Successful private banking business models: what gives smaller players giant-sized powers?

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Introduction

In our Swiss private banking market update 2022, we have recently found that larger private banks continued to enjoy a significant advantage over their smaller counterparts in generating attractive returns on equity (RoE). However, while the inherent advantages of scale may appear to favour larger banks, our analysis has shown that a few smaller banks were able to achieve comparable levels of financial success. This study looks at the business models enabling these smaller private banks to achieve similar RoE to their larger peers in a challenging market, despite their lack of scale. We wish you an illuminating read.

Overview of figures

Target group

Private Banks with AuM < CHF 30bn

Questions:

20

business model insights

Participants:

32

Swiss private banks

Quota:

ca. 60 %

of target group participated

Methodology

The scope of this study includes private banks with less than CHF 30bn in Assets under Management (AuM). In total, 55 banks in this size category with a predominant focus on private banking activities in Switzerland received an identical questionnaire consisting of 20 key questions covering the core pillars of their business model as well as their operational set up.

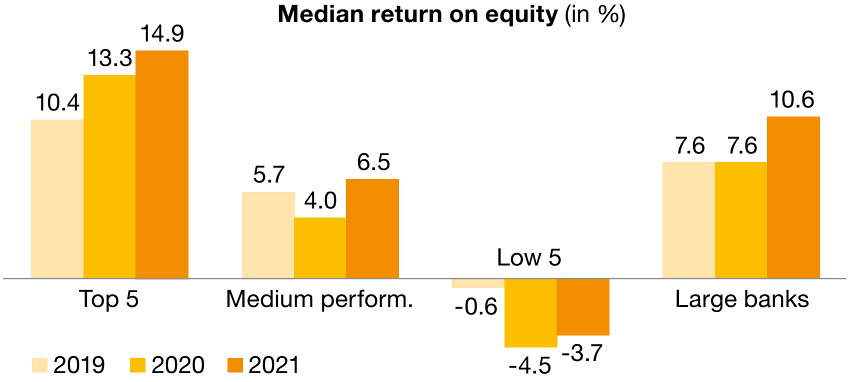
The participating 32 banks were subsequently grouped into three buckets (Top 5, Medium performers and Low 5 performers) based on their financial results achieved from an operational and profitability performance perspective over the period from 2019 to 2021 according to the results presented in their annual reports.

The financial results realised by the participating 32 banks were additionally compared with the corresponding results achieved by the large, Swiss-based private banks (> CHF 50bn). This comparison relied primarily on the RoE numbers generated over this period, given that this ratio is widely regarded as a robust performance indicator covering all the important financial value drivers of a bank. In combination with the qualitative insights shared by the surveyed private banks, business model drivers and strategic orientations were elaborated upon in order to assess their impact on the financial results.

Financial performance – Return on equity

The business models of banks with a specific focus on private banking are typically complex and multifaceted, with numerous levers available for adjustment. The financial KPI that summarises the numerous business model decisions best is the return on equity (RoE). The opposite graph provides an illustration of the median RoE results for each bucket from 2019 to 2021, indicating a bank's market positioning and success in terms of financial performance achieved:

Median return on equity (in %)



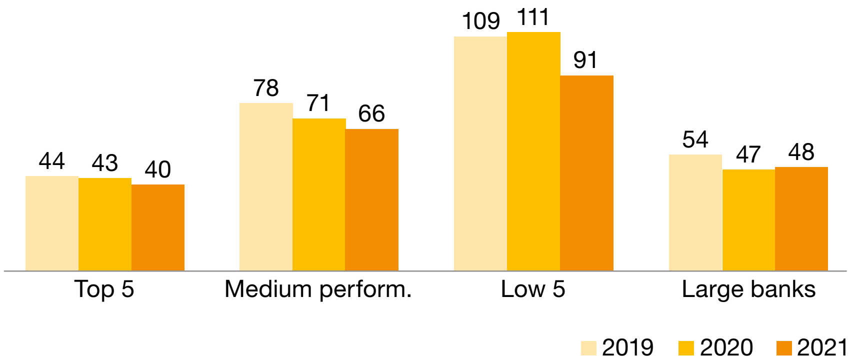
Our sample analysis reveals that the Top 5 performers consistently outpaced their peers from 2019 to 2021, setting themselves apart from the other two surveyed cohorts, which struggled to achieve robust RoE figures. Notably, the Top 5 group demonstrated an impressive ability to increase returns, even in challenging market conditions such as those experienced in 2020.

Surprisingly, even the median large private bank failed to keep pace with its Top 5 peers, despite having a larger asset under management (AuM) volume base. Taking a holistic view of the in-sample banks' RoE performance across the Top 5 and large bank cohorts, a clear pattern emerges. Over the three-year period under review, the Top 5 consistently positioned themselves in the top or midfield position when compared to their larger bank peers on an individual basis. Thus, the Top 5 outperformed certain large bank peers by a substantial margin.

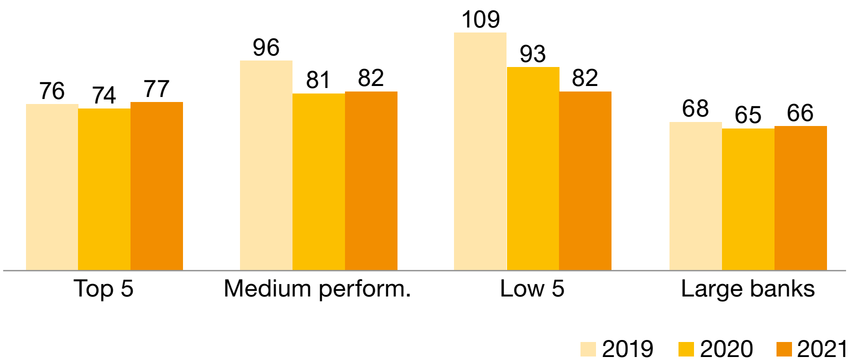
Conversely, the results for the surveyed banks outside the Top 5 confirm the introductory notion that smaller private banks generally face a disadvantage in terms of RoE achieved when compared to their peers managing higher AuM volumes. Their median RoE figures significantly trail behind those of the Top 5 and large private banks, often failing to generate any economic value added to shareholders, with median RoE frequently below the cost of equity rates.

Since our analysis has shown that the equity capitalisation in relation to the business volume (AuM plus loans) is similar among the different banks analysed (only a few, distinctively over-capitalised private banks) and therefore does not make a huge difference, the two primary drivers of private banks' RoE are Operating Income and Operating Expense (OPEX). These key determinants are primarily influenced by business model components and strategic market positioning decisions.

Median OPEX margin (in bps of avg AuM)



Median operating income margin (in bps of avg AuM)



In terms of operating expenses as a percentage of AuM, the Top 5 exhibit notably lower OPEX margins from a median standpoint compared to their peers of similar size. Only large private banks come close to matching the low OPEX margins of the Top 5. At private banks, personnel expenses are the primary drivers of OPEX, while G&A and IT expenses have a relatively lower impact but can still vary considerably. Therefore, strategic decisions regarding the operational landscape as well as personnel setup and compensation structure can heavily influence OPEX and ultimately impact the RoE. Interestingly, both Top 5 and large private banks have consistently reported lower operating income margins in terms of AuM compared to their smaller peers.

Upon examining the operating income contributors across the surveyed banks, it is apparent that the Top 5 cohort places a significant emphasis on net fees and commission income (NFCI), which accounts for an average of approximately 78 % of their operating income over the period of analysis. Conversely, the remaining peers of similar size report lower percentages, with medium performers at 64 % and low performers at 68 %. This indicates that the non-Top 5 banks rely more heavily on net interest income and other forms of revenue in comparison to the Top 5 banks, which seem to focus more on core private banking activities.

It is worth mentioning that the top-performing group displays a relatively low ratio of deposits to AuM, with a median value of approximately 10 %. In contrast, the low-performing banks exhibit a median ratio of 20 %, which may explain the higher proportion of net fees and commission income (NFCI) observed in the Top 5 group. Since loan penetration (loans as % of AuM) is similar across the four buckets in the 4 % - 6 % range, the impact of net interest income is not driven by significantly different loan penetration values. Therefore, the overall proportion of the different income drivers is not diluted by notably high loan penetration ratios.

The Top 5 and large private banks achieve superior RoE figures by operating on an efficient cost base. The reasons behind this efficiency vary, with large banks achieving economies of scale thanks to their sheer size and large AuM basis, whereas successful smaller banks compensate for the size disadvantage with a smart combination of business strategy components and the right kind of operational set up.

The following deep-dive sections provide insights into four key parameters of business model areas of the successful smaller banks resulting from the exclusive PwC survey.

1. Product offering

2. Clientele

3. Personnel structure

4. Operational landscape

1. Product offering

Across the poll results, all private banks participating in our survey primarily pursue an active investment approach, which – after all – is, and has remained, a strong selling proposition of Swiss private banks. Making investment decisions based on in-house research and analyses looking to achieve superior investment returns for their clients remains part of the private banks' DNA. However, the product offering across the surveyed small banks demonstrates diversity, with a tendency among the three buckets under review.

The Top 5 focus on a relatively small product portfolio with a clear focus and a high percentage of discretionary clients. In fact, the median Top 5 small bank managed more than 55 % of its AuM as discretionary mandates compared to the median low performer, whose share of discretionary mandates was roughly 25 % in 2021.

The survey responses of the Top 5 emphasise the tendency to allocate lower significance to advisory and execution-only mandates in the overall context of the bank's product offering. By delegating the investment decisions to the corresponding banks, clients express their trust towards the respective bank and its investment strategy. Furthermore, discretionary mandates usually result in more consistent and less fluctuating revenues as opposed to advisory and execution-only mandates. Other surveyed participants place a higher significance on a larger product portfolio, including corporate finance activities, payment solutions or collaboration with external asset managers as examples.

The most important asset classes offered by the Top 5 banks are traditional asset classes such as equities and bonds. Other banking groups have a more diverse asset class, offering additional asset classes such as alternative investments (e.g. private equity, hedge funds or fund of hedge funds) as well as structured products or derivatives. It is interesting to note that the Top 5 primarily compose the client's portfolio individually, whereas medium and low-performing banks utilise a standardised approach.

A clear majority of the low-performing banks grant special conditions to a high percentage of their clientele compared to their standard fee structure for the individual services. Given their overall bottom line results, this high percentage of special conditions offered to clients might indicate a certain price leakage issue. Conversely, the Top 5 banks have a clear focus on all-in fees and attach low importance to offering special conditions to clients, indicating a strong market position and a high level of discipline among client relationship managers in adhering to the standard terms. Moreover, the medium performers attach a lower significance to offering special conditions to clients, instead relying on a transaction-based fee structure – not surprisingly, given their significant share of advisory and execution-only mandates.

Finally, there is no clearly observable pattern in terms of product trends. All banks surveyed follow the ongoing ESG and Crypto asset trends. However, ESG already enjoys a very high importance at just a few institutes, with many banks indicating medium importance for this. Crypto assets, on the other hand, were assigned only low importance by the banks in our sample.

> A lean product portfolio with a focus on discretionary mandates improves revenue consistency while adherence to standard pricing contributes to strong profitability.

Conclusion

The Top 5 indicate an emphasis on a clear and focused product strategy with a narrow product portfolio mainly relying on core investment instruments. This strict and dedicated focus puts them ahead in terms of financial results achieved, since this product strategy positively affects OPEX as it consequently reduces overhead costs, complexity and product development expenses. Nevertheless, we estimate that other banks offering a wider product range have the potential to close the gap from a profitability perspective, once they get their cost base under control and streamline their processes.

The high importance of special conditions offered to clients at low-performing banks can be due to a number of different reasons. Two such reasons might be rewarding long term client relationships, and attracting new customers. In the latter case, this would also indicate that the banks are struggling to acquire clients, whereas Top 5 and medium performers have had fewer issues in this regard or do not have to entice new clients by offering them very attractive conditions. Those banks therefore attract clients with other features such as a successful investment strategy, client focus or credibility of their business model, and do not have to rely heavily on offering special conditions to clients.

The focus of the top performers on individualisation of client portfolios by tailoring investment portfolios to specific clients' needs and to each client's investment objectives contributes positively to the bottom-line results. This makes it possible to build up strong and stable client relationships, with high client retention and stickiness as well as positive word-of-mouth endorsement to attract new clients.

2. Clientele

A clear and well-defined client structure allows the bank to tailor its services and offerings to meet the specific needs and preferences of its clients, thereby improving customer satisfaction and loyalty.

In addition, a strong client structure can help private banks to build a reputation for expertise and specialisation in specific areas, such as wealth management, investment advice or estate planning. This can attract high-net-worth clients and increase the bank's profitability.

Across the surveyed Swiss-based private banks, there is a natural focus on Swiss residents as their customers. Whilst smaller banks focus more on the domestic market and clients, the greater the volume managed by the private banks and the larger they become, the more they shift their focus towards attracting customers on a more international basis – from surrounding European countries, or even further abroad.

Interestingly, only a very low number of the Top 5 performers count clients from outside Switzerland as their clients. Without exception, they indicate that Swiss-domiciled clients are at the core of their strategic direction. Medium and low performers, on the other hand, place higher significance on clients domiciled abroad.

For all banking groups, the utmost importance is allocated to private clients as business relationship partners. Less significant shares are assigned to institutional clients, foundations or external asset managers. Overall, medium and low-performing banks tend to have more exposure to institutional clients than the Top 5 banks.

All the private banks surveyed indicate their strong focus on high-net-worth individuals (specified range from CHF 1m to 30m). Especially for most Top 5 banks, the highest focus is on these client types whereas the other peer groups have a more diverse focus, including ultra-high-net-worth individuals (CHF > 30m) or affluent clients (250k to 1m).

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Conclusion

In our view, the continuing emphasis on 'Swissness' in banking is underlined by the responses of the surveyed banks, which highlight the critical role of trust and loyalty in every successful collaboration, with a high focus on domestically domiciled clients. However, client retention should be based on sustainably sound factors such as the bank's expertise, reputation, and customised services rather than preferential conditions.

From our point of view, the ideal client category for smaller private banks are high-net-worth individuals with investable assets of around CHF 1m to 5m.

It is notable that banks outside the Top 5 do not have a clear focus in terms of targeted client segment, but try to cover all kind of client segments from affluent clients to ultra-high-net-worth individuals. Whereas with the former segment private banks additionally compete with universal banks (e.g. Swiss cantonal banks), the latter segment is highly lucrative for large private banks as well as for generally large universal banks. Therefore, this competition often causes the smaller private banks to apply pricing discounts with negative impacts on bottom-line results.

A comparatively stronger focus on institutional clients witnessed among the surveyed medium and low performers may negatively affect profitability due to higher volumes at clearly lower fees. In particular, it negatively impacts RoE when the operational platform is not as efficiently structured for generating economies of scale by managing such larger volumes.

3. Personnel

Private banking has always been a relationship-driven business. The ability to establish and maintain strong, long-term relationships with clients is essential for success. Understanding clients' unique needs, preferences, and goals, and developing customised solutions that meet their specific requirements, are key characteristics of successful private banks. In this respect, it is the quality of the client relationship managers in particular that plays a crucial role for the success of private banks, as they are responsible for building up and maintaining strong and stable client relationships, managing risk and delivering high-quality products and services.

It is therefore not surprising that personnel expenses usually account for the highest share in the context of operating expenses. While such personnel costs can be significant, they are also an essential investment in the success of a private bank.

Attracting and retaining relationship managers is critical for the success of private banks. One key factor in achieving this, besides strong brand recognition or company culture, is to offer competitive compensation packages. Interestingly, many medium and lower performing banks offer a variable compensation component that is below 25 % of the overall compensation package, whereas most top performers offer a variable compensation component of more than 25 %. Given their success in recent years, this focus on a relatively high variable compensation component seems lucrative for well-connected and performance-oriented relationship managers.

Another important metric used to measure the productivity and efficiency of a bank's relationship managers is the AuM per relationship manager ratio. Most top-performing banks have an average AuM per client advisor of more than CHF 150m, whilst the other buckets show clearly lower AuM levels per relationship manager. This indicates more productive and efficient relationship managers as they seem to manage a higher amount of client volume and assets without sacrificing the quality of service provided. This is beneficial for the bank as it leads to increased revenue and profitability levels for the Top 5 bucket. Furthermore, the Top 5 banks have a higher ratio of front-oriented FTEs (more than 40 % of their employees are relationship managers) in terms of total FTEs compared to their less successful peers (roughly 30 % of whose employees are relationship managers).

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Conclusion

Ultimately, the balance between personnel costs and other expense factors depends on the specific business model and strategy of each individual private bank. Some banks may choose to invest heavily in personnel to differentiate themselves in a crowded market, while others may prioritise technology and invest heavily in a digitalised business model. The key is to find the right balance that enables the bank to achieve its strategic objectives while also maintaining a healthy financial position.

From our point of view, the private banks should build an environment that attracts and retains talented relationship managers. This can help to drive growth, build a strong brand and establish a competitive advantage in the marketplace. Eventually, this will in turn attract talent and reiterate the process. To achieve this, the compensation package must be aligned with the overall strategic objectives and goals. Incentivising relationship managers with a significant share of variable compensation is a common way to increase employee productivity. However, ensuring that the overall values of the bank are afforded the utmost significance in its daily operations is highly important.

4. Operational landscape

The strategic choice of an appropriate operational landscape in private banks is a crucial factor that affects the bank's ability to deliver services effectively and efficiently. By automating routine tasks and streamlining processes, the bank can reduce manual errors, enhance efficiency and focus on value-adding activities that benefit clients directly.

Outsourcing of business processes that do not help to differentiate a bank from its peers is an effective way to enhance the efficiency and effectiveness of a private bank's operations, particularly for the smaller banks in our sample. However, medium-sized banks, with assets under management exceeding CHF 5 billion, show a clear tendency to keep the greater part of their operations in-house and do not make use of outsourcing services.

The majority of the Top 5 cohort makes use of outsourcing solutions both in the business process area as well as in the IT area (application service providing). Given the vast selection of possible sourcing partners in the market, there is no leading provider with which most of the surveyed banks are partnered. Since the low-performing banks and roughly half of the medium performers also primarily make use of outsourcing, there is no obvious tendency indicating that outsourcing clearly leads to better financial results.

Nevertheless, outsourcing is strongly worth considering where in-house knowledge is not available, if a bank lacks the necessary size to build up the required know-how in-house, or if the respective expertise is not core for the success of a private bank. Third-party providers typically have specialised skills and resources that allow them to handle tasks more efficiently and effectively.

Similarly to the vast choice of business process outsourcing and application service providers operating in the market with a focus on private banking institutions, there are also numerous core banking platform providers. Again, across the sample banks no provider can position itself as the clear number one provider for the surveyed banks, with avaloq, finova and FNZ being the most often cited. In the end, the selection of an appropriate banking software is highly dependent on the expected functionality, potential scalability, flexibility and – in particular – reliability.

The absence of any clear distinction between the Top 5 performers and the low performers driven by a specific, technological set-up decision (outsourcing vs. in-house, IT core banking platform) for the operational landscape highlights the importance of the employee factor as an aspect of daily operations.

Besides the technological pillar of the operational set-up, the branch network also plays a crucial role for private banks. Branch networks can serve as a physical touchpoint for clients to meet with their relationship managers and receive personalised advice on their financial goals and investments.

In today's digital age, private banks also need to consider complementing their branch networks with robust digital platforms to meet the evolving needs of their clients. However, most of the banks surveyed still allocate very high importance to the physical branch in which they operate. The relatively larger banks in our sample usually possess more branches than their smaller peers. This indicates that many of those banks have been aiming for growth and have opened new locations, but this does not necessarily mean a positive bottom-line impact. The Top 5 banks, on the other hand, rely on merely one to a few physical branches, which emphasises their healthy reluctance to open more locations despite strong business performance.

Whether a private bank operates in one or more branches, physical meetings remain by far the most important client interaction channel. Whereas, for the Top 5 banks, this channel is without exception the most significant, medium and low performers also emphasise further channels such as e-banking or their respective mobile apps.

> A well-designed operational landscape supported by a flexible and state-of-the-art IT platform can help a private bank to manage its costs and optimize its operations.

Conclusion

The decision to outsource operations to a third-party provider should be approached on a case-by-case basis, as there is no one-size-fits-all solution. While there are benefits to building in-house processes, outsourcing can bring specialised skills and resources to the table. Careful consideration should therefore be given to the matter before any outsourcing decisions are made.

While banks tend not to change their banking software regularly, upgrading to a new and more advanced platform can improve operational efficiency.

In the private banking industry, physical presences remain crucial for client interaction, brand recognition, trustworthiness and the bank's credibility. The hybrid banking model does not yet play such a crucial role for the current generation of private banking clients. Our survey results indicate that some highly profitable Top 5 banks with relatively lower AuM volumes operate at just one single location in Switzerland, with no sophisticated digital offering in place. Therefore, before expanding domestically or abroad, a comprehensive analysis of various factors such as market opportunity, competition, and product decisions should be conducted in order to make informed decisions about the potential for success.

The choice of strategic orientation should be assessed thoroughly and a profound analysis of different aspects should be conducted before deciding to expand domestically or abroad.

Study conclusion

This PwC survey has demonstrated that smaller banks, too, can be highly profitable or even outperform large private banks when it comes to profitability. It has further emphasised certain characteristics of such successful banks that have been identified as contributors to their substantial success, and which represent the so-called areas of improvement for other banks in the medium and low-performing categories. The following overview highlights the business model components upon which the Top 5 performers put their main focus:

Product offering

- Lean private banking core offering
- Investment strategy with specialisation in traditional asset classes (equity and bonds)
- Strong discipline in pushing through standard pricing conditions (low percentage of clients with special conditions)

Clientele

- Private clients, lower importance of institutional clients
- Swiss residents and clients from only a few selected foreign key markets
- High-net-worth individuals (investable assets of CHF 1m to 5m)
- Discretionary mandates

Personnel

- Front-oriented organisation (40 % or more of total FTEs)
- Attraction and retention of competent and well-connected relationship managers
- Offering of an appealing employee incentive scheme as part of a sustainable, people-oriented strategy

Operational landscape

- Flexible and cost-effective IT core banking system
- Lean operational set-up with outsourcing of non-core functions (business processes, IT)
- High significance of Swiss-based bank location, no extensive branch network or presences abroad
- Physical meetings as predominant client interaction channel

Size advantages clearly exist in the private banking industry. However, this does not mean that smaller banks in this industry cannot be successful as well. Our study has evidently outlined that smaller banks in the private banking industry can compensate for a purely size-related disadvantage with a smart combination of business strategy components and the right kind of operational set-up.

By doing this, they are able to successfully compete in today's demanding market environment.

What's next?

In view of the extensive industry data that we have collected, we are offering our benchmark analysis services from both quantitative and qualitative angles to interested parties. Feel free to contact the authors if you would like more information.

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