Private Banking Industry In Asia 2015. Identity Crisis.

With regulation like Basel III, Dodd-Frank and other local regulations it is no wonder that banks are turning to asset management and private banking to generate fee income. The wealth generation in Asia has caught the attention of the private banking industry and many banks are investing heavily in building and growing their Asian businesses. The Asian private banking scene is an interesting one. The trust between clients and banks has been tenuous and it has been difficult to scale businesses profitably.

Principal Agent Model: Brokers, not fiduciaries.

The single most important question for a private bank is one of identity. An organization behaves the way it does because of the what it is; it cannot act against its nature. Arguably, most so-called private banks in Asia are in fact brokerages. Fee paying AUM is in low single digit percentages of total AUM. Their relationship with their clients is defined by earning commissions or transaction fees, receiving retrocessions from product providers, and providing leverage. Private bank investment research is provided for free and in return clients are encouraged to transact and thus pay commissions. Where managed products such as funds are concerned, in addition to charging the client commissions, private banks are paid trailer fees or retrocessions by product providers. For example. the distributing bank typically takes half of the management fees from the mutual fund manager for distributing their products to their clients. Transaction fees encourage activity and can lead to advisors churning their clients assets. Trailer fees lead private banks to represent the interests of the fund managers above those of their clients.

In discretionary and advisory portfolio management services, clients pay private banks to manage or advise on their assets. They pay an annual management or advisory fee regardless of the activity of the account. Private banks then buy the cheapest available versions of each particular investment instrument, or if trailer fees are collected, rebate these to the clients. Commissions and activity are transparent to clients. Private banks operating under this model are aligned with the client because the client is their paymaster and as a result the banks are contractually bound to represent the client above all other parties.

In Asia, discretionary and advisory assets are in the acute minority. Asian clients are reluctant to pay fees for discretionary management or advice preferring to retain control over their investments. Trust has been difficult to build in the aftermath of 2008 when products and funds sold by private banks either incurred substantial losses or restricted liquidity. Also, the dearth of international and cross asset / cross market expertise among private bank advisory staff does not instill confidence. Asian HNWs are also likely to be first or second generation wealth and actively managing their operating businesses. The returns on equity on their operating businesses far exceed what they can reasonably expect to earn in a private wealth portfolio. Clients do not yet understand that the route to a multiple of return on capital can only be purchased with a significant probability of catastrophic loss of principal. Operating businesses take time, effort and risk to build. When the time taken to generate the return multiple is taken into consideration, internal rates of return might not be that attractive. Additionally, when the risks are factored in, the risk reward may not be that attractive either. Private banking clients are the ex post successful sample, the ex post unsuccessful sample falling away and not being counted. The return and risk targets of a wealth preservation portfolio are far more conservative and the diligence and complexity of investment strategies are directed at risk mitigation rather than unfettered returns generation. Remarkably, few clients see the contradiction in leveraging up such portfolios with full recourse credit lines provided by the same private banks. The private banks clearly do not. The return on assets from the bank’s fees perspective make this a reasonably attractive business, especially if there is recourse to the client as well as to the assets.

Private Banks to do list:

- Decide on their identity, if they are brokers or fiduciaries.
- Private banks who want to be brokers are not purveyors of advice or investment management; they are purveyors of market access and transaction capability. They need scale and volume and they should recognize margin compression as a reality and an eventuality. The resources they require are very different. Brokers can survive on far fewer human resources than fiduciaries. Technology resources for brokers are also different than for fiduciaries and can and should be used to replace human resources. Brokers are more capital intensive, have lower overheads, slimmer margins, more volatility of cash flows and need scale.
- Private banks who want to be fiduciaries seek stability and predictability of fee income and better margins. Overheads, however, will be higher as technology solutions cannot be deployed to replace costly human resources. Fiduciaries are not purveyors of transaction capabilities but
  of advice and investment management. Fiduciaries need to invest in experienced and expert advisors and relationship managers. Fiduciaries are less capital intensive, have higher overheads, better margins, less volatility of cash flows and do not require scale.
- If any universal banks attempt to do both it is best that both businesses are run separately with Chinese Walls. There are no synergies to be had here, only potential for conflict and revenue cannibalization.

Clients to do list:

- Diversify between brokers and fiduciaries. Decide on the proportion of assets they wish to allocate to active self-directed management, that is to their broker, and what proportion they wish to allocate to a discretionary manager.
- Select a broker with the lowest all in cost, the best market access and good reporting.
- Select a fiduciary with the best investment management talent, operational integrity, risk reporting and client service.

- Resist the temptation to replicate the fiduciary portfolio at the brokerage. On the one hand this cheapens the fiduciary service but at the same time it concentrates the risk and dilutes the diversification benefit.