

# The Affluent Investor

## Can banks keep the profit engine running?

*Affluent customers have always been a significant profit generator for banks. With financial assets of €100,000 or more, they comprise a small portion of a retail bank's total clients, yet account for the majority of financial assets. In Germany, for example, about 10 percent of households are affluent, but account for roughly 60 percent of total household financial assets. As people live longer and accumulate wealth beyond the age of 60, the affluent segment is becoming increasingly important.*

Investors worldwide have suffered from the financial crisis. Those in the United Kingdom and the United States (where strong stock-market traditions combine with private, market-based pension plans) have watched the value of their financial assets decline by an average of 20 percent (see figure 1 on the following page). In countries such as Austria and Germany, where public pension systems are the norm and only 10 percent of the population is directly invested in equities, the losses are limited to less than 5 percent since a 2007 market high.

The affluent segment has been among the hardest hit, as many people are within 10 years of retirement and heavily invested in the stock market. Studies show that the affluent keep two-thirds of their financial investments in sophisticated market products—including corporate pension plans, life insurance and real estate.

As the crisis continues, many affluent customers are shifting their assets to

“safer” venues. In Europe, for example, as equities and mutual-fund values plummeted in the first three quarters of 2008, deposits and money-market funds grew correspondingly, according to the European Central Bank (see figure 2 on the following page). The picture for bonds is mixed, as customers shifted money into bonds but also watched as bonds lost value. Recent data suggest that bond value is even lower today.

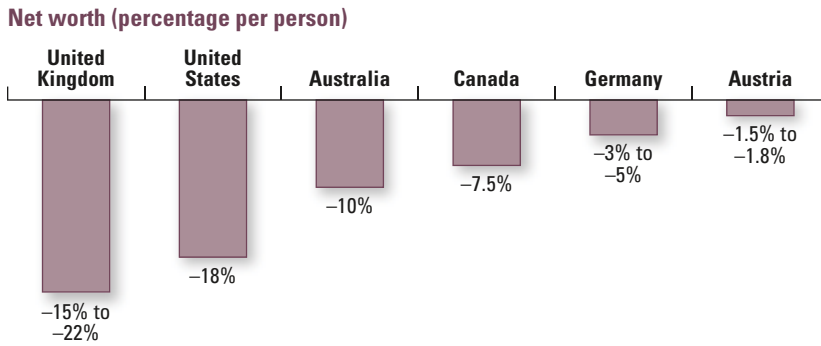
Many investors are shifting funds into cash accounts, as the example of Germany illustrates, and away from actively managed mutual funds into exchange traded funds (ETFs), which have risen by 25 percent. They are seeking simpler, more transparent products and are more cautious with derivatives—as the market for “certificates” has declined by 40 percent.

In the second half of 2008, one in nine German stockholders withdrew completely from the stock market, according to Deutsches Aktieninstitut (Association of German Shareholders).



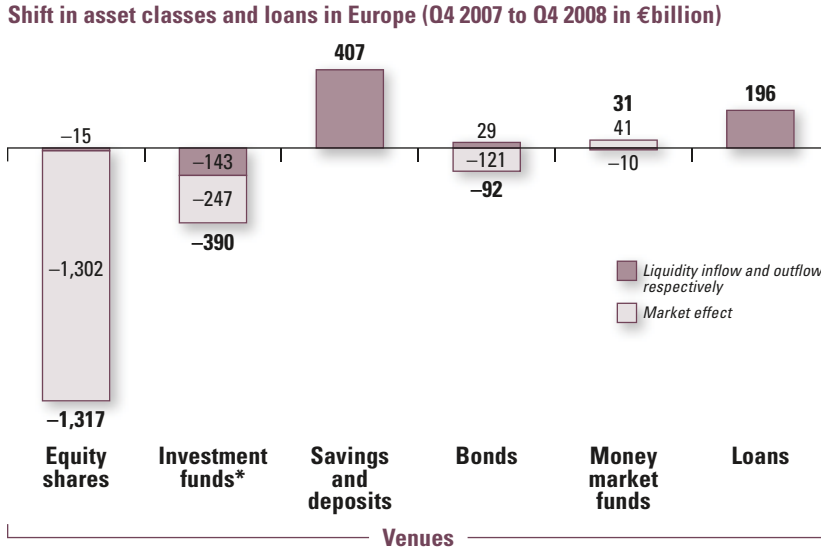
*If changes in the banking industry are not temporary—as we suspect—it will require more fundamental adjustments to the “serving-the-affluent” business model than anything we’ve seen.*

**FIGURE 1: Average impact on personal net worth\***



\* Percentage per person compared to 2007 high (except for Canada and Austria where the high occurred in Q2 2008)  
 Sources: International monetary fund; OECD; Morgan Stanley; Bank of England; Acadametrics; U.S. Federal Reserve, Australia CommSec, Statistics Canada; Deutsche Bundesbank, Österreichische Nationalbank; Die Bank; press articles; A.T. Kearney analysis

**FIGURE 2: Affluent customers are shifting assets to “safer” venues**



\* Excludes money market funds  
 Sources: Deutscher Derivate Verband; Deutsches Aktieninstitut; BVI; European Central Bank; Deutsche Bundesbank; Österreichische Nationalbank; A.T. Kearney analysis

## Should Banks Prepare for the Worst?

Banks are losing money as devalued portfolios generate less management-fee revenues, and as the shift to lower-margin products hurts profits. A.T. Kearney analysis finds a revenue gap of about €300 per “lower affluent”

customer in 2009—a 20 percent decline from the previous year. This is a huge hit to retail banks’ bottom lines, as the affluent segment typically contributes the most to their margins. Private banks are not faring well either. Some universal banks have welcomed the shift to liquid products

in the short-term, while acknowledging that this cannot be a long-term strategy for the affluent segment or for private banks.

Revenues from commissions have been plummeting along with margins. In fact, the poor performance of many mutual funds and wealth-manager portfolios—in absolute terms and relative to benchmark indices—has motivated some asset managers to cut back on management fees for fixed-income products. This might not be a temporary move. While markets almost certainly will make a comeback, once fee levels have been reduced it will be difficult, if not impossible, to reinstate them. We still do not know if investors will come back to complex, high-margin derivatives, even if wealth accumulation becomes popular again.

If these changes are not temporary, as we suspect, it will require more fundamental adjustments to the “serving-the-affluent” business model than anything we’ve seen. Our analyses indicates that one of the following two scenarios could play out in the future.

## Scenario One: Back to Black

If fee levels generated by the affluent should drop by more than 25 percent, banks will have to abandon their current operating models. Banks would not employ client-to-adviser ratios of 300 to 400, offer personalized services in branches, develop ad-valorem pricing models or provide a constant flow of new derivative products that generate significant revenues. Instead, banks will have to adjust their strategies as follows.

Determine who receives advisory services. Rather than offering advisory services to the affluent in general,

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banks will have to limit such services to the very, very affluent. In recent years, the affluent category has been extended to include a wider group of customers. This will become more difficult to justify. Furthermore, the client-to adviser ratio will have to take into account a lower trading intensity and longer holding period for investments, which is exactly what regulators intend. Both measures will lead to fewer clients in the affluent segment, and to a higher client-to-adviser ratio. The number of advisers could be reduced by as much as one third.

**Provide more remote services.** Technology will be essential to helping banks provide remote services to their affluent customers. Rather than face-to-face visits, banks will offer online services well beyond the basic reporting and trading functions that are the standard today. Offering advice through call centers and using customer relationship management applications will play a big role, especially in tracking potentially affluent custom-

ers who don't yet merit costly face-to-face interactions.

**Develop a new pricing model.** Pricing models will become more important as more customers complain about management fees that do not adequately reflect performance. Finding a fair and sustainable pricing model will be difficult, however, as traditional value percentages are not popular. Indeed, in some markets just 10 percent of affluent customers are charged according to performance-based pricing models. Although flat-fee models are rarely used, they can provide for differentiated positioning (*see sidebar: Price Matters*).

Banks will have to simplify their service and product offerings, particularly for the marginally affluent. Smaller banks might even consider franchise agreements, whereby asset managers might provide a brand, products, tools, a standard pricing model, remote services and an advisory approach.

At first glance, this first scenario appears reasonable. There is a risk, how-

ever, in eliminating services designed to generate sales of more profitable products. Some argue that revenues and profits will come back, which seems to be supported by customer behavior. In fact, while most affluent

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and private banking customers are complaining about their banks, only a few have actually left and gone to another. "They know me, and I know them" is the typical attitude—and so people stay.

## Price Matters

In banking, there are two major pricing goals: to stop revenue leakage and to increase margins.

**Stop revenue leakage.** In the current financial crisis, keeping revenues high is critical to retaining the affluent segment. The groundwork for doing so requires a thorough analysis of current client services, with a focus on identifying complementary services. Such services could range from providing free advice and information to offering more convenient ways to perform transactions. It is important to keep track of these offerings—using detailed measures to address each free service so not to provide too many free services.

**Increase margins.** Successful pricing depends on developing a framework that aims to increase margins. Instead of simply exploiting customers' readiness to pay for existing services, the focus should be on their *willingness* to pay for new services. Find the range of services in which customers see a benefit and are willing to pay for, such as getting financial advice on weekends or one-on-one advisory services.

## Scenario Two: Profit Rebound

If a bank learns from and reacts positively to past performance issues, it could regain customer trust. That is because other banks are perceived to have similar performance and so "a better bank" simply does not exist.

We are not recommending that banks take a wait-and-see approach. Even in the best case, private banks and divisions that serve affluent customers should strive to capture the "white spaces" of their businesses. Three opportunities stand out:

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**Pensions.** Pensions are a core growth area for banks, particularly in the affluent segment. However, current products are not ideally suited to capture this opportunity. For example, using traditional life-cycle models, banks begin shifting customer assets from equities to bonds before the age of 60. Yet people now live longer and can expect to generate an additional 20 years in stock-market returns. This is especially the case for affluent customers who continue to accumulate wealth beyond the age of 70 (significantly later than the average population), while their negative cash flow is largely due to spending on health care. Several products are designed for older customers—such as reverse mortgages and variable annuities. However, in Europe, these products are not yet widespread, and banks, like insurers, are hesitant to take the associated risks. Also, in the United Kingdom, regulatory changes are making pensions less attractive.

**Lending.** The affluent in Europe are not only investors but also borrowers. About one in every three affluent customers has an unsecured consumer loan, and more than 40 percent of the affluent have mortgages. These products frequently are held by another bank, as advisers to the affluent focus mainly on investments. Some banks are moving in on this opportunity by adding lending advisers to their affluent-customer teams.

**Emerging affluent.** Younger customers with wealth potential often fall through the cracks as their financial assets do not qualify them for affluent treatment, and their net income might still be below necessary thresholds. Yet independent financial advisers (IFAs) are targeting this segment as they focus on recent graduates from top schools and the 30- to 40-year-old age bracket, as this is when many people acquire life insurance, pension contracts and first mortgages. The challenge for

banks is to identify those with wealth potential and accompany them through their first phases of wealth-building, bearing in mind that the life and pension contracts typically mature 25 to 30 years later.

## Keeping your Affluent Customers Happy

Whichever scenario plays out, banks cannot stand still in the absence of an alternative profit engine. The mortgage and consumer finance business, although profitable in terms of new business, will likely suffer as the economy continues its downturn. It will not be easy to compensate for the profits earned in the affluent segment. As banks face some uncomfortable realities, they must remember one thing: Success now and in the future depends on keeping your affluent customers happy.

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