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Asian Private Wealth Management to Serve the Real Economy

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- Asia's economic growth is on track to make Asia home to the largest pool of private wealth in the world by 2017. China will be home to 60 per cent of the projected US$48 trillion in private financial wealth[1].

- Ownership of this wealth is highly concentrated and the share owned by millionaires is set to increase. Ninety per cent of wealth is currently held through banks or managed personally.

- Asia must harness this wealth to support its long-term growth and so:
  - Deepen and strengthen capital markets
  - Provide early-stage business financing
  - Create jobs
  - Provide better returns to those who created the wealth
  - Pave the way for steadily greater Asian integration

- Developing Asia's nascent wealth management industry to meet Asia's long-term needs means that:

  - Financial institutions must develop business models that win the trust and confidence of Asia's wealthy, who are often first-generation entrepreneurs. The largest opportunity is onshore, though achieving near-term profitability is a challenge outside of home markets. Offshore is profitable but with intense competitive pressures.

  - Policymakers must balance compliance and regulatory issues with more attention on how to develop private wealth funds to drive innovation and deepen capital markets. This will in turn create profitable opportunities for financial institutions with the right capabilities.

  - Policymakers and financial institutions need to work together to ensure a regulatory framework consistent with meeting customer needs, earning sustainable profits and managing risk. Priority should be given to attracting and retaining capital through appealing investment opportunities rather than preventing cross-border flows primarily through hard-to-police capital controls.

[1] *Maintaining Momentum in a Complex World: Global Wealth 2013, The Boston Consulting Group.*

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Asia's economic rise is generating unprecedented levels of financial wealth, creating millionaires and billionaires, as well as spreading increasing wealth to Asia's growing middle classes. Asia ex-Japan is on track to overtake North America and become the world's largest wealth region by 2017, with private financial wealth rising from US$28 trillion to US$48 trillion by one estimate[2]. The profits earned by institutions serving millionaire households could also rival the profitability of the North American market by 2016[3]. While there will be short-term variations as economic growth slows or strengthens from year to year, the underlying dynamics are clear.

Over 90 per cent of this wealth is held onshore, with offshore wealth accounting for 7 per cent of the total. Chinese wealth dominates. Its share of the Asian ex-Japan total is set to rise from just under half to nearly 60 per cent by 2017. Wealth ownership is highly concentrated with a relatively small number of millionaire households controlling 39 per cent of private financial wealth. And the rich are set to get richer. Millionaire households could own around half of all Asian private wealth by 2017. Yet the roughly 1.7 millionaire households in Asia account for less than 0.2 per cent of Asia's households[4].

Such a significant, yet concentrated, pool of wealth brings both opportunities and challenges. Managed effectively, it can make a critical contribution to Asia's continued development. This means deploying these funds where they can earn the most attractive returns and meet real financing needs in the economy.

Fundamentally, the wealthy are able to take a longer time horizon and bear greater risk on at least some portion of their portfolio. These characteristics fit well with Asia's needs for early-stage business financing, deeper capital markets and infrastructure finance.

Bringing together the needs of the wealthy with Asia's development imperatives provides the opportunity for financial institutions to build their own profitable businesses and create service sector jobs.

Nonetheless, high wealth concentrations can cause social tensions and resentment, if this wealth is not seen as legitimately earned and if investments are primarily speculative. Tax reporting, compliance and corporate governance regulations need to develop further to ensure the legitimacy of wealth creation and appropriate fiscal contributions. Harnessing Asia's private wealth effectively also means giving people the chance to see examples of how private wealth is contributing to society's development.

As a sector in its own right, wealth management in Asia is in a nascent phase today. There is a lot of activity but also much scope to make it more attractive for both customers and financial institutions.

The Asian wealthy have different needs and behaviors from those in more established markets. Many are first-generation entrepreneurs – though this mix is shifting as family businesses mature and corporate managers earn greater wealth themselves. They have not been brought up with either Swiss-style relationship private banking or securities-based models as in the U.S. or Japan. They are often used to finding their own investment opportunities through informal personal networks and remaining in control of key decisions. As much as 90 per cent of private wealth is held outside of the private banking sector, with the bulk in commercial banks or managed personally.

There are also differences in asset allocation. Asian millionaires hold a greater portion of their wealth in cash, cash equivalents and real estate than those in North America. Bond holdings are lower than in the rest of the world. Alternative investments are quite well established in Asia and have strong growth prospects.

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[2] *Maintaining Momentum in a Complex World: Global Wealth 2013, The Boston Consulting Group.*

[3] *McKinsey Global Private Banking Survey 2013.*

[4] *1.7M millionaire households (McKinsey & Company); 1.8M millionaire households (Cap Gemini/RBC Wealth Management).*

While the wealthy everywhere invest close to home, this is even more the case in Asia. Across Asia ex-Japan, only US$1.8 trillion of the US$11 trillion in millionaire wealth (16 per cent) is invested offshore with an estimated US$830 billion placed in Hong Kong and Singapore[5]. Capital controls in markets such as China and Korea play a critical role, though varying levels of investor sophistication and currency risk also contribute. Many wealthy do find ways to place a portion of their wealth offshore through the invoicing practices in their business or through underground channels.

Experience in the U.S. and in European markets indicates that a substantial 'home country' bias will persist even without capital controls. Nonetheless, there is considerable scope for increasing integration of wealth flows across Asia. Research indicates significant pent-up demand by the Chinese wealthy to increase their holdings of overseas investments beyond current levels. The other side of cross-border investment flows is the investments made by the non-Asian wealthy in Asia. This is particularly relevant in light of Asia's strong economic trajectory. Attracting non-Asian wealth to invest in domestic Asian markets with the right products and markets is an important opportunity.

In the face of these opportunities, Asian and Western financial institutions are keen to secure rapid growth. However, they find profitability more challenging.

Capital controls, regulations and country differences mean that the bulk of the market opportunity is onshore, not offshore. Each onshore market has different regulatory and institutional contexts. Domestic players are often the best-positioned for success and profit today, even if they lack some of the product and relationship capabilities of global wealth managers. Success in each market will require dedicated infrastructure, investment and management attention. Offshore too, clients have high demands on relationship managers – yet talent is naturally in tight supply in what is a new and rapidly growing sector. Staff compensation levels reflect this demand across all functions. Yet the combination of demanding clients not used to paying for advice and many firms competing for business pushes pricing down. Profitability did, however, improve from 2011 to 2012.

China – accounting for nearly 60 per cent of Asian wealth by 2017 – is a particular challenge for foreign institutions. Capital requirements for local banking incorporation, ownership limits on joint ventures and the separated regulation and licensing of banking, securities and insurance all contribute. Commercial banks are unable to earn sufficient revenues from deposits alone and are not able to easily offer securities trading. Securities houses and trust companies that also target wealthy clients face their own constraints on product range and distribution – and, for foreign players, there is no straightforward route to management control of the business.

Faced with the rapid emergence and growth of Asian wealth, policymakers and regulators also face challenges in their approach to wealth management. The wealthy have only recently become a sizeable group in their own right. Regulation has often not needed to treat this group differently and so has often not done so. Regulators are grappling with how best to address risks and compliance in fast-changing environments, where transparency has historically been low. Critically, however, there has been much less focus on how to best take advantage of private wealth funds to drive innovation in the finance sector – for example, by creating a larger investor base for capital markets – and to support the real economy more broadly through financing and creating employment in its own right.

Globally and in each country, regulators have placed a strong emphasis on defining and fully implementing KYC (Know-Your-Client) and

[5] *Maintaining Momentum in a Complex World: Global Wealth 2013, The Boston Consulting Group.*

AML (Anti-Money Laundering) processes for all clients. Their implementation can be difficult in fast-growing economies where the business and legal frameworks are also evolving. For financial institutions, compliance issues now bring increasingly severe regulatory sanctions and reputational problems. On a global level, offshore centers have felt the greatest pressure. Historically, complete confidentiality was an important part of the value proposition for many offshore centers – and thus the potential, at least, for money laundering and tax evasion. This has become unacceptable to major economies in the past few years for reasons of national security and fiscal policy. Cross-border cooperation with increased information flows on investment and tax compliance is a major focus for the OECD and G20. It will only increase in the future.

In Asia, Singapore and Hong Kong are the major offshore centers. They have gained wealth inflows from Europe, at least partly due to weakening confidentiality conditions in Swiss banking. Importantly, however, these centers have also been at the forefront of actions to maintain and grow offshore wealth activity based on capabilities and full compliance.

Beyond prudential regulation, Asian wealth offers a significant opportunity to shape financial reform, contribute to economic growth and generate employment. It is the offshore centers of Singapore and – more recently – Hong Kong that have seen most clearly the opportunities that a vibrant wealth sector can bring. Other countries also need to create strong wealth sectors that keep capital at home and attract overseas capital rather than relying on the effectiveness of capital controls alone to steer capital flows. This will also create jobs. It requires an explicit regulatory and policy framework for wealth that addresses the needs of clients, financial institutions and broader society. Key aspects include a streamlined approach to product innovation, improved capital markets infrastructure and standards, and investor protection regulation appropriate for wealthy investors. Financial institutions need to be able to offer the full product range that the wealthy demand seamlessly and in a way that is consistent with prudential risk management. Regulators need to encourage the development of products that match the needs of wealthy investors with the needs of the real economy, for example in early stage business finance and infrastructure finance.

Senior leaders of financial institutions are well versed in the steps needed to develop profitable businesses within a regulatory framework. Given diverse client needs, diverse market contexts and diverse starting points of the financial institutions, a range of business models is likely to prosper. There is a debate about how successful “Swiss-style” relationship banking will be compared with brokerage-type approaches as in the U.S. and Japan. The scale and diversity of Asia will likely accommodate both approaches and others too. Domestic players continue to have the advantage in onshore markets. Competitive pressures in offshore markets will only intensify as emerging Asian financial institutions also build up in these locations. For global wealth managers, network connectivity offers a source of advantage over purely domestic players – for example, a relatively limited onshore China presence together with a strong offshore presence can still be sufficient to serve the overseas wealth of Chinese clients. This is especially true for entrepreneurs, where there may be a broader corporate banking relationship.

Financial institutions also have an opportunity to engage more actively with regulators so as to ensure that the wealth management sector contributes the most it can to the economy in terms of products and jobs. They need to lead rather than lag on all aspects of compliance and risk management. Even more, they need to articulate clearly how regulations shape their ability to build profitable businesses and demonstrate the value of global network and capabilities in creating vibrant onshore wealth sectors. Together, industry and regulators can create training, increase the talent pool, and raise standards in relationship management, risk and compliance.

Developing the most effective wealth management sector for Asia's future will require ongoing dialogue and cooperation at both the national and regional levels. Continued focus on compliance, risk management and transparency needs to go hand-in-hand with regulatory change that supports attracting wealthy investors, innovation and profitability. This will also lead to job creation and capable businesses that can attract the wealthy from outside of Asia into the region. The alternative is that capital flows increase away from domestic economies to offshore centers. The opportunity to harness Asia's wealthy investor base to drive innovation and change in the financial sector is significant and must be grasped.

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