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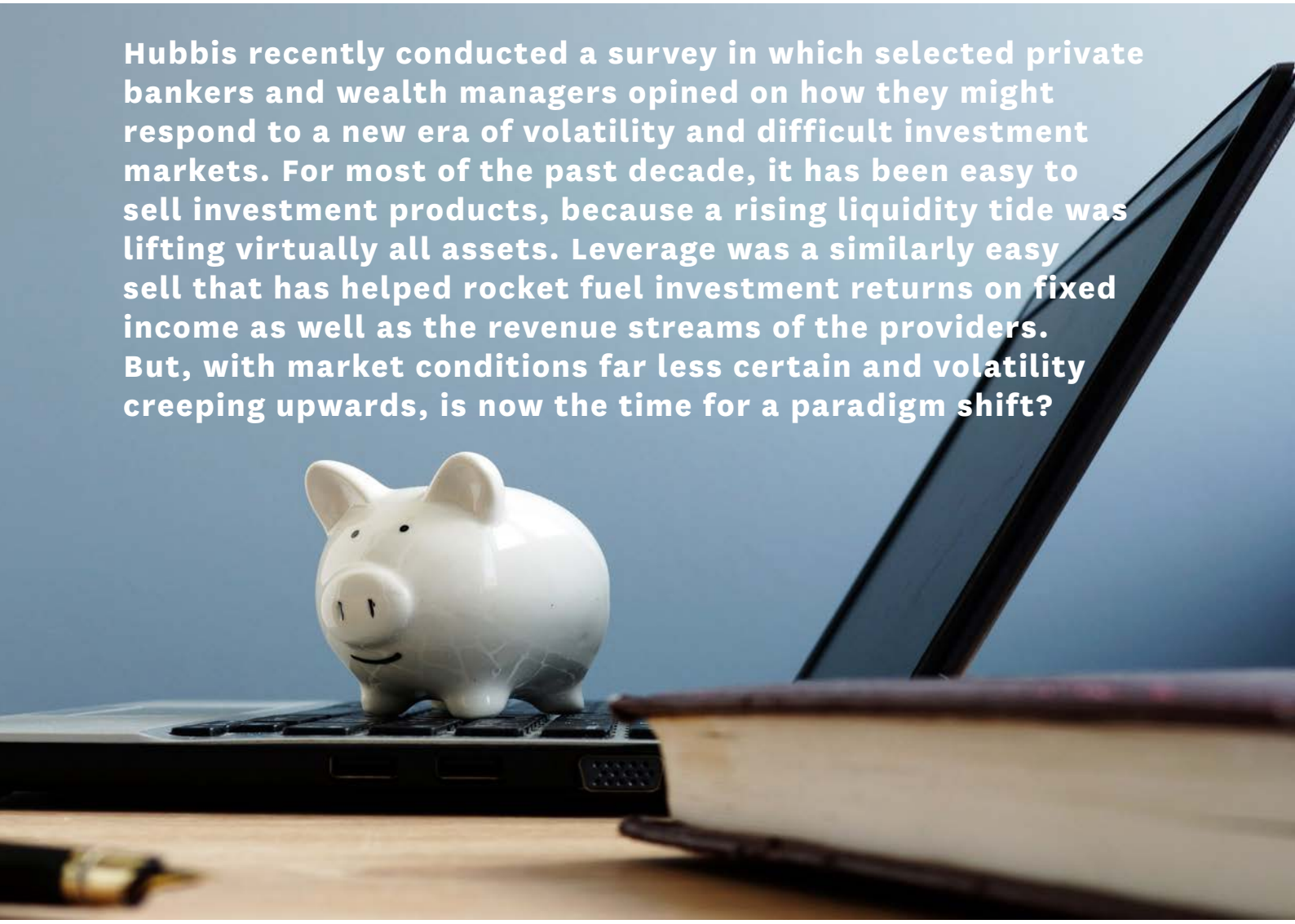
Private banking in Asia – time for a behavioural paradigm shift?

Hubbis recently conducted a survey in which selected private bankers and wealth managers opined on how they might respond to a new era of volatility and difficult investment markets. For most of the past decade, it has been easy to sell investment products, because a rising liquidity tide was lifting virtually all assets. Leverage was a similarly easy sell that has helped rocket fuel investment returns on fixed income as well as the revenue streams of the providers. But, with market conditions far less certain and volatility creeping upwards, is now the time for a paradigm shift?



2017 WAS AN EXCELLENT YEAR for private banks in Asia, and globally. Mainstream financial market indices continued their seemingly inexorable rise that began once the worst of the 2008-9 Global Financial Crisis (GFC) fears had tapered off. Take for example the S&P 500, which by 2017 had nearly tripled since its post GFC low in March 2009. In 2017 alone, it surged 20%.

As markets rose across the globe, so did economic activity and so did the wealth of the wealthy. According to a Capgemini and RBC Wealth Management report, the number of high net-worth (HNW) clients around the globe grew by 7.5% in 2017, while their private wealth increased by 8.2%.

A veritable tsunami of AUM

As all this took place, the assets under management (AUM) of the private banks also surged. In fact, the AUM of the top 25 private banks in the world increased by 17% in 2017 alone to more than USD16.2 trillion, according to Scorpio Partnership's 2018 Global Private Banking Benchmark. The same study showed that Asia produced the highest gains.

However, while these are impressive figures, there are those who consider the benign investment conditions in recent years an 'easy win' that has to some extent distracted the private banking community from some strategic discussions that are needed for the industry to thrive in the future, especially in less favourable global financial conditions.

There are also those who note that the intense competition amongst banks to win AUM has forced margin compression on the industry, meaning that returns on those AUM are not quite as healthy as might appear from the headline asset growth numbers.

Resting on their laurels?

In admittedly simplistic terms, private banks in Asia made good money in 2017 primarily because AUM inflows rose and because transactional revenue was high, as clients enthusiastically bought funds and structured products in a booming market.

Private banks also made solid returns from the leverage they provided clients, from management investment fees on the discretionary management portfolios (DPMs), as well as a variety of other revenues streams, including their involvement in Universal Life sales for their clients and other insurance products.

But whatever the headline AUM figures, there is no definitive clarity on what portion of their Net New Assets flows (NNA) were derived from pure new money rolling in to their banks, or from the reinvested leverage taken out by their clients in a type of double-counting game.

As it stands, private banks continue, perhaps not to their long-term advantage, to make most of their revenue from managed investment fees and from transactions - with an increased emphasis on managed investments and structured products.

Then again, some banks are charging a composite all-in-one fee for management and trading. Some argue this makes the relationship less transparent for the client, while others claim that if a client pays, for example, 1% on the value of the assets in their portfolio, it is relatively easy to determine if that is a good deal or not, by referencing the general market performance and/or the performance of those investments the client manages personally.

Transitioning to fee-based income – an uphill task

Typically, the transition to earning more advisory fees and fees from DPM - the twin holy grails for many of the private banks - has been frustratingly slow, especially in Asia, where 'wealth' is younger and which is considerably behind the more mature European wealth market.

It is difficult to gauge precise numbers - they are simply not available in the public domain and therefore observers must rely to some extent on hearsay - but some estimate that as much as 90% of private bank revenue in Asia is still accounted for by transactional revenue and as little as 10% comes from fees for advice or DPM.

This contrasts with the evolution in more developed wealth markets. For example, experts report that in Europe, the split would be more like 40% DPM and 60% advisory/transactional.

The current status quo in Europe is partly, some bankers note, driven by the wealth-age factor - as the wealth passes through generations and is owned by a larger number of people in a family, so the move towards managed assets accelerates.

In Asia, the market is still earlier in its development, meaning that 'wealth' in general has not passed down more than one or two generations.

When wealth is more vested in the hands of the founder-patriarchs, bankers note that he, or she, is often confident in their ability to continue to grow their wealth themselves.

And the super liquid financial markets of the past eight to nine years have done little to convince these founder-patriarchs or many other wealth clients that they themselves are not rather gifted asset managers; this in turn means that the private banks and other wealth managers find it more difficult to convince these HNWIs that they should part with DPM or advisory fees.

Taking the holistic view

But, worldwide, there is a developing and accelerating trend that an EY Wealth Management report has highlighted, namely that the demands of the rich and super-rich investors are in the process of changing. The new client of today and the clients of tomorrow want their private wealth to be viewed and managed on a more personalised basis, the report found; this type of client expects a new class of support, which is advisory rather than product-driven.

What this means is that wealth managers that take a holistic view of client wealth and portfolio composition taking perspectives across many assets classes including potentially alternative assets such

as art or other collectibles, are set to become significantly more important in the next decade. EY estimates that such wealth managers' share of the global market will increase from practically zero to between 20% and 30%.

The corollary is that the long-term prospects for the traditional wealth manager, whose business has hitherto been product-based, reactive rather than proactive, and primarily geared toward the management of mainstream financial assets, are set to become much more limited, the EY report found.

That private banks are too dependent on transactional revenue and are not making the switch fast enough begs the immediate question as to what might happen if there is a dramatic correction in the markets? Are the banks in a stronger position to weather storms than they were in the GFC? If clients reduce product purchase, slash back their trading activities and cut back on leveraged investments, how will the banks replace those revenue streams?

Indeed, how much of the leverage the banks provided to the clients will turn to distress or possibly default, and what existential threat does that pose to the private banking industry?

The markets weather that mini storm, but sentiment in Q2 is already markedly weakened and whispers of the death of the multi-year bull markets are becoming more widespread and louder.

Global markets: intimations of mortality

In recent months, stock markets across the world have flirted with corrections. The S&P 500 Index saw a 10.2% decline from the record high close on January 26 through the close on February 8 and most global markets emulated this volatility. The markets weather that mini storm, but sentiment in Q2 is already markedly weakened and whispers of the death of the multi-year bull markets are becoming more widespread and louder.

There are, as always, many divergent views in the global financial markets, with some predicting a downturn of 20% to 30% in mainstream financial indices. Reasons cited include: bull market fatigue; the end of QE; excessive valuations, especially in selected sectors such a BigTech that have driven many indices higher; rising dollar (and possibly other) interest rates; rising oil prices and the specter of inflation; the gridlock over US infrastructure spending plans; a potentially dangerous trade war between the US and China; possible geopolitical crises such as Russia, Syria, Iran or the Koreas; to name but the obvious suspects.

When Hubbis recently ran a survey across our community of stakeholders in the Asian wealth management space, an overwhelming majority of the respondents generally reported that they do expect a correction, but that they were improving their readi-

ness for any such eventuality. In other words, taking the glass half empty perspective, fear of such a correction is rising.

Some of those we surveyed however were more skeptical of the markets' ability to stay the course. "I think the correction is coming," said a Hong Kong based private banker. "With interest rates rising in the US and QE tapering in the Eurozone, liquidity getting tighter, and a US president with potentially disruptive policies on trade and politics, a correction of 20% is inevitable."

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The remuneration games

Much of the backlash post GFC was about how bankers, especially investment bankers, were remunerated. Short-term product sales or deal-making, especially those in which their own financial institutions participated, might quickly have turned to into a financial tsunami, but the bankers walked away with their bonuses, based on their upfront deal fees, not the possibly calamitous consequences as the deals unwound.

In the private banking world, has enough been learned, or remembered, from the fallout from the GFC?

Are the remuneration packages of private bankers still slanted excessively towards their ability to generate short-term revenue, to sell products, to garner more clients that take on additional leverage, and therefore buy more products? Or does the private banking industry need to remove this potential area of conflict and focus on the performance of the clients' portfolios, or drive the industry more towards advisory fees that have no financial legacy for the financial system?

While it is certainly true that private bankers who do not perform for their clients will lose those clients - and not win others so easily - there is potentially a disconnect between the short-term revenue generation, the remuneration structures and incentives for private bankers and the longer-term performance of the AUM on behalf of the clients.

As one old hand in the wealth management space pointed out: "One bank we know targets margin of 150-200 basis points per client, another has RMs, who might meet the client once a year, telling clients that 'unless I can make at least USD20,000 transaction, product and margin income over and above the custody fee then it's not worth me dealing with you'."

While there are those who consider that reasonable for what is supposed to be hands-on service - after all $20,000 equates to a 1% fee on an account with $2 million in assets - others have doubts.

One wealth manager, for example, argues that QE has driven markets and leverage upwards in parallel, in a benign alliance of liquidity and easy gains.

With rising indices and an easy, healthy carry, investors have produced excellent returns and private bank revenues have soared, creating what many see as a false perspective of the ease of investing in financial markets. That era is at an end. "Combined with QE-induced AUM growth, it has created a false picture of the entire economy and financial markets," he says.

"The problem with the last nine years is that the clients are all investment geniuses now because whatever they buy goes up." He hypothesises that when the next serious markets decline occurs - and history shows it will happen, sooner or later - the banks will be over-extended, exposing how practices have not sufficiently changed at the banks. In that scenario, it will highlight the importance of independent, non-conflicted advice from the private banking cohorts.

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Time to unwind all that leverage?

The easy win in 2017 for private bankers was selling a global income fund to their clients, leveraged from four times to nine times, according to the private banker grapevine. Which begs the question - what will happen when all that leverage is unwound?

According to one wealth manager, the private banking industry is in for a major, possibly radical, adjustment in client holdings as a direct reflection of levered exposure to fixed income. "If we go back to 2016, one of the great economic inefficiencies in private banks was how cheaply they would lend to clients; lending rates were based on the cost of funds, which was largely driven by a risk-free rate," he explains. "If you remember the relative steepness of the curve, you could easily borrow fairly cheaply and then easily reinvest those funds at higher rates."

In such an environment, he says, with accommodative monetary policy and no red flags on the horizon in terms of economic growth, it was actually a reasonable call to recommend the use of prudent leverage on such a cost-effective basis. "If you could borrow 1.5% percent and invest in a fund that delivered a predictable, visible source of yield at 3.5% to 4.5%, that is an attractive return profile," he explained. As long as clients had a full understanding of the magnifying effect on the upside and the downside of borrowing it was, therefore, a reasonable recommendation to have clients levered in a portfolio, he reasons.

Goodbye super-cheap rates, and hello the flattened yield curve

However, what made sense then, does not work today, he maintains. "A good reference point is the end of December 2013, and if you look at that date, the 10-year was at 3.03%, the five-year was at 1.74%, and the three-month Libor was at 0.25%," he recalls.

"Fast forward to today, and dollar Libor has gone up by more than 200 basis points, the 5-year has gone up by more than 100 basis points, and the 10-year has declined to just under 3%, and that shows you the flattening of the curve."

With borrowing rates perhaps 100bp over the 3-month dollar Libor rate of just over 2.35% on May 23 (it was 1.3% on July 1, 2017), the same banker reasons that the game appears to be over, as 10 year US Treasuries that same day yielded 3.01% and 30 year Treasuries barely any higher at 3.17%. And if bond funds are the underlying asset against which leverage is taken, then those will have considerably more credit and duration risk, but only modestly higher returns.

Just as it was reasonably fair to recommend prudent leverage when the rates were so low and the yield curve steep, it therefore appears prudent to now recommend an unwinding of much of the leverage now.

"Firstly," he says, "investors are no longer being rewarded for the leverage, and secondly there is greater downside risk. These are already very different times and the banks and investors should react accordingly."

But what if the paradigm does not shift?

According to one wealth manager, in a scenario where the markets correct significantly, the private bank most likely to be hit hard will be those with numerous heavily leveraged client positions. Their

internal risk controls may force them to close positions, withdraw leverage, or revise loan-to-value ratios. This will then have a knock-on effect throughout the financial system, especially if markets crash rather than correct.

One wealth manager notes that his advice would be to switch from a direct, leveraged holding in the fund units, into an option on the fund. "Due to the low volatility of the fund, the option premium could be equal to - or less than - the equivalent cost of funding a direct, leveraged holding in the fund units," he says.

"However, the option position avoids the potential downside (beyond losing the option premium) if the fund NAV declines." Leverage can make wealth disappear quickly, and if banks are not more careful they will find this out the hard way again, some of the more conservative observers caution.

No new GFC, but potential for localised storms

"The next round of global regulation is probably going to focus on this type of leverage, as the regulatory attention is still fairly light," says one of those Hubbis surveyed. "Just like in the run up to the GFC, when clients were asking for structured and derivative products, now they are asking for leverage and the banks appear happy to comply for many reasons," he adds.

In the run up to the GFC, the core problem was the derivatives that were being sold and recycled from this financial institution to the next in a game of pass the parcel that suddenly turned disastrous. And at that time, the banks did not have sufficient regulatory capital and the central banks were effectively asleep at the wheel.

This time round, the crisis could be a collapse of the physical leverage, if mainstream financial markets crash and do not recover rapidly enough. But the fault, if there is one, is not down to the private banks alone. The global central banks have encouraged leverage due to flooding the world's financial system with liquidity at or close to virtually zero rates. And the aspirations - or greed - of the clients also know few bounds.

So, is it chicken or the egg? Do the banks foist product on the unwitting wealth clients? Or do the clients demand leverage to earn over-sized returns? Either way, the banks owe a duty of caution that is greater than simply their personal remuneration packages or their clients' portfolio returns as many of the leading private banks are universal banks that are vast and vital cogs in the global financial system.

A cautionary tale

Time will tell if the leverage incurred throughout the global financial system in the past decade is manageable. If the new normal of historically low interest rates is a reality for the foreseeable future, then chaos can be avoided. But if a new era of rising inflation and rising interest rates comes about - a genuine possibility even if currently widely discounted - then the massive global debt burden will create seismic shocks throughout the world's financial system.

For the private banks and their Asian wealth clients, there is greater uncertainty in the mainstream markets than for quite some years. Caution, de-leveraging and diversification, might just be the finest advice a private banker can provide. But for private bank revenues, unless they have converted a majority of their Asian wealth clients to DPM mandates, the near-term hit to revenues, and remuneration, will be painful. ■