

OLIVER WYMAN

Financial Services

Trust me, I'm your Private Banker



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1. A crisis of trust

These are difficult times for the Private Banking industry. The immediate problems are obvious: a sharp depreciation in the value of portfolios and a migration of assets from high-margin products to the safety of deposits, money market products and government bonds. But something potentially more damaging to the long-term interests of the industry has also occurred. Many Private Bankers have lost the trust of their clients.

The problem is not merely that markets moved against Private Banking clients. Such events happen from time-to-time and need not undermine confidence in financial advisors. The serious problem is that the financial crisis has exposed unsound incentive structures in Private Banking, which were disguised – or, at least, ignored – when clients were benefiting from bull markets.

Cost-cutting initiatives and the recovery in equity prices are helping to return Private Banking to healthy profits in the short term. However, we believe that long-term growth could require a more fundamental change in the Private Banking business model – one that avoids the current conflicts of interest between Private Banking advisors and their clients.

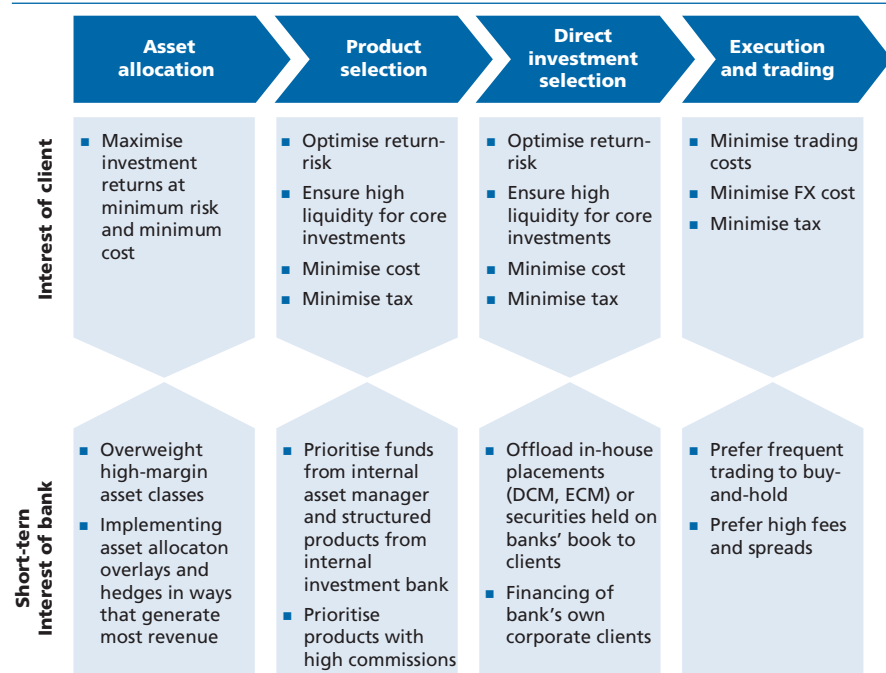
In this report – which aims to provoke thought – we describe a Private Banking business model that targets exactly this. We call it the True Advisor Bank. After reviewing the incentives that exist in parts of the industry today, we describe the True Advisor Bank: first its operating model and then its economics.

2. Conflicting interests

As with all advisory relationships, trust is a necessary condition for managing the wealth of others. But trust in Private Banks has been damaged by fees that are often out of proportion to the value of the services received, by ill-conceived products and by mis-selling. Press reports about poor fund due diligence, high portfolio churn, hidden charges, public demonstrations and lawsuits have created a public relations headache for the industry.

A key underlying cause of this trouble is flawed incentives of Private Banks and bankers; incentives that create potential conflicts of interest with their clients. As shown in Exhibit 1, such conflicts occur at many points along the investment advice value chain.

Exhibit 1: Potential areas of conflicting interests between Private Bank and HNWI client



Clients' best interests are served by advice, products and execution that maximises returns relative to the level of risk appropriate to the clients' situation and ambitions. A bank understands this, yet at the same time its short-term interests are served not by achieving this client goal but by selling the products or services with the highest margins, even when they are not optimal for the client. This conflict of interest, especially if the relationship manager (RM) is failing to view the client as a long-term prospect, can lead to poor advice and, ultimately, erode trust.

Growing awareness of such potential conflicts of interest is encouraging clients to take action. The richest of them, the ultra-high-net-worth individuals (UHNWIs) are seeking to "own" the advisor through moving money in-house or placing it with like-minded families (for example through use of independent advisors or family and multi-family offices).

Further down the wealth scale, affluent investors are taking a more active role in managing their own costs rather than relying on advisors. Eighty five percent of retail trades are now conducted online and new brokerage accounts have been opening at an increased rate during the market crisis. Facebook-like web investment communities are becoming popular, and the likes of Saxo Bank are promoting this "democratisation" of investment by offering the "instividual" access to advanced trading tools and analytics.

The question is what will happen to those between the affluent and the ultra-high net worth, traditionally the core segment for Private Banks? We believe that structural changes in Private Banking are required to retain many of these clients over the long term. As Private Banks compete to regain trust, they must dissociate themselves from discredited aspects of the business.

3. How to rebuild trust: the True Advisor Bank

In this section we sketch a business model for the True Advisor Bank that minimises conflicts of interest with its clients. The model has four important elements:

1. Single-fee revenue model

Clients pay a single fee that covers all activities they want performed on their behalf by True Advisor Bank (from a standard package of services – see below). All “hidden fees” are eliminated or rebated back to the client. Since the asset allocation, the products used and the number of transactions make no difference to what the client pays, the advisor has no bias in his investment advice, nor any incentive to churn the client’s portfolio.

The fee could be specified as a dollar amount or as a percentage of assets under management (AuM). Since the dollar amount charged would need to vary with the burden created by the client’s account and, since this burden will roughly correlate with AuM, there may ultimately be little difference between these two approaches (see section 4 for further discussion).

This new, single-fee revenue model may seem to create its own questionable incentive. Whereas the traditional model encourages advisors to over-trade a client’s account, this new model encourages the opposite. Since reallocating the client’s assets represents a cost for the advisor but generates no extra income, advisors have an incentive to do too little – to spend all their time trying to attract new clients and their single-fees and none to managing the accounts of their existing clients.

This risk can be offset, for example, by simply limiting the number of clients that an advisor may serve. Once an advisor’s client portfolio is full, his interests are served by retaining his most valuable customers and, if the single-fee is expressed as a percentage of AuM, by increasing the value of his clients’ portfolios. Another potential mechanism would be to introduce a performance fee element into the fee structure to maintain attention.

2. Holistic advisory services

Most Private Banks talk about holistic advice and broad service offerings, but it is rarely clear what this encompasses. At the True Advisor Bank “holistic advice” has a precise meaning. Basic levels of tax, retirement and succession planning and liability-side management are standard elements of the core service offering. All are covered by the single-fee paid by the client. Integrating these elements into the wealth management offering improves asset allocation and investment management for clients by allowing for a careful planning of ingoing and outgoing future cash flows.

3. Focus on asset allocation rather than securities selection

Clients of the True Advisor Bank are offered a “core-satellite” investment strategy of the kind commonly used by sophisticated institutional investors. The focus is on asset allocation, given that this accounts for more than 80% of portfolio value creation. The core of the portfolio would be invested in low-cost passive vehicles, such as exchange-traded funds (ETFs) and index funds, according to the needs of each client. Securities selection and investment advice on liquid products (standard, quoted securities) is not undertaken by the True Advisor Bank. For investments in illiquid or alternative assets, however, the client will receive expert advice on pre-vetted investment vehicles.

4. Add-on specialised service offering

Core services, including financial planning and asset allocation, will be provided in-house. More complex or specialised services and investment products can be sourced from third parties or be provided in-house. Clients would have to be charged extra for unusual or highly sophisticated advisory services. Traditional banking products, such as current accounts, payments and credit facilities, will be offered as today.

4. Economics of the True Advisor Bank

Can the True Advisor Bank be profitable? At first sight the economics appear to be disadvantaged. The only source of revenue is the fees clients pay for the overall service. And this may seem problematic, for two reasons. First, many clients have been reluctant to pay fees for advice and are shielded by opacity from appreciating the full cost of Private Banking. Hence it has become industry folklore that revenues must be derived from transactions. Second, because these fees are transparent in a way that client charges on the traditional model are not, the single fee or fee-for-service model is likely to put downward, competitive pressure on prices and, hence, on revenue.

The second of these concerns is legitimate. Indeed, price transparency is the intended purpose of the fee-for-advice model, and this will inevitably increase price competition. However, insofar as this concern is legitimate, the first concern is less so. Rational customers should favour a transparent and simple pricing mechanism to an opaque one, especially when the opaque mechanism has been exposed as exorbitant and a source of skewed advice. The True Advisor Bank will market its offering by pointing out that its pricing is not only simpler and better aligned with client incentives but, in aggregate, lower.

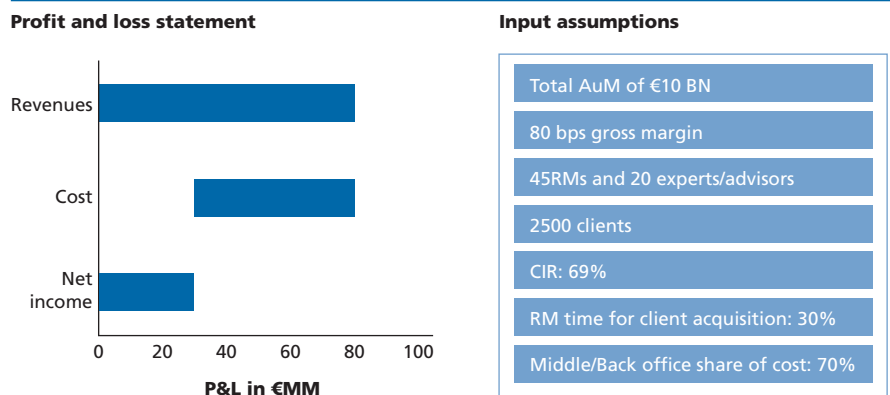
We cannot now know by how much such transparency will drive down aggregate pricing. In part, this is because it is difficult to know current aggregate pricing. We estimate it to be in the range of 1.0 to 1.5 percent of AuM. For the purpose of testing the financial viability of the True Advisor Bank (see Exhibit 2), we assume an average fee-for-advice of 0.8 percent of AuM.

Lower average revenue (as a percentage of AuM) is the bad news concerning the economics of the True Advisor Bank. The rest of the news is good. By increasing client trust and focusing RMs on activities that are valuable to clients, the True Advisor Bank has several economic advantages over the traditional model:

- **Higher client retention rate:** fee-only advisors tend to have better retention rates because they have broader relationships, providing more than merely investment advice
- **Higher share of wallet:** holistic advice helps the True Advisor Bank to win a higher share of total client AuM. A larger share of wallet increases both revenues and profitability, because the marginal cost of managing additional assets from existing clients is low
- **Smoother earnings profile:** revenues are independent of clients' asset allocations and product selection and therefore less volatile
- **Reduced costs:** the shift from securities selection to asset class allocation reduces the time RMs and investment managers spend on making decisions and on explaining them to clients
- **Additional business volume from expanded service offering:** revenues are captured from the traditional sphere of lawyers and tax accountants which are offered in-house

To test the financial viability of the new model, we have simulated the P&L of a small, standalone True Advisor Bank. Given reasonable assumptions about key performance drivers, a Private Bank with 2500 clients and AuM of €10 BN (average €4 MM/client), would deliver a net income of around €25 MM (see Exhibit 2 below).

Exhibit 2: Economics of a simulated True Advisor Bank



Implementing such a model is relatively straightforward from a technical perspective: it requires few new products or supporting technology. Indeed a number of Private Banks are starting to launch related products. It requires only changes in the way clients are billed and the bundle of services they are offered. Such changes can be made quickly and at moderate cost.

Nevertheless, the transformation presents a very significant management and cultural challenge. In the short term, revenues will probably decline and some RMs, perhaps some of the highest producers, may be tempted to defect to competitors. Maintaining the loyalty of staff and the confidence of group management whilst shifting the economic model and culture will require the transformation to be well planned and executed. As an initial starting point, this means identifying the likely sources of short-term disruption – both in terms of revenue at risk, and required changes in behaviour – in advance and devising measures to mitigate them.

Moving to the True Advisor Bank model will thus require a serious commitment and vision from management – the will to ride out the internal “political” storm and to tolerate a period of subdued profits as they reposition for the long-term. But banks that succeed will be able to say with conviction what clients are demanding: “Trust me, I’m your Private Banker”.

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