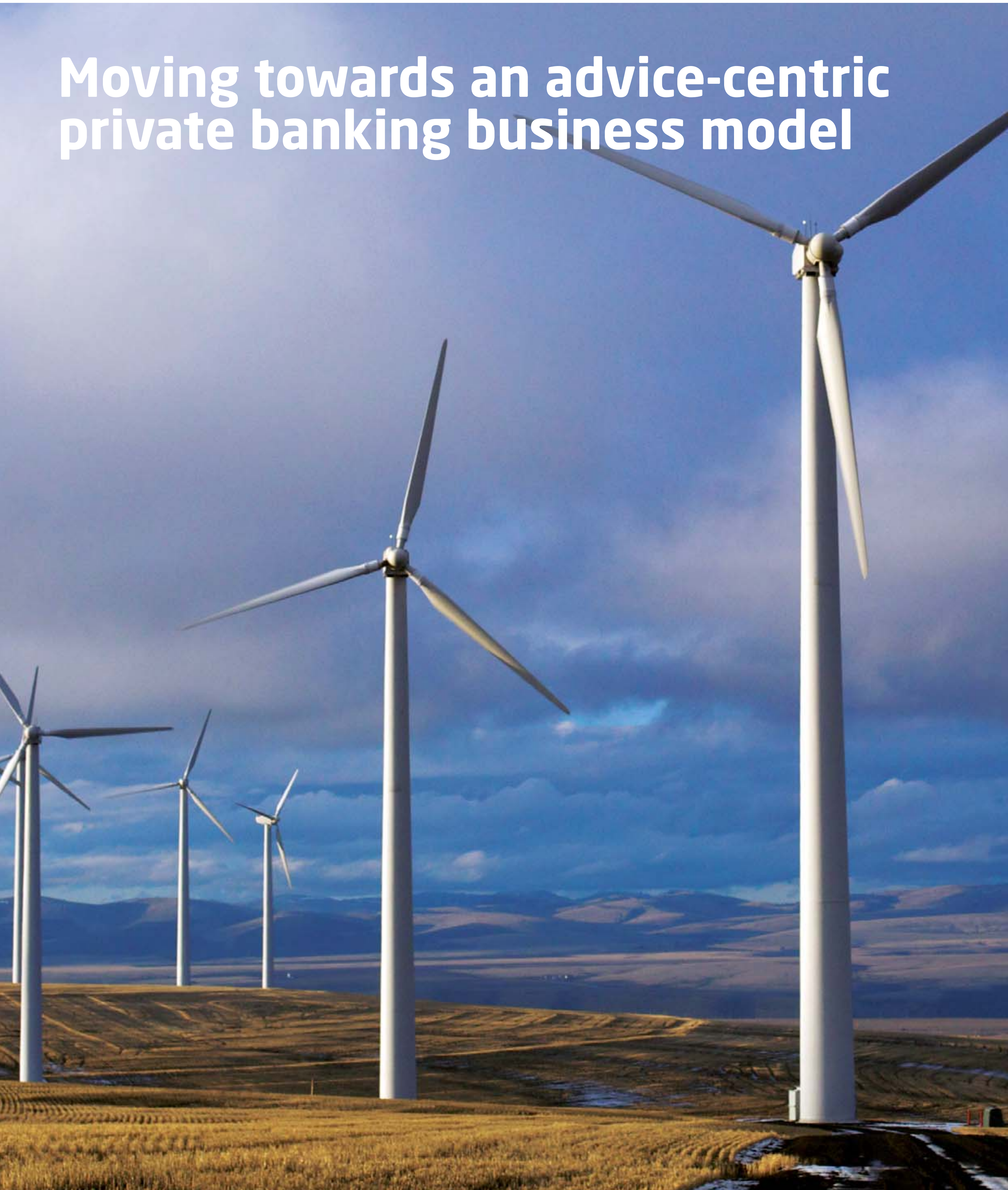
timetric

Moving towards an advice-centric private banking business model



Contents

Executive summary

- **Industrialisation of product manufacturing and research increases time to market and customer centricity**
- **Operational efficiency has become a necessity, not a competitive differentiator**
- **IT investment priorities should be aligned with the business strategy and customer needs**
- **Most private banks are good at managing clients but not as good at managing profitability**
- **'Pay for advice' may be more sustainable for banks, but customers take time to adapt to the concept**

Introduction

The private banking industry has gone through tremendous change in the last five years after the financial crisis shattered client trust and it became obvious that the traditional private banking business model lacked sustainability in crisis times.

Since then the industry has struggled to follow new regulatory requirements and internal policies that have increased the administrative burden and sent operational costs through the roof. Customers have also matured and today demand better service, better advice and more transparency from their banks. In combination with the moderate returns given the sideward performance of the global economy, private bankers had to up their game to make their clients happy and provide better advice, compared with the pre-crisis days of growth.

As a result private banks have found themselves in a transformation process, struggling to win back lost trust while managing growing costs in a far more complex environment. To deal with these challenges, many private banks have turned to technology as an enabler to simply stay in the business. Automation, and the streamlining of multiple processes in the middle and back office, therefore has become a key enabler in the frontline's ability to service clients better and more efficiently.

Although private banking has always been about delivering superior service and advice to clients, the last years have highlighted the disconnection between the traditional execution-centric revenue model and clients' best interests. The current revenue model is still focussed on maximising sales and assets under management, instead of delivering increasing value to the customer.

Given these challenges, it is not a big surprise that the "quality of advice" is believed to be the future differentiator in the industry. While this concept is not new, the trend of an entire industry moving into this direction is a novelty.

For this whitepaper, written by Private Banker International (PBI) and sponsored by Omgeo, PBI interviewed 12 private banks, operating in the private banking centres of Singapore and Switzerland. We discussed their strategy to position themselves in today's operating environment, the potential trend towards a more advice-centric private banking model, and how this might affect the investment priorities in the front, middle office and back office.

The need for a more sustainable model in private banking

"Private banks need to focus on the quality of financial advice they provide to their clients, which will then allow them to charge for advice rather than depend solely on the execution of investment trades for their income. Execution is hardly a differentiator today and those who cannot do it properly should not be in the business. The digitalization of execution will further erode the already small margins. Therefore I anticipate a shift towards a "high-tech, high-touch model".

Rajesh Malkani
Head, Private Banking East, Standard Chartered Private Bank

Regain client trust

- **Transparency is fundamental to re-establish trust**
- **Frequent, non-sales communication helps to position the bank as trusted advisor**

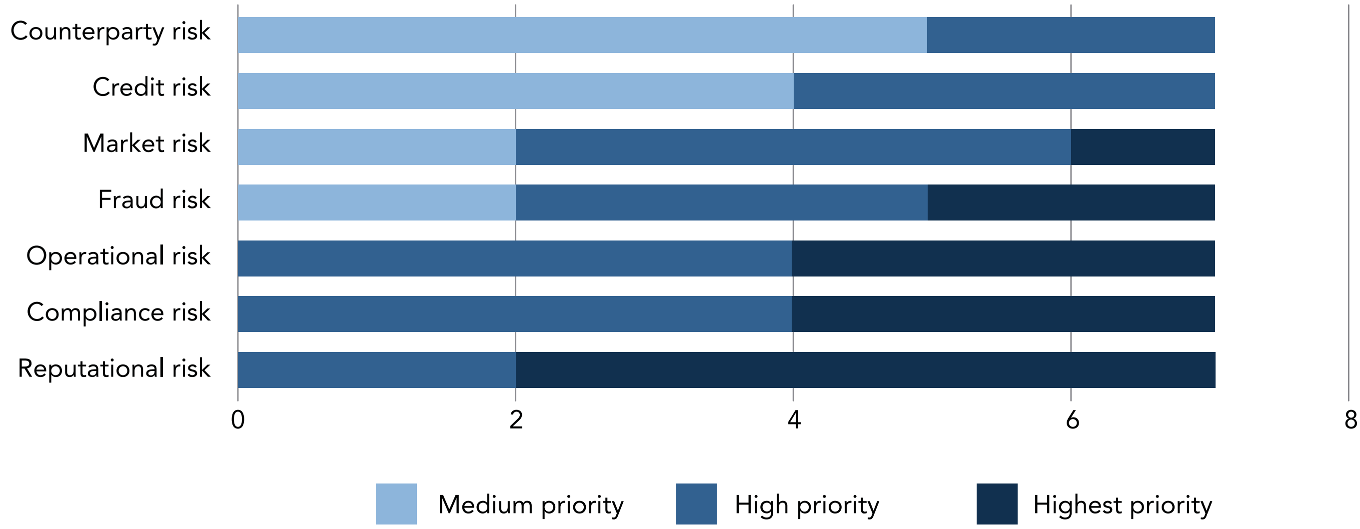
How deeply client trust was shattered is reflected in a Prince & Associates survey from 2008 that found that 81% of American high net worth individuals (HNW) planned to switch their relationship manager (RM) and 86% would recommend other investors to avoid their own adviser.

Ever since the financial crisis banks have tried to rebuild the trust of their clients by increasing transparency, improving the quality of relationship managers through training and certifications, and changing remuneration models – sometimes voluntarily or with a push from regulators.

According to Michael Blake, general manager Asia at Coutts: "There is a lot of change happening in the industry at the moment, with regulators moving to increase transparency and quality of advice. In the UK, the FSA took a clear stance on differentiating charges related to advice from charges related to a product. Without wanting to prejudge or predetermine the outcome of the FAIR review in Singapore, the panel is looking at similar issues: how best to improve quality of advice, increase transparency of commissions and fees and increase the professionalism of the industry."

Transparency clearly has become a priority today, but the level desired by customers still differs from what the banks are currently willing to offer. Very often fees are not displayed openly enough to the customer and rarely publicly. Commission structures remain opaque and kickbacks are not shared with the client. Often, banks are also not willing or able to display client portfolio profitability at a frequency desired by the customer. This demonstrates the difficulties that many banks face adapting to modern times, where the client is in the driver seat.

How do you prioritise different areas of risk in private banking?



Source: Timetric

When we asked the audience about how they prioritised risk in their organisation, it was not a big surprise that most respondents gave reputational risk the highest priority in a private banking institution, followed by compliance and operational risk. Credit-, market-, and counterparty risk were ranked lower, mostly because the respondent banks either had a limited exposure or adequate capabilities in place to manage them effectively already. An additional category, which four respondents cited as increasingly important, was information risk, given the recurring incidents of client data leaks to authorities or the media.

Improving client communication was seen as another priority for banks as they seek to provide better content at a higher frequency and develop a more structured and guided advisory process. Today, communication with the customer often still means an opportunity to make a sale or spam the customer's inbox with bank research to pave the way for the next sale, a practice that has contributed to the poor reputation of private bankers.

Nicolas de Skowronski, head of investment advisory at Julius Baer highlights the intrinsic value of good customer communication, when he stated: "In 2008 we began to call our customers on a daily basis simply to discuss what was happening in the markets, not to sell products. This was really well perceived by our customers who liked and appreciated this commitment. Post-crisis we saw a boost to our advisory assets."

Delivering a more targeted and customised selection of the extensive bank research is another opportunity to improve the customer's trust, but only when it is filtered to what is relevant to the client. If clients are forced to scan through the bulk of research reports, investment outlooks, CIO views themselves, the value to the bank and the client is limited and conveys the message that the bank does not understand the customer's needs.

Regulatory compliance

- **With growing regulatory requirements, automation is necessary to manage costs**
- **Automation of compliance reduces workload of the frontline and eliminates human errors**

Private banking in the "age of the regulator", as some bankers call the current period with increased regulatory scrutiny around the world, has fundamentally changed the way the business is run.

Relationship managers are spending an increasing amount of time on administrative tasks in order to comply with external regulation and internal guidelines, diminishing the time to be spent with clients.

The automation of many of these processes, such as facilitated and standardised data entry or embedded system compliance checks to speed up the identification of positives and minimise compliance violations, allows banks to manage growing cost while reducing the administrative burden on the frontline.

In short, an efficient process and IT infrastructure contributes to better delivery of advice by reducing the administrative burden on the frontline, minimising false or unsuitable advice, and can even promote a more balanced portfolio management approach.

Bringing in digital channels to supplement the RM

- **Customers demand digital channels and a solid multichannel capability**
- **This increases the pressure on back office to provide real-time data**

Customers are demanding a richer and more direct channel experience, in particular portable devices such as smartphones and tablets. Building a digital channel proposition for private banking can be a challenge, given strict KYC requirements and higher transaction values that do not allow any room for error.

Leveraging digital channels also requires banks to deliver real-time data on portfolio information and on-the-go trading of various asset classes to the customer. This not only will increase the volume of lower-value transactions volumes enforcing the need for process automation, but will also leave those banks who fail to adapt in a difficult position.

Particularly in markets like Asia, where customers are more actively involved in the investment process, the ability to provide a rich digital channel experience to supplement the relationship manager in the role as financial advisor will be crucial to capture the next generation of HNWIs.

Manage the business more efficiently

- **Private banks are good at managing clients, not profitability**
- **Banks need to be more disciplined to onboard and retain the right client**

The rapid growth of wealth in Asia and the increasing number of players in the market with ambitions to increase assets under management has resulted in a business practice where the profitability of the individual customer has been neglected in anticipation of future returns. The tail of unprofitable and non-qualified customers, who fail to meet the minimum requirements of funds in the bank, has become a huge cost driver for many.

Shayne Nelson, CEO of private banking Asia at Standard Chartered emphasises: "It is important how you manage your business. Most private banks have a good client focus, but have missed out on managing the business. Ultimately, what you want is for your RMs to be able to provide excellent service to clients that qualify in the private bank. This means that from time to time you need to cut the 'tail' and move those customers to another segment or impose a management fee, if they do not qualify for private banking - even at the cost of losing them. This 'tail' is like that of a gecko – you cut it off, but it grows back. Given the rising cost of the business, it is important to maintain discipline around ensuring you have the right clients booked in the right segments so that you are able to offer the appropriate level of services and advice that bring value to the client."

A disciplined onboarding process is important to not only acquire and retain qualified customers, but it has to be a priority for private banks who want to put the quality of advice as their value proposition. Allowing the RM to focus his efforts on the right customers is crucial to delivering this promise. However many private banks in Asia would rather grow at all cost and take on unprofitable customers while neglecting the profitable ones. "It is really important to us to only have qualified clients in private banking, which means a minimum of $2m with us. We do not recognise any revenue for clients that do not qualify. We may put a fee on them to incentivise them to top-up to the minimum within six months or we will ask them to change to our priority banking", Nelson adds. He estimates that in Asia there are quite a number of banks who carry a 'tail' of over 40% of their total customers. "You will always carry a certain load of non-qualifying customers, because they are new to the bank and haven't committed the necessary assets yet. I believe a tail of less than 20% is good and less than 10% would be optimal."

"It is really important to us to only have qualified clients in private banking, which means a minimum of $2m in AUM with us. Our RM scorecards do not recognize revenues from clients that do not qualify. In addition, we encourage non-qualifying clients to top-up to the minimum within six months or to bank with our priority banking", Nelson adds.

Private banks also need to focus more on the profitability and productivity of the RM. Business intelligence systems to monitor the sales, net new money, and other performance indicators of the RM help to manage the cost and provide a business model that is more sustainable in a downturn, as the bank is not carrying dead weight.

Given the fast growth of wealth in Asia, the low penetration of wealth management and a small talent pool, looking at profitability is a big challenge for private banks. Many make the case that the Asia business is still in investment and growth mode, and that profitability will come once the market matures and the client base is big enough. Following this argument, some banks in Asia have been operating at a loss over the last 15 years. Growing at all cost can lead to onboarding unprofitable and risky clients and puts the bank at risk in an economic downturn. More than that, RMs can get distracted by customers who are not profitable to the bank at the expense of those who are.

Technology as a key enabler of the business

- **Operational efficiency has become a necessity, not a competitive differentiator**
- **IT investment priorities should be aligned with the business strategy and customer needs**

Generally private banks were late to embrace technology in order to run their business more efficiently compared with other business lines such as retail banking, corporate banking or investment banking. This is particularly true in Asia, where customer numbers tend to be smaller and limit firms' abilities to justify expensive IT investments. This benefitted larger private banks with the scale and volumes to invest in technology, giving them a competitive edge over smaller players. Over the last years however given growing client and transaction volumes, comprehensive regulatory and internal risk compliance requirements, private banks have been forced to ramp up capital expenditure in technology and revamp their business processes to remain competitive.

In a modern private bank, everything should be conceptualised for straight through processing recommends Standard Chartered's Nelson. "Today it has become crucial to increase the productivity of the headcount in the middle and back office. It is also becoming increasingly important to integrate and consolidate retail and private banking operations. In the end you need to build a platform that can deliver all products."

Traditionally only larger institutions with the scale to build technology in-house moved ahead, simply as there were no suitable solutions available in the market. Private banks which were part of a larger banking group were also at an advantage due to their ability to leverage the core systems of other business lines or outsource certain processes to other units. Foreign branches and smaller boutique players were challenged to commit a similar level of investment in technology.
Given the changes of the private banking environment, the smaller players have come under enormous pressure to become more efficient. Given the latest advances in technology, such as IT outsourcing and more affordable off-the-shelf solutions, smaller banks have caught up. An efficient operational infrastructure for this reason is not only a necessity, but is becoming today's standard.

Prioritisation of the right solutions and balancing and aligning capabilities between the frontline and the back office with the business strategy remain the key challenges today. "No amount of investment in front office systems can take bad data from the back office and make it look presentable to the client", says Brad Novak, head of IT at Barclays Wealth. Nonetheless for many banks investment in frontline technology remains more attractive, given its impact on revenues, client satisfaction and the smaller ticket size. Vontobel's head of sales- and product management Thomas Heinzl said: "Much has changed in the prioritisation of private banks today. While many of us traditionally were very product focused, this has changed towards getting the processes right, in particularly automation to increase straight-through processing and modularisation."

A considerable effort goes into pushing the back office towards the frontline automating and connecting front and middle systems, and streamlining the overall process.

A good example are post-trade operations, which are still handled manually in many of the smaller private banks, while larger players sometimes address the issue in silos for each asset class with their own proprietary systems. As a result they are struggling with incompatible technology, making it difficult to collect and collate enterprise-wide information and deploy more complex trading strategies and offset market volatility. Additionally, manual or semi-automated (via e-mail and spread sheets) trade verification and post-trade matching processes leave banks vulnerable to trade failure and create a more risk-prone environment because there is more room for error in comparing trade details. The duration of the process also increases a bank's exposure to counterparty risk.

As we mentioned, private banks that leverage synergies within a banking group are at an advantage, as processing is often outsourced to the group's investment banks, where much larger trading volumes have forced banks to put in place the adequate processing platforms, including compliance and risk management. Technological solutions for the automation of post-trade matching processes are also available for smaller banks, and many are taking advantage of them in order to play in the same league of their bigger rivals.

The recent advances in back office automation and streamlined process architectures, as well as heavy investments in the banks' core systems, have allowed banks to accelerate time-to-market for new products and turnaround times and resulted in more reliable execution and settlement due to the reduction in error-prone human intervention.

However with more private banks reaching advanced automation levels, the traditional differentiator of fast and reliable execution combined with a large product range has fallen away. With the narrowing of the technology gap between larger and smaller players, product commoditisation and efficient execution as a standard, private banks need to develop new and sustainable differentiators beyond pricing or adding ever more costly non-revenue generating services to entice their customers.

Conceptualising a more sustainable revenue model for private banking

- **The way the wealth management business is run has changed, but the revenue model has not. It fails to align customer and bank interests**
- **'Pay for advice' may be more sustainable for banks, but customers take time to adapt to the concept**
- **'Advisory mandates' diversify the revenue structure by introducing an intermediary solution between the execution model and discretionary models**

Many private banking fundamentals have changed since the financial crisis, such as customers, transparency, regulation, and technology and operations, but the business model has remained largely the same. Adjustments were made to create a more differentiated and sustainable revenue model, and banks were eager to expand the discretionary component of the business, but the advisory business remains heavily execution-centric. Given that advisory services account for about 60% of the total AUM in Swiss private banks and for over 90% in Asian private banks, the dependence on transaction fees leaves banks vulnerable to market movements and, in some cases, giving biased advice.

Moving from a transaction-centric to an advisory-fee business model may be the right direction for some private banks, as it aligns RM and client interests and will sanction those who fail to provide good advice to their customers.

Charging customers for advice directly also comes with a number of advantages for the bank, such as increasing client stickiness, increasing share of wallet, and increased fee transparency. Nonetheless, it will be a long and difficult process to get there and it will require serious commitment and investment to improve the quality of staff, delivering relevant insights and advice to the customer, restructuring of remuneration and KPIs, as well as customer education.

Advisory fees will be a more transparent and sustainable business model believes Standard Chartered Private Bank's Head Private Banking East Rajesh Malkani, adding "If customers do not see the 'value' in the advice of a private banker, they will go somewhere else. Private bankers will be measured on the relative returns and increasingly on risk-weighted returns. The industry needs to work together to develop common standards for the measurement of returns in order to make it easier for customers to understand the relative performance of their portfolio and enable them to benchmark the quality of financial advice."

We have seen some attempts in the past to price the quality of advice and discussions around flat fee business models. However, most banks are not eager to move, second guessing that customers will not be willing to pay for advice.

Some Swiss banks, such as Julius Baer, Vontobel and UBS are leading the way and offer fee models that aim to put a price on advice in the advisory business.

"In the early 2000 some banks tried to establish the all-in-fee approach in Switzerland, but back then the customers didn't like it. The financial crisis has changed this and clients are more open to the idea today. We have always been the forefront of these developments, as an example we have introduced all-in-fees and advisory mandates over the last years", says Vontobel's Heinzl.

Fee structures of an advisory-fee model often gear towards all-in fees or a hybrid model that reduces transaction fees against a higher management fee. It is important to align these changes with the remuneration of advisors, for instance by linking remuneration to the performance of the client portfolio and client appraisals of the RM. This aligns the client's interests with that of the RM.

Yves Mirabaud, partner at Mirabaud confirms: "Our business model focuses more on fixed fees, such as administration fees for custodian services or management fees for advisory mandates rather than on variable fees, such as transaction fees. Generally the trading turnover of our portfolios is not very high. This advice-centric business model was not new to us, but we reinforced it about five years ago."

Asia is still at a much earlier stage in this development. Most of the Asian respondents argued that their customers are not yet willing to pay for advice, but some banks believe this is slowly changing.

In the last two years, international players have been promoting advisory mandates as an intermediate model between discretionary and transaction-centric advisory models. Olivier Gourgeon, Regional CEO Asia Pacific at Societe Generale Private Banking says: "In the last year we have been more successful with signing clients for advisory mandates, but overall their share of the total AUM remains quite low in Asia. Charging for advice is very difficult and the model is still relying on transaction fees. It is crucial to show the client that this approach creates real value first and to build the trust before moving to the next step."
In fact there is intense competition among the pioneering players, such as waiving of management fees to get customers interested in the model. With growing customer acceptance, this model could move to a 'pay for advice' structure based on portfolio performance and a larger portion of fixed fees with discounted variable fees or all-in fees.

A global Asian player also identified the potential of offering a broader variety of fee models to their customers. Bank of Singapore's CEO Renato de Guzman says: "I can imagine it would be good to build a third leg in the form of a fee-based advisory model to supplement the professionally-managed and the client-managed models we have today. For the moment, however, it is more important for us to grow the discretionary model and establish a strong track record with our clients."

Moving towards an advisory-fee model will be a time-consuming and difficult process and it may take another 10 to 20 years for the model to really take off – depending on the development of the global economy. Generally, European markets are likely to move ahead of Asia, but there will be some factors that may accelerate this development in Asia.

Asia is about to experience an era of generational change with the generation who created the wealth turning over the helm to a generation with different needs and investment behaviour.

Another push towards this direction may also come from the regulators, who are still in the process of defining their policies towards governing remuneration, commissions and fee transparency. Initiatives such as the Retail Distribution Review in the UK are addressing some of the issues mentioned and other regulators are likely to follow with similar initiatives to protect investors.

About Timetric
Timetric is a leading provider of online data, analysis and advisory services for the financial services industry. We provide integrated information services covering risk assessments, forecasts, industry analysis, market intelligence, news and comment. Our industry Intelligence Centers are premium web-based services that provide access to interactive tools, comprehensive research and expert analysis in key sectors. They provide invaluable decision support presented in an easily digestible format and grounded in deep research. Timetric also offers a range of briefing services, which offer cutting-edge thought leadership and expert commentary on and for the financial services industries. We help over 1500 financial services institutions globally through the development and delivery of innovative research, consulting and data visualization solutions that are designed to provide competitive advantage and profitability to our clients.
www.timetric.com

For more information about Timetric and its services please contact:
asiapacific@sg.timetric.com

For more information about the research please contact the analyst:
Thomas.Zink@sg.timetric.com

This whitepaper is sponsored by Omgeo

About Omgeo℠
At Omgeo, we are the operations experts, automating trade lifecycle events between investment managers, broker/dealers and custodian banks. We enable 6,500 clients and 80 technology partners in 52 countries around the world to seamlessly connect and interoperate. By automating and streamlining post-trade operations, we enable clients to accelerate the clearing and settlement of trades, and better manage and reduce their counterparty and credit risk. Our strength lies with our global community and our ability to adapt our solutions to enable clients to realize clear returns on their investment strategies, while responding to changing market and regulatory conditions. Across borders, asset classes, and trade lifecycles, Omgeo is the global standard for operational efficiency across the investment industry. Formed in 2001, Omgeo is jointly owned by the DTCC and Thomson Reuters.
www.omgeo.com

For more information about Omgeo and its services please contact:
askomgeoasia@omgeo.com
askomgeoeurope@omgeo.com