White Paper

For wealth managers, COVID-19 is a wake-up call

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For wealth managers, COVID-19 is a wake-up call

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FOREWORD

As we write this paper, it is still impossible to assess the impact of COVID-19 on the economy. China has now started to encourage workers to return to work, and hopes that its various policy measures, such as interest rate and tax cuts, will stimulate its economy in the second quarter. Although this may offer a reassuring precedent for the rest of the world, many epidemiologists predict a more or less global need to restrict public life and business activities well into the autumn of 2020, or even into 2021. The resulting recession might well be U- or even L-shaped, rather than V-shaped, as in previous pandemics. The negative impact on long-term economic growth could be significant. A deep dive can be found in BCG's think tank paper written by the Bruce Henderson Institute: "Strategic and tactical impact scenarios for the COVID-19 crisis and recovery".

With this outlook and uncertainty, major indices around the world have fallen by more than a third from previous peaks. The slump has been one of the fastest in history. For example, the S&P 500 index lost more than 30% of its value in just a month. Volatility is at levels not seen since the financial crisis of 2008.

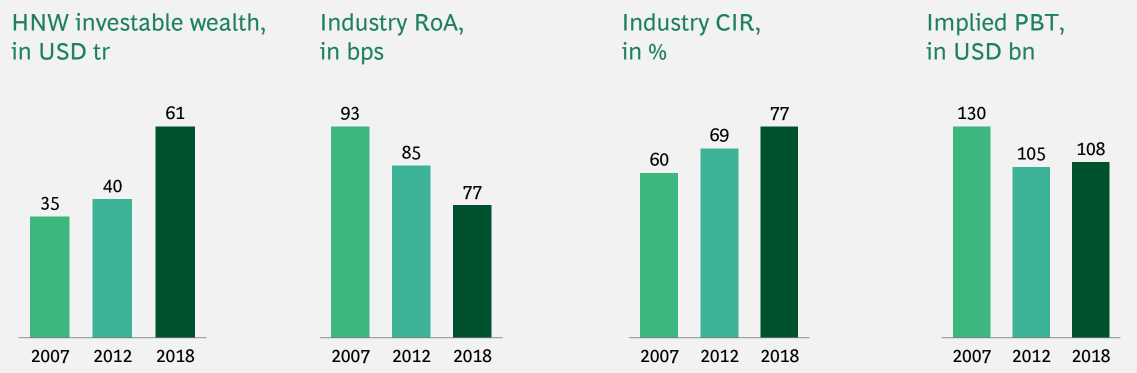
For now, clients' personal wealth has primarily been affected by stock markets. On average, wealthy individuals hold 35-40% of their assets in equity and related instruments. This percentage is even higher in some markets, such as the United States. The impact has therefore already been severe. Some investors have so far taken comfort from the knowledge that markets are now just back to the – then very healthy – index levels of 2016 or 2017, while many clients have a cushion of past gains that helps keep them calm. However, risks continue to be high, and margin calls have started to kick in. In a prolonged downturn, second-order effects will materialize, and other asset classes, such as corporate and government debt or real estate, will also be increasingly hit. Nor should one forget that clients are also feeling the impact in their personal lives. Their businesses are suffering, they face unprecedented restriction on movement, and they are anxious about their loved ones and their communities.

Many wealth managers are unprepared

Outsiders might think that the wealth management industry, after a ten-year bull market, should be in good shape to weather the storm. But this is not what we find (See Exhibit 1).

While high-net worth investable wealth was 75% higher in 2018 than in 2007, wealth managers' profits in absolute terms are still far from pre-crisis levels. The industry's 2018 cost-income ratio, at 77%, was 17 percentage points higher than in 2007. Even when allowing for some profit growth during 2019, the average firm thus has a much lower buffer to absorb shocks. It is worth noting that players in growth markets have actually held up better, while European players in particular face much lower profitability than in 2007.

EXHIBIT 1 | Wealth managers entering the Covid-19 Crisis worse off than before the Global Financial Crisis



Source: BCG Global Market Sizing and Wealth Manager Performance Benchmarking Databases
Note: HNW wealth is defined as total personal financial wealth (excl. real estate) >$1M of adult individuals. Investable wealth includes deposits, debt and listed equity securities and managed funds; life insurance and pension assets are excluded. RoA = Revenues over average AuM. PBT = Profit before tax

Short-term, trading revenues have spiked. However, if markets do not recover quickly, major revenue shortfalls are looming, and profits will be hit hard. As a simple comparison, the financial crisis temporarily reduced the industry profit pool by 44% from 2007 to 2009. Even when taking countermeasures on the cost side, already weak firms will struggle to survive.

These might be hard times for short-term profitability, but they also present wealth managers with a once-in-a-decade opportunity to offer genuine differentiation and strengthen client trust by providing targeted and personal advice as well as emotional reassurance. However, many firms have so far relied on general CIO broadcast messages, sometimes by physical mail, and on the individual relationship managers' skills and ability to reach out to clients with a more or less personalized message.

Technology, data and advance planning offer many opportunities to excel by means of an institutionalized, systematic and scalable response. Admittedly, wealth managers now face considerable operational challenges, such as the need to separate teams with people working from home, and to keep critical processes running under increased loads. Even allowing for these challenges, many firms have so far wasted the opportunity to really make a difference.

Manage short-term actions more systematically

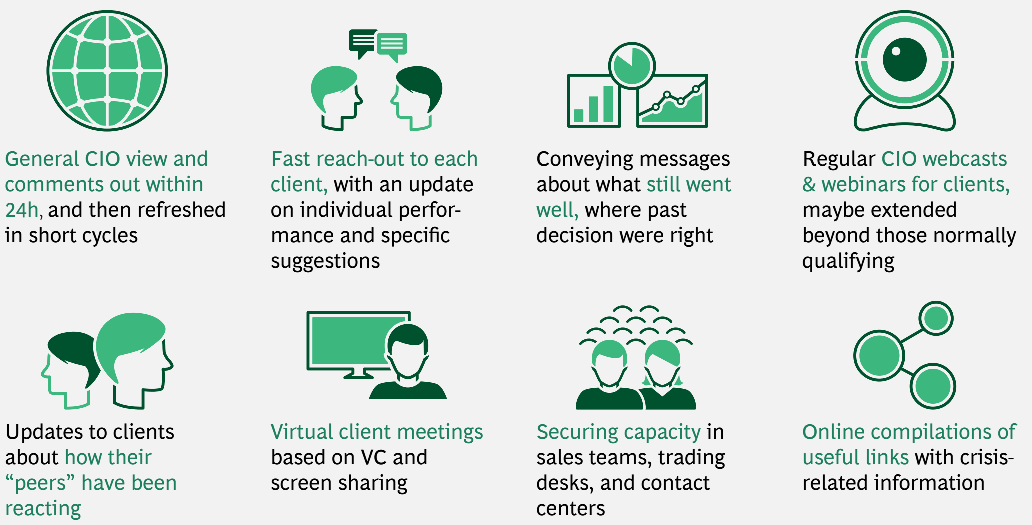
We believe that wealth managers should focus on four areas for short-term action. These actions relate to staff engagement and business continuity; client experience; costs; and scenario planning. While most firms have addressed some of these already, we believe that doing more, and doing it more systematically, can create significant additional value and an opportunity to also start to trigger change that many wealth managers have been waiting for to kick-off, yet have not initiated to date. For those firms with relevant capabilities to leverage, targeted philanthropic investment offerings might be a fifth area.

1. **Keep your people safe, operational and engaged:** Employees need to be assured that their well-being is a top priority for management. Where required, they should receive support to handle personal challenges arising from the crisis. Communication about this has to be strong and consistent. Obviously, business continuity measures such as split teams and back-up for critical decision makers need to be implemented. Remote work and virtual collaboration needs to be accelerated, and the required infrastructure, such as secure laptops, be provided quickly. Business risk management processes need to be reviewed in order to remain effective without causing an additional burden. On a different note, examples from the financial crisis have shown that these circumstances represent a unique opportunity to build and foster a team spirit and a sense of purpose.

2. **Upgrade the client experience:** If, as is well possible, market turmoil goes on and spreads to other asset classes, clients will continue to require timely personalized advice, reflecting their individual portfolio, their actual risk tolerance, and

their past investment behavior. Such efforts should ideally target the clients not only as investors, but as individuals, with appreciation for their personal circumstances in the crisis, and as entrepreneurs, reflecting how their business activities are affected. Measures should be orchestrated in taskforce mode, with clear roles for relationship managers, investment specialists, research, product management, compliance, and support positions, as well as for middle and top management. They should be developed by harnessing the ideas of client-facing staff, and with continuous client feedback and adjustments. (See Exhibit 2). Even at those firms where technology has so far played no major role in client interaction, short-term measures can be taken. For example, these could include updating formalities to allow for digital communication, using video-conferencing applications, or enhancing current apps for improved, up-to-date market information and assessments.

EXHIBIT 2 | Select measures in short-term client communication



Source: BCG Wealth Management Segment

3. **Manage costs strictly, but wisely:** Wealth managers should strive to maintain a minimum level of profitability throughout the crisis even under adverse assumptions. The gap to be closed for an individual firm will depend on their current P&L strength and the projected revenue impact, which will differ across regions and business models. Some firms will need to act on costs simply because they would not survive otherwise. Meanwhile, other firms might choose to accelerate adjustments that have already been planned beforehand. However, management should be acutely aware of the impact that rash measures can have on employee collaboration and morale. Critical business operations should be kept soundly resourced, with sufficient back-up capacity. The focus should be on structural cost measures with sustained medium-term impact (see medium-term initiatives in the following chapter) and on creating increased efficiency across the organization.

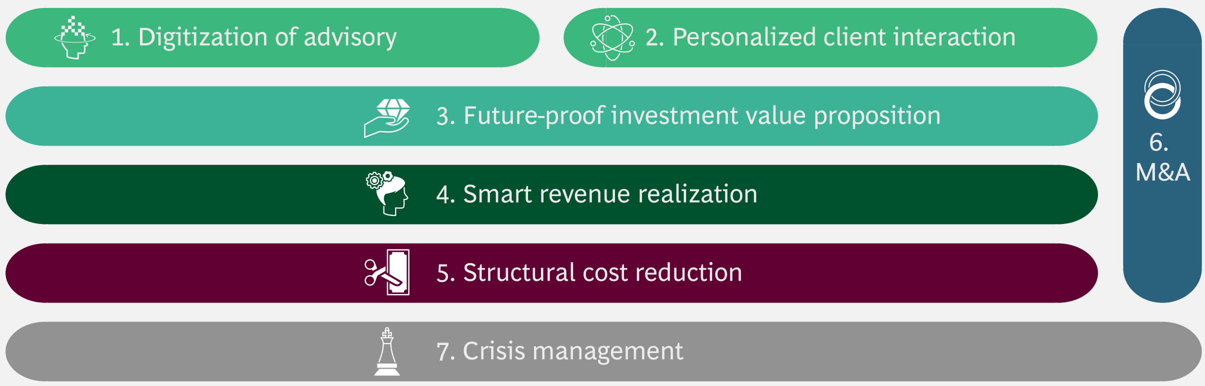
4. **Run scenarios and stress tests:** The current outlook contains many unknowns and risks, among them stock market developments, spill-overs to other asset classes, further margin calls, the spread of COVID-19 in the workforce, further restrictions imposed by authorities, or loss-making products potentially triggering client claims. Firms need to thoroughly evaluate such scenarios and risks, evaluate preemptive measures, develop contingency plans, and ensure they are actionable if needed. This exercise will also sharpen thinking with regard to short-term measures around client experience, people, and costs.

5. **Help clients help others:** COVID-19 provides numerous opportunities for philanthropic investments. For example, as we see the epidemic spread to Africa and Latin America, many affected states and communities will not be able to provide medical care or economic relief on their own. Across the world, the cultural sector is already struggling, having lost almost all near-term revenues. Enabling clients to support good causes via proven and effective channels will strengthen relationships and also be rewarding for employees.

Accelerate medium-term initiatives now

Recent developments have reinforced the case for a number of strategic initiatives that every wealth manager should drive forward. Required measures will be far-reaching, and will include numerous trade-offs. We therefore suggest that wealth managers should address these not as separate projects, but through an overall transformation, led from the top. (See Exhibit 3).

EXHIBIT 3 | Seven levers to ensure better resilience



Source: BCG Wealth Management Segment

1. **Accelerate the digitization of advisory:** Wealth managers must work towards truly hybrid models, where a large part of client contacting and servicing is performed via digital channels; where clients can receive, assess and simulate the impact of investment proposals; and where clients and advisors have the option to interact effectively in new digital formats. Many firms have been experimenting witch such models, but functionalities have often been limited, and internal adoption rates have been low. Efforts need to be driven from the top, and must incorporate the voice of customers and advisors. Offerings need to be developed and implemented in agile development cycles. Delivery should be designed with a strong focus on scalability. Cross-border players might face more specific challenges in implementing a more digital proposition, but they also have ample opportunity to improve, and stand to benefit disproportionately from getting closer to clients in the virtual sphere.

   Clients and relationship managers should be actively persuaded and potentially incentivized to adopt such models. Relationship managers will remain at the core of the client relationship, yet digital technologies will enable them to serve their clients better, in a more effective and personalized way, in these challenging times as well.

2. **Personalize client interaction:** Wealth managers need to embrace the power of data and information in their systems to make any client communication both more relevant and more personal. For example, market updates to advisory clients should not only be different from the ones going out to discretionary clients, but should be tailored to each client's specific investments, risk tolerance, and transaction and interaction history. For example, some wealth managers have implemented targeted investment proposals based on clusters of comparable clients. Such approaches need to be enhanced and extended across the value proposition. They will make client interactions not only more relevant when markets tumble, but also more engaging and effective in normal times, and will help take relationships with the firm to a new level of trust. Moreover, by establishing these capabilities, wealth managers will massively enhance the client experience, as well as improve client acquisition, pricing and client retention, thereby creating significant bottom-line impact.

3. **Review investment value propositions:** Wealth managers need to assess whether their approach and tools have really passed the COVID-19 stress test. Typical questions to ask are: Has actual client behavior matched the documented risk tolerance? Were clients emotionally prepared for, and are they accepting, what is happening to their portfolio right now? Was leverage given only to those who could afford it? Where hedging strategies discussed with interested clients, and required formalities put in place proactively? Were alternative asset classes used, and have they delivered adequate diversification? Have recommended products proven resilient and provided sufficient liquidity? Or in short: has past advice really added value, when measured against client goals? And if not, how can the proposition be improved and trust be rebuilt?

4. **Enhance revenue realization:** Our analysis has shown year after year that the most profitable wealth managers excel primarily in terms of revenues. Firms must act decisively to stop the deterioration of top-line margins. This would include a fundamental review of pricing practices, with a move to client-specific target prices that make use of the power of analytics, and with comprehensive support for relationship managers. The drive would also include "Sales Management 2.0", moving beyond traditional carrot-and-stick methods towards approaches that are created and promoted by relationship managers themselves; towards more coaching – top-down and peer-to-peer; and towards better contextualization, building on a firm's specific strengths and unique offerings. Finally, it would include a quantum leap in the use of data to decide on next best actions, cross-selling and churn prevention.

5. **Tackle your structural cost base:** Many wealth managers took significant efficiency measures after 2008. However, the decline of revenue margins and the costs of increasing regulation more or less wiped out the gains. In recent years, with a benign market environment, attention shifted elsewhere. Many of the more structural levers have so far been used only half-heartedly. Wealth managers should actively assess outsourcing options and ecosystem plays not only in IT, operations and support functions, but also in asset management. This will reduce both operating costs and the need for own investments. They should reduce complexity in management layers and matrix organizations, and consolidate compliance and risk organizations, which in the past proliferated with increasing regulation. They should digitize client journeys end to end, realizing both improved client experience and significant efficiency gains. And they should review their investment budgets and question whether they are striking the right balance, for example between hiring relationship managers and building digital capabilities. The overall goal should be a massive increase in both efficiency and scalability.

6. **Pursue consolidation opportunities:** After a strong surge during the last decade, M&A activity in wealth management has recently slowed down, as even subscale players and businesses were doing well. However, with renewed pressure on margins and profitability, new opportunities for consolidation will arise, and acquisition prices might come down. Acquisitions in wealth management often require building trust with current owners over time. The approach therefore needs to be proactive, sustained, and not just opportunistic. Firms with sufficient funds and strong integration capabilities are likely to benefit.

7. **Prepare for the next crisis:** No one knows when the next shock to wealth managers will unfold, or what will cause it. But it will happen, and firms need to be prepared. Wealth managers should critically review what they have learned from the current crisis; whether they have absorbed the lessons from earlier crises sufficiently; and how well their business and operating model has been able to absorb shocks. In the last weeks, many will have found they need a more robust approach to deal with such events. They should use this opportunity to build one.

The concrete actions required will of course vary according to the particular player. The necessary actions will depend for example on the regions in which the player operates, its segment and offering focus, its current operating models, and whether it is a pure-play or a part of a larger financial institution. However, after a number of good years for the industry, COVID-19 is a tough wake-up call for wealth managers to start or accelerate a much-needed transformation. They must act now, to ensure both short-term resilience and success in the post-crisis world. Past crises have shown that those who move fast and decisively can realize disproportionate gains in the longer term.

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