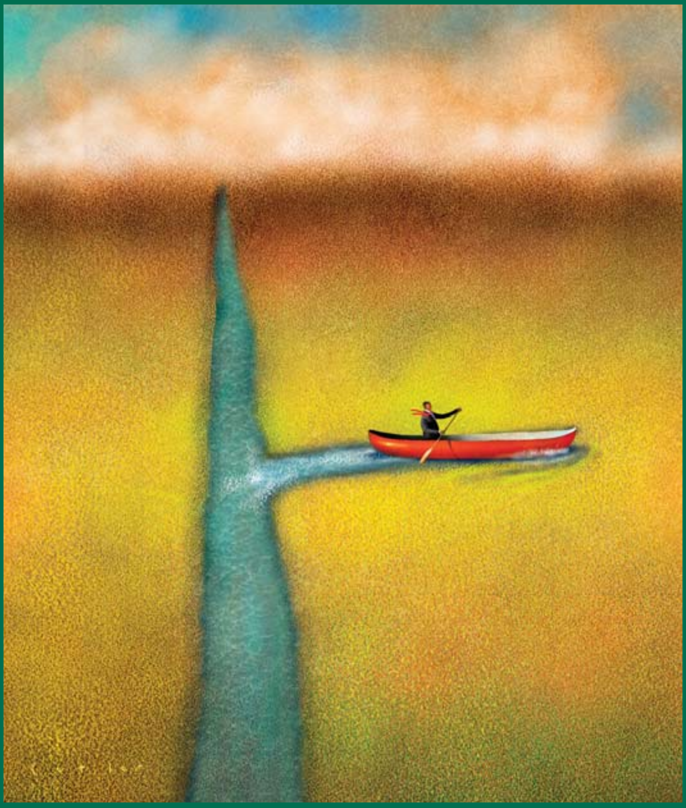
BCG

Report

Global Wealth 2011

Shaping a New Tomorrow

How to Capitalize on the Momentum of Change



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Shaping a New Tomorrow

How to Capitalize on the Momentum of Change

Global Wealth 2011

Jorge Becerra

Peter Damisch

Bruce Holley

Monish Kumar

Matthias Naumann

Tjun Tang

Anna Zakrzewski

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Fax: +1 617 850 3901, attention BCG/Permissions
Mail: BCG/Permissions
The Boston Consulting Group, Inc.
One Beacon Street
Boston, MA 02108
USA

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Introduction

Global wealth climbed by 8.0 percent in 2010 to $121.8 trillion, or about $20 trillion above where it stood during the depths of the financial crisis. The rate of growth has slowed since the sharp turnaround in 2009 and was below the pace set during the precrisis boom—from year-end 2002 through 2007—when wealth grew at a compound annual rate of nearly 11 percent. Still, the outlook remains upbeat. Global wealth is expected to increase at an annual rate of nearly 6 percent over the next several years, with exceptional growth in emerging markets.

Despite such encouraging signs, our benchmarking survey of 120 wealth managers around the world found mixed results for 2010. The average pretax profit margin of wealth managers increased to 23 basis points, up 4 basis points from 2009. In most regions, however, revenue margins remained lower than they were before the crisis (and in some places continued to decline), while cost-to-income ratios remained higher (and in some places continued to rise). Offshore wealth managers, particularly those based in Switzerland, faced the most significant challenges, as the push to increase tax and regulatory compliance as well as international reporting stemmed the flow of assets and imposed new costs.

More broadly, changes in client behavior and competitive dynamics are affecting virtually every type of wealth manager. In some regions, clients are becoming more price sensitive, prices are becoming more transparent, and competitors—particularly those wielding new or alternative business models—are using the combination of these two trends as a way to gain market share. For many wealth managers, however, pricing remains a vastly underutilized tool for improving revenue margins. At many wealth-management institutions, pricing strategies are more arbitrary than deliberate and are often decoupled from the service levels provided to specific client segments.

As much as the sustained recovery of global wealth reaffirms wealth management's place as a relatively stable and attractive part of the financial services world, it also masks important and lasting changes to the dynamics of this industry. Perhaps more than ever, a wealth manager's adaptability—its capacity to anticipate and respond to a combination of regulatory, client-driven, and competitive changes—will determine how well it prospers from the continued growth of wealth.

Market Sizing

Capitalizing on a Sustained Recovery

Global wealth grew in nearly every region of the world in 2010, with assets under management (AuM) showing signs of a sustained recovery in both developed and emerging markets.[1] (See Exhibit 1.) By the end of the year, AuM had increased by $9 trillion and was at a record-high level.

Global Overview

North America had the largest absolute gain in wealth, at $3.6 trillion, and the second-highest growth rate, at 10.2 percent. Its $38.2 trillion in AuM—nearly one-third of global wealth—made it the world's richest region. In Europe, wealth grew at a below-average rate of 4.8 percent, but the region still gained $1.7 trillion in AuM. North America surpassed Europe as the wealthiest region in part because its capital markets had a stronger recovery, but also because the euro lost value relative to the dollar in 2010.

Wealth grew fastest in Asia-Pacific (ex Japan), at a 17.1 percent rate (the region is classified as "emerging" because of the predominance of emerging markets). In the Middle East and Africa, growth was above the global average, at 8.6 percent, but was limited by volatility in the price of oil as well as by the real estate crisis in Dubai. In Latin America, wealth grew by 8.2 percent. Together, these three emerging-market regions accounted for $29.7 trillion in AuM, and their share of global wealth continued to rise—from 20.9 percent of global wealth in 2008 and 22.9 percent in 2009 to 24.4 percent in 2010.

Wealth declined by 0.2 percent in Japan to $16.8 trillion. Although Japan remains one of the largest wealth markets in the world, its share of the Asia-Pacific region's AuM has been declining. As recently as 2008, Japan accounted for more than half of all the wealth in Asia-Pacific. In 2010, it accounted for about 44 percent.

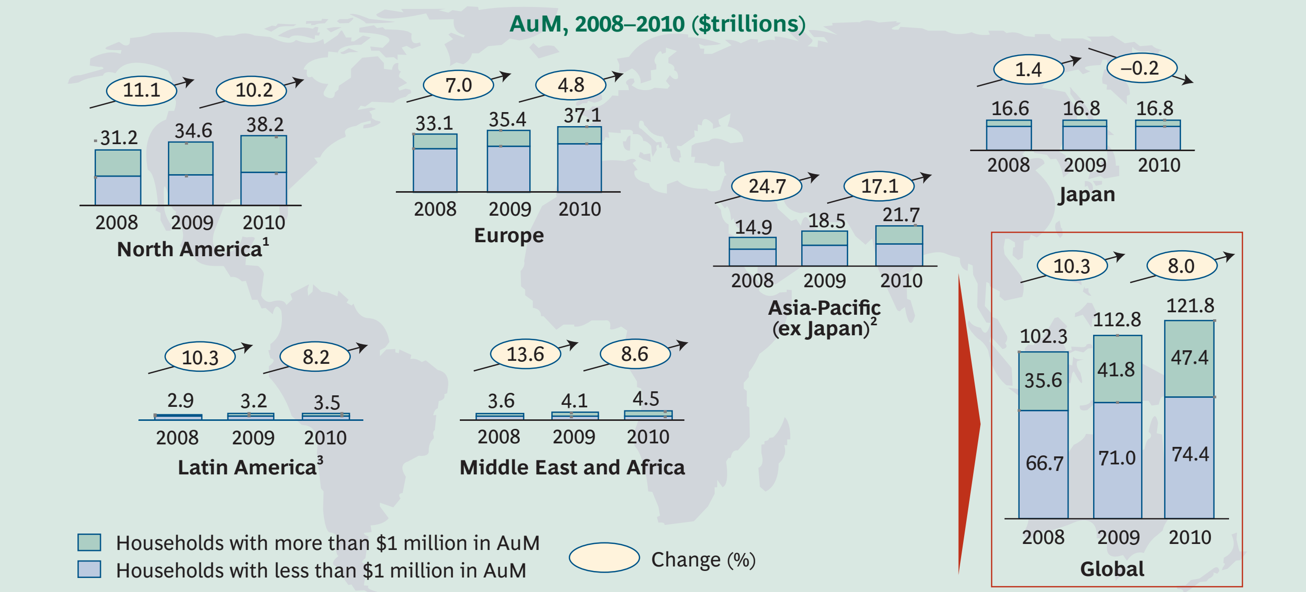
Adjusted to reflect fluctuations in exchange rates—in other words, with wealth converted to U.S. dollars using prevailing year-end exchange rates for each year rather than using year-end 2010 exchange rates across all years—global wealth grew by 9.4 percent in 2010. (See Exhibit 2.) The difference was most noticeable in Asia-Pacific, where local currencies gained in value relative to the U.S. dollar. In Asia-Pacific (ex Japan), the currency effect turned a 17.1 percent increase, measured at a constant conversion rate, into an increase of 22.8 percent. In Japan, it turned a 0.2 percent *decline,* measured at a constant conversion rate, into a 12.8 percent gain.

The currency effect had a small but positive impact on the growth of wealth in Latin America and also in the Middle East and Africa. In Europe, on the other hand, it actually dampened growth, as the euro lost value relative to the U.S. dollar. Adjusted for exchange rates, European wealth grew by only 0.4 percent in 2010, compared with 4.8 percent on the basis of constant exchange rates.

Drivers of Growth. The strong performance of the financial markets accounted for 59 percent of the growth in

1. AuM includes cash deposits, money market funds, listed securities held directly or indirectly through managed investments, and onshore and offshore assets. It excludes wealth attributed to investors' own businesses, residences, or luxury goods. Global wealth reflects total AuM across all households. Unless stated otherwise, AuM figures and percentage changes are based on local AuM totals that were converted to U.S. dollars using year-end 2010 exchange rates for all years in order to exclude the effect of fluctuating exchange rates.

Exhibit 1. Global Wealth Continued to Grow in 2010, but at a Slower Pace



Source: BCG Global Wealth Market-Sizing Database, 2011.
Note: AuM numbers for all years were converted to U.S. dollars at year-end 2010 exchange rates to exclude the effect of currency fluctuations. Percentage changes and global totals of AuM are based on complete (not rounded) numbers. Calculations for 2008 and 2009 are based on the same methodology used for the 2010 calculations. Global wealth is measured by AuM across all households.
[1]United States and Canada.
[2]Includes Australia and New Zealand.
[3]South America, Central America, and Mexico.

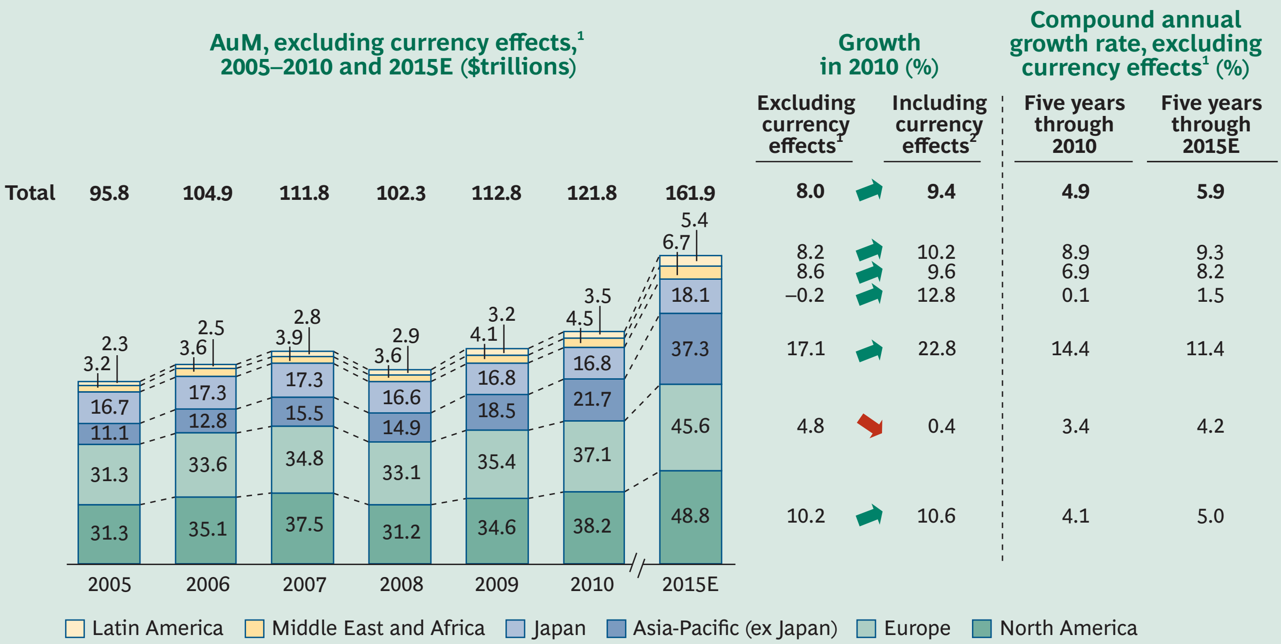
AuM in 2010. The remainder came from savings. The impact of the financial markets was amplified by the ongoing reallocation of wealth. During the crisis, cash was king. Since then, clients have been redirecting their assets back into riskier investments. From year-end 2008 through 2010, the share of wealth held in equities increased from 29 percent to 35 percent, while the share of wealth held in cash and deposits declined from 49 percent to 45 percent. (Bonds accounted for the remainder of global wealth.)

The rising share of wealth held in equities was heavily influenced by changes in North America, where the absolute amount of wealth held in equities increased by 18.1 percent and where financial market performance accounted for 81 percent of the increase in AuM. The region continued to have the highest proportion of wealth held in equities—44 percent, up from 41 percent in 2009. The change was significantly smaller in all other regions except Asia-Pacific (ex Japan), where the proportion of wealth held in equities grew from 30 percent to 34 percent. Despite these increases, we do not expect the share of wealth held in equities to reach its precrisis level of 39 percent until 2013.

Millionaires

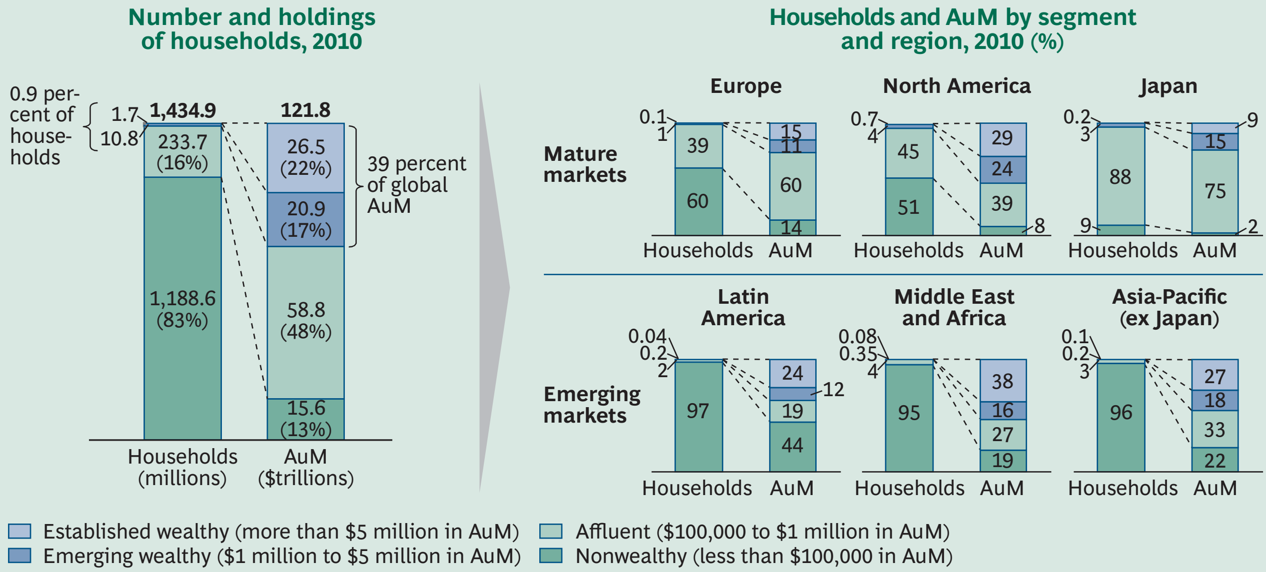
The vast majority of the world's wealth, 87 percent, was owned by households with more than $100,000 in AuM. (See Exhibit 3.) Millionaire households represented just 0.9 percent of all households but owned 39 percent of global wealth, up from 37 percent in 2009 (measured in U.S. dollars). The proportion of wealth owned by millionaire households increased the most in Asia-Pacific, at 2.9 percentage points, followed by North America, at 1.3 percentage points. A subset of this group—the established wealthy, with more than $5 million in AuM—represented about 0.1 percent of all households and owned nearly 22 percent of global wealth, up from 20 percent in 2009. Again, the proportion of wealth owned by these households increased the most in Asia-Pacific, at 2.2 percentage points, followed by North America, at 1.5 percentage points. Emerging markets, in general, had some

Exhibit 2. A Weak U.S. Dollar Magnified the Growth of AuM (Except in Europe)



Source: BCG Global Wealth Market-Sizing Database, 2011.
Note: Compound annual growth rates are calculated on the basis of year-end values and complete (not rounded) numbers.
[1]AuM numbers for all years were converted from local currencies to U.S. dollars at year-end 2010 exchange rates (that is, at a constant rate of exchange).
[2]AuM numbers for 2009 and 2010 were converted from local currencies to U.S. dollars at year-end 2009 and year-end 2010 exchange rates, respectively.

Exhibit 3. Wealth Was Much More Concentrated in Emerging Markets



Source: BCG Global Wealth Market-Sizing Database, 2011.
Note: Discrepancies in totals reflect rounding.

of the highest concentrations of established wealthy households.

The number of millionaire households increased by 12.2 percent in 2010 to about 12.5 million. The United States had the most millionaire households, followed by Japan, China, the United Kingdom, and Germany, while small countries continued to have some of the highest concentrations of millionaire households. (See Exhibit 4.) In Singapore, 15.5 percent of all households had at least $1 million in wealth. Switzerland had the highest concentration of millionaire households in Europe and the second-highest overall, at 9.9 percent. The United States had the largest number of ultra-high-net-worth (UHNW) households (those with more than $100 million in AuM), while Saudi Arabia had the highest concentration of UHNW households, followed by Switzerland, Hong Kong, Kuwait, and Austria.

Outlook

We expect wealth to grow at a compound annual rate of 5.9 percent from year-end 2010 through 2015 to about $162 trillion, driven by the performance of the capital markets, the growth of GDP, and increased savings in countries around the world. Wealth will grow fastest in Asia-Pacific (ex Japan), at a compound annual rate of 11.4 percent. As a result, the region's share of global wealth is expected to increase from 18 percent in 2010 to 23 percent in 2015. In Japan, the amount of wealth is expected to decrease slightly in 2011 and then grow slowly for several years. The impact of the recent earthquake on private wealth is still unclear, but it could put further stress on Japan's growth rate.

In general, wealth will grow at above-average rates in emerging markets. (See Exhibit 5.) In India and China, it will increase at a compound annual rate of 18 percent and 14 percent, respectively, from year-end 2010 through 2015. China alone will account for 19 percent of the overall increase in AuM over the period, while India will account for about 8 percent. We expect growth rates in Western Europe and North America to be slightly below the global average.

Regional Focus: Asia-Pacific (ex Japan)

Private wealth grew at more than double the global average in Asia-Pacific (ex Japan) in 2010, propelled by the region's vibrant economies. The two most prominent of

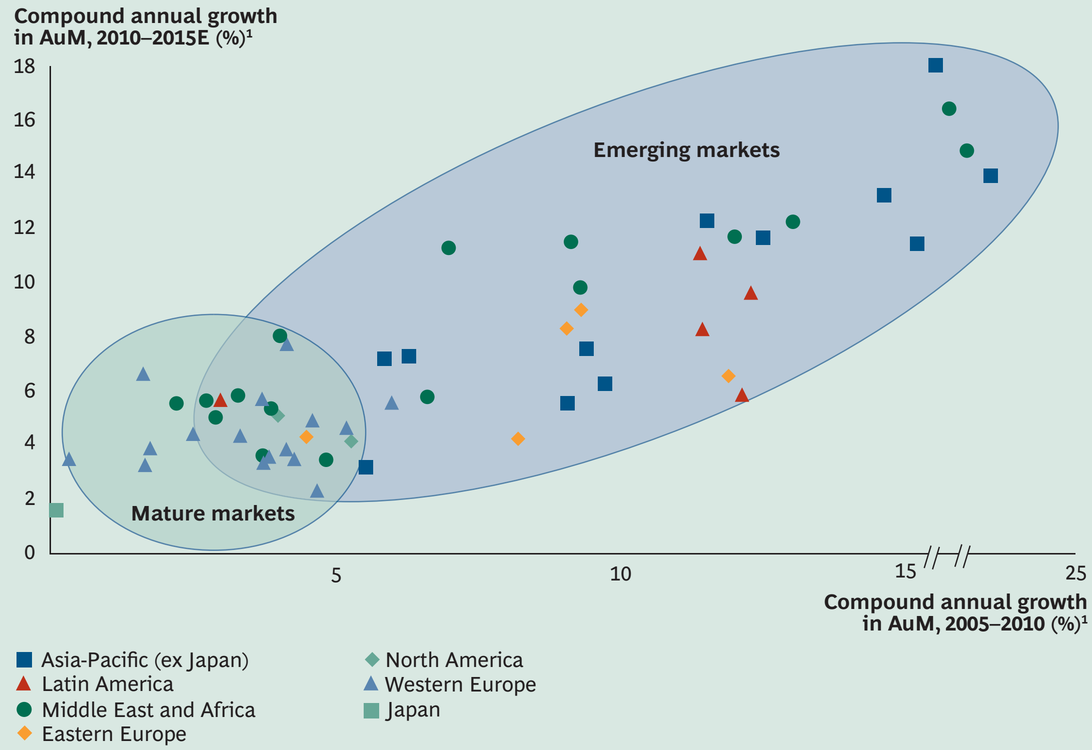
Exhibit 4. Saudi Arabia and Switzerland Had the Highest Proportions of Ultrawealthy Households

Millionaire households: Number of millionaire households (thousands)		Millionaire households: Proportion of millionaire households by market (%)		Ultra-high-net-worth (UHNW) households (more than $100 million in AuM): Number of UHNW households		UHNW: Proportion of UHNW households by market (per 100,000 households)	
1. (1) United States	5,220	1. (1) Singapore	15.5	1. (1) United States	2,692	1. (1) Saudi Arabia	18
2. (2) Japan	1,530	2. (3) Switzerland	9.9	2. (2) Germany	839	2. (2) Switzerland	10
3. (3) China	1,110	3. (2) Qatar	8.9	3. (3) Saudi Arabia	826	3. (3) Hong Kong	9
4. (4) United Kingdom	570	4. (4) Hong Kong	8.7	4. (4) United Kingdom	738	4. (5) Kuwait	8
5. (5) Germany	400	5. (5) Kuwait	8.5	5. (5) Russia	561	5. (4) Austria	8
6. (7) Switzerland	330	6. (6) UAE	5.0	6. (6) Italy	494	6. (6) Norway	7
7. (8) Taiwan	280	7. (7) United States	4.5	7. (7) Canada	425	7. (7) Qatar	6
8. (6) Italy	270	8. (8) Taiwan	3.5	8. (13) China	393	8. (8) Denmark	5
9. (9) France	210	9. (10) Israel	3.4	9. (8) France	377	9. (10) Singapore	5
10. (10) Hong Kong	200	10. (9) Belgium	3.1	10. (9) Switzerland	352	10. (9) UAE	5
11. (12) India	190	11. (12) Japan	3.0	11. (10) Turkey	341	11. (11) Israel	4
12. (14) Canada	180	12. (11) Bahrain	2.6	12. (11) Austria	297	12. (12) Sweden	4
13. (16) Singapore	170	13. (13) Ireland	2.3	13. (12) Netherlands	278	13. (13) Netherlands	4
14. (11) Netherlands	170	14. (14) Netherlands	2.3	14. (14) Australia	231	14. (14) Belgium	4
15. (13) Spain	160	15. (15) United Kingdom	2.2	15. (15) Hong Kong	223	15. (15) Canada	3

( ) = Ranking in 2009

Source: BCG Global Wealth Market-Sizing Database, 2011.
Note: UAE is United Arab Emirates.

Exhibit 5. Wealth Will Continue to Grow Fastest in Emerging Markets



Source: BCG Global Wealth Market-Sizing Database, 2011.
Note: Compound annual growth rates are calculated on the basis of year-end values. Not shown in the exhibit: New Zealand (negative projected growth); Yemen and Tunisia (very high historical growth).
[1]AuM numbers for all years were converted from local currencies to U.S. dollars at year-end 2010 exchange rates (that is, at a constant rate of exchange).

those—China and India—had exceptional growth in AuM at 29.0 percent and 21.6 percent, respectively.

The deterioration of revenue margins has done little to deter international wealth managers from expanding in the region, even though the competition for talent seems certain to prolong the pressure—both international and regional wealth managers have announced plans to expand their Asia-Pacific teams this year, some by hiring hundreds of staff. To meet their aggressive annual growth targets for AuM, many of which range from 25 percent to 50 percent, international wealth managers are exploring new avenues of growth.

Onshore Expansion. International wealth managers typically focus on only the region's offshore wealth, which accounts for just 7.4 percent of its total AuM. Accessing the other 92.6 percent can be challenging. In many markets, foreign wealth managers are held back by regulations limiting the kinds of products they can provide. These constraints—together with underdeveloped capital markets and the competitive edge that local players often have, owing to their extensive branch networks and customer bases—make it harder for international wealth managers to differentiate their value proposition from that of retail banks and to realize a quick return from new onshore platforms.

The payback from onshore expansion may not be immediate, but it is likely to be substantial over the long run given the expected growth of AuM as well as the potential for market and regulatory developments to pave the way for higher-margin activities. To tap this opportunity, however, international wealth managers will need to focus on clients who are less wealthy and less sophisticated than most offshore investors and developed-market clients. This shift poses a significant challenge—most business models have ossified around practices and products geared toward wealthier, more experienced clients. To move down market, wealth managers will need to reconfigure their product offerings, simplify and standardize their advisory processes, adjust the ratio of relationship managers (RMs) to clients, and modify their distribution networks to include more locations and direct channels.

International wealth managers also have to address larger questions dealing with the implications of moving down market. Can the offering be adjusted without making existing customers feel that they have been downgraded? How will the organization need to be changed to serve lower-end segments? Will there be separate RM teams for less wealthy clients, for example? If so, will RMs view this as an attractive career path? Will there be conflicts between new and existing teams?

Clients in Asia-Pacific have a hands-on, product-driven approach to managing their wealth.

Next-Generation Products. Clients in Asia-Pacific have a hands-on, product-driven approach to managing their wealth. They value access to investment ideas and like to retain control of their portfolios—less than 10 percent of the region's AuM is held in discretionary mandates. In Europe, by comparison, that proportion generally ranges from about 15 percent to almost 25 percent. Recently, however, client behavior has been changing in ways that lend a sense of urgency to the development of new products.

Before the crisis, complex structured products were a key driver of growth for wealth managers in Asia-Pacific. Many investors, alarmed by the scale of the financial crisis, have since shifted assets into simple, low-margin products, undercutting the ROAs of many wealth managers. To spur growth and improve gross margins, wealth managers need to explore opportunities to create new and innovative products, such as the following:

- *Renminbi-Denominated Products.* In 2010, offshore renminbi deposits in Hong Kong increased sharply to RMB 315 billion, up from RMB 64 billion in 2009. Despite this surge, there is a dearth of renminbi-denominated investment products—offshore renminbi bonds amounted to only about RMB 80 billion in Hong Kong. Given the strong fundamental demand, Hong Kong's stock exchange is actively promoting the launch of renminbi-denominated equities and other investment products, while major banks in Hong Kong, such as HSBC, are preparing to launch renminbi-linked structured products.
- *Discretionary Mandates.* Second- and third-generation clients tend to be more open to the idea of discretionary mandates than are first-generation clients. Wealth managers should anticipate and help drive the growth of these mandates.
- *Real Estate Investments.* Wealthy individuals typically have 20 to 30 percent of their wealth in real estate. As important as this asset class is, it is largely ignored by international wealth managers. There is a shortage of real-estate-related research and investment products.
- *Corporate Finance for Midsize Companies.* Many wealthy Asian investors are entrepreneurs. Their companies, for the most part, are not very large and thus are not targeted or adequately served by global investment banks. Their needs, however, can be complex, in part because an entrepreneur's personal wealth is often entwined with the company's assets. Wealth managers can gain a competitive edge by serving both entrepreneurs and their companies.
- *Inheritance Planning.* Many Asian investors are first-generation entrepreneurs. They have no blueprint for passing their wealth or their companies on to the next generation, as evidenced by a rash of high-profile family disputes. Wealth managers have a clear opportunity to help clients navigate the complicated inheritance-planning process.

Regional Focus: Latin America

Latin America is the smallest wealth market in our study, but its AuM is expected to grow at an above-average rate over the next few years. For international wealth managers, however, Latin America poses two major challenges.

First, the crisis played to the strengths of local wealth managers, which had limited or no exposure to the innovative, high-risk investments engineered by Wall Street. With their clients' portfolios on firmer footing, they managed to preserve trust at a time when many other wealth managers were struggling to defend their reputations.

The "trust gap" was evident in their performance relative to that of foreign competitors. Large local banks saw their AuM increase in 2008—a year in which global wealth dropped by about 8.5 percent (at constant exchange rates)—while their pretax profit margins declined only slightly. In contrast, international banks in Latin America experienced declines in both AuM and pretax profit margins in 2008. Second, Latin America is an exceptionally diverse market. Client characteristics and needs differ widely. There are also wide variations in the split between onshore and offshore investing, as well as in regulations.

There are four markets worth singling out for their size, growth, or unique characteristics. These markets are likely to remain the focus of foreign wealth managers interested in expanding in Latin America or tapping the region's flow of offshore wealth.

Brazil is the region's largest wealth market. It had some $1.4 trillion in AuM in 2010, up 9.3 percent from 2009. Millionaire households accounted for about $410 billion of this total. The growth of the country's wealth has been remarkable, and even more so when AuM is converted to U.S. dollars using then-prevailing exchange rates for the different years—and thus factoring in the appreciation of the Brazilian real. Measured in this way, the country's AuM grew at a compound annual rate of roughly 19 percent from year-end 2005 through 2010. Wealth is expected to continue growing at an above-average pace, driven by the country's sustained economic expansion as well as by its mature, well-regulated financial system, which includes some of the most advanced banking, private-pension, and fund-management industries in the region.

Eighty-four percent of Brazil's AuM is held onshore, well above the regional average of about 73 percent. This is a clear reflection of the commanding positions held by large universal banks, most of them local. A small number of global institutions have built competitive wealth-management platforms over the years. Several others are committed to developing their onshore presence through partnerships with, or acquisitions of, local wealth managers.

Mexico is one of the region's fastest-growing wealth markets. From year-end 2005 through 2010, its AuM grew at a compound annual rate of 12.3 percent (excluding the impact of changes in the value of the peso). Millionaire households owned 47 percent of the country's $855 billion in AuM, and they held about 75 percent of their wealth offshore. Onshore alternatives, however, are gaining ground. Over the same five-year period, the growth of onshore wealth outpaced the growth of offshore wealth by an average of 3.4 percentage points per year, and the share of total wealth held onshore increased to 64 percent. Much of the country's newly generated wealth is staying onshore as investors take advantage of higher returns relative to offshore alternatives.

Eighty-four percent of Brazil's AuM is held onshore, well above the regional average.

Competition is increasing across all wealth bands, as local wealth managers improve their products and services and foreign competitors expand their onshore presence. Recently, three foreign banks entered the market with offerings geared toward high-net-worth (HNW) individuals, generally defined as having more than $1 million in AuM.

Chile is mainly an onshore market. About 93 percent of its $301 billion in AuM was held onshore in 2010—a reflection of the increasing sophistication of the local banking industry, which includes a mix of specialized boutiques and universal banks. The strongest competitors are able to leverage their integrated asset- and wealth-management businesses and provide both onshore and offshore investment options. Offshore investments are more relevant to millionaire households, which owned 21 percent of the country's wealth in 2010 and held about one-third of their AuM offshore. The UHNW segment stands out even more in Chile: comprising about 20 families, this group owned about $27 billion of the country's bankable wealth in 2010.

Argentina had $236 billion in AuM in 2010, of which 42 percent was owned by millionaire households. The country's wealth grew at a compound annual rate of 11.5 percent from year-end 2005 through 2010 (excluding the impact of changes in the value of the peso). Households with at least $100,000 in AuM accounted for about 64 percent of the country's wealth and held 74 percent of their wealth offshore. As a result, the local wealth-management industry is very small. Much of Argentina's offshore wealth is managed by established private banks using RMs based in Europe, the United States, or Uruguay.

Offshore Wealth

Adapting to New Complexities

The amount of offshore wealth—defined in this report as assets booked in a country where the investor has no legal residence or tax domicile—increased to $7.8 trillion in 2010, up from $7.5 trillion in 2009. (See Exhibit 6.) The increase was driven by a combination of market performance and asset inflows, primarily from emerging markets. At the same time, however, the proportion of wealth held offshore slipped to 6.4 percent, down from 6.6 percent in 2009. The decline was the result of strong asset growth in countries where offshore wealth is less prominent, such as China, as well as of stricter regulations in Europe and North America, which prompted clients to move their wealth back onshore, thus lowering the net increase in offshore assets.

Offshore private banking, in general, remains a tumultuous part of the business. The relative importance of off-

Exhibit 6. Most Offshore Assets Are Still Held in Europe

Wealth held in offshore centers, 2010 ($trillions)

Destination of offshore wealth

Origin of offshore wealth	Switzerland	United Kingdom, Channel Islands, and Dublin	Luxembourg	Caribbean and Panama	Hong Kong and Singapore	United States[1]	Other[2]	Regional total
North America	0.06	0.23	–	0.36	0.05	0.003	0.03	0.7
Europe	1.04	0.74	0.54	0.14	0.09	0.12	0.27	3.0
Asia-Pacific	0.25	0.36	0.06	0.15	0.70	0.17	0.12	1.8
Latin America	0.24	0.08	0.013	0.18	–	0.38	0.02	0.9
Middle East and Africa	0.49	0.52	0.04	0.06	0.02	0.04	0.26	1.4
Booking center total	**2.1**	**1.9**	**0.6**	**0.9**	**0.9**	**0.7**	**0.7**	**7.8**

Source: BCG Global Wealth Market-Sizing Database, 2011.
Note: Discrepancies in totals reflect rounding.
[1]Predominantly Miami and New York.
[2]Includes Dubai and Monaco.

shore centers is changing rapidly. Some are benefiting from continued asset growth, while others are seeing large asset outflows, with wealth being repatriated to onshore banks, transferred to other offshore centers, redirected into nonfinancial investments, or simply spent at a faster rate.

Constraints on Growth and Profitability

Several trends are undercutting the appeal of offshore banking.

There will always be clients wanting to put their money offshore. Tax considerations have certainly influenced the flow of offshore assets, particularly for clients from North America and Western Europe. Most offshore clients, however, are less concerned with taxes and more concerned with safety and stability, often because their own countries have shaky political systems or badly regulated or poorly run financial sectors. In addition, some clients value the discretion, privacy, and secrecy ensured by offshore private banks, owing to a lack of trust in local banks or authorities or concerns about criminal threats in their home countries. More discerning clients rely on offshore centers for their unmatched expertise, specialized products, access to sophisticated investments, and integrated wealth services. A small minority of clients value offshore centers for the status and prestige they confer.

Although most of the core drivers of demand remain relevant—as evidenced by the recent unrest in parts of Africa and the Middle East—other trends are undercutting the appeal of offshore banking. For example, there is a widely held but misguided presumption that all offshore wealth is illicit, even though tax considerations—as described above—are far from the only reason why wealthy individuals hold their assets offshore. In most countries outside of Western Europe and the United States, taxes play a minor role in the decision to hold assets offshore.

The de facto criminalization of offshore wealth has helped drive a concerted push for greater transparency. This effort, which is certain to cause at least some of the wealth held offshore to evaporate, is unfolding on several fronts.

- In March 2009, Austria, Belgium, Luxembourg, and Switzerland withdrew their reservations to Article 26 of the OECD Model Tax Convention on Income and on Capital, paving the way for the bilateral exchange of tax information. In the case of Switzerland, government authorities now provide information on individual clients and their holdings to foreign tax authorities, not only in cases of tax fraud (such as submitting false documents to avoid taxes) but also in cases of tax evasion (such as not declaring assets). But Swiss authorities have taken a stand against so-called fishing expeditions—they do not allow foreign tax authorities to have automatic access to account information or to conduct investigations at random, and will provide information only if there is reasonable suspicion. The implementation of Article 26 is now being codified in individual double-taxation agreements between offshore centers and client-domicile countries that are seeking tax information from abroad.

- In October 2010, Switzerland signed a declaration of intent with Germany and the United Kingdom to collect a flat-rate tax on earnings accruing to clients from these two countries. The tax revenues will be transferred to the respective country, although the clients will remain anonymous. Switzerland also agreed in principle to levy a one-time tax on any undeclared assets held in Switzerland by German and U.K. clients, thus rendering the assets tax-compliant. The modus operandi of this tax has yet to be defined.

- Under the U.S. Foreign Account Tax Compliance Act (FATCA), which takes effect on January 1, 2013, all foreign financial institutions—including banks, traditional funds, hedge funds, and private-equity companies—will be required to disclose information about their U.S.-taxable clients to the U.S. Treasury. This will affect clients who are from the United States, as well as any clients who hold U.S. assets in any form. If an institution is not willing to comply, its clients will be charged a tax of 30 percent on all “withholdable payments” in the United States, including investment returns, personal income, and gross proceeds from the sales of securities or property. To comply with FATCA, institutions will need to adopt a more intensive know-your-client process and will have to fulfill additional reporting requirements stipulated by the U.S. Internal Revenue Service.

- In response to the recent turmoil in the Middle East and Africa, various governments, primarily in Western Europe, have frozen the assets of politically exposed persons (PEPs)—typically senior government or political figures—who are associated with dictatorial regimes. As a result of careless communication and inaccurate press coverage, many clients are concerned about the way offshore centers might react to these developments. Under the mistaken belief that their own assets could be in jeopardy, clients are transferring their wealth to countries that have not taken such action against PEPs.

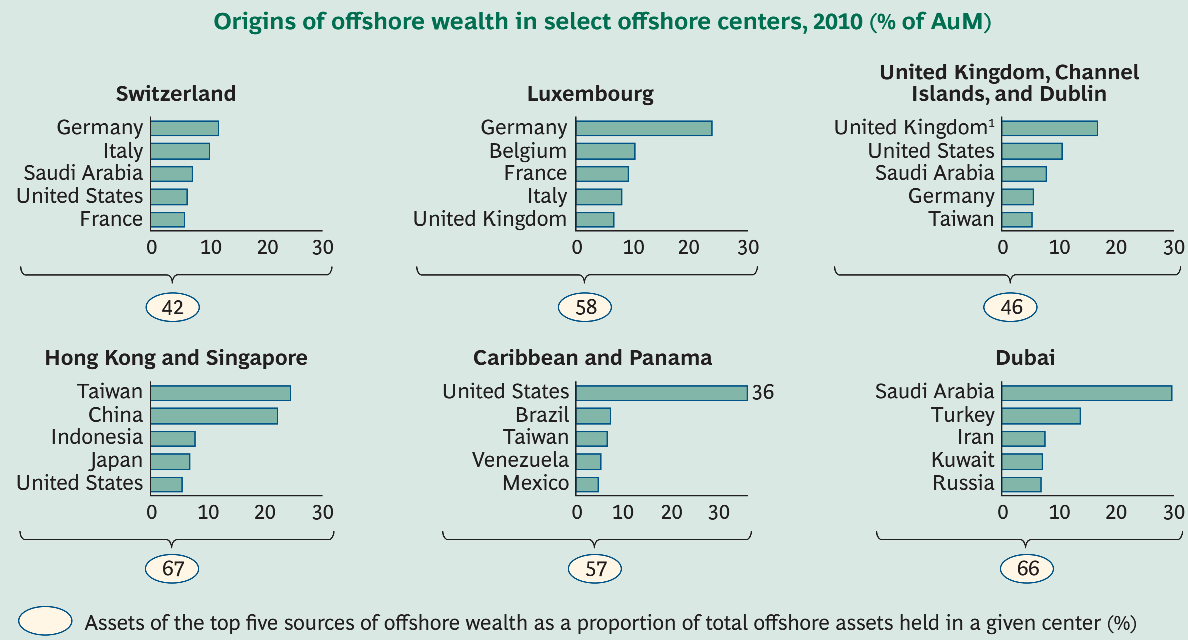
These measures are not the only factors stemming or reversing the flow of assets to offshore private banks. In some countries, onshore options are becoming more attractive as local wealth managers begin to develop more competitive investment products and tax-optimized solutions. In addition, some clients, having experienced dramatic losses during the recent financial crisis, are questioning the relatively high fees charged in offshore centers. (The challenges to offshore institutions' profitability and growth are described in more detail in the next chapter.)

New Competitive Dynamics

The pressures on offshore private banks are complicated by two changes in the competitive landscape. The first involves a rebalancing of offshore demand across regions. Traditionally, about half of all offshore wealth has originated in Western Europe and the United States. Regulatory pressure, however, is expected to constrict the flow of offshore assets from these markets. In emerging markets, the impact of the new rules is not expected to be as dramatic, in part because tax avoidance is less of an issue (since, in many of these markets, local taxes are relatively low) but also because the primary drivers of demand—safety and stability—still hold true.

The second change involves increased competition among offshore centers. In an effort to maintain or increase their share of global assets—and their associated revenue pools—many centers are focusing on the qualities and characteristics that influence a wealthy individual's choice of offshore center. For example, many clients prefer offshore centers that present no cultural or language barriers and that are close to their country of residence. (See Exhibit 7.) Some clients look for offshore centers that are

Exhibit 7. Proximity Influences the Flow of Offshore Assets



Source: BCG Global Wealth Market-Sizing Database, 2011.
[1]Assets flowing from the United Kingdom into the Channel Islands and Dublin.

known as centers of expertise in areas such as discretionary mandates, hedge funds, trade finance, or philanthropy. Others favor offshore centers that double as appealing holiday destinations, or that might be a nice place to live.

By focusing on these attributes, offshore centers are becoming more specialized and differentiated. This is bound to intensify the flow of assets to and from such centers. With a substantial amount of assets in motion—and much of it at risk of going back onshore entirely—it is important for wealth managers to understand the strengths and weaknesses of their respective centers. Although they share important characteristics, each offshore center has a unique sweet spot, along with equally distinct challenges.

Offshore centers are becoming more specialized and differentiated.

Switzerland and Luxembourg. These offshore centers have similar characteristics, including political and economic stability, a strong culture of banking confidentiality and privacy (despite growing regulatory pressure), high-quality products and services, and a concentration of skilled, multilingual personnel.

- *Switzerland.* Swiss private banks are known for their expertise in discretionary portfolio management. They are well positioned to capture the wealth emanating from the Middle East and Africa and also Latin America, owing to their established reputations. Switzerland is also attractive for holidays and relocation. As an offshore center, however, Switzerland is under tremendous pressure. About half of its AuM comes from Western European countries that are increasing their oversight of cross-border banking. As a result, Switzerland is likely to experience a significant decline in assets owned by Western European clients, many of whom will be compelled to repatriate their wealth, spend it at a faster rate, or transfer it to other investments, such as real estate. Assets that remain offshore could be subject to penalty taxes.

- *Luxembourg.* For decades, Luxembourg's offshore banks have thrived by capturing asset flows from their closest neighbors. Recently, however, clients from Western Europe—particularly from Belgium, Germany, and the Netherlands—have been repatriating their wealth. In addition, the G-20 is trying to force Luxembourg to give up banking secrecy entirely.

The United Kingdom, Channel Islands, and Dublin. These centers have similar levels of political and economic stability, along with a reputation for quality products and services. They also share many of the same (strict) regulatory and supervisory controls and the same protections for the privacy and confidentiality of financial information.

- *United Kingdom.* U.K. offshore banks, especially those based in London, are considered very strong in complex structures such as multijurisdictional trusts, as well as in asset management and mutual funds—and are well positioned to attract offshore wealth from China, India, Latin America, and the Middle East, owing to historical ties to these markets. Although offshore clients can become U.K. residents without having a domicile there, increased pressure from tax and regulatory authorities is expected to trigger some outflows of money.

- *Channel Islands and Dublin.* Banks based in these offshore centers are known to be highly skilled in both private fiduciary (trusts) and corporate fiduciary (fund administration and custody). Various external asset managers (EAMs) use single-premium insurance policies, written by large insurance companies, to run private-client accounts; the assets are held by the insurance company but the advice comes from the EAMs. Clients pay fees to the insurer, and the insurer pays commissions to the EAMs in a fee-sharing arrangement. Major global banks located in these offshore centers typically focus on managing the fund and trust businesses for large clients. Smaller boutique banks offer specialized services, including the setup of coinvestment funds, special-purpose vehicles, and pension funds or trusts. The Channel Islands and Dublin recently implemented Article 26 of the OECD Model Tax Convention, but tax authorities have yet to put significant pressure on these offshore centers. Still, large amounts of British-owned assets are likely to be repatriated.

Hong Kong and Singapore. These countries have a number of strengths as offshore centers, including deep pools of financial services expertise; well-developed law, accounting, and regulatory systems; large numbers of multilingual professionals; financial stability; and robust equity and foreign-exchange markets (although the bond markets remain relatively underdeveloped). In general, Hong Kong is emerging as an offshore renminbi center, and Singapore's offshore banks are known for private banking. While the governments in both offshore centers are focusing on tax compliance, the regulatory pressure is not as severe as it is elsewhere. In fact, private banks have been building booking centers in both places, in part to capture assets flowing back to the region but also to provide an offshore option that is closer to home for Asian clients and is able to provide renminbi-denominated products.

- *Hong Kong.* Low taxes are an identifying feature. There is a flat 15 percent income tax for people working in Hong Kong, and there is no capital gains tax, sales tax, or VAT, nor is there an estate duty on Hong Kong assets. A shortage of talent is the biggest impediment to Hong Kong's growth as a financial center. Still, its growth prospects remain bright. Recent changes have strengthened Hong Kong's place as the premier offshore center for Chinese clients—banks can now conduct more business in renminbi for corporate clients based in Hong Kong, while local companies are allowed to issue renminbi-denominated bonds.

- *Singapore.* There is no estate duty for foreigners, but Singapore's tax regulations are set to become tighter owing to the government's commitment to meeting international standards. The government has renegotiated tax agreements with six OECD countries and aims to conclude talks with seven others soon.

Dubai. Dubai boasts political and economic stability; a good capital-markets infrastructure, which revolves around a dollar-oriented stock exchange and the Dubai International Financial Centre (DIFC); a well-regulated financial-services sector; and separate legal jurisdiction from the United Arab Emirates. In addition, it allows full foreign ownership of local companies and full repatriation of profits, and does not levy any taxes on individual or corporate income and profits. As an offshore center, however, Dubai faces several challenges. Recently, DIFC has had limited success in attracting significant operations, owing in part to the real estate crisis and concerns about government debt. It also faces increasing competition from the Qatar Financial Centre Authority and the Bahrain Financial Harbour. Still, Dubai is likely to emerge as the most prominent offshore center in the Arab world, given its appeal to clients from other Arab and Islamic countries. (For more on serving these clients, see the sidebar "Tapping the Growth Potential of Islamic Wealth.")

Latin America. This region has a number of offshore centers that continue to have substantial tax advantages.

Tapping the Growth Potential of Islamic Wealth

Managing wealth in accordance with Sharia has become more mainstream than alternative in the Middle East and parts of Africa and Asia—areas that encompass fast-growing wealth markets and some of the highest concentrations of millionaires in the world. But to grow in these markets—and to serve Muslim clients around the world—wealth managers need to contend with the intrinsic complexities of Islamic wealth management, along with increasing competition.

A Growing Niche

Islamic wealth management is defined by a set of far-reaching strictures, including a ban on activities associated with usury *(riba)*, gambling *(maysir)*, or undue risk *(gharar)* or that otherwise contravene the principles of Islam. Most notably, it prohibits the charging of, or benefiting from, interest. It also bars investments in forbidden *(haram)* industries, such as those involving alcohol, or in companies that have excessive borrowing.

The growth of Islamic wealth management parallels the growth of the Islamic banking industry, which, since the late 1990s, has been working to improve regulations and codify rules and practices. Today, there are more than 300 Islamic financial institutions operating in more than 75 countries. Globally, Sharia-compliant assets total $939 billion. About 31 percent of these assets, or some $292 billion, is held in banks.

Spurred by the formalization of banking practices and growing interest in Sharia-compliant products, especially in the wealthy countries of The Cooperation Council for the Arab States of the Gulf (known as the GCC), Islamic finance has become one of the fastest-growing segments of the global financial system. In 2010, there were more than 600 Islamic funds, with an estimated $50 billion in assets. Although equities remain the dominant asset class, investors have been shifting some assets into Islamic ETFs and hedge funds.

Tapping the Growth Potential of Islamic Wealth (continued)

Interest in such funds is not confined to Muslim investors. Islamic funds have been marketed to non-Muslim investors as a form of socially responsible investing, largely because these funds avoid investments in industries deemed unethical, such as gambling or weapons manufacturing. At the same time, Middle Eastern institutions and investors are seeking to tap into international markets through globally issued *sukuk* (Islamic alternatives to conventional bonds).

Complexity and Competition

The complexities of Islamic wealth management form perhaps the greatest barrier to entry for Western banks. The principles of Sharia may be timeless and unyielding, but their implementation—as it pertains to wealth management—is anything but straightforward.

Islamic investment advisors and wealth management institutions abide by the rulings of a Sharia board, which is usually unique to each financial institution. The board, comprising scholars who are experts in the field of Islamic banking, establishes parameters for Sharia observance and certifies compliance. Although it is common for scholars to sit on multiple Sharia boards, inconsistencies still arise, largely because of the lack of unified principles or a consolidated view of rulings. The differences are evident not only across markets—for example, the GCC is generally considered to be more conservative than South East Asia—but also within countries. Some institutions use these inconsistencies to push the boundaries of innovation and to gain a competitive edge over their peers.

Islamic wealth management is also a competitive market. Local wealth managers generally have the upper hand because of their established brands, networks, and customer bases, along with their familiarity with the principles of Sharia. Competition also comes from international institutions, which have been ramping up efforts to provide Sharia-compliant products. Some international banks, having entered the market as early as the 1990s, have built up extensive networks. Citibank, HSBC, and Standard Chartered Bank have separate business units or subsidiaries dedicated to Islamic banking, which allows them to distribute their products directly to clients.

An Accessible Opportunity

This growth opportunity, while foreign in many respects, is still quite accessible. As a first step, wealth managers need to identify pockets of attractive growth. In many markets, there is an inverse relationship between client wealth and the demand for Islamic banking. Wealth managers should look for markets that deviate from this trend, or that have populations that are large enough to still have significant numbers of wealthy clients interested in Sharia-compliant products.

Next, wealth managers should listen to what customers want and create a small set of Sharia-compliant products that meet their needs but that are not too difficult to develop and maintain. For a mutual fund, for example, a bank would filter out investments in forbidden activities or industries and would continuously monitor the portfolio to ensure that the product remains Sharia-compliant.

Wealth managers should then decide how best to distribute the products. The easiest approach is to partner with Islamic banks and rely on their extensive networks and established relationships. Some wealth managers, however, might want to develop offerings that are geared toward offshore investors. Despite the pressures bearing down on offshore banks, demand for such services is expected to remain relatively stable, if not robust, in countries where clients are searching for safe havens.

In Panama, for example, entities that have their assets or activities beyond the country's borders are exempt from taxes. In other offshore centers, such as Uruguay, banking secrecy is still guaranteed. The region's traditional offshore havens, however, are under significant pressure from the OECD, which has prompted some centers to move toward greater transparency and international cooperation. Recently, the OECD reclassified Uruguay from the black list to the grey list, which signals better adherence to certain standards for the exchange of information.

Winning Strategies in Offshore Banking

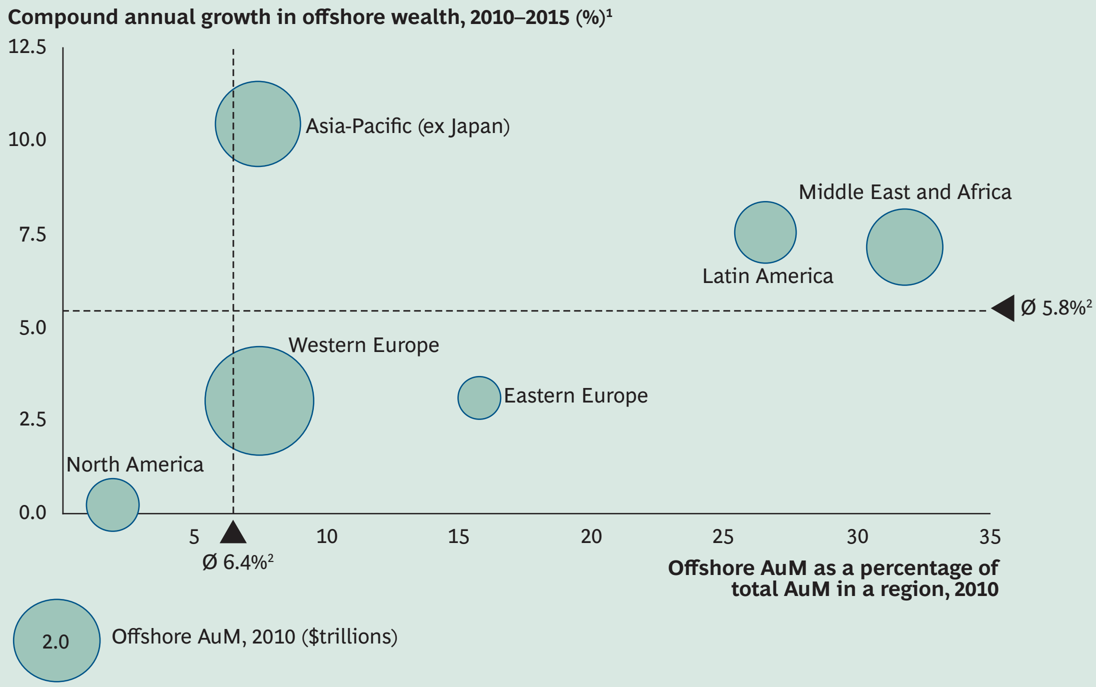
Given the pressures on demand and margins, coupled with shifts in the competitive landscape, it is becoming critical for wealth managers to concentrate on areas of the business that suit their strengths. Most will ultimately realize that they can improve their results and reduce operational risk only by narrowing their focus.

- *Concentrate on a mix of mature and high-growth markets.* Offshore wealth managers need to focus on building viable positions in a limited number of mature and high-growth markets in order to reduce costs and complexity. Emerging markets, in particular, will be an important source of new offshore assets. (See Exhibit 8.) For Western European countries such as Germany, France, Italy, and the United Kingdom, offshore wealth managers generally need to have at least $3 billion in AuM from each market in order to achieve a cost-to-income ratio of 70 percent. It is becoming more important for wealth managers to set a minimum threshold for maintaining a viable presence, given the intensive work involved in offering market-specific products and investment advice and providing tax reporting that meets the requirements of the tax authorities in the client's country of domicile.

- *Turn RMs into market-specific experts.* Wealth managers should reallocate clients among RMs to ensure that each advisor has a clear focus on just a few client domiciles, thus allowing them to develop market-specific expertise while reducing the costs associated with training, certification, and travel. To help in transitioning their clients, wealth managers can implement revenue-sharing practices during a predetermined hand-off period. In parallel, wealth managers can train and educate RMs about country-specific regulations, tax systems, investment opportunities, and other factors—such as local customs and culture—that affect client relationships. Wealth managers should also consider introducing specialists who would be available to work closely with RMs.

Without question, the business of managing offshore wealth is becoming more challenging, but it is not in danger of growing irrelevant or obsolete. The main drivers of demand remain unchanged, and asset inflows will continue to be strong from particular clients and regions. Wealth managers that deal with regulatory change and reorient the business around promising markets will find opportunities for growth.

Exhibit 8. Offshore Wealth Will Grow Fastest in Emerging Markets



Source: BCG Global Wealth Market-Sizing Database, 2011.
Note: Compound annual growth rates are calculated on the basis of year-end values.
[1]AuM numbers for all years were converted from local currencies to U.S. dollars at year-end 2010 exchange rates (that is, at a constant rate of exchange).
[2]Weighted average.

Wealth Manager Benchmarking

Competitive Evolution in Europe

To understand how the industry fared in 2010, BCG benchmarked the performance of 120 institutions—either private banks or wealth management units of large universal-banking groups—in Europe, Asia-Pacific (ex Japan), North America, and Latin America. The study uncovered regional variations in asset growth, revenues, costs, and profitability, although the sharpest differences were arguably within one region—Europe—and in particular between offshore and onshore private banks.

Comparing Key Measures of Performance

The wealth management industry, on the whole, experienced mixed results in 2010. The average pretax profit margin of wealth managers increased to 23 basis points, up 4 basis points from 2009. (See Exhibit 9.) Revenues and costs improved, but performance deteriorated in other areas.

- AuM growth slowed from 12.8 percent in 2009 to 7.5 percent in 2010, mainly because the recovery in the financial markets slowed.
- The average ROA remained flat at 82 basis points, while the average change in revenues swung from –7.1 percent in 2009 to 8.5 percent in 2010.
- The average cost-to-income ratio dropped from 77.8 percent to 73.7 percent, as costs associated with sales and front-office services (as a percentage of total costs) declined by more than 5 percentage points. Operations and IT costs (as a percentage of total costs) increased by 2 percentage points.
- The productivity of RMs fell sharply. There was a 20 percent decline in client assets and liabilities (CAL) per RM as well as a 17 percent decline in revenues per RM, most likely because RMs are not only increasingly busy with the administrative side of compliance but also constrained by regulations, including limits on travel and advice.
- The rate of net new asset (NNA) generation, measured by NNA in relation to the asset base at the end of the previous year, increased from 1.3 percent in 2009 to 2.3 percent in 2010, although it remained far below precrisis levels. (NNA measures the difference between asset inflows and outflows.)
- Business volume per client, measured by CAL as well as by revenues per client, increased dramatically, owing mainly to the consolidation of accounts and the discontinuation (or transfer to retail-banking units) of smaller client accounts.

The benchmarking study highlighted sharp variations between and within regions. (See Exhibit 10.) Again, there was a mix of positive and negative results.

- In 2010, average ROA increased by 1 basis point in Latin America and remained flat at 73 basis points in Asia-Pacific. Cost-to-income ratios were unchanged at 81 basis points in Asia-Pacific and increased slightly in Latin America to 67 basis points. In both regions, assets increased by more than 10 percent.
- European offshore institutions improved their ROAs (from 87 basis points to 89 basis points) and cost-to-income ratios (from 74 percent to 69 percent) but, relative to onshore wealth managers, struggled to in-

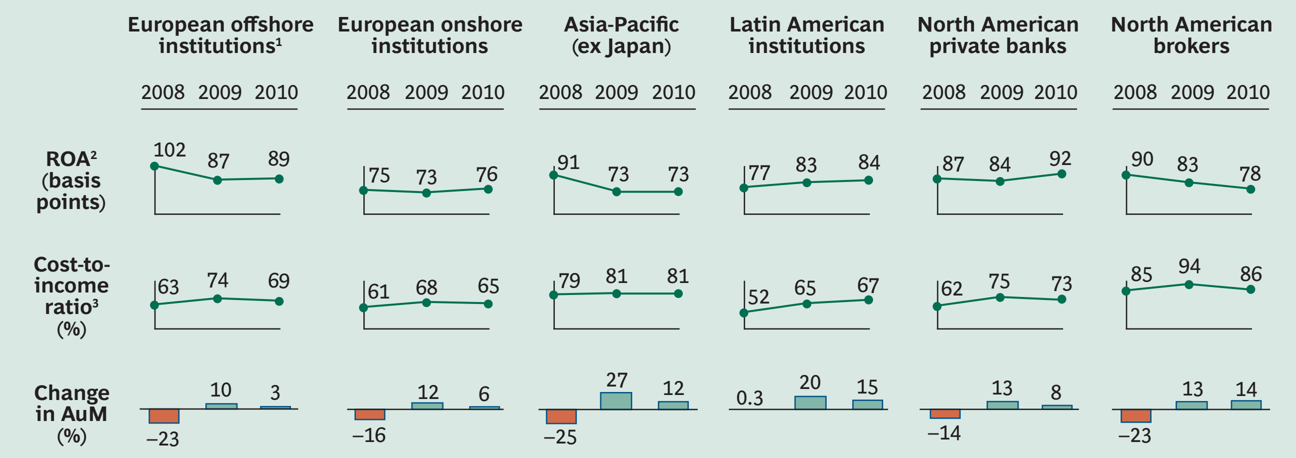
Exhibit 9. RM Productivity Fell Sharply from 2009 to 2010

		2009	2010	Change
Growth	Growth in AuM (%)	12.8	7.5	–5.3 ppts ↘
	Net new assets (% of prior year AuM)	1.3	2.3	1.0 ppt ↗
	Change in revenues from prior year (%)	–7.1	8.5	15.6 ppts ↗
	ROA[1] (basis points)	82	82	0 bps
Frontline excellence	Net new assets per RM ($millions)	3.7	3.2	–12% ↘
	Revenues per RM ($millions)	1.9	1.6	–17% ↘
	CAL[2] per RM ($millions)	242	194	–20% ↘
Clients	CAL[2] per client ($millions)	1.8	2.4	32% ↗
	Revenues per client ($thousands)	13.8	17.9	30% ↗
	Clients with less than $1 million in AuM (%)[3]	75.3	64.5	–10.8 ppts ↘
Products and services	Discretionary mandates (% of AuM)	14.9	14.9	0 ppt
	Alternative investments (% of AuM)	4.2	4.9	0.7 ppt ↗
	Direct equity (% of AuM)	22.5	23.8	1.3 ppt ↗
Efficiency	Cost-to-income ratio (%)	77.8	73.7	–4.1 ppts ↘
	Pretax profit margin (basis points)	19	23	4 bps ↗
	Sales and front-office costs (% of total costs)	60.4	55.1	–5.3 ppts ↘
	Operations and IT costs (% of total costs)	15.6	17.6	2.0 ppts ↗

↗ Increase ↘ Decrease

Source: BCG Wealth-Manager Performance Database, 2010 and 2011.
Note: This analysis was based in euros except for absolute figures, which are calculated in U.S. dollars. All figures are global averages weighted by client assets and liabilities. Abbreviations: ppt(s) = percentage points, bps = basis points.
[1]Revenues divided by yearly average client assets and liabilities.
[2]Client assets and liabilities.
[3]As a percentage of the total client base.

Exhibit 10. Margins, Cost Ratios, and AuM Growth Varied Widely



Source: BCG Wealth-Manager Performance Database, 2009 through 2011.
Note: This analysis was based in euros for European offshore institutions and in U.S. dollars for all other institutions; averages were weighted by client assets and liabilities.
[1]Offshore institutions included private banks from Switzerland, Luxembourg, and Andorra.
[2]Revenues divided by yearly average client assets and liabilities.
[3]Cost-to-income ratios for European onshore institutions are likely to be understated because large banks often do not fully allocate costs to their private-banking operations.

crease AuM, for reasons discussed earlier. European onshore institutions experienced a similar increase in ROA and enjoyed a larger increase in assets.

- Among North American private banks, the average cost-to-income ratio declined by 2 percentage points to 73 percent, and it declined by 8 percentage points among brokers. Revenue margins moved in opposite directions, however. Among North American private banks, the average ROA increased by 8 basis points, but among brokers it continued to fall, declining by 5 basis points.

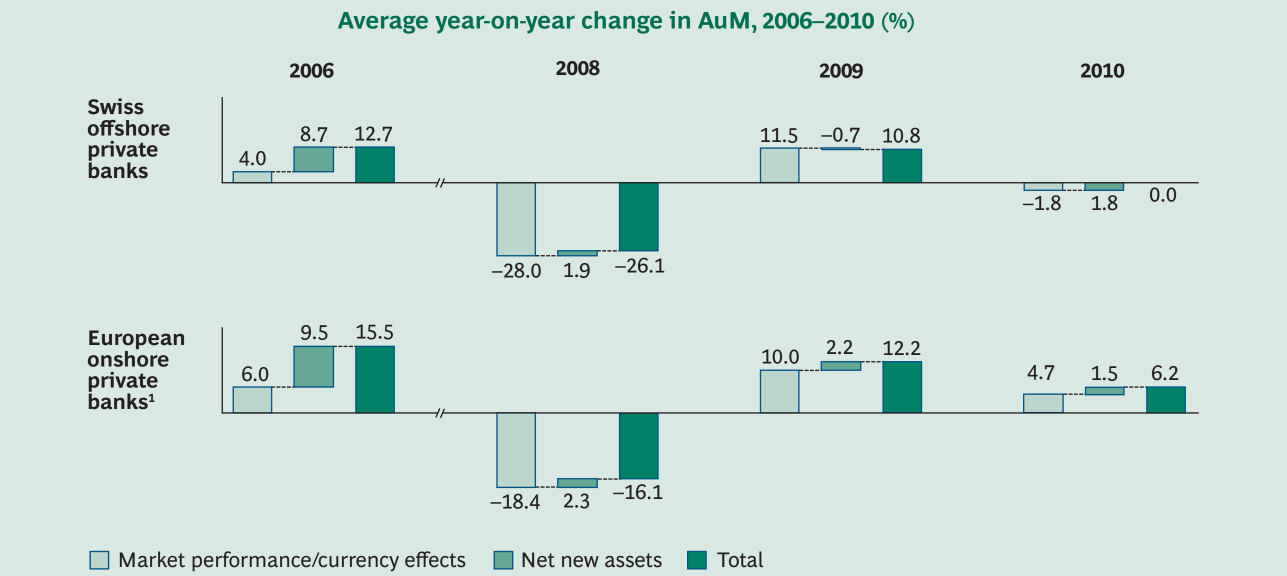
European Onshore Private Banks Versus Swiss Offshore Private Banks

The variation in performance among our benchmarking participants was most noticeable between Swiss offshore private banks and European onshore private banks. Their distinct business models gave rise to sharp differences across a range of performance measures.

AuM. European onshore banks increased their AuM by 6.2 percent in 2010, driven by a 1.5 percent increase in NNA as well as strong market performance. (See Exhibit 11.) Many of these banks benefited from the repatriation of offshore assets, while some also enhanced their product and service offerings and increased their salesforce effectiveness. At the same time, however, many struggled to retain assets and suffered significant outflows.

Assets of Swiss offshore banks remained almost unchanged in 2010, as negative market performance canceled out a gain in net new assets. The negative market performance was partly driven by currency effects—the Swiss franc appreciated versus the euro, diminishing the value of euro-denominated investments—while the increase in NNA was driven by AuM from emerging markets, which more than offset the loss of North American and Western European assets. (See Exhibit 12.) On the whole, most Swiss offshore banks—despite the net gain in assets—struggled to retain AuM. Several of them experienced high asset outflows, mainly as the result of regulatory pressure. The problem was more acute among banks that had focused more on growth than on client retention and had not planned ahead by, for example, training their RMs to retain and grow assets under the new regulatory environment.

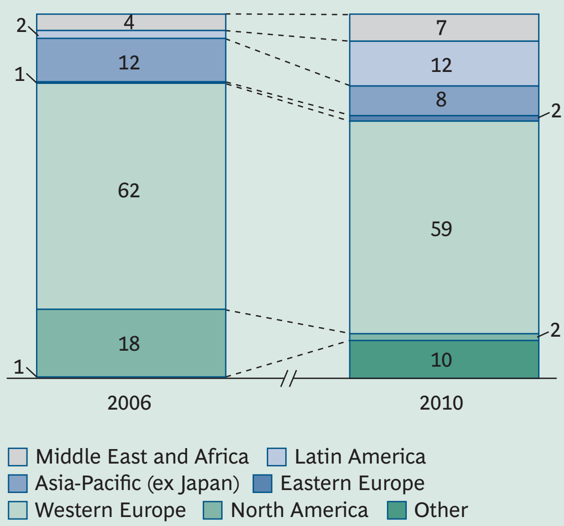
Exhibit 11. European Onshore Private Banks Have Had a Stronger Recovery Than Swiss Offshore Private Banks



Source: BCG Wealth-Manager Performance Database, 2007 through 2011.
Note: This analysis was based in euros for European onshore institutions and in Swiss francs for Swiss offshore institutions.
[1]Other than from Switzerland, Luxembourg, and Andorra.

Exhibit 12. The Flow of North American Offshore Assets out of Switzerland Has Been Significant

Origin of AuM of Swiss offshore private banks, 2006 and 2010 (%)



Source: BCG Wealth-Manager Performance Database, 2007 through 2011.
Note: AuM numbers for both years were converted from local currencies to Swiss francs using year-end 2010 exchange rates.

Revenues. The revenues of Swiss offshore banks increased by 1 percent in 2010. (See Exhibit 13.) The change in revenues was the outcome of two opposing forces. On the positive side, the proportion of assets held in higher-margin products—such as direct equities, hedge funds, and structured products—increased as markets improved and clients regained confidence. (See Exhibit 14.) On the negative side, revenues were constrained by new restrictions pertaining to Western European clients, who accounted for 59 percent of the total offshore wealth managed by Swiss banks in the survey. The regulations, by limiting the scope of advice that offshore banks can provide to these clients, dampened portfolio activity. In addition, the proportion of AuM held in discretionary mandates, while higher, was still below precrisis levels—clients remain wary of ceding too much control over their portfolios, and many have become more independent since the financial crisis.

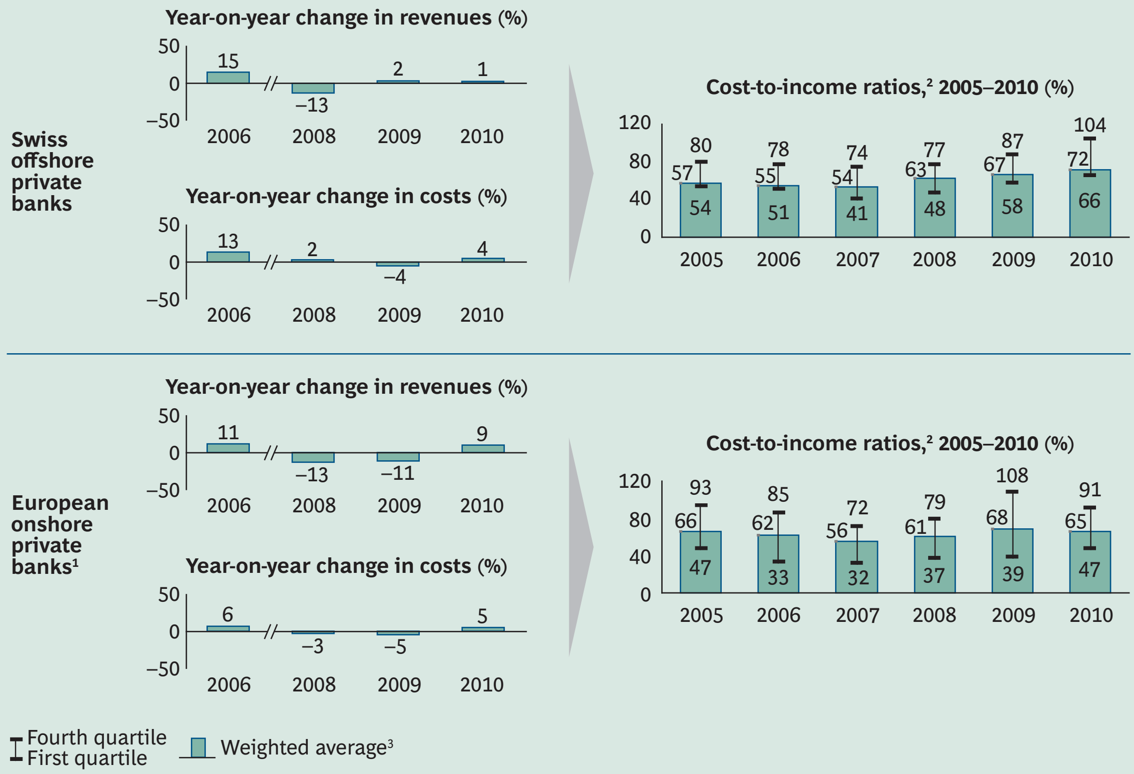
European onshore banks increased their revenues by 9 percent in 2010. Low interest rates on cash and deposits helped to drive assets into bonds, funds, and alternative investments, while several wealth managers introduced innovative discretionary mandates (for example, mandates based on ETFs) in an effort to coax assets out of cash. As a result, the proportion of AuM held in discretionary mandates increased among European onshore banks.

Although many of the clients of both Swiss offshore and European onshore banks regained some of their appetite for risk, they still hold significant amounts of their assets in cash or low-margin products such as ETFs or bonds. Top-performing banks grew revenues by developing innovative products or aggressively promoting in-house products, but the push to pry assets away from lower-margin products was evident across all European benchmarking participants. Swiss offshore banks, in general, increased the share of assets held in their own managed funds from 8.3 percent to 8.6 percent, although the proportion of assets held in their own structured products declined from 3.5 percent to 3.3 percent. European onshore banks maintained the proportion of assets held in their own managed funds at 13 percent and were able to increase the proportion of AuM held in their own structured products by 1 percentage point to 4 percent.

Costs. The average cost-to-income ratio of Swiss offshore banks increased by 5 percentage points to 72 percent, as banks made internal investments to comply with—or adapt to—new regulations. Among other things, banks started to produce country-specific reports and tax statements; create tax-optimized products and services for specific markets; and train and certify RMs. Banks also had to meet higher capitalization and liquidity requirements. In addition, many Swiss offshore banks had not reduced their staffing levels in line with the decline in assets caused by the crisis. They remain overstaffed in virtually every element of the value chain, particularly in IT and operations.

In contrast, the average cost-to-income ratio of European onshore banks decreased by 3 percentage points to 65 percent. As with offshore players, costs increased owing to various transparency and disclosure requirements, along with increased liquidity and capital requirements. Some onshore banks also spent money to extend their branch networks or enhance their products and services. The improvement in the ratio was mainly a function of strong revenue growth. It should be noted as well that the

Exhibit 13. Cost-to-Income Ratios Have Been Steadily Rising Among Swiss Offshore Private Banks



Source: BCG Wealth-Manager Performance Database, 2006 through 2011.
Note: This analysis was based in euros for European onshore institutions and in Swiss francs for Swiss offshore institutions.
[1]Other than from Switzerland, Luxembourg, and Andorra.
[2]Cost-to-income ratios for European onshore institutions are likely to be understated because large banks often do not fully allocate costs to their private-banking operations.
[3]Averages were weighted by client assets and liabilities.

cost-to-income ratios for European onshore institutions are often understated because large European banks do not fully allocate costs (such as for IT and overhead functions) to their private-banking operations.

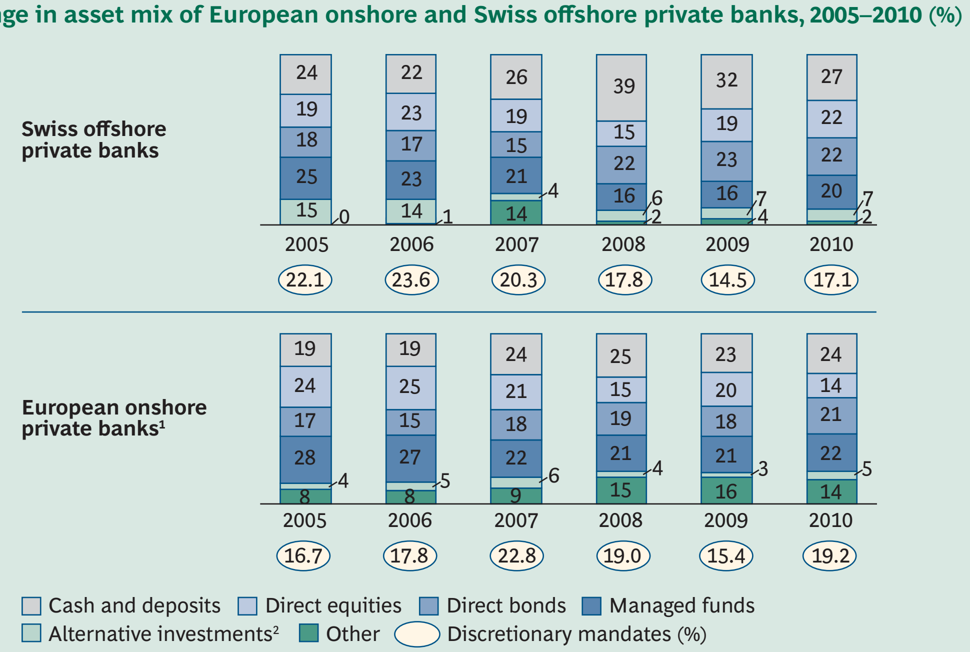
Profitability. Among Swiss offshore banks, the average ROA increased by 2 basis points to 99 basis points. (See Exhibit 15.) For European onshore banks, the average ROA increased by 3 basis points to 76 basis points. Pretax profit margins, on average, dropped by 1 basis point to 30 basis points for Swiss offshore banks and stayed stable at 27 basis points for European onshore banks. Some wealth managers initiated cost-reduction programs, but most of these initiatives were not sufficiently strategic or comprehensive and were therefore unable to counteract the sharp rise in costs stemming from new regulations.

Improving Performance in a Challenging Market

The benchmarking study underscored the need for many wealth managers in Europe to improve their profitability, either by increasing revenue margins or lowering costs. Onshore and offshore banks will likely take different paths to make these improvements, but their efforts will revolve around the same set of core imperatives.

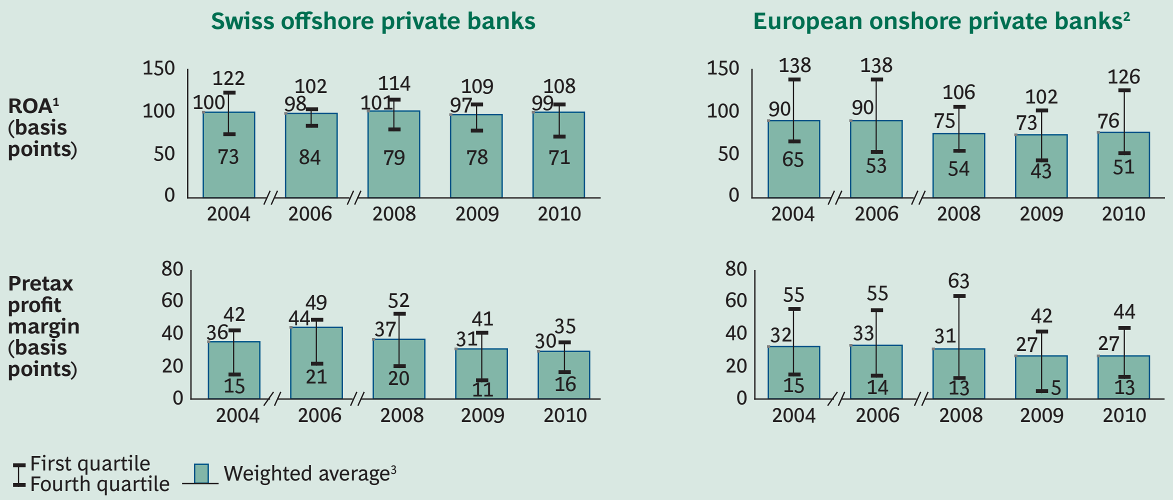
- *Reduce complexity.* Private banks can decrease costs by simplifying the business—for example, by rationalizing client segments, discontinuing unprofitable client relationships, eliminating low-volume products from the portfolio, and slimming the organization through delayering.

Exhibit 14. Asset Allocations Have Become Less Conservative



Source: BCG Wealth-Manager Performance Database, 2006 through 2011.
Note: This analysis was based in euros for European onshore institutions and in Swiss francs for Swiss offshore institutions.
[1]Other than from Switzerland, Luxembourg, and Andorra.
[2]Hedge funds, private equity, and structured products.

Exhibit 15. Profitability Remained Below Precrisis Peaks for European Private Banks



Source: BCG Wealth-Manager Performance Database, 2005 through 2011.
Note: This analysis was based in euros for European onshore institutions and in Swiss francs for Swiss offshore institutions.
[1]Revenues divided by yearly average client assets and liabilities.
[2]Other than from Switzerland, Luxembourg, and Andorra.
[3]Averages were weighted by client assets and liabilities.

- *Enhance pricing.* The one-size-fits-all approach to pricing has become outdated. Wealth managers need to revise their pricing models to more accurately account for the cost of serving specific client segments. (For more on this, see the next chapter.)

- *Focus on "sticky" products.* Wealth managers should focus on selling products such as mutual funds and discretionary mandates, which tend to be longer-term investments and therefore help increase NNA over time.

- *Improve frontline performance.* Sales-force effectiveness can be improved at many wealth managers. Relatively straightforward initiatives, such as coaching RMs or improving the management of prospects and referrals, can have a significant impact on productivity.

- *Lower costs.* Cost-to-income ratios can be improved by streamlining middle- and back-office functions. Many wealth managers have opportunities to automate processes or adjust capacity, especially in operations and IT, to reflect the current scope of the business.

Pricing and the New Realities of Wealth Management

Although global wealth posted its second consecutive year of growth and was $10 trillion higher than the precrisis year-end peak, the pressure on wealth managers—at least in some markets—has yet to fully subside. In Europe and Asia, in particular, wealth managers' gross margins continue to be squeezed by the increasing popularity of lower-margin products (especially ETFs), greater client awareness of fees and charges that have no obvious correlation with service or performance, and the regulatory push for greater transparency and disclosure.

Pricing is generally the most effective lever for boosting revenue margins in wealth management. To a certain degree, however, the traditional approach to pricing has become more of a hindrance than a help. Prices tend to be too complicated for clients to understand, while pricing models are still relatively unsophisticated and often not aligned with the wealth manager's business strategy. Many allow for unguided—and sometimes almost arbitrary—discounting. As a result, there is tremendous potential for wealth managers to differentiate their offerings and increase margins by adopting a more nuanced approach to pricing.

The Cost of Ambiguous Pricing

Pricing in wealth management tends to be more confounding than clear. Different wealth managers, for example, may have different names for the same kind of pricing scheme or component, making it hard for clients to make meaningful comparisons. Moreover, a single wealth manager might have a range of methods for charging administrative or transaction fees, while some aspects of pricing, such as transaction costs or certain product fees, are difficult or even impossible to see. As a result, few clients ever believe that they have an accurate view of the prices they pay.

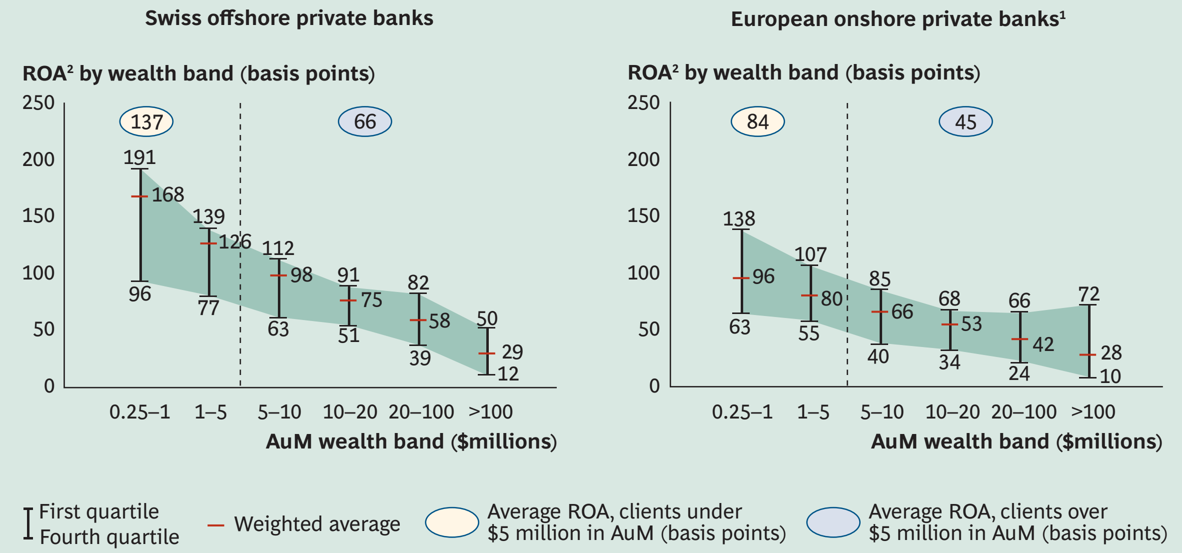
The lack of structure does hold one important advantage for clients: it allows plenty of room to bargain for better deals. This, in turn, leads to significant variation in pricing and hence ROA, even within narrowly defined client clusters. (See Exhibit 16.)

In addition, many wealth managers give their RMs substantial discretion to use discounts. As a result, RMs tend to provide excessive discounts in an effort to increase—or, as was the case during the financial crisis, protect—their asset bases, sometimes with little or no prodding from clients. One wealth manager in our benchmarking survey reported that many RMs had an "all or nothing" approach to discounts—when discounts were given, they were usually given in full, irrespective of client size.

For years, this capricious approach proved to be highly profitable. Most clients were not overly concerned with pricing, provided their portfolios performed well. In fact, some clients even regarded wealth management as a Veblen good, with high prices conferring a sense of status or exclusivity. (To a certain degree this still holds true, although many clients are now more inclined to question the value of their wealth manager's services.) By generating higher margins among clients who were less concerned with—if not completely indifferent to—pricing, wealth managers could subsidize lower-margin services geared toward more cost-sensitive clients, while underwriting aggressive discounting for the sake of client acquisition and retention.

Exhibit 16. Variation in ROA Reveals Opportunities to Improve Pricing

ROA by wealth band, 2010



Source: BCG Wealth-Manager Performance Database, 2011.
[1]Other than from Switzerland, Luxembourg, and Andorra.
[2]Revenues divided by average client assets and liabilities.

The financial crisis laid bare the weaknesses of this convoluted, undisciplined approach. Among the wealth managers in last year's benchmarking survey, the average ROA declined by 13 basis points in 2009, in large part because of inadequate pricing. Even though revenue margins have stopped deteriorating, it is increasingly obvious that an ambiguous approach to pricing is not suited to the new dynamics of the business, for a number of reasons:

- In some markets, new and potentially disruptive business models have put pressure on margins. Online offerings, for example, base their value proposition on the simplicity, transparency, and competitiveness of their prices. Social-media platforms provide greater transparency into both pricing and the quality of service. Some even offer investment recommendations and access to unique products.

- Clients still have a relatively high proportion of their assets in lower-margin products. Some clients favor passively managed products, such as ETFs, which tend to be less costly and more transparent. For others, the perceived safety of cash, gold, or government bonds still matters a great deal. Events such as the Japanese earthquake and tsunami and the unrest in Africa and the Middle East cast a shadow over the global economic recovery and lend even more appeal to investments that are considered relatively stable or easy to understand. At the same time, there is a demand for superior, tailored advice as well as for advanced reporting and tax statements. The cost of these activities is hard to reconcile with the low margins being realized on many assets.

- In many markets around the world, particularly in Europe, there is growing pressure for wealth managers to divulge, or even pass along to clients, the fees they receive from product suppliers. In Europe, for example, MiFID (the Markets in Financial Instruments Directive)—an EU law that aims to harmonize the regulatory regime for investment services in member countries, particularly with regard to consumer protection—will have a significant impact on fee-sharing arrangements. In addition, the U.K.'s Retail Distribution Review (RDR) framework addresses the potential for remuneration to distort advisors' recommendations. In Germany, banks are obligated to compile detailed minutes of every client interaction that involves investment advice.

- Many clients have become adamant about understanding the costs associated with managing their wealth and have started asking for total expense ratios in order to facilitate comparisons. Many have also become more price sensitive, in part because new competitors are providing more transparent and competitive prices. Together, these trends suggest that clients are likely to become more inquisitive—and critical—about the link between prices and value. For example, more actively managed investment portfolios tend to incur much higher fees—and while the variable costs may well be higher for these accounts owing to more frequent transactions, clients may start to question whether the higher fees are matched by an equally dramatic difference in service and performance levels.

- With clients becoming more price sensitive, wealth managers can no longer count on charging some clients higher prices in order to offset lower fees and charges—or aggressive discounts—for other clients, particularly when the variations in pricing are not part of an orchestrated plan but rather are driven by the priorities of individual RMs.

Clients are becoming more inquisitive about the link between pricing and value.

Wealth managers simply cannot afford to overlook the importance of pricing and the need to adapt their pricing strategies and practices to the new realities of wealth management.

Four Imperatives for Improving Pricing

To ensure that pricing leads to higher margins without compromising asset growth or retention, wealth managers should pursue a mix of strategic and tactical initiatives. Strategic initiatives should focus on creating a more transparent, consistent, and logical pricing model by linking pricing to value propositions. Such initiatives often involve fundamental changes, which can take months or even years to implement. Tactical measures, on the other hand, have a more immediate impact on price realization. Examples include limiting discounts or making small changes to certain prices in order to improve revenue margins. To guide these initiatives, wealth managers should follow four imperatives, each of which has important ramifications for the service model.

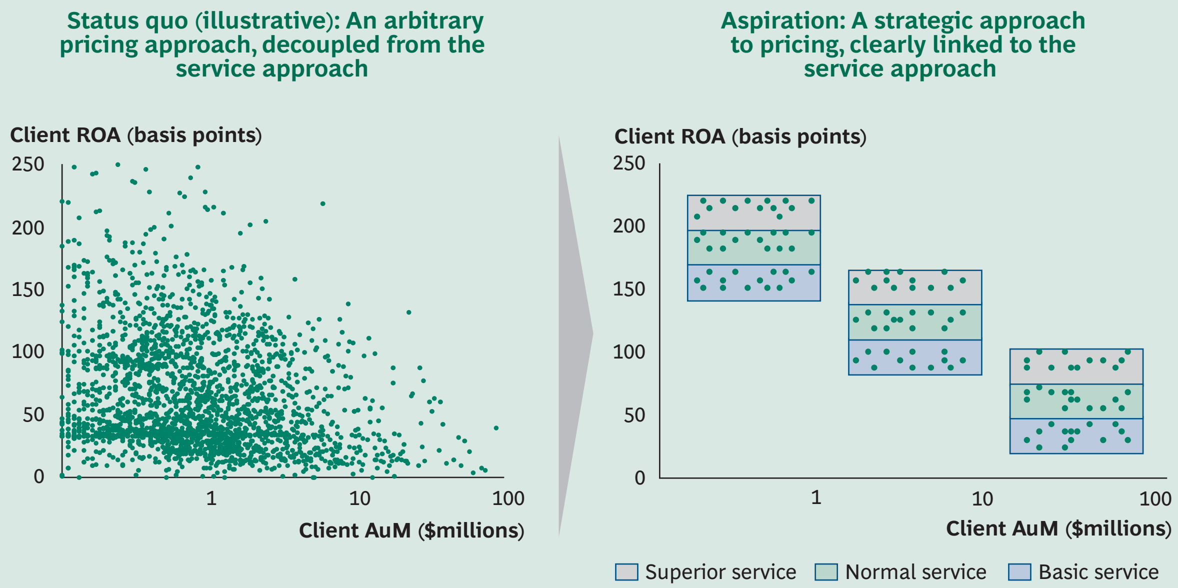
Service and pricing models should be profitable for each client segment. In general, wealth managers should ensure that the level of service (along with the corresponding cost) is aligned with a client segment's ability to generate revenues. *This basic equation should be considered inviolable.* What's more, client segments should not simply be based on wealth bands but should also factor in client behavior, which has important implications for service levels. Delegators, advice seekers, and self-directed traders have very different needs and hence different expectations for price–service models.

For some wealth managers, tough decisions will be unavoidable. They may need to downgrade services for low-revenue client segments, or else impose minimum fees to make these segments profitable to serve. Wealth managers might also consider moving clients to different channels, where the level of service is commensurate with their revenue potential.

The difference between high- and low-cost offerings should be unmistakable. With clients having become more aware of value for money, wealth managers must ensure that the price differences among client segments are matched by equally clear differences in service levels. (See Exhibit 17.) Clients who are charged higher prices will demand enhanced levels of advice, reporting, and wealth planning. The services they receive should be noticeably more sophisticated and tailored than lower-cost offerings, which should be relatively basic and standardized.

This differentiation is critical to the first imperative—ensuring that each segment is served profitably—but it also influences client satisfaction. A client who needs the guidance and support of an active and involved RM, who in turn might call on investment specialists and wealth-planning experts, should obviously have a markedly different experience—and a higher price point—than a client who is more self-directed. Some clients may want a

Exhibit 17. Pricing Needs To Become Much More Strategic and Deliberate



Source: BCG project experience.

particular combination of products, services, and prices that a wealth manager does not provide. A wealth manager that cannot find a suitable alternative in its existing stable of services might be better off advising a client to move to another wealth manager, rather than shoehorning that client into an ill-fitting or uneconomical service model.

Clients should have a say. RMs are often reluctant to talk to their clients about price and value, out of concern that such frank conversations could do more harm than good. But this reluctance is increasingly out of step with changes in the industry: clients *are* becoming more price sensitive, prices *are* becoming more transparent, and competitors *are* using the combination of these two trends as a way to gain market share.

Wealth managers should aim to involve clients in decisions that affect their costs. RMs could present several different pricing models and determine which model best suits the client's specific mix of products, services, interaction preferences, and channels. They could also allow clients to set their own prices by selecting a bundle of services that suits their needs. A self-directed client might choose a transaction-only service, whereas a client who is less familiar or comfortable with financial matters might opt for an advisory model that provides access to investment specialists. To help customize the pricing model, RMs have plenty of variables at their disposal, including flat fees, minimum fees, performance fees, and contingent fees. (For more on performance fees, see the sidebar "Performance-Based Pricing.") For clients to make an informed decision—and to gauge the "value for money" of a particular offering—wealth managers need to spell out the prices of certain services such as financial planning, holding mail, tax reporting, and extended portfolio analysis.

There should be some flexibility in pricing in order to maximize share of wallet. Having established the principle that each client segment should be profitable, wealth managers should nonetheless allow for some discretion in setting prices. Pricing, in other words, should remain personal. Wealth managers can ensure that pricing is both disciplined and flexible by following a two-step process.

First, they should define upper and lower pricing bands for each client segment, using a combination of consumer research and field tests to ensure that the range is aligned with client expectations and behaviors. Wealth managers should also give weight to competitors' offer-

Performance-Based Pricing

Performance-based pricing is common in the fund management business, mainly for institutional clients. In the wealth management business, however, it remains both rare and discreet. Some private banks allow it for discretionary mandates, but only when clients request it.

Performance fees are typically triggered when actual performance exceeds a given benchmark or hurdle. The fee itself might be based on an absolute increase in value, or on the difference in value between investment gains and a benchmark. In some cases, a performance fee is levied only after past negative performance has been recouped.

Surveys show that most clients react favorably to the idea of performance fees. It gives them the sense that their wealth manager has more at stake and is confident in its ability to grow wealth. But once clients hear about the mechanics of performance-based pricing, they tend to be overwhelmed by the complexity or underwhelmed by the benefits. In a bull market, for example, the performance fee could end up being significant, but the client still bears the risk of losing money when markets decline. For performance fees that are pegged to an index, a slight amount of above-average performance—exceeding the index by, say, 1 or 2 percent—could trigger a fee that represents a relatively high proportion of the client's absolute gain. As a result, many clients end up reverting to or staying with a standard pricing model that has no performance component.

Performance-based pricing remains more of a niche strategy than a mainstream practice. Among sophisticated clients who are not intimidated by complexity, however, this approach could be extremely effective in retaining or attracting assets.

ings, in order to understand how those offerings might influence their own clients' investment decisions or attitudes about pricing. This approach should lead to a minimum price (which would generate an acceptable gross margin) and a maximum price (which would lead to higher margins without compromising client acquisition or retention).

Next, wealth managers should give RMs some leeway to set prices (including providing discounts) on a client-by-client basis. Wealth managers can add more science to the art of adjusting prices by using a robust statistical process to set target prices for each client on the basis of the client's sociodemographics, relationship with the bank, profitability, multichannel behavior, risk profile, product usage, and price sensitivity. Such an analysis should pinpoint the ideal price for a particular client within a given price range. RMs can deviate from this target price provided they are fully mindful of the price floor.

With regard to discounting, the guidelines should be tighter and simpler, with clearly defined ranges depending on RM seniority and management level. More important, discounts should be based on a client's potential to generate revenues and margins—the higher the potential, the greater the discount. Even then, however, RMs must believe that the discounts will lead to new cross-selling opportunities or an inflow of client assets. Moreover, discounts intended to attract more of a client's assets or to support cross-selling should be granted only for a certain period of time, after which they should become contingent on capturing the intended potential.

On the whole, pricing should be fairly rigid and less prone to manipulation, effectively eliminating the indiscriminate, unproductive use of discounts. At the same time, there should be an escalation process whereby RMs can seek exemptions in special circumstances. Some discounting practices should also be transparent to clients as a way to entice them to shift more assets to the wealth manager or to encourage them to invest in certain products.

Finally, wealth managers will need to monitor the use of discounts very closely while giving RMs incentives to maximize price realization. They could highlight the amount of money "left on the table" as a result of discounts, for example, and ensure that RMs are not automatically granting maximum discounts but instead are putting some thought into how much of a discount to provide. Wealth managers could also highlight any lack of consistency in the use of discounts, as well as the potential benefits—to both the institution and the RM—of achieving better price realization.

In the end, this is about simple economics. Wealth managers need to ensure that prices correspond with a client's overall contribution to the business in terms of margins and revenues. There are two barriers to making this vital connection. First, many wealth managers lack a clear view of the actual cost to serve different client segments. Second, they often shy away from cutting service levels for low-revenue, low-margin clients. More broadly, although wealth managers are taking steps to improve their pricing strategies, few have adopted a fundamentally new pricing regime—one that dovetails with changes in client demand, business strategies, and regulations.

Many wealth managers lack a clear view of the actual cost to serve different client segments.

Guidelines for Implementing New Pricing Strategies

Pricing is a perennial issue—something that wealth managers revisit on a regular basis. For a variety of reasons, however, most efforts to fundamentally change pricing tend to stall. Common pitfalls include inadequate alignment between new pricing policies and client expectations, poor external communications, and internal misunderstandings that prevent high-level policy from properly influencing frontline activities—all of which can end up alienating clients and undermining price realization.

To ensure that their plans for transforming pricing take hold, wealth managers should focus on several factors that have been shown to facilitate such change.

- *Maintain an appropriate balance between strategic and tactical initiatives.* Wealth managers should avoid the temptation to focus only on tactical initiatives, which give a quick boost to revenues or margins. Quite often, strategic initiatives are geared more toward ensuring the right alignment between prices and services and are therefore critical to ensuring that a sense of fairness prevails under the new pricing regime.

- *Conduct consumer research.* A poorly conceived or executed change in the pricing model can prompt clients to shift their assets to lower-margin products—or, worse still, to another wealth manager—and cause lasting damage to a wealth manager's reputation. It is therefore critical that wealth managers conduct extensive consumer research before rolling out any changes, using techniques such as conjoint or van Westendorp analyses to understand client preferences and likely responses to the new pricing regime.

    - *Model the financial impact.* Wealth managers should also model the probable impact of pricing changes on their P&L on the basis of assumptions about price elasticity, competitive reactions, and the likely effects on volumes, revenues, and cost to serve. It is particularly important that wealth managers anticipate competitor reactions in terms of specific products and services.

- *Ensure that communication to the client is direct and unambiguous.* It is hard to overstate the importance of communicating price changes clearly and well in advance. Wealth managers should ensure that clients have time to understand and ask questions about new policies. They need to be especially mindful about communicating changes that, from the client's perspective, represent a negative change to service levels, prices, or any other aspect of the relationship, such as the client's inclusion in a particular segment. But communication is not simply about preventing a backlash. Wealth managers can and should emphasize the transparency of their prices as a way to stand behind their value propositions.

- *Train and coach RMs to adhere to—and embrace—new pricing practices.* RMs will need to understand and abide by new policies about discounting, high and low price limits, and the amount of discretion they have to adjust prices. Even more important, RMs need to believe in a new pricing scheme in order to sell it to clients. The changes should be seen as a way to mold the offering—the combination of products, services, and prices—around the client's needs. Including RMs in the development and client-testing phases of new pricing practices has proved to be an important step in improving price realization.

Wealth managers should recognize that pricing, while generally in need of an overhaul, is something best not transformed all at once. The risks posed by hasty change are too high, and there is much work to be done simply to lay the groundwork for a new pricing model—for example, by conducting extensive consumer research, benchmarking competitors, and generating an accurate, comprehensive view of the internal costs of serving various client segments. Strategic initiatives, in particular, must be designed carefully and implemented gradually to ensure the right alignment between prices, services, and client segments.

The wealth management industry has overcome tremendous adversity over the past several years, and the sustained recovery of global wealth bodes well for its future. But the positive signs should not be misread as a return to normal. A set of disruptive forces, including regulatory reforms and changes in client behavior, are rewriting the rules of the game—both literally and figuratively.

Wealth managers must not allow the ongoing recovery to lead to a sense of complacency. Many of the changes that are reshaping the industry present fundamental, lasting challenges to growth and profitability. The best wealth managers will capitalize on the disruption by accentuating their strengths, fine-tuning their offerings to reflect the growing importance of transparency and value for money, and focusing more aggressively on levers such as pricing, which can have a significant impact on revenue margins. In short, they will recognize this period for what it is: an opportunity to shape a new tomorrow in the post-crisis world.

For Further Reading

The Boston Consulting Group publishes other reports and articles that may be of interest to senior financial executives. Recent examples include those listed here.

Operational Excellence in Retail Banking: How to Become an All-Star
A Focus by The Boston Consulting Group, February 2011

The Road to Excellence: Global Retail Banking 2010/2011
A report by The Boston Consulting Group, December 2010

In Search of Stable Growth: Global Asset Management 2010
A report by The Boston Consulting Group, July 2010

Leveling the Playing Field: Upgrading the Wealth Management Experience for Women
A White Paper by The Boston Consulting Group, July 2010

Regaining Lost Ground: Global Wealth 2010
A report by The Boston Consulting Group, June 2010

Building a High-Powered Branch Network in Retail Banking
A White Paper by The Boston Consulting Group, March 2010

Risk and Reward: What Banks Should Do About Evolving Financial Regulations
A White Paper by The Boston Consulting Group, March 2010

Note to the Reader

About the Authors

Jorge Becerra is a senior partner and managing director in the Santiago office of The Boston Consulting Group and leads the Financial Institutions practice in Latin America. **Peter Damisch** is a partner and managing director in the firm's Zurich office and leads the wealth management topic in Europe. **Bruce Holley** is a senior partner and managing director in BCG's New York office and a topic expert for wealth management and private banking in the United States. **Monish Kumar** is a senior partner and managing director in the firm's New York office and the global leader of the asset and wealth management segment of the Financial Institutions practice. **Matthias Naumann** is a partner and managing director in BCG's Zurich office and leads the Financial Institutions practice in Switzerland. **Tjun Tang** is a partner and managing director in the firm's Hong Kong office and leads the Financial Institutions practice in Greater China. **Anna Zakrzewski** is a principal in BCG's Zurich office and a core member of the Financial Institutions practice.

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For Further Contact

To discuss our findings in greater detail, please contact one of the authors.

Jorge Becerra
Senior Partner and Managing Director
BCG Santiago
+56 2 338 9600
becerra.jorge@bcg.com

Peter Damisch
Partner and Managing Director
BCG Zurich
+41 44 388 86 66
damisch.peter@bcg.com

Bruce Holley
Senior Partner and Managing Director
BCG New York
+1 212 446 2800
holley.bruce@bcg.com

Monish Kumar
Senior Partner and Managing Director
BCG New York
+1 212 446 2800
kumar.monish@bcg.com

Matthias Naumann
Partner and Managing Director
BCG Zurich
+41 44 388 86 66
naumann.matthias@bcg.com

Tjun Tang
Partner and Managing Director
BCG Hong Kong
+852 2506 2111
tang.tjun@bcg.com

Anna Zakrzewski
Principal
BCG Zurich
+41 44 388 86 66
zakrzewski.anna@bcg.com

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