Private Banking Industry In Asia. An Increasingly Difficult Business.

It is important to correctly define what is meant by private banking, especially in the context of Asia.

Many private banks in Asia struggle despite asset growth because of margin and cost pressures. One reason for margin compression is the failure to distinguish between private banking, brokerage and lending businesses. A typical private bank may have 5% – 10% of AUM under discretionary management, and a further 15% – 40% in annuity fee paying AUM. The rest are deposits which are mined for transaction income.

A significant proportion of annuity income takes the form of retrocessions from managed product providers. This model too is under threat from regulation which is encouraging the industry towards greater fee transparency. Regulators are also encouraging a proper alignment of interests and guiding banks towards charging clients directly rather than charging them indirectly through the receipt of trailer fees paid by fund managers but ultimately funded out of the net asset value of investors’ capital.

Mining deposits for transaction fees is not true private banking. That is a brokerage business. Asian clients are highly fee sensitive and tend to compress brokerage fees very quickly. A bank can mitigate this by offering unique product but this is difficult as regulation encourages product providers to seek multiple distributors leading to competitive pressures on transaction fees. In the retail segment, products are bought on-line or through low cost bank branch generalist sales staff. Private banks relationship managers are too expensive to be so deployed.

Many private banks react to this margin compression by trying to grow AUM at a rate to compensate for the margin compression. In the limit this takes the form of consolidation, a dynamic already well underway in Asia. In the long run there are limits to this business strategy.

As transaction fees compress private banks have turned become leverage providers. This is a very different business as the bank now has capital at risk. Systems, processes and people have to be deployed to properly manage the risk. Essentially this is a prime brokerage business for private investors. Witness the margin compression in the prime brokerage business servicing hedge funds where sub scale clients (hedge funds) are turned away. The analog has not happened and private banks continue to compete for AUM driving down underwriting standards. Clients can shop around to find the cheapest and most leveraged offerings. It is questionable if the loans are being properly priced in terms of capital consumption. In Asia it is still possible to obtain leverage at cost of funds + 0.60% for good clients.

For clients, leverage may not be optimal, it may, but the advice around crafting a leveraged portfolio seldom revolves around risk. Clients are encouraged by relationship managers to maximize leverage. Client and relationship manager are often negotiating on the same side against risk managers. And private bank credit and risk managers are not quite as sophisticated as their counterparts at prop desks, the investment bank or prime brokerage. Very often their credit modelling is rudimentary, that is if they are not calling around to their peers on the street to align lending values. Relationship managers under pressure to perform can be persuasive and influence senior management to relax lending standards for good customers. And senior management often accommodate for the sake of quarterly revenues.

Leverage is not a bad per se. It magnifies upside as well as downside and when interest rates are as low as they are now, leverage can be a very attractive tool. However, private bank investor loans are rarely term loans and have strict loan to value covenants which may trigger margin calls. When leverage is not matched to either the duration of the asset or the gestation of the investment strategy, the investor crucially loses control of the strategy.

To summarize, Asian private banks define their remit as, discretionary and advisory management, which is traditional private banking, and then more innovative activities such as brokerage and leverage. That brokerage and leverage income represents the majority of income by a wide margin is not ideal. Brokerage is highly cyclical and volatile while leverage involves capital at risk.

Rightsizing a private bank like most businesses begins with self-awareness and defining the nature and core strengths of the private bank. It involves defining clearly what businesses it is in, and what businesses it will not engage in. Failure to do this will lead to over-resourcing and wastage.

The future of brokerage can be seen in the history of equity sales. Low single digit basis points commissions. The future of leverage provision can be seen in prime brokerage where only clients of a critical size are entertained as their scale and profitability pay for sophisticated risk management and engagement. In 2008, Lehman was the only major prime broker to fail but the credit worthiness of almost all of its peers were sorely tested. They survived, but only after many of their hedge fund clients were decimated.

The future of Asian private banking is clouded. One hopes it matures and clients engage private banks as trusted advisors and fiduciaries. Unfortunately the private banks mostly live by a quarterly revenue target which necessitates pressuring clients to transact and to leverage up. Cost pressures also discourage private banks from hiring high quality investment and risk managers and competent advisors. Faced with the painfully evident quality of advisor facing them, the client reacts rationally and eschews passing discretion to the bank. And so the cycle of mutual mistrust perpetuates.