

PRIVATE BANKING



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PAYING FOR INVESTMENT ADVICE – A PRIVATE BANKING REVOLUTION

Swiss private banks are first movers in an industry shift to fee-based, fiduciary relationships with clients. Asset managers need to reassess their product and service offerings.

SUMMARY

Pivate banking is undergoing a shift. It used to provide clients with services for free, recouping costs via commissions. Now the industry is starting to charge clients for investment advice.

Swiss private banks are first movers in this shift to a fee-based model – already most advisory assets held for Swiss-domiciled clients are managed this way. EMEA and Asia-Pacific clients should follow this year, and the trend will likely spread to banks in other regions.

Why has the model changed? New regulations aiming to enhance transparency around fees are challenging traditional revenue streams while adding to costs. Digitalisation is also allowing relationship managers to deliver more value-added services to clients.

Establishing a contractual fiduciary relationship with clients is one of the biggest transformations the private banking industry has ever undergone. To offer state-of-the-art investment advice at a defined price is forcing banks to change their approach. Before it was about product placement. Now solutions are key.

The result is that private banks need to offer clients a top-down investment view focusing on asset allocation. A structured process ensures that all investors can

be advised equally. Consistency also helps restore trust in the advice process.

A robust asset allocation process requires investment building blocks, for example alpha from high-quality active funds, low-cost beta, while adding environmental, society and governance (ESG), and other thematic overlays. Similarly, asset managers should reassess their offerings to private banks.

Clients are the winners. They receive transparency on advice costs and more research expertise, juggling price with the service needed. Meanwhile, this new model helps private banks by improving their interaction with clients – a big benefit in markets with reverse solicitation regulations.

What is more, banks should benefit from better client retention as well as a potential increase of net new asset flows. And whereas before bank revenues were volatile and dependent on market movements, the new model offers more certainty.

The adoption of fee-based advice by large and mid-size private banks looks set to transform traditional banking not only in Switzerland but globally. Banks and investors should benefit, while opportunities open up for asset managers¹.



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PAYING FOR INVESTMENT ADVICE – A PRIVATE BANKING REVOLUTION

Introduction

The business model of private banking is undergoing a subtle but profound shift. Historically, the industry provided its wealthy clients with services such as investment advice for free, while recouping costs via commissions from products sold and trades executed. Slowly, but surely, the industry is moving towards charging clients explicitly for investment advice.

Swiss private banks are the first movers in embracing this shift towards a fee-based advisory model. The trend started a couple of years ago following a Switzerland Supreme Court ruling on retrocessions. Already most of the advisory assets held for Swiss-domiciled clients have been shifted to the new pricing model. It is likely to be rolled out to other EMEA and Asia-Pacific clients over the course of 2018. Following the Swiss banks' lead, the trend will likely spread to banks in other regions.

A confluence of forces is driving the shift. First, regulatory changes, such as the upcoming MiFID II directive, aim to enhance transparency around client charges. New regulations are also challenging industry revenue streams while adding to costs. Finally, digitalisation is changing the provision of investment advice. As technology helps efficiency in parts of the process, it allows relationship managers to deliver more value-added services to clients.

The ambition to bring investors under a contractual binding framework thereby establishing a fiduciary relationship is one of the biggest transformations the private banking industry has undergone in recent years. Offering state-of-the-art investment advice at a defined price forces banks to change their client services approach. Whereas before banks focused on product placement, now they have to be solutions providers.

Private banks will likely need to deliver their clients a top-down investment view with a strong focus on asset allocation. A structured investment process, including a strong house-view framework, ensures that all investors can be advised similarly. This kind of consistency helps satisfy the important investor need of restoring trust in the advice process.

In implementing asset allocation decisions per their new fiduciary capacity, private banks will look for

investment building blocks. Most likely this will take shape in the form of alpha exposure from high-quality active funds, complimented by low-cost beta exposure from passive products, perhaps with ESG and other thematic overlays. Asset managers, therefore, need to reassess their product and service offerings for private banks.

The new fee-based advisory model offers investors greater transparency on how much they are paying for advice while also getting access to investment research expertise beyond their relationship manager. Indeed, investors can customise the price they pay depending on the level of advice and service they require. What is more, all fee-based advisory models include an embedded risk-mitigated investment approach and multiple forms of debts and portfolio health checks.

Over time the new model should increase both the frequency and quality of interaction between clients and relationship managers. For instance, this new contractual framework allows relationship managers to contact investors proactively – a strong benefit especially in markets with reverse solicitation regulations such as the UK and several Nordic countries.

In so far as the new model should lead to more satisfied investors, banks should benefit from better client retention as well as a potential increase of net new asset flows. In addition, in the previous model, bank revenues were uncertain and dependent on market movements. The new model offers banks less volatility in cash flows and revenues, and hence the opportunity of better business planning.

Getting clients to pay for a service is nothing new, but for a traditional industry such as private banking this marks a fundamental shift. The increasing adoption of a fee-based advisory next year by large and mid-size private banks looks set to transform traditional banking not only in Switzerland but at a global scale. The new model has potential benefits for banks and investors alike. In addition, it offers opportunities for asset managers involved in the value chain¹.

Definition of fee-based advisory

Paying for a professional expert's advice is naturally accepted across most service industries, such as legal

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and medical consultation. The provision of investment advice by banks, however, has been the exception to this norm. Thus far, this service has operated on the basis of an implicit rather than explicit payment system. In this model, a fee is charged on the associated products sold on the back of the advice rather than the advisory service itself. This model, however, is undergoing a profound shift with banks now starting to charge investors directly for investment advice.

Some investors may find it odd that they now have to pay for something that has always been free in the past. This is an illusion. In truth, investors used to pay *indirectly* for a service that clearly incurred a cost to deliver, including the work of numerous financial professionals. The major difference is that in the traditional model, advisor revenues relied on commissions from the trades made and inducements on the products sold to the investor. This pricing scheme was transaction focused and the investor paid for advice implicitly.

In the new fee-based advisory world, investors pay an explicit fee for advice, typically based on a set percentage of their assets. Investment advice has not become more expensive – the pricing has just become more transparent.

Key drivers for the adoption

The emergence of fee-based advisory models is being driven by three major trends in the private banking industry: intensifying regulation, changing investor needs, and digitalisation (Chart 1).

First, new regulatory developments, such as the 2012 Swiss Supreme Court ruling on retrocessions and the Markets in Financial Instruments Directive II (MiFID), aim to protect investor interests by fostering greater accountability and transparency around costs. The fee-based advisory model helps achieve this as banks are no longer exposed to conflicts of interest when it comes to product selection. Moreover, complying with new regulations impacts the traditional transaction-based revenue model of banks. Therefore, banks are increasingly turning away from a product-driven to solution-orientated approach where they get paid for service rather than on single investment building block.

Second, investors deserve and increasingly demand transparency regarding as well as the underlying advisory and investment processes. Fee-based models help meet this demand. The contractual-based framework defines all underlying costs as well as service deliverables such as the frequency of interaction with investments specialists, and the frequency of portfolio health checks. Furthermore, a structured investment process, including a strong house-view framework, ensures that all investors can be advised with the same views. Such transparency helps satisfy the important investor need of restoring trust in the investment advice process.

Digitalisation is the third trend helping advance fee-based advisory models. A new generation of investors expects banks to offer a greater use of digital channels, apps, web-based solutions, and push alerts. For banks themselves, digitalisation is an important tool to help avoid potential litigation costs occurring from misadvice or misselling. At the same time, digitalisation also helps increase the efficiency of

Chart 1: Changing market sentiment - market, regulations and client needs



¹ Source: Deutsche Asset Management, data as of January 2018

For illustrative purposes only. No assurance can be given that the CDI construction process will perform better than other methodologies.

relationship managers and therefore reduces costs. However, this does not mean that traditional communication channels will disappear. Automation of tasks such as portfolio monitoring and basic advice will allow relationship managers to spend more time on servicing and fostering their client relations. Rather than becoming obsolete, advisors should become more efficient leading to a hybrid model where technology enables the advisor in delivering a broader service offering to investors.

Benefits for Investors, Banks and Advisors

The investor centric approach inherent in fee-based advisory models promises multiple benefits for investors, banks, as well as relationship managers along the value chain.

For investors, the most obvious benefit is greater transparency about how much and how they pay for professional advice. They are also shielded from potential conflict of interests inherent in the old model where investment advice was a route to generating commissions for the service-provider. Moreover, clients gain access to investment and research expertise (via a dedicated house-view) and continuous portfolio health checks.

Investors must not underestimate the value of these risk mitigation services. Within the past decade alone, the global economy has experienced several economic crises accompanied by market downturns of up to 50 per cent. Clients need to be vigilant against similar risks in the future. All fee-based advisory models include an embedded risk-mitigated investment approach and multiple forms of debts and portfolio health checks.

In a fee-based advisory model, there is a clear focus on educating and involving the investor – an involvement that the investor can actively steer according to their own preferences and requirements. As most fee-based advisory models are offered with options for varying service levels, the investor is now able to tailor the price they pay according to the service needed. Investors can choose the scope and intensity of advice, portfolio monitoring, investment proposals, and the interaction with dedicated investment specialists, in addition to their relationship manager.

Over time this new model should help enhance both the frequency and quality of interaction between clients and relationship managers especially in more

sophisticated advisory mandates where investment consultants are involved in giving advice.

Investors appreciate having a sparring partner regarding investments, receiving tailor made advice, having access to a one-stop-shop (robust portfolios, trading ideas, risk analytics, and so on) and receiving honest and transparent service. At the same time, clients are aware that one relationship manager cannot single-handedly take care of the relationship, do administrative tasks, carry out research, design an investment strategy, and measure risk figures. Support from a fully functional mid and back office is needed.

The investment consultant model, therefore, offers relationship managers both a short-term and a long-term benefit. In the short term, complexity on the relationship manager's side is reduced. Certain clients use more sophisticated investment products and are subject to complex cross border regulations – both of which can be handled by the investment consultant. This allows relationship managers more time to devote for existing investors as well as on prospects and acquisitions. The long-term effect should be to increase the overall quality of the interaction with investors. In the past, investors have preferred relationship managers that are able to deliver as much of their banks' capabilities as possible.

Therefore, with relationship managers positioned as the unique selling proposition, investors should experience an increase in service quality with fee-based advisory models. If this leads to increased investor satisfaction, banks will benefit from better client retention as well as a potential increase of net new asset flows. In addition, in the old model, bank revenues were uncertain and dependent on market movements. The new model offers banks less volatility around cash flows and revenues, and hence the opportunity of better business planning.

However, banks will have to be clear that clients not choosing a discretionary or advisory mandate will lose access to a personal relationship manager. Obviously, the downside of this is easier to comprehend for investors who have experienced having a personal relationship manager in the past – they will know what they are going to miss¹.

Cost structure

If investors are going to pay explicitly for investment advice in the future, a key question is how much.

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We look at the pricing models of the large Swiss institutions as a guide, point out the major differences among them, and highlight the most compelling options for investors. In summary, the current pricing landscape is diverse and a best in class approach suitable for all investors is yet to emerge.

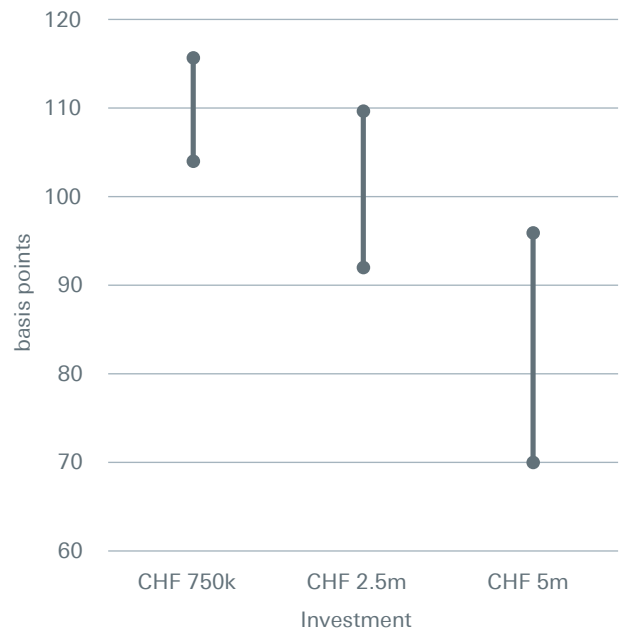
Current pricing models for advisory services in the Swiss market differentiate by the level of service and the intensity of interaction required by a client. In addition they also account for other factors such as the investor's underlying risk profile, the amount of assets, the size and asset-class of a trade, and the underlying product (mutual funds, ETFs, options). Furthermore, some banks offer attractive discounts for their in-house product offering.

The major Swiss institutions currently offer the option of a ticket fee, brokerage fee or all-in fee model. The general pricing components include a safekeeping fee, an advisory fee as well as a ticket/brokerage fee. The latter is the major differentiation point between the ticket fee and the brokerage fee model. The ticket fee model charges a fixed amount (say 50 Swiss francs) for trades, while the brokerage fee model charges a proportion (say 100 basis points) of the trade value if the size remains within a certain band. Although similar, the periodicity of trades and the investment size could make a significant difference in fees.

The all-in fee models, meanwhile, have no ticket/brokerage fee and no safekeeping fee embedded. But they do not include a higher advisory fee. For higher trading frequencies and larger trades the all-in model is more attractive. But assuming average trading intensities, all-in models tend to be relatively more expensive. In addition, the divergence of costs between the models increases with the invested amount. The overall average total cost in basis points, however, decreases with the amount invested.

As an example, for a balanced strategy with an investment amount of 750,000 Swiss francs and two trades of two per cent portfolio value a month, the average fee observed across the various models is 111 basis points, with a difference of 11 basis points between the highest and the lowest fee model. Now assuming an investment size of five million Swiss francs in the same balanced strategy with the same trading profile, the average cost declines to 87 basis points with a gap of 25 basis points between the highest and the lowest fee. This shows clearly that investors and their advisors need to find the pricing model best suited for their individual characteristics (chart 2).

Chart 2: Fee range for Balanced Portfolio of leading Swiss Banks¹



Assumptions:

- a) Balanced Strategy
- b) Lower sophistication level
- c) two trades a month with 2.0% portfolio value.

Key findings

- +/- 100 basis points – average total cost, decreasing with scale
- «All-in» generally more costly – assuming average trading intensity
- Cost highly correlated to asset class allocation – Equity portfolio more expensive across the board

Model definition

- «All-in» Fee – Advisory fee only. No extra trading/brokerage charge
- «Ticket/Brokerage» Fee – split in safekeeping, advisory and brokerage fee. Trading charges separately

Progress, future scope, and potential challenges

The ambition to bring investors under a contractual binding framework – establishing a fiduciary relationship, offering state of the art investment advice at a defined price, is one of the largest transformations the private banking industry has undergone in recent years.

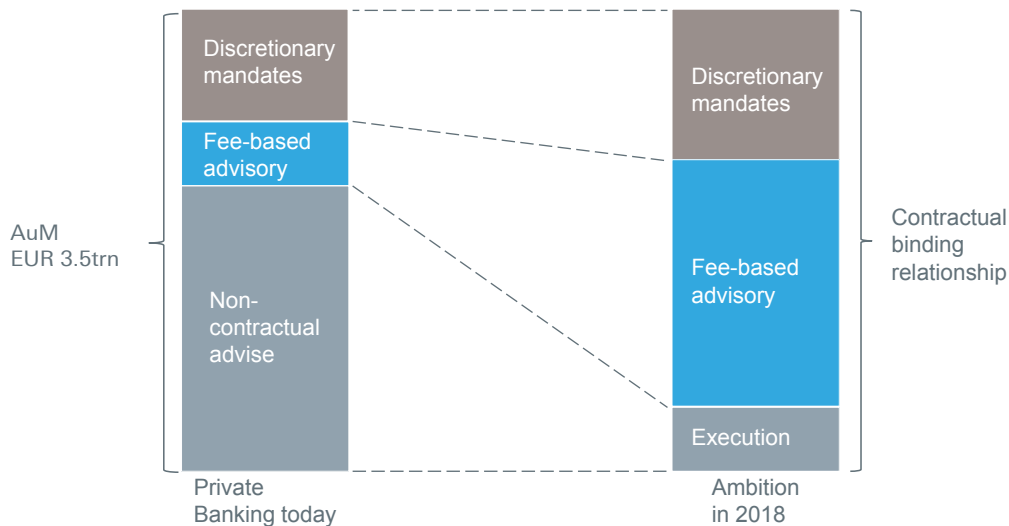
¹ Source: Bank websites publications

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Switzerland emerged as the first-mover in the adoption of this fee-based advisory model with the first wave of coming in 2013 and 2014. It is already well-advanced with a chunk of the advisory assets of Swiss private banks currently subject to this pricing model. The industry has an ambitious target of transforming almost its entire advisory asset book of nearly two trillion euros over the course of 2018. The shift is referred to as the “book transformation” process (Chart 3).

To make a transformation to a fee-based advisory model a lasting success, banks should look beyond pure advisory and focus on their investor relationship in a more holistic manner. This requires a broader appreciation of clients’ needs – moving from portfolio advice to total wealth counselling by taking all assets and liabilities into consideration. Banks also should strengthen the entertainment part of their service, which means providing a compelling story to advisors and investors,

Chart 3: “Book transformation” into contractual binding relationship in full progress¹



Switzerland’s lead should lead to a broader recognition of the new model across the global industry landscape over time. In particular, private banks in the rest of EMEA and the Asia-Pacific region should be the next to start adopting this model.

One challenge is investors that do not want to enter a discretionary or an advisory mandate agreement. These clients, commonly referred to as execution-only investors, can be divided into two groups. The first group, at the top end of the spectrum with regards to sophistication, include family offices and semi-institutional investors that do not want to take a bank’s investment advice. The second group are self-traders and traditional buy-and-hold investors that only use a small proportion of the services a bank can offer.

Another challenge to the fee-based advisory model is delivery. Banks will need to stabilise and improve existing technology systems for example, while also making investments necessary to come up with innovations suitable for an emerging digitalized infrastructure. One innovation would be automated trade recommendations that enable the relationship manager to serve more investors within a mandates framework.

enhancing the investor experience and helping build an engaging and longer-lasting relationship.

Last but not least, operating in a global environment requires global solutions that not only meet local regulatory standards but fulfil investor specific demand. Meeting global needs, unlocking new regions, and providing a truly global experience will provide the necessary scale and scope¹.

Shifting demand for asset manager products

The ongoing shift in the relationship between private banks and their clients has implications for associated service provider industries as well. Asset managers for instance need to reassess their product suite aimed at this client base.

When implementing asset allocation decisions per their new fiduciary capacity, private banks will look for investment building blocks. This will likely mean alpha generation from high-quality active funds, low-cost beta exposure from passive products, as well as ESG and other thematic overlays. Asset managers,

¹ Source: SFAMA, Swiss Banking Association, Banking Research, September 2017

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therefore, need to reassess their product and service offerings for private banks.

Being a more institutionalised investment vehicle, exchange traded funds and other indexed investments have historically gained greater attention across discretionary mandates. With the emergence of advisory mandates and the general pursuit of managing assets under contract, ETFs should increasingly become a core vehicle in advisory asset allocation models. There are a variety of ways to justify the greater implementation of ETFs in advisory mandates. When following a certain benchmark approach, low cost ETFs allow for tactical allocation calls and strategic investment directives. What is more, a bank's house-view mostly drives the investment process, so ETFs offer easy, flexible and efficient access to markets. And ensuring flexibility in a transparent structure while fulfilling multiple regional and regulatory requirements makes ETFs an easily implementable solution, particularly for mandates across multiple domiciles. The increasing number of available exposures, for example thematic, ESG, and liquid fixed income solutions, enable a more targeted and diverse asset allocation framework.

Conclusion

Persuading clients to pay for a service is nothing new, but for a traditional industry such as private banking, it marks a fundamental shift. The increasing adoption of a fee-based advisory model by large and mid-size private banks will transform traditional banking not only in Switzerland but on a global scale.

The drivers and the necessity of accepting this shift – changing investor needs, digitalisation and regulatory demands – are evident and here to stay. The change should benefit investors by providing them greater transparency on costs and more control over the level of service they need. Banks themselves should benefit from a more stable revenue stream.

A pricing model change will see private banks adopt a fiduciary responsibility for their clients. This will require them to move from a product placement mentality to a more service-orientated approach. A top-down investment view with a focus on asset allocation will be key for banks.

There are broad implications not only for banking but also for other participants along value-chain. One such industry, asset management, needs to reassess its product and solution offerings to adapt to the likely increase in penetration of passive investing brought about this shift.

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