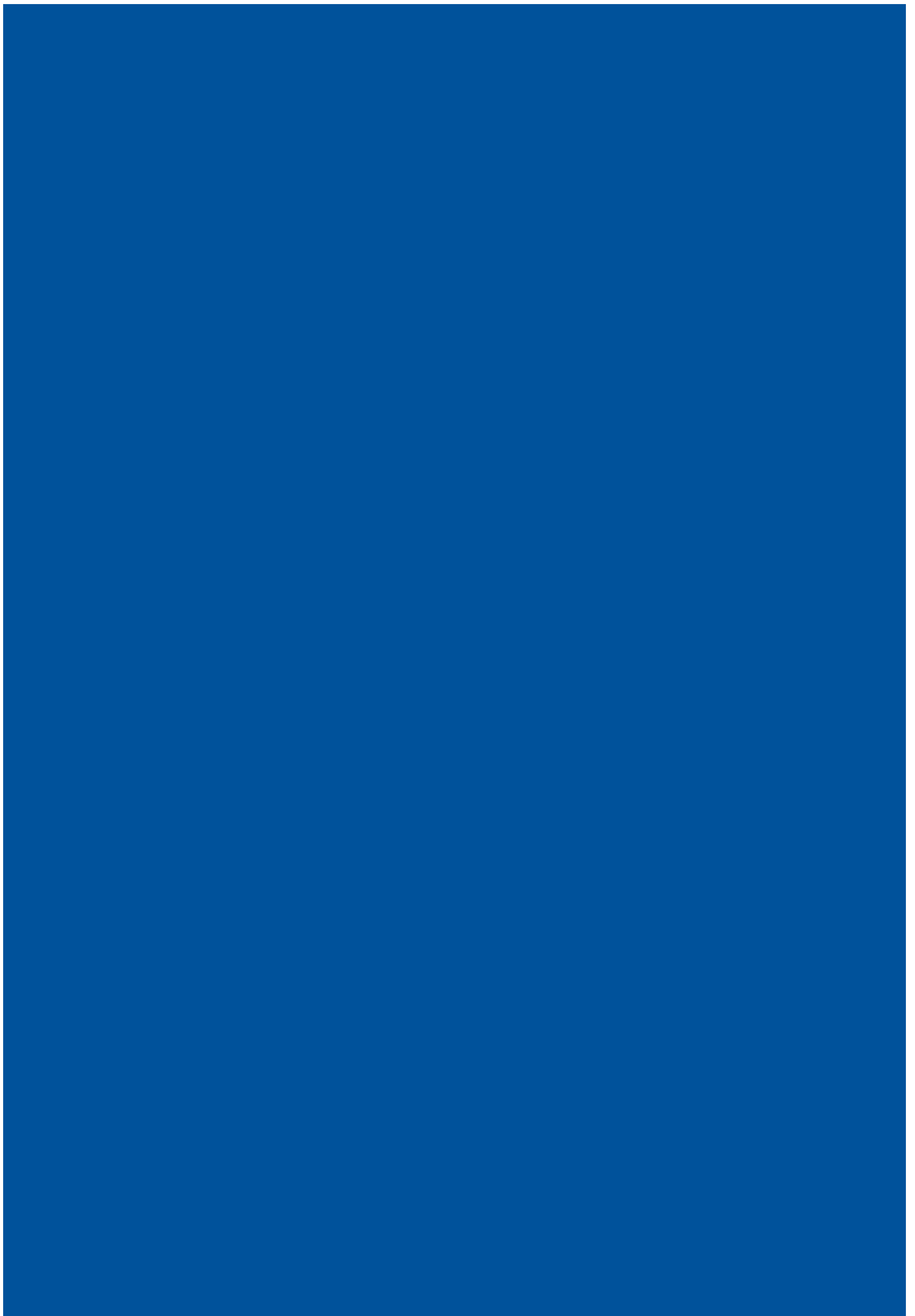

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