Shanghai Private Banking Market Brief

Edited by: Wenjuan Zhan
U.S. Commercial Service in Shanghai

Private Banking:

Private Banking is a segment of the Financial Services industry that caters to High Net Worth Investors (HNWI). The primary financial planning services provided to this High Net Worth market are Cash Management, Asset Management, Liability Management, Estate Planning and Tax Planning. Some of the more boutique firms have branched out into Concierge Services and Family Legacy Counseling for their clients as well. Typically, private banks have a minimum investable net worth of $1 million or greater that investors must reach in order to become a client. This minimum net worth size ensures that Private Banking Clients are larger than the average Retail Client, which allows Private Banking Advisors to personalize their service model and tailor their services toward the needs of the client. The competition for clients has grown over the years, which has caused private banks to increase their service offerings and lower the fees they charge. The increased service and lower fees have decreased the overall margins that can be achieved in the Private Banking segment of the Financial Services Industry.

The China Market:

The expansion of China's economy over the past two decades has started an expansion in the size of the HNWI market in China that is likely to continue, possibly at an increasing rate. According to Capgemini, the number of HNWI in China has increased at an annualized rate of 12% since 2006 and has grown to a total number of just over 525,000 in 2010. These clients held approximately $2.35 trillion in 2009, which means that the average net worth per investor was almost $5 million. This average value is slightly higher than other countries in Asia or even developed countries in North America and Europe. This concentration has been skewed upwards due to the fact that the wealthiest 128 people in China, all billionaires, hold almost $250 billion, or greater than 10% of the total wealth of HNWI. Boston Consulting group believes that wealth in China will grow at an 18% annualized rate over the next 5 years, which will allow the Private Banking Institutions to pursue new business in a growing market, which will decrease overall competition.

The Shanghai Market:

The HNWI market in Shanghai should account for approximately 30% of the number of HNWI in China, but only 20%-25% of the total assets of HNWI in China. The discrepancy is based on how the HNWI built their wealth. Shanghai is populated by more professional managers and less business owners than Guangzhou, or even Beijing, so Shanghai will tend to have more people on the lower end of the HNWI spectrum. Professional managers tend to be less aggressive in regards to their investing, which means that investors in Shanghai will be more open to the concept of asset allocation and diversification. It also means that Shanghai HNWI will have less of their wealth invested in a family business. This bodes well for Private Banking Institutions in that they will have more assets to invest, meaning they will have more assets on which to charge fees.

Chinese Investor Behaviors and Preferences:

Since asset management is such an important part of private banking, it is important to understand what biases Chinese investors have in their investment choices and how Private Banking Advisors can prepare for these.

Private Bank Usage:

In 2009, Bain and Company estimated that only 8% of the HNWI in China used Private Banking services. Part of this low usage comes from the fact that Private Banking Institutions are new to China and it will take time for HNWIs to grow comfortable with the idea of one institution overseeing all of their financial needs. The low usage can also be attributed to the timing of the 2008 financial crisis and the disruption that this caused in the confidence building process. This confidence has started to rebuild as the markets have rebounded and the number of HNWI using Private Banking services has increased.

Stage of Investing:

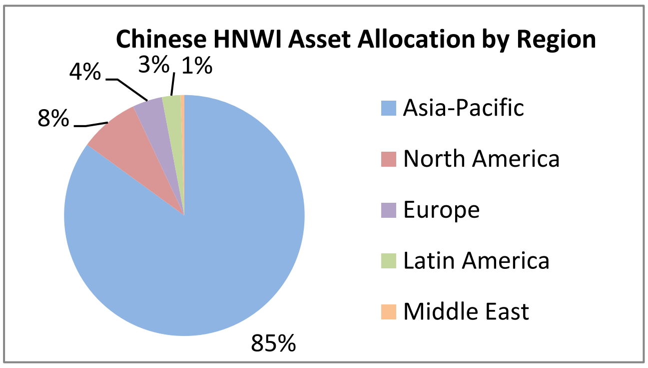
Most investors are in the accumulation phase or consider themselves to be in the accumulation phase of investing. This is because of two things. First, the investor population is relatively young, so they still have a considerable amount of their life for which to plan. Second, they have witnessed the extreme amounts of wealth that have been created over the last couple of decades and the enhanced status that comes with it. They want to take part in this growth and build their own wealth and increase their status. All of this will lead to a HNWI who will seek out high returns before low risk, which will lead to decreased loyalty if portfolio returns start to drop.

Tax Considerations:

The tax regime in China is a progressive tax with a range of 5% to 45%. The 45% is reached when the individual reaches monthly income of CNY 100,000. Capital Gains and dividends are taxed at a flat 20%. The government will use tax as a form of market control, so China has been known to adjust its policies on taxation regarding real estate to try and expand or contract the market. China does not have an inheritance tax, so this decreases the amount of estate planning that private banks typically perform for the HNWI, however, it is important to consider that an inheritance tax may be implemented in the future.

Regional Bias:

According to Capgemini, Chinese investors have invested approximately 85% of their assets in the Asia-Pacific region, which can be seen in the graph below. The primary Asia-Pacific markets have been mainland China and Hong Kong.



While this would typically signify that the investors are regionally biased, this is not necessarily the case here. Some of this may be due to investor preferences, but most of it is due to China only opening up foreign investments to institutional investors. Retail investors must still invest within the borders of China, which does include Hong Kong. Private Banking Advisors should have sufficient knowledge of and experience in the region.

Tangible Assets:

Chinese investors tend to hold more investments in tangible assets than their peers do in developed countries. This is normal in developing countries that are building a financial infrastructure and the financial institutions are still trying to build consumer confidence in their operations. In this environment, tangible assets give investors a sense of security because they can physically see and touch the object in which they invest. Tangible assets are also preferred in China from a social/status perspective. This is one of the reasons that Chinese investors purchase more jewelry than most of the other countries in Asia. The dramatic rise in property values has also caused people to flock towards Real Estate as a means of investment because they feel the returns will subsist. This is of concern to people inside and outside of China because of the possible bubble formation. Private Banking Institutions that have a perceived or actual expertise in tangible assets will be better positioned to develop a strategic advantage.

Luxury Goods:

As Chinese investors continue to build their wealth, they want to show their rise in society by purchasing more luxury goods than they have in the past. Private Banking institutions should be aware of this and the draw on the asset base of the client. One way to possibly offset the decrease in revenues is to develop a concierge service that will help facilitate these purchases and increase the total fee or charge a separate fee for these services.

Market Participants

Private Bank Participation Methods:

Private Banks have entered the China market using three basic strategies. The first strategy is a Joint Stock Bank, where a local bank partners with a foreign bank and they offer services under the joint umbrella. An example of this is the partnership between Agriculture Bank of China and Bank of Montreal. However, this particular example is structured more as a Cooperation Agreement and not necessarily a Joint Operation. The Bank of Montreal will provide cross border services to ABC clients and vice versa. There have been other examples of Joint Stock Banks in the past, but most of the foreign banks have pulled out and discontinued the partnership.

The second strategy is a Foreign Owned Bank, where a foreign bank builds its own branches in the country. The most successful example of a Foreign Owned Bank is HSBC, headquartered in London, which has worked its way to the number one private banking spot in China according to The Financial Times. This strategy is typically viewed as the most advanced and sophisticated type of institution. However, because the Private Banking model in China is so new, the demand for this level of sophistication has not yet reached a large scale level. If a company were to enter the Private Banking market in this manner, it would typically take a minimum of 1 year to receive a Private Banking license and closer to 2 years if you do not have any banking features already established in the country.

The third strategy is as a division of one of the State Owned Banks. The most successful example of this is ICBC Bank, which was awarded the first Private Banking license in 2008 and has been named as the best Private Bank in China according to Euromoney. Typically, this model is thought of as being the most reliable and secure, however, the level of sophistication and expertise is below that of the foreign owned banks. This strategy seems to be experiencing the most growth.

How Clients choose a Private Bank:

HNWI in China are looking for three primary factors when selecting a Private Bank. The first is expertise, which the advisors in China are currently lacking. The average advisor in China has less than 9 years of experience while the average advisor in the U.S.A. has about 24 years of experience. Since the number of HNWIs utilizing Private Banking Institutions is relatively small and their estate planning needs are not as complex as in other parts of the world, this is not a huge hurdle to overcome. In the current environment, it is important to have some knowledge of tangible assets. As the HNWIs continue to grow in size and sophistication, expertise will be an important differentiator in attracting new business.

The second factor is customer service and relationships. The State Owned Banks have an advantage here because they already have a good bit of the commercial or retail services of the client. The Private Banking services can just be an extension of their existing services. The State Owned Banks know the intricacies of the Chinese culture and how to operate within this culture and they understand what clients value. In regards to increasing this advantage, they understand that they must pay for talented representatives, so they should be able to expand their customer service offering by paying up for talent. This will, however, decrease their margins in the future as competition increases.

The third factor is reputation. Foreign owned banks tend to be viewed as more advanced than the state owned banks, but they are also viewed as being less reliable in times of stress. Currently, the market does not have a need for high levels of sophistication, which means that the perception of the foreign owned banks being more advanced does not give them a strategic advantage. However, since most Chinese believe that wealth is abundant in the U.S., it may be a form of enhanced status for a Chinese HNWI to tell your friends that your Private Bank is a U.S. firm.

List of Major Competitors:

Private Bank Name	Type	AUM* (Year)	Locations
HSBC	Foreign	$499 B (2010)	Global
Societe Generale	Foreign	$120 B (2011)	Global
Standard Chartered	Foreign	$46 B (2010)	Global
Bank of Singapore (New)	Foreign	$26 B (2010)	Greater Asia
ICBC	State	$ 54 B (2010)	China
Bank of China	State	N/A	China, Hong Kong and Switzerland
China Merchants Bank	State	$ 41 B (2010)	China
Agriculture Bank of China (Bank of Montreal)	Joint	N/A	China

**AUM = Assets Under Management*