

# So You Want To Run An Asian Private Bank

When the going gets tough the tough find another gig. Basel III and Dodd-Frank getting in the way of your investment banking business? Taxpayers tired of footing the bill for your proprietary trading desks' follies? Pesky shareholders asking you what your next trick is going to be to get the share price rising again? Wealth management. Private banking. Too mature a business in Europe and the US? Head east. Wealth creation and the growth in the number of wealthy promise immense potential for banks willing to set up shop entertaining Asia's wealthy.

Investment banking is so yesterday. It always has to be other peoples' money but the days when it was shareholders' and taxpayers' money is so Banking 1.0. Banking 2.0 is having a blast with clients' money. Downsize the investment bank, rationalize the corporate bank, invest in wealth management and private banking, and do it in Asia. Follow the money.

Asia is minting more millionaires than any other region in the world, mostly in China, but for the neighbouring countries, growth is robust as well. Herd mentality is strong among bankers, so strong they must be the only people who would be attracted to a cloud of zombies. What are they up to? Maybe they have money?

It is not all plain sailing in Asian private banking, however. Rich clients are newly minted, which means they've recently or are currently raking it in. It takes some audacity to approach an entrepreneur generating a 20% ROE on his operating business and presuming to provide financial advice, but fortune favours the brazen.

There is an eminent necessity for succession planning, risk management and wealth preservation but these are not items high on the list for many of the newly rich. These are the strengths of traditional private banking. 30% plus annual returns are best attempted at the tables of a Sands or Resorts Casino.

So the private banker faces either an unmotivated investor, or an investor seeking over 20% returns.

The unmotivated investor is fee sensitive and transactional and tends to lack trust in the private banker. Since they are unmotivated they tend to be suspicious of the motives of salesmen in any guise. The private banker reciprocates by being transactional, give'em what they want, and tries to achieve target returns on assets for the bank (not the client) by encouraging activity. Investing is often like baking, if not given enough time, the investment like the pudding fails to rise.

The high target return investor needs to be sold leverage, especially in a low return environment. The investor is happy to obtain leverage, since he will undoubtedly be offered more leverage than he ever was on his operating business. This is like Christmas come early. For the banker, charging on gross notional assets invested and on the leverage provided, this is also an early Yuletide. Everyone is happy except the credit officers who have to monitor margins and collateral.

Fortunately, or unfortunately, for the bank and investor, depending on how close one is to retirement or moving to another institution, credit underwriting at private banks are of a rather different standard than at the investment bank or prime brokerage.

As for the transactional business, it is lucrative but volatile with commissions rising and falling with the volatility in markets. This instability of revenue is a bit of a concern for senior management since private bankers' pay and other overheads are markedly less volatile. Commissions are also getting thinner as on-line trading platforms proliferate. Asian clients are also very price sensitive and tend to shop around. It is not beyond clients to transact with one bank and transfer to another if commissions are lower at one bank and leverage cheaper at another.

Annuity business is the holy grail of private banking. Discretionary management is a decent margin business but clients for this are hard to find, since it requires quite a lot of trust for a client to pass control over their investments to strangers with their sophisticated investment strategies. An Asian private bank would typically have between 5% – 15% of total assets under management in discretionary management. Mutual fund retrocessions are another source of annuity income. This is where the private bank is paid by the fund manager of the fund the client is investing in and not the client themselves.

The client pays the fund manager a high management fee which the fund manager then splits with the private bank who is in fact their distributor. Since the bank is being paid by the fund manager there should be no surprise who the bank is looking out for, the fund manager or the client. Banks recommend funds to clients for free, out of the goodness of their hearts. It is the fund managers who pay. Such charity cannot be bought.

The usual organization in a private bank involves a range of people with different skills and duties. These various constituencies have to be carefully managed.

Bankers are there to serve clients, to talk to them, understand them, their needs, and to communicate this to the discretionary managers and investment advisers. Some bankers are purely relationship bankers and have little or no opinion, or expertise, in investments. They rely on investment advisers and product managers to advise them and sometimes to directly advise their clients. Bankers with little expertise are often eyed with derision by investment advisers, product managers and analysts. They are mistaken. Such bankers are the most efficient partners, not diluting, confusing or confounding the house view. They do not compare with bankers who interfere with investment and product strategy in terms of disruptiveness.

Investment advisers are mini portfolio managers. They mostly do not have discretion to manage client assets but instead advise clients how to invest their money. In some organizations, investment advisers KPIs include sales revenues which sometimes encourages them to balance their advice between the interests of the client and their year-end bonus. A balanced score card approach to bonuses ensures that the client is never disadvantaged. Never. Investment advisers sometimes regard the CIO with derision. Because they cannot advise a client unless the advice is endorsed by the CIO, and the lack of such endorsement can be inconvenient. Everybody believes they are the smartest people in the room.

Product managers are in charge of their respective products from equities to bonds or FX and derivatives thereof. Funds are another delivery vehicle, another product. Product managers are heavily reliant on the CIO to endorse a product. Without the marketing machine of the CIO behind a product or investment theme it will be difficult to excite bankers, investment advisers and clients about a

product. Some clever product managers have found ways to incentivise bankers and investment advisers to sell their products by offering overseas training trips to the top sales people. This has been a highly successful sales strategy in Asia where sales people regard such training trips as incentives. When these training programs take place in Paris, London, New York and other such exotic locations, it is easy to see why being chosen to attend training trips is seen as an incentive.

The Chief Investment Officer's Desk or Office. This is the brain of the investment operation. The CIO performs the research and analysis on the state of the world and prognosticates on investment strategy. These are translated by the investment advisers into actionable trades which can be presented to clients. Product managers are also very sensitive to the musings of the CIO and translate their views into products which can be sold to clients. The CIO is also often the face, or mascot, of the bank. It pays to have a charismatic and well liked CIO who can provide direction and confidence to clients in difficult markets. The job of CIO is a thankless one. No client or investment advisor credits the CIO with good ideas, only dud ones. Clients will always claim winning bets as their own, as will investment advisers. To compensate, the clever CIO always provides 6 investment ideas. 3 of them are either negatively correlated or mutually exclusive from the other 3. With the passage of time the CIO can claim success on at least 3 of his sage predictions with certainty. The 3 failed strategies are never referred to again. Except perhaps by the clients who took the advice.

Operations are at the less glamorous end of the supply chain. They make things happen. Try advising, executing or generally taking any kind of real action without the help of operations and you will soon discover how important the back office really is. As usual, however, the back office, as operations is often referred to, is relegated to what many consider the plumbing of the bank. Plumbing is important, and especially so for some types of businesses.

Compliance, Know Your Customer, Anti Money Laundering. Poor chaps, nobody likes these folks. Clients hate them for their intrusive questions and need for certified true copies of everything from ID and passports to utility bills. Bankers hate them because irate clients vent on bankers. Back office folk are insulated from the wrath of clients and pay for it in the form of a remuneration discount. Management hate them because they are often the conscience of the bank

and an important obstruction to the smooth running of business. Since regulators have placed personal liability upon the shoulders of Compliance folk they have begun to become an effective and real conscience of the bank and it is a wise CEO who pays attention to them. Still, they remain the least cool people in banking where modesty and propriety trade at a steep discount.

Here comes that investment bank again. The downsized beast is still a repository of some serious intellectual capital and formidable corporate relationships. Synergies beckon like sin. Securitize the bank book and place the liabilities with private clients? Coinvestment opportunities with the proprietary investment portfolio? Cross selling of products? Bond and equity issues originated from capital markets? Structured products to raise long term liquidity and provide clients with products. But the synergies are not without complications for who is principal and who is agent? Whose interest does the bank represent? The corporate client or the private client? When the bank trades as principal, what duty is owed the client? Disclosure and transparency are decent and right but can get lost in the day to day complexities of life.

So you want to run a private bank? it's exciting but it means growing revenues faster than costs, it means keeping the various constituencies happy, and keeping the client happy, while complying with regulations and the law.

A little help...

How does one build trust? The intransigence and price sensitivity of clients is often down to a lack of trust. Trust is not just about reliability, dependability, competence and integrity. These qualities are laudable but those last two are difficult to observe and prove. And trust takes time, which no CEO has since they manage to quarterly, monthly and in some cases, weekly sales numbers.

Let me speak for the investor.

Trust is all well and good but it is no substitute for skin in the game, a shared fortune, transparency, and a responsibility of fiduciary duty. Senior management and business owners should have skin in the game. We don't require you to have a junior or subordinated position, no thank you, we've seen that trick in CDOs and CLOs where the riskiest parts turned out to be lower risk than the highly rated tranches. No sir. You don't just eat your cooking, you eat what

we eat. Sorry, but we have trust issues.

We suggest you should retain staff bonuses to be invested in products offered by the bank. All products sold to clients should be available to staff. The terms and conditions should be the same for staff and for clients so that there is no advantage for either party. We would like you to publish the capital invested and moving in and out of products by your employees, which would be an indication of the de facto asset allocation of the staff in aggregate. It would be an excellent gauge of what staff really thought about the investment outlook and the prospects and quality of the various products. Call this portfolio the House Strategy. We understand the need for individual privacy but transparency to the aggregate investment decisions of the staff should not violate that. We fully understand that junior staff have riskier, less sophisticated portfolios and senior staff have more conservative portfolios so disclosure as to the pay distribution of staff, again disclosures of aggregates will preserve individual privacy, should allow investors to adjust their interpretations of the asset allocation.

We suggest that you have a Principal Strategy, managed by your CIO which is offered as a product to your staff as part of the bonus retention policy. You should use the Principal Strategy to showcase your investment capabilities by publishing its detailed strategy, trading activity and performance. We would expect the Principal Strategy to be similar if not identical to clients' portfolios managed on a discretionary basis.

We'd like to know, just out of interest, how much of staff capital went to the House Strategy and how much to the Principal Strategy. The House Strategy is the result of a de facto voting process, by the general staff, whereas the Principal Strategy is managed by the CIO. It would be interesting to see to what extent the staff agree with the CIO.

With trust enhanced or replaced with a shared or tied destiny perhaps clients would be more inclined to take advice or even engage the discretionary management services of the bank. Annuity income would rise, transactional income might rise and the business would be more stable. The image of the greedy, rapacious banker would be replaced with a trusted fiduciary and a co-investor. In institutional markets, structured credit managers are required by regulation to have skin in the game, why is the same standard not required of private

wealth managers?

Technology can play an important part in a rejuvenated business model. Clients are provided personal bankers if they need them, not as a status symbol. Alright, that's a bit of a stretch in Asia, but it makes business sense. Personal bankers are expensive and to hire them to function as execution brokers, lunch dates, investment therapists and drinking buddies is simply uneconomic. If the client uses the bank as a broker, they should be given a log in and an internet account / mobile app, to provide them information and transaction services. If the client seeks value added services and advice, they should pay for them and receive access to advisers.

Entire legions of bankers would be reclassified as either trusted advisers or brokers and appropriately compensated. Entire legions of clients would similarly be reclassified as private banking clients or brokerage accounts. Let the service meet the need and the cost, the revenue potential. Let the size of the market opportunity be correctly estimated so that we are not trying to sell cheese to the lactose intolerant or tourbillions to the tardy.