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Private Banking Beyond the “Perfect Storm”

Perspectives on the future of Swiss private banking after the
financial crisis

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Executive Summary (1/3)

The Wealth Management industry is in the midst of a “perfect storm”, and the flow of negative news has not stopped yet. Markets have devaluated, several of the largest wealth managers have vanished, and most have seen their market capitalization shrinking to a fraction of their valuation only 12 months ago.

So far Switzerland’s private banks have weathered the storm relatively well, and most traditional “private banks” and also the *Kantonalbanks & Regionalbanks* have benefited from “windfall” Net New Assets (NNAs), as clients have left the big banks in great numbers.

But the massive devaluation of the Assets under Management (AuM) base, paired with a significant reduction in profit margins, means that full 2008 results are still overstating the real situation, driven by a strong 1st half year 2008. The private banks must expect to lose an additional 25-30% of their FY’09 revenue pools if the market remains fragile. Furthermore, the regulators have only just started to reshape the rules of the game and, as examples from other markets show, private banking clients can react sharply to game changes.

Over recent weeks Booz & Company has interviewed more than 20 opinion leaders in Switzerland’s private banking industry, to understand the scale of the pressure the industry is currently facing and to form a (still early) perspective on the industry beyond the “perfect storm”:

1 Business model assumptions

- The current financial crisis is seen as the most severe since the 1930s, and none of the interviewees expect a recovery before 2010.
- Consolidation in the (still very fragmented) private banking industry has only just begun, and is expected to accelerate both globally and locally as smaller players will lack sufficient scale to sustain profitability or the right skills to survive in a more demanding market.
- The focus by governments, regulators, and the public on private banking will continue. Regulatory pressure (and enforcement) will further accelerate.
- However: none of the private banking executives interviewed expect their private banking business model to change fundamentally, and all interviewees are confident of having the right strategy to gain market share during this crisis.

Executive Summary (2/3)

2 Offshore/Onshore Private Banking

- The perspective on the future of offshore private banking varies significantly between the large “megabanks” and the “pure play” private banks. For the large megabanks, non-declared offshore is seen as a discontinued business, but given their global footprint this business still carries significant operational/reputational risks. Smaller private banks are staying with it as they see this as their legacy business and they often lack the “multi-shoring” capabilities of the large megabanks.
- Going onshore is seen as the right way forward for Swiss private banks, but this has to be handled very carefully, and costly experiments need to be abandoned in some cases.

3 Client behaviour

- Pure play private banks and banks with a real/perceived government guarantee (“Staatsgarantie”) have gained favour with clients, but the sustainability of the asset shifts towards them is questionable as most of these assets are parked in “liquid” asset categories, and so far these players have not taken action to upgrade their private banking value propositions to make these clients stay.
- Client preference for structured products will return but, given the increased demand for transparency, revenue pools will consolidate at a much lower level. Clients will distinguish very carefully between alpha and beta performance and will react very sensitively to mis-priced products.
- However: client behaviour is not expected to change, as client memory has proven to be short-term in the past and ultimately client “aspiration” will replace the current “fear”.

4

Profitability management

- Given the significantly lower value pools, private banks need to get serious about rightsizing their cost base.
- So far they have lowered their cost base mainly through linear budget cuts (“10% always works”), but this approach might not suffice this time and more strategic cost management will be needed.

Executive summary (3/3)

5 Governance

- Non of the interviewees expected a turmoil of this magnitude to happen. Private banks were not prepared to deal with such a sudden and deep change in market conditions, nor with the ferocity with which the regulators are turning against Switzerland's private banks.
- Compliance, risk management and flawless execution are seen as key success factors for the private bank going forward.

In summary, Switzerland's private banking industry is in a storm of unprecedented scale, and client trust and confidence in financial institutions, as well as in the regulating authorities, have deteriorated rapidly. Private banking clients have already reacted sharply to these disruptions, and the regulators have only just begun to reshape the rules of the game.

Interviewees agree that 2009 will be an extremely difficult year, and a perspective on the future of private banking has only started to emerge. However, all the private banking executives interviewed believe that their business model is not fundamentally challenged, and that they have the right strategy to win market share during this crisis.

In our view, Switzerland's private banks need to take some short-term actions to steer through the storm (e.g. developing contingency plans for the complete, uncontrolled meltdown of Swiss banking secrecy) whilst developing the agenda for the time beyond.

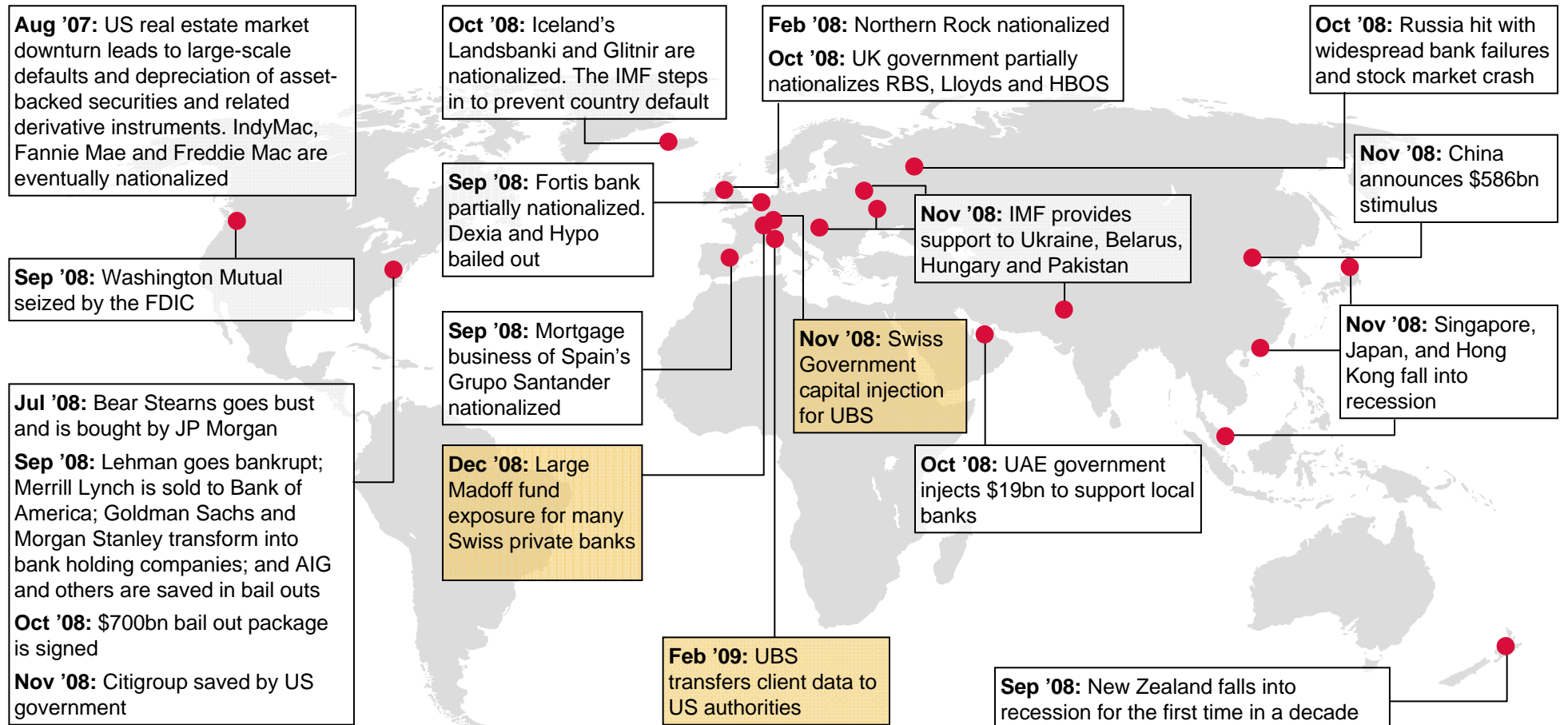
We wish to thank all interview partners for participating in our study and sharing their insights and perspectives.

Introduction

Private Banking Beyond the “Perfect Storm”

A Strategic Agenda for the Private Banking Executive

Over the last 12 months, the US-led sub-prime crisis has evolved into a “perfect storm” on a global scale



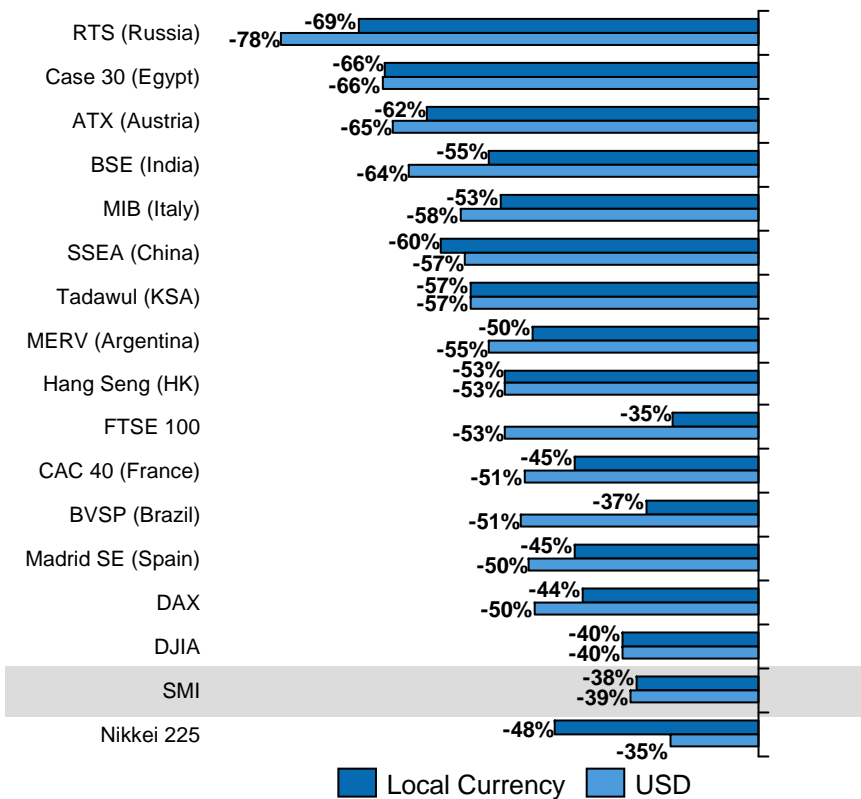
Source: Booz & Company analysis

Massive devaluations have happened across all markets and asset classes (excluding bonds)

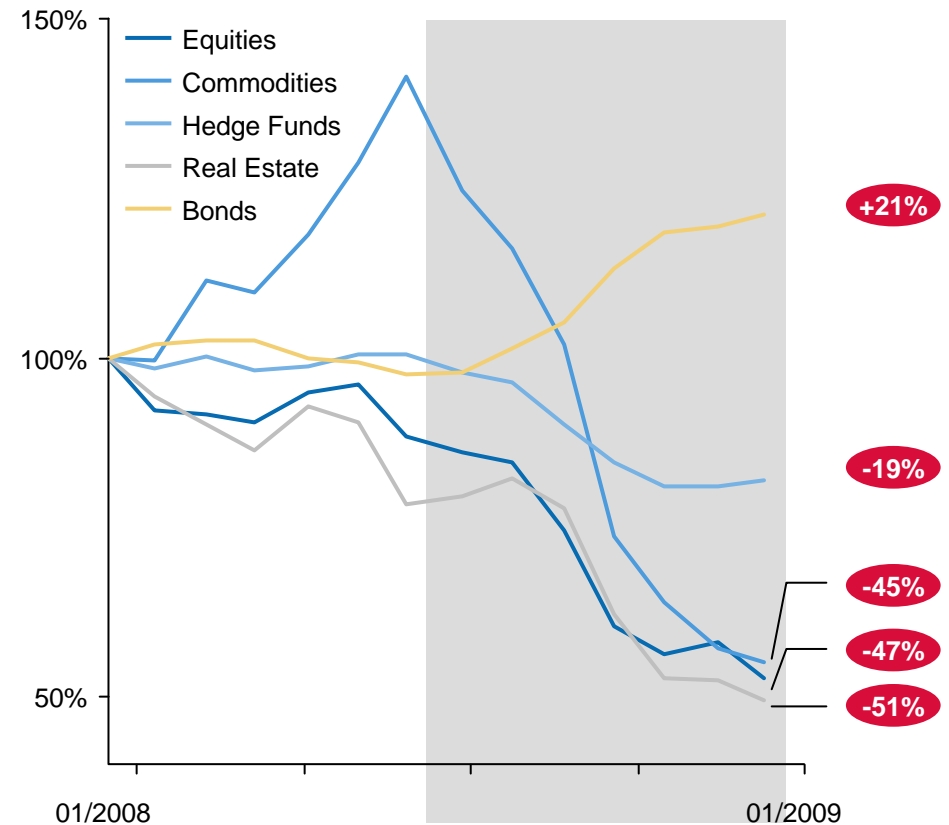
Overview on key index developments in last 12 months

Equity markets performance (%)

01/01/2008–31/01/2009



Indexed Performance of key asset classes Performance (%) 01/01/2008–31/01/2009

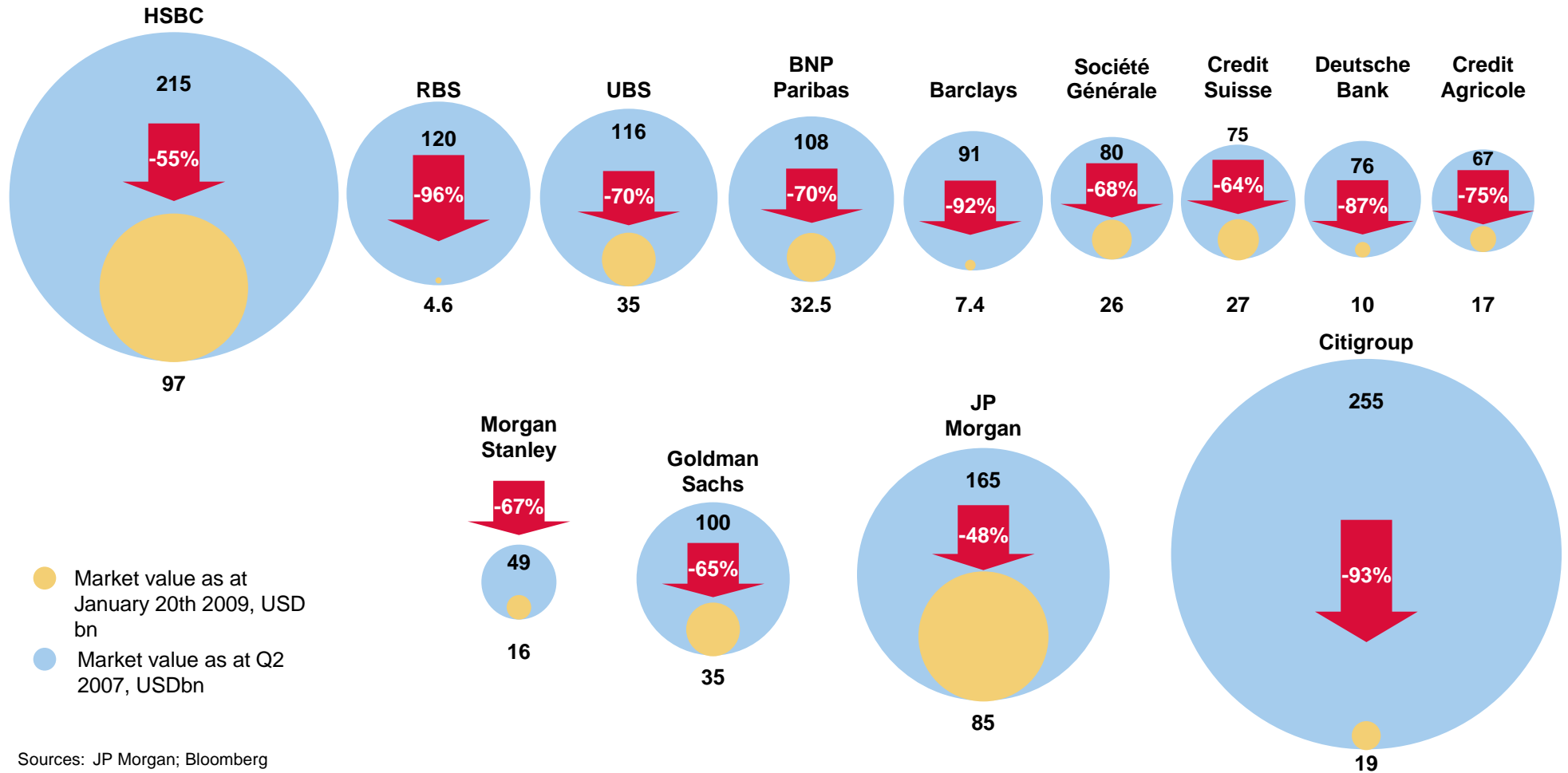


Sources: UBS; Thomson Financial; Economist; Bloomberg

Equities: MSCI World, Bonds: Bloomberg EFAS Government Bond Index, Hedge Funds: CS Tremont Index, Commodities: GSCI, Real Estate: EPRA/NAREIT Global

Several leading wealth managers have vanished over the last 12 months – many others have lost significant market cap

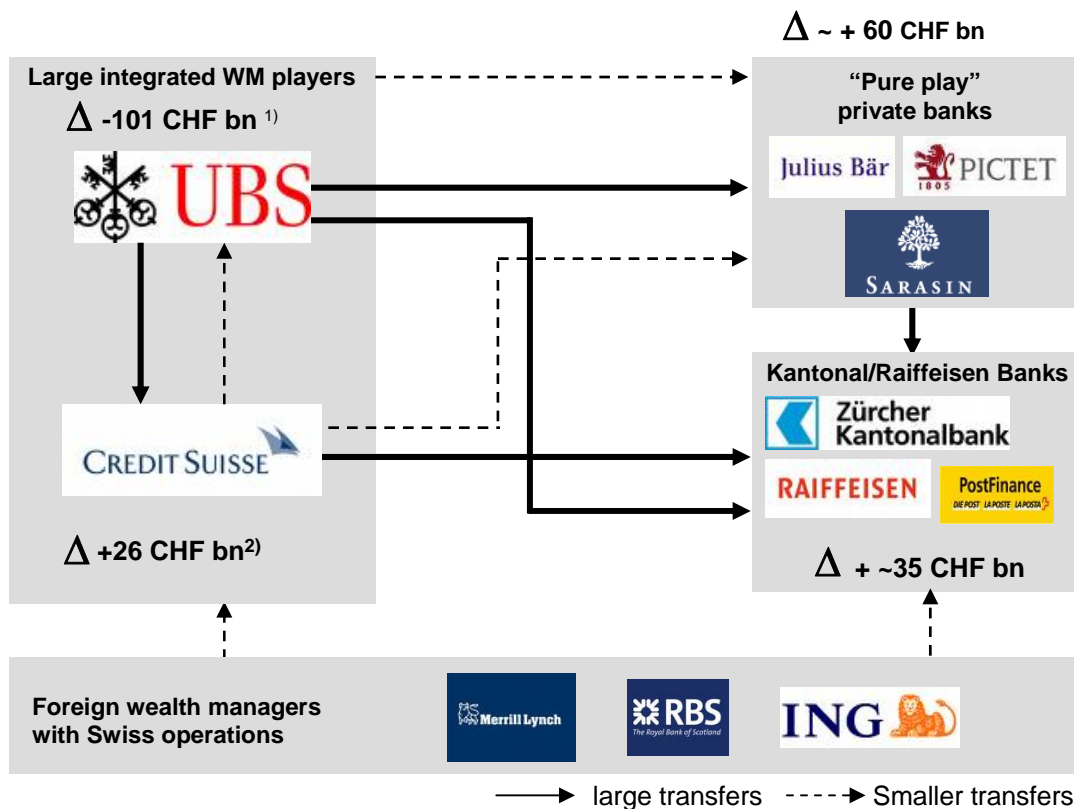
Development of leading Wealth Mmanagement (WM) market capitalization [year-on-year]



Sources: JP Morgan; Bloomberg

Significant asset shifts have altered the competitive landscape, putting traditional players under pressure

Estimated NNA Movements, Swiss Private Banking Market 2008



- 2008 saw significant asset shifts among Swiss wealth management players
 - Integrated Wealth Management players (UBS, CS) saw significant outflows, especially in the second half of 2008, benefitting mainly “pure play” private banks, Kantonal-/Raiffeisen banks
 - “Pure play” private banks and banks with perceived “state underwrite” were mainly able to benefit from this trend
 - Mixed picture amongst foreign players – potential market exit expected for “nationalized” banks from countries fighting “tax haven”
- Going forward, the question will be whether clients remain with the smaller banks or win-back strategies from UBS and CS result in clients returning to the large players

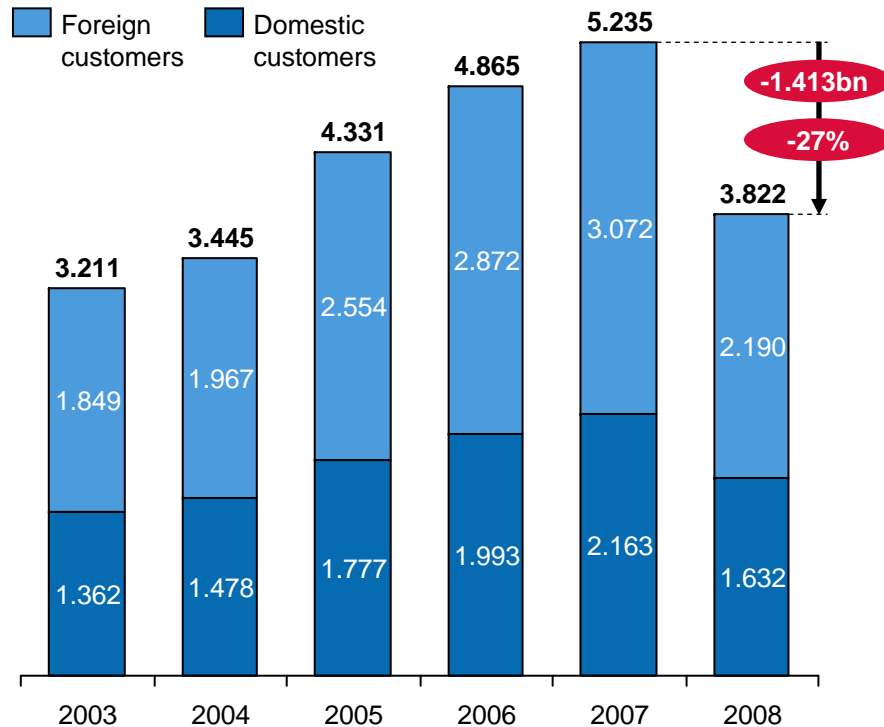
1) UBS Wealth Management International and Switzerland

2) Excluding NNA from the Americas (16.6 CHF bn)

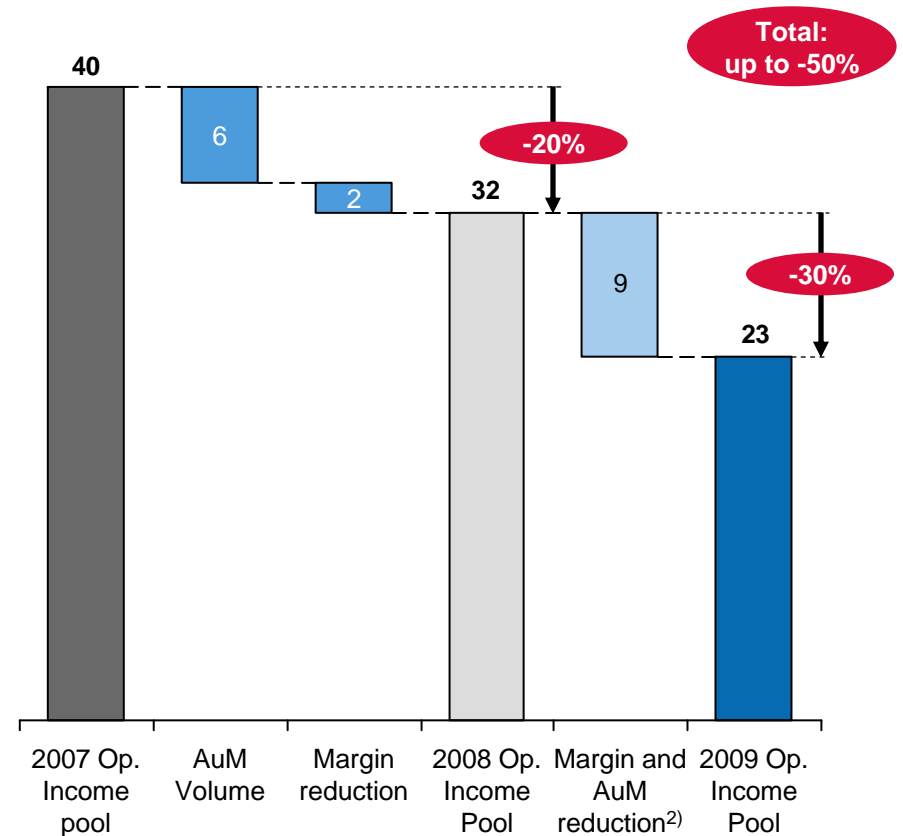
Sources: Interviews; Press; Company reports

The storm hit Switzerland in 2008, but given devalued AuM and profit margins an additional loss of up to 30% of revenues must be expected in 2009

Customer deposits at banks
(CHF bn)



Estimated development of operating income pools¹⁾
(CHF bn)

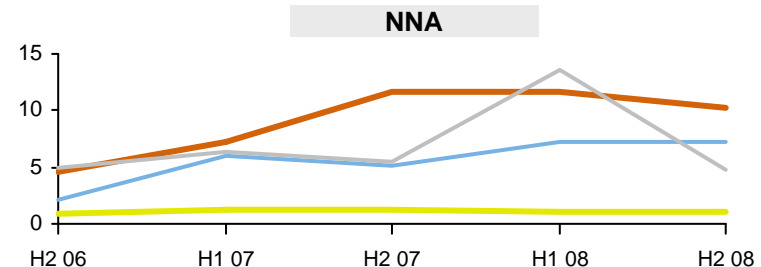
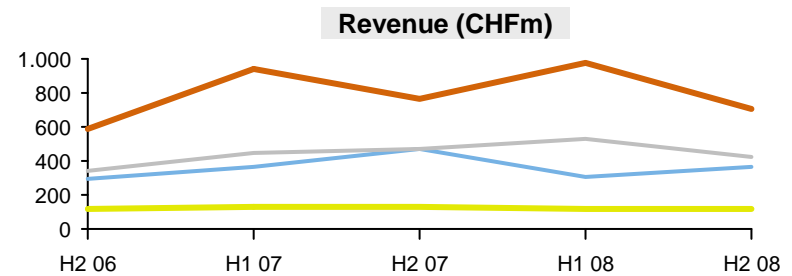
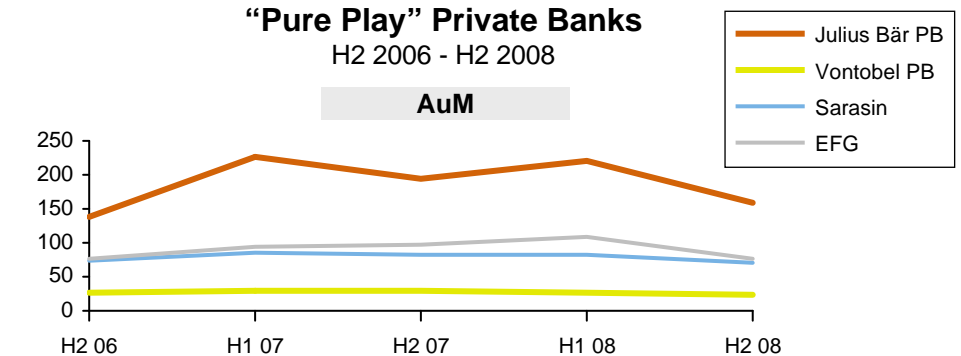
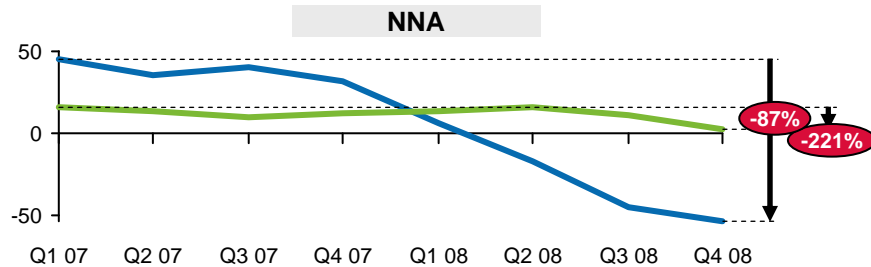
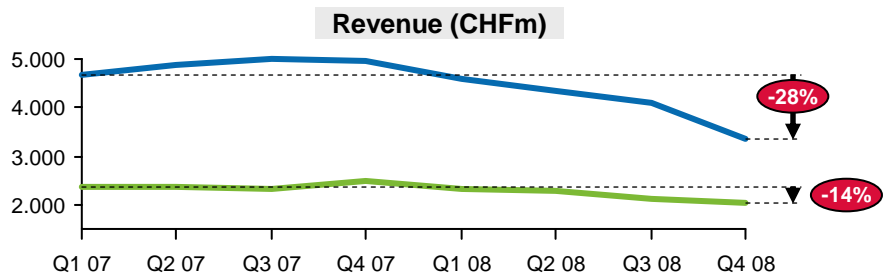
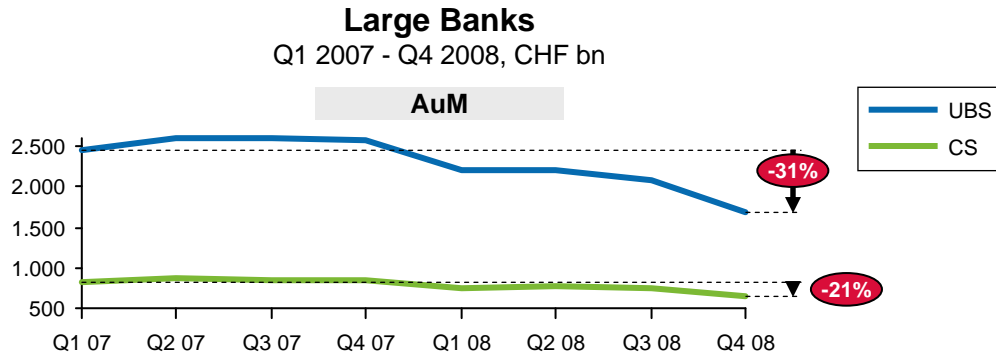


1) Estimated development based operating income development for 25 largest private banks

2) Mainly due to price discounts and significantly lower transaction volumes

Sources: SNB; company data; Booz & Company analysis

Switzerland's "pure play" private banks have weathered the storm relatively well so far, but Q4 results indicate: worse is yet to come



Sources: Company reports, Booz & Company analysis

Introduction

Private Banking Beyond the “Perfect Storm”

A Strategic Agenda for the Private Banking Executive

Over the recent weeks, Booz & Company has conducted over 20 interviews with key opinion leaders to form a perspective on the future of Switzerland's private banking industry

Methodology

- Personal interviews with senior executives from leading Swiss wealth management institutions and relevant stakeholders for the Swiss private banking market
- Supplementary interviews with further industry representatives and Booz & Company wealth management experts
- Supporting desktop research (market and company data, industry reports, press)

Universal Banks

- Senior private banking executives responsible for onshore and offshore markets

"Pure Play" Private Banks

- Senior private banking executives

Regulator

- Senior private banking representatives, FINMA

Industry Association

- Senior representatives, Swiss Banking Association

Other Wealth Management Experts

- Several wealth management senior opinion leaders

The current financial crisis is seen as the most severe since the 1930s – recovery is not expected before 2010

Key Findings/Comments from Interviewees

Question:

How severe is the current crisis for the private banking industry?

- Not a major problem
- Mainly media hype



- Severe crisis
- High impact, potentially disruptive

- The current financial crisis is seen as the severest crisis private banking has seen in decades (but some interviewees point out that private banking has always been and will always be a cyclical business)

Question:

How long will the crisis last?

- Till Q2 2009
- Quick recovery



- Beyond 2009
- Slow recovery

- Recovery in the financial markets is not expected before 2010, while the real economy might stay depressed well beyond
- None of the interviewees expects an early and fast recovery in 2009

So far Switzerland's private banks have weathered the storm relatively well, but leading indicators are worsening

Key Findings/Comments from Interviewees

Question:

How will the relative position of Switzerland's private banking industry change?

▪ Weaken



▪ Strengthen

- So far Switzerland's private banking industry has performed relatively well. However, sub-prime exposure at UBS and large-scale investments in Madoff products by (mainly) mid-size private banks have substantially damaged the reputation of and trust in the "Swiss" brand
- Annual results FY 2008 are still fairly positive, but the sudden drop in revenues over the last 2-3 months is a lead indicator for worse to come, and interviewees expect 2009 to be an extremely tough year
- On the positive side, relative macro-economic stability has helped to re-confirm Switzerland's position as a safe haven, and even in a world of "declared offshore" the position of Switzerland as a leading offshore hub will be maintained, since many clients distrust the future of state finances in their home countries

Consolidation of the (still very fragmented) private banking industry is expected to accelerate both globally and locally

Key Findings/Comments from Interviewees

Question:

Will the private banking industry consolidate further?

▪ No



▪ Yes

- Consolidation is already happening: many big players (e.g. Merrill Lynch, Morgan Stanley) have lost independence already
- Private banks that are unable to reduce total costs in line with declining assets/revenues will go out of business/be acquired by more fluid competitors in the medium-term
- Many smaller private banks are now facing very obvious scale challenges as AuM/revenues decreased by 30% and clients are calling for improved services/research and better pricing
- Foreign private banks now owned by their local governments will see their “raison d’être” questioned, e.g. Swiss subsidiaries of state-owned German and UK banks

The focus by governments, regulators and the public on private banking will continue, and regulatory pressure will accelerate further

Key Findings/Comments from Interviewees

Question:

How severe will the regulatory pressure be for Swiss private banking?

▪ Not severe



▪ Very severe

- All interviewees agree that increasing regulatory pressure is the major risk for Switzerland's private banking industry, as regulators/governments tend to overshoot in strained times¹⁾
- Switzerland's private banking industry is not ready to counter this increasing pressure with a common voice, and adequate lobbying is lacking on both the national and international level

1) Most interviews conducted prior to FINMA asking UBS to hand-over client documents

None of the executives interviewed expect the/his private banking business model to change. All interviewees are confident to have the right strategy to gain market share during the crisis

Key Findings/Comments from Interviewees

Question:

Are you expecting Swiss private banking to change fundamentally?

▪ No



▪ Yes

- All interviewees believe the private banking business model in its current form is here to stay – no significant change (e.g. disintegration of the value chain, disregard for open product architecture) will emerge
- The ability to play “multi-shore”, high service quality and political stability will secure Switzerland’s position as a leading private banking hub

Question:

Do you have the right strategy/ business model to gain market share during this crisis?

▪ No



▪ Yes

- All the executives interviewed are convinced they have the right strategic agenda to weather the storm, and only minor changes are needed
- All the executives interviewed believe they will gain market share during this crisis and they will operate as an active consolidator during these demanding times

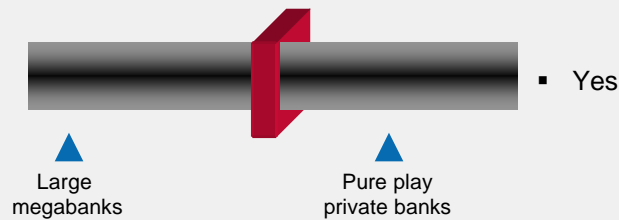
The perspective on the future of offshore private banking varies significantly between the large megabanks and the “pure play” private banks

Key Findings/Comments from Interviewees

Question:

Will the “classic” offshore private banking model survive?

▪ No



▪ Yes

- Managing undeclared offshore assets is seen as a discontinued business model by the large megabanks
- “Pure play” private banks are staying with it, as this is where they see their strength and often they lack the means to play “multi-shore”
- All interviewees recognize that cross-border private banking is increasingly complex and compliance with regulatory requirements require discipline and flawless execution

Going onshore is still seen as the right way forward for Swiss private banks, but this has to be handled very carefully

Key Findings/Comments from Interviewees

Question:

Will you continue your onshore strategy?

▪ Will carefully review



▪ Full speed ahead

- Going onshore is still considered the right strategy to counter regulatory pressure and the client trend to repatriate assets
- Market entry strategies need careful review as many fundamental assumptions might have changed, especially in markets with the biggest losses from crisis (e.g. South-East Asia, Russia, Argentina, Middle East), and losses need to be cut where the fundamentals are no longer in place
- The onshore footprint needs careful review as locations in 2nd tier offshore domiciles (e.g. Channel Islands, Caribbean, Mediterranean Islands) might have become toxic in a new world

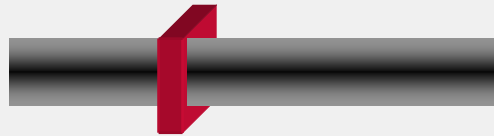
“Pure play” private banks and banks with a real/perceived “state underwrite” have gained favour with clients, but the sustainability of these asset shifts is questionable

Key Findings/Comments from Interviewees

Question:

Who will be the winners and losers in the crisis?

- Pure play private banks will win



- Large megabanks will win

- So far the “pure play” private banks, “Kantonalbanken” and “Regionalbanken” (incl. Raiffeisen) have been able to snap market share in the Swiss onshore market
- Many affluent clients who have expanded their personal banking footprint (and even larger clients) have shifted liquid assets to higher-interest accounts at smaller banks
- The sustainability of these shifts in liquid assets is questioned by most interviewees – this will be the major battleground over the next 12 months

Question:

Will the large megabanks recover their market position?

- No



- Yes

- Most interviewees believe Switzerland’s large megabanks will continue as major players in the industry, and after rebuilding client confidence a strong rebound is to be expected
- The competitive situation might intensify as expensive acquisition strategies (e.g. through higher interest rates) are becoming increasingly common

The client preference for structured products will return but, given the demand for transparency, revenue pools will consolidate at lower levels

Key Findings/Comments from Interviewees

Question:

Is the client preference for low risk/low return products being maintained?

▪ No



▪ Yes

- After recovering from the crisis, clients will return to structured products, but this time with greater awareness (which therefore also applies to the Relationship Managers). Easy-to-understand, transparent products will attract attention, while complex, non-transparent structures will not see recovery in the short term
- Product profitability will not return to pre-crisis levels, as lower-margin products will remain in focus (e.g. ETFs)

Question:

Will risk management become more important in client relations?

▪ No



▪ Yes

- Defining and executing advisory processes will be the key differentiator in the market. Risk management (e.g. fully understandable risk reporting, risk training) will carry much more weight in client relationship management
- Capital protection will gain in importance, though this may again prove to be pro-cyclical, as clients are often over-enthusiastic in good times and over-pessimistic in difficult times

Client behaviour is not expected to change, as client memory has proven to be short-term in the past and ultimately client “aspiration” will replace the current “fear”

Key Findings/Comments from Interviewees

Question:

Will client behaviour change due to this financial crisis?

▪ No



▪ Yes

- Client fear is currently at its height, and a high share of assets are being held in liquid assets, gold, and money-market funds
- Clients are (once again) exhibiting pro-cyclical behaviour, but all interviewees believe that once the market mood changes clients will come back to investing in higher risk products, “to make up for their losses”
- Significant assets are currently held in cash, ready to get back into the market

Due to significantly lowered value pools, private banks have to get serious about rightsizing their cost base

Key Findings/Comments from Interviewees

Question:

Are you expecting to significantly lower your cost base in 2009?

▪ No



▪ Yes

- All interviewees are planning to further reduce costs in 2009 to respond to significantly lower value pools (“we need to learn how to make money again”)
- The financial crisis will provide an opportunity to adjust the people mix and correct any mis-hiring which occurred during the peak period; the high proportion of variable pay offers is a great advantage in these times
- Cost-cutting will need to take in all areas - front, middle and back office. Many Regional Managers now have small-sized portfolios, and therefore front office organization and team structures need to be adjusted
- “Make or buy” decisions need to be taken for all components in the value chain

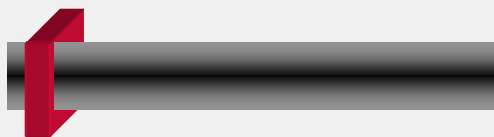
Nobody expected a turmoil of this magnitude, and no precautionary measures were taken to prepare for a sudden and deep downturn

Key Findings/Comments from Interviewees

Question:

How well were the Swiss private banks prepared to deal with this crisis?

▪ Not at all



▪ Well prepared

- None of the interviewees expected a crisis of this magnitude
- No precautionary measures were taken, and early warning signals were generally ignored
- Private bankers, aware of the cyclical nature of their business, pursued aggressive growth strategies even after the market had turned for the worse

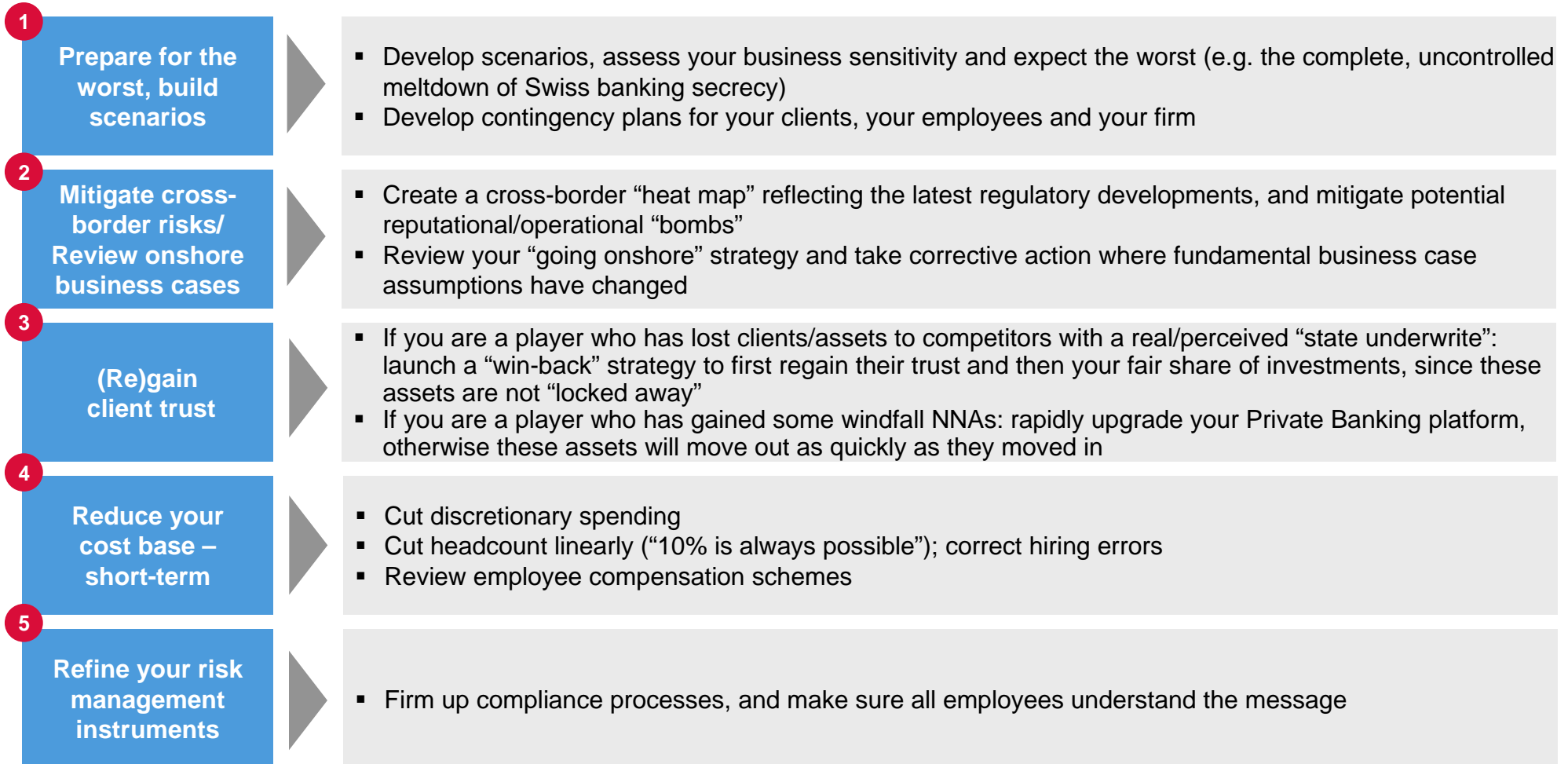
Introduction

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A Strategic Agenda for the Private Banking Executive

Short-term actions need to be taken to steer through this storm...

Short-term Action Plan



... while setting the agenda for the time beyond

Agenda Beyond the “Perfect Storm”

