To cook or to be cooked —that is the question

Stirring up the perfect investment offering and pricing in a post-MiFID II world

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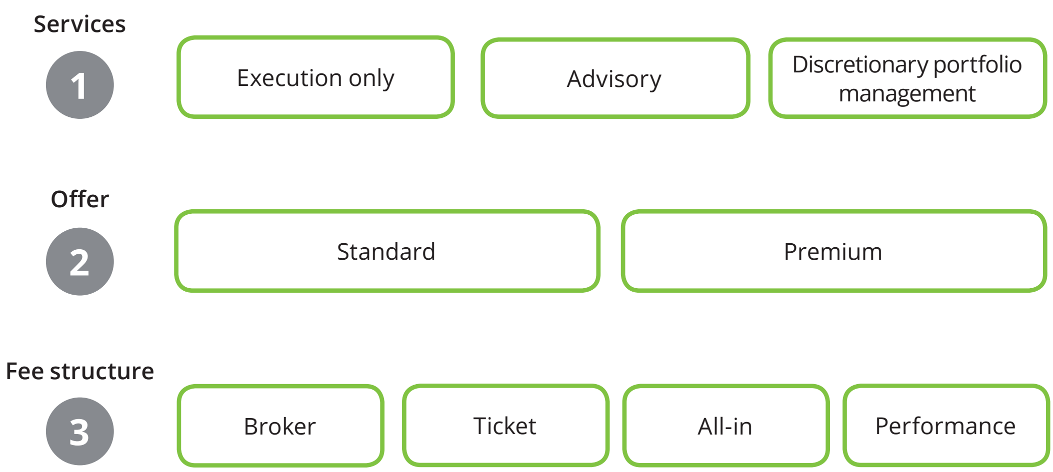
What do restaurants and private banks have in common?
More than you might think... Changing ingredients and shifting customer behaviors are compelling banks to review existing recipes and make strategic choices regarding the future of their business models. The private banking market has undergone significant changes in recent years as external pressures such as an evolving economic environment and regulatory challenges take their toll. The provisions of MiFID II have fundamentally challenged their existing business models and forced banks to react. While many banks seem to have been unsure of how to respond until recently, the entry into force of the new regulation has prompted the majority of banks to review their menu, introducing a new service offering and pricing.

Banks are spicing up the menu with a new value proposition

To provide an overview of these redefined offerings, Deloitte has analyzed almost 15 private banks in Luxembourg, including pure player private banks and universal banks with a private banking department. The results of this analysis show that the services on offer continue to range from execution only to advisory and discretionary portfolio management, but the range of ancillary services has become more diversified.

Luxembourg private banks can set themselves apart from the competition on three main aspects: service, offer and fee structure.

In this changing environment, banks are reacting in a relatively homogenous way. As MiFID II enters into force, we observe that the majority of banks have decided on a new value proposition for their investment services, reviewing the range of services that they provide to customers and adapting their fee structures accordingly. Consolidating the pricing grids submitted by the 15 individual banks on a voluntary basis allows us to provide a market overview of private banks in Luxembourg, especially in terms of investment offering. We looked at services, offers, and the proposed fee structure, as well as fee levels for the proposed investment offering.



1. Three different types of services are typically offered to clients based on their requirements.

	1 Execution Only	2 Advisory	3 Discretionary portfolio management
Definition	Clients manage their own investment.	Clients receive advice on their investment strategy from the bank professionals, but take the final investment decisions themselves.	Clients choose an investment strategy that reflects the level of risk they are willing to accept and entrust the management of their portfolio to bank experts.

2. For each of these services, banks may choose to provide their clients with a standard offer only or with both a standard and a premium offer.
A premium offer usually includes additional features, such as a more active and individualized advisory approach.

Level of service offering	1 Execution Only	2 Advisory	3 Discretionary portfolio management
Standard	• Consists in the execution of transactions requested by clients and on their sole initiative	• Less active management • Reactive/on demand advisory by RM • More general investment advisory • Less frequent portfolio reporting	• Standard service offering • Mostly dedicated investment advisor • More general investment strategy (often through funds)
Premium	• Consists in the execution of transactions requested by clients and on their sole initiative through a direct access to trading room	• More active advisory approach/ ongoing contact with dedicated financial advisor • Personalized recommendations • More frequent portfolio revenue reporting	• Tailored service offering • Dedicated investment advisor • Tailored investment management

3. **There are four different fee structures within each service and offer category: ticket fees, broker fees, all-in fees, and performance fees.**

   Some fee structures are applicable to all types of services and offers, whereas others are particularly well-suited to specific service offerings. Ticket fees, for example, exist solely for execution only services, while broker fees can be charged for all three services.

	1 Ticket fees	2 Broker fees	3 All-in fees	4 Performance fees
Definition	• Ticket fees **generally include** the administration fees and custody fees • Ticket fees **do not include** transaction fees	• Broker fees **generally include** the administration fees and custody fees • Broker fees **do not include** transaction fees	• All-in fees **generally** include administration fees, custody fees, transaction fees, and advisory or discretionary management fees	• Performance fees are **generally** a variation of classic all-in fees, with lower rates than all-in fees but with a performance fee that may be applicable in case of good performance
Standard calculation	• Ticket fees are calculated based on a fixed amount applied per transaction (hence, independent of the transaction amount and of the financial instrument category)	• Broker fees are calculated based on a percentage (**generally,** depending on the transaction amount and the financial instrument category) applied to the transaction amount	• All-in fees are calculated based on an annual rate (**generally,** depending on the level of assets) applied to the total assets in portfolio	• Performance fees are calculated based on an annual rate (**generally,** depending on the level of assets) applied to the total assets in portfolio and with a performance fee added in case of good performance (calculation differs)

In summary, the new bank menu has the following key features:

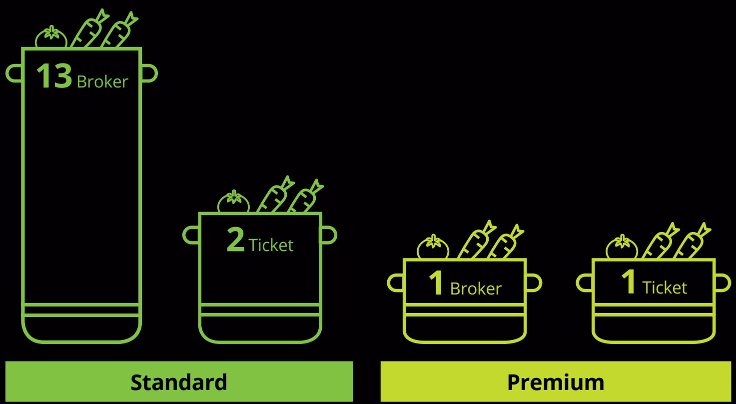
Execution only is becoming a staple. In a break with the past, execution only services are increasingly emerging as a packaged offering for a number of banks. In particular, banks whose clients typically have lower total net worth are using packaged execution only offers to attract clients and eventually upsell toward advisory or discretionary services.

Novelty is shaking up the menu. Clients are being proposed newer and more innovative pricing models than in the past, as banks respond to the changes they face. Discretionary portfolio management clients, for example, can now choose more traditional fee structures, such as broker and all-in fee structures, or more innovative performance-related all-in fees.

A premium menu is on offer if clients are willing to pay. Banks are increasingly differentiating between standard and premium offers; while some banks continue to propose only one type of offer for each service, a large number of banks are attempting to respond to the changing structure of the Luxembourg private banking market by creating a more segmented offer tailored to the needs of individual clients.

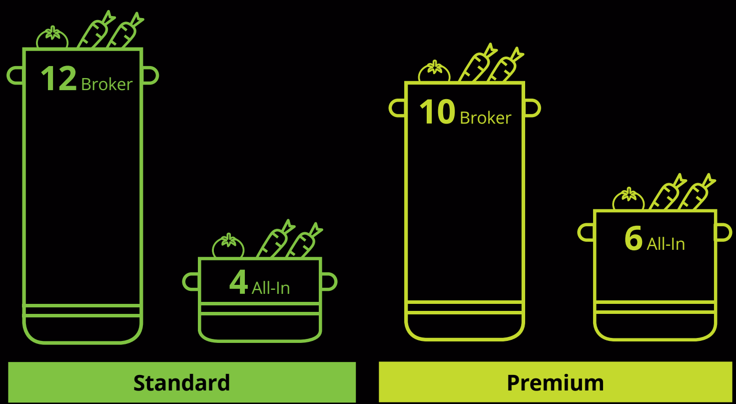
Broker models are the predominant fee structure for execution only and advisory models, while all-in models are most common for DPM (all numbers out of 13)

Execution Only Models Benchmark



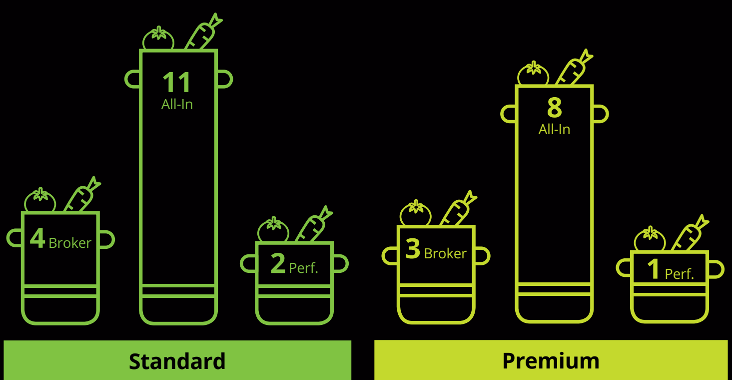
- **All actors offer execution only broker services and premium services are rare.** Only one actor provides premium execution only services
- **Specific ticket models are limited.** They are mainly available for execution only and here are only offered by a few actors
- **Entry thresholds are not commonplace.** Only one actor has an entry threshold for the standard offer of €250,000

Advisory Models Benchmark



- **Broker models are predominant for advisory models and premium models are commonplace.** Nine actors offer premium models
- **All–in models vary in terms of services included.** For example, out of six actors offering an all-in structure for premium advisory, only three actors offer a "real" all-in model, while the other two offer a hybrid model (i.e., account management and custody fees come on top of all-in management fees)
- **Approximately one-third of actors have an entry threshold.** For standard offers ranging between €125,000 and €1 million, and for premium between €1 million and €5 million

DPM Models Benchmark



- **All–in models are the prime fee structure for discretionary portfolio management.** Eleven actors offer an all-in model for a standard DPM offer
- **A majority of actors only present standard DPM mandates in their official pricing grid**
- **Only two actors provide performance models.** There is one for both the standard and premium DPM

Not all prices are adapted to the menu and clients

The majority of private banks have a clear strategy regarding the services and clientele they want to target. However, by applying the pricing grids of the actors analyzed to 10 different simulated investor profiles[1], it is clear that not all actors have actually aligned their pricing with the strategy that they have defined.

The 10 profiles encompass a wide array of services and investor behaviors, ranging from a smaller client with €600,000 in execution only and not very active to a large client, investing €20 million in a discretionary portfolio management mandate. These sample clients are based on classic portfolios and the related transactional behaviors. More information on each of the profiles can be found in the table below.

Selected information on profiles included in the pricing benchmark

N°	Sample Client Profile	Strategy	AuM (mio €)	Turnover rate
1	Standard Execution Only Broker		0.6	20%
2	Standard Execution Only Broker / Ticket I		0.8	44%
3	Standard Execution Only Broker / Ticket II		1.0	59%
4	Standard Advisory Broker		0.6	35%
5	Standard Advisory All-in		1.5	60%
6	Premium Advisory Broker		2.6	46%
7	Premium Advisory All-in		2.6	88%
8	Standard DPM All-in		2.6	85%
9	Premium DPM All-in I		5	94%
10	Premium DPM All-in II		20	–

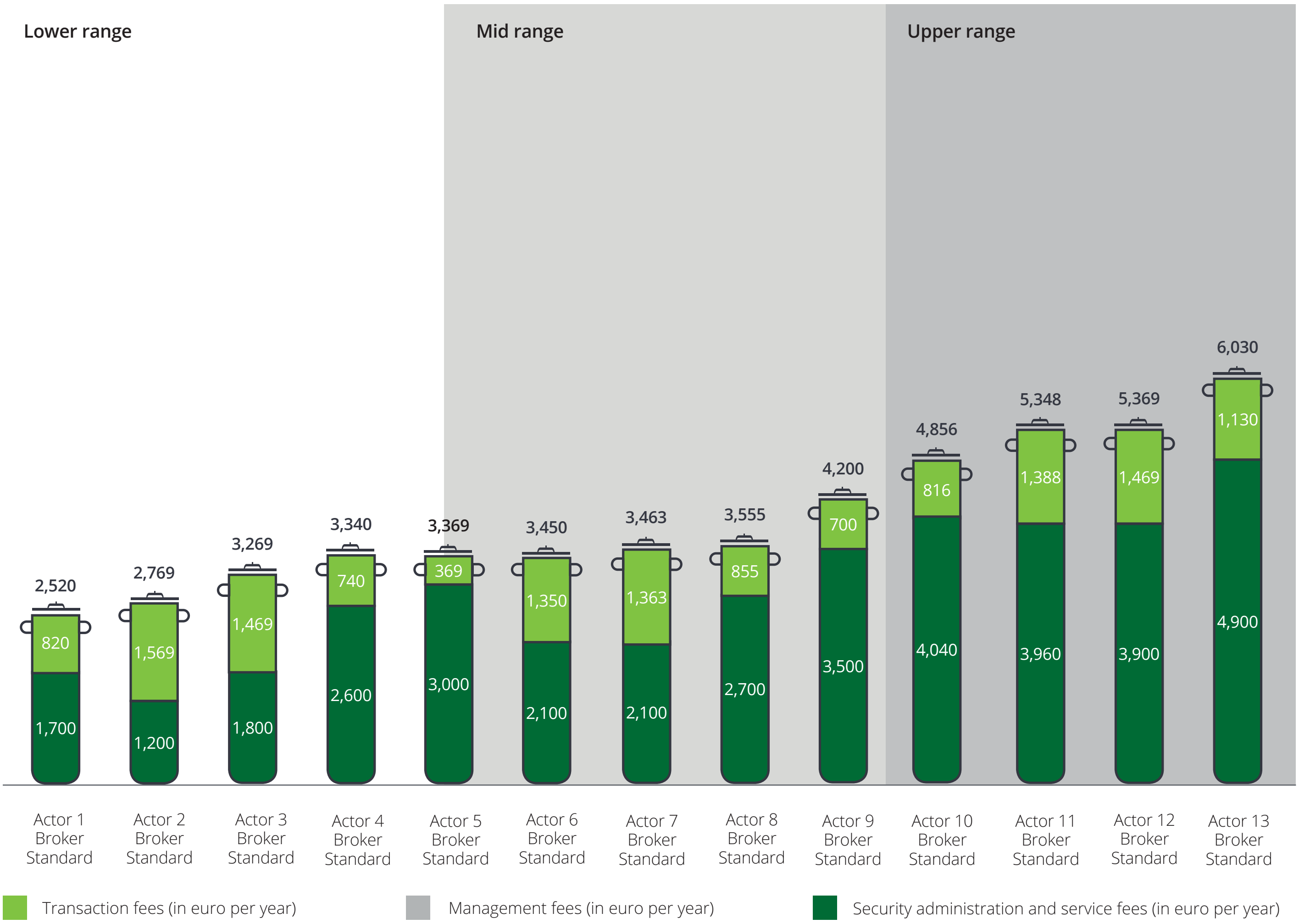
Balanced High

1 Representing a diversity of investors in terms of services required (execution only, advisory, discretionary portfolio management), investment strategy, assets under management and turnover.

The extent to which strategic positioning and pricing are aligned varies significantly between banks

The results show that the market is fragmented regarding the degree to which banks' pricing is aligned with their strategy. Some actors seem to have carried out significant analysis and definition work resulting in pricing grids that are aligned with their strategy, attracting target clients and dissuading non-target clients. By contrast, other banks' pricing is actually attracting clients that do not belong to their target segment, often resulting in a high cost to serve and low margins, or they are pitching prices too high, and thereby dissuading clients in their target segment. Let's take a look at the example of execution only broker pricing for a client with €600,000 performing three transactions for €120,000. The levels of fees charged to the client differ significantly among banks, with the cheapest actor pricing its services at approximately €2,500 per year and the most expensive actor pricing them at approximately €6,000 per year.

Amount of fees paid per year in EUR[2]



If we consider the extremes, it is interesting to note that both actors are private banks targeting mainly advisory and DPM clients with AuM of at least €2 million. One actor clearly aligns its pricing to its strategy, while the other is attracting clients it does not desire:

- The most expensive actor (Actor 13) aligns its pricing to its strategy by charging a high security, administration, and service fee, which is prohibitive to less desirable clients
- The least expensive actor (Actor 1), in contrast, attracts clients that do not belong to its core target market by pricing its execution only services for a client with €600,000 of AuM lower than the private banking departments of universal banks
- Private banking departments of universal banks are intentionally pitching their prices at relatively low levels as they actively target these clients as part of their efforts to move affluent clients from retail banking to private banking and encourage upselling

2 Does not include fees charged by third parties on financial, expressed excluding VAT and excluding trailer fees or rebates

Conclusion

As banks are reviewing their menus, offering new dishes based on new recipes, they need to ensure that they adapt their prices accordingly. We have observed that two-thirds of banks have reviewed their pricing grids in the wake of MiFID II. Pricing should not be underestimated but should instead be seen as a key contributor to the implementation of the bank's strategy, which can lead to a significant increase in profitability by driving the RoA of each individual customer.

As in the case of a restaurant, banks need to take a strategic approach to defining their pricing strategy, looking both at the revenue side—identifying the clients that they want to target, their willingness to pay, and their perception of different pricing models—but also the cost side. From the revenue side, a very simple calculation shows this; should Actor 1 increase its pricing by €1,000 to €3,520 (e.g., by increasing its security administration and service fees), it would position itself in the mid-range of execution only services for a client with €600,000. As a result, the RoA for this individual client would increase from 0.49 percent to 0.59 percent[3].

From the cost side, the wrong pricing will attract non-target customers, which may have a negative impact on the bank's bottom line by acting on both drivers for a number of reasons, including a diluted brand image, a potential inability to serve these clients adequately, or a high cost to serve.

In contrast, having a tailored pricing model will ensure that margins are safeguarded and increase the profitability of individual clients.

3 This RoA calculation is particularly simplistic, as it does not reflect sources of revenue other than transaction fees, management fees, and custody and security administration fees. While it is not comprehensive, it provides an indication of the potential impact of a coherent pricing strategy.