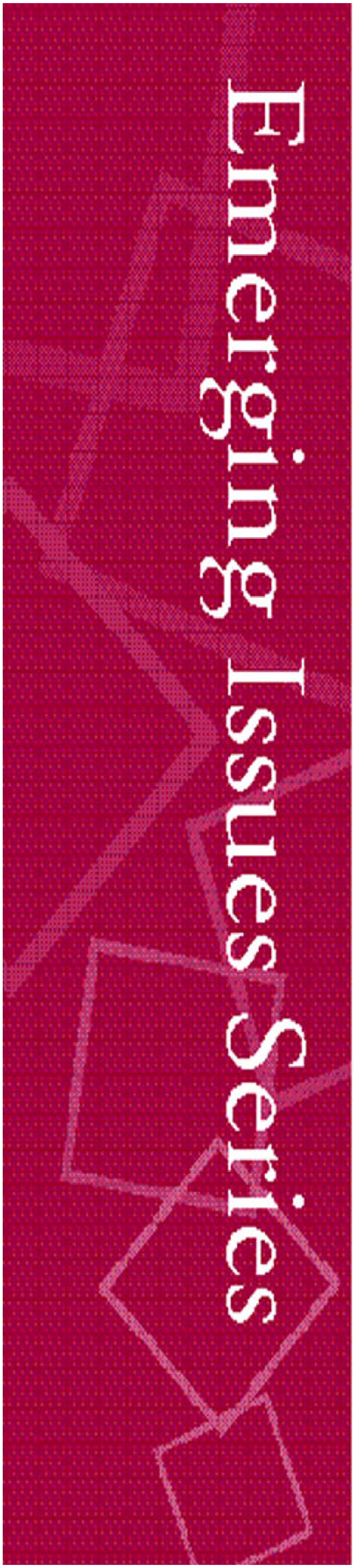

QUESTIONS EVERY BANKER WOULD LIKE TO ASK ABOUT PRIVATE BANKING

AND THEIR ANSWERS

Michael Atz

Emerging Issues Series
Supervision and Regulation Department
Federal Reserve Bank of Chicago
May 1999 (S&R-99-6)

QUESTIONS EVERY BANKER WOULD LIKE TO ASK ABOUT PRIVATE BANKING

AND THEIR ANSWERS

Michael Atz

May 1999

Address correspondence to Michael Atz, Supervision and Regulation, Federal Reserve Bank of Chicago, 230 South LaSalle Street, Chicago, IL 60604-1413. Phone 312-322-4763, Fax 312-322-5894, E-mail: Michael.E.Atz@Chi.Frb.Org. Requests for additional copies should be directed to the Public Information Center, Federal Reserve bank of Chicago, P.O. Box 834, Chicago, Illinois 60690-0834, or telephone (312) 322-5111. The Federal Reserve Bank of Chicago's Web site can be accessed at: http://www.chicagofed.org/publications/workingpapers/emergingissues.cfm

QUESTIONS EVERY BANKER WOULD LIKE TO ASK ABOUT PRIVATE BANKING

AND THEIR ANSWERS

By Michael Atz*

Private banking--What is it? Barron's Dictionary of Banking Terms provides an excellent and clear definition of private banking. It defines private banking as banking services, including lending and investment management, for wealthy individuals. Private banking primarily is a credit service, and is less dependent on accepting deposits than retail banking. Another interpretation can be found in The Federal Reserve Supervisory Letter (SR97-19). Under this definition private banking includes among other things, personalized services such as money management, financial advice, and investment services for high net worth clients. Although high net worth is not defined, it is generally thought to refer to households having income of at least $100,000 or net worth greater than $500,000. Larger private banks often require even higher thresholds before they will furnish private banking services. Several now require their new clients to have at least $1 million of investable assets. By next year it is estimated that over 15 million households will meet the $100,000 income test. Most of the private banks further segment this group into the young affluent or retired affluent. Several of the more sophisticated institutions may further differentiate their clients by type of services they require.

The number of affluent babyboomers has been growing at double-digit rates in recent years, particularly due to the fact that many baby boomers are now reaching the peak of their career earnings. Many have little difficulty meeting the net worth test because of their investment in company sponsored thrift plans, rising stock prices, and rising real estate values. One good tool to measure how this affluent group is faring, at least in stock performance, is the Wilshire 5000 Index. This is the most broad equity index; measuring the performance of more than 7000 capitalization-weighted securities. It covers virtually every U.S. Company that trades on any major exchange. During the first quarter of 1999 this index reached the 11700 level which means that the market value of all securities were then valued at $11.7 trillion. This represents almost a 1000% increase since its inception on December 31, 1980 with a value of $1.4 trillion.

Where can private banking services generally be provided? Private banking may be provided in a separate department of the bank, an Edge Corporation, or a foreign

* The views expressed are the author's and do not necessarily reflect the views of management of the Federal Reserve Bank of Chicago or the Federal Reserve System.

subsidiary. These are the most common arrangements seen in large foreign banking offices or money center banks. Private banks may also be stand-alone entities. Coutts Bank in Miami is an example of a stand-alone bank. Private banking may also take place in the trust or investment management division of a bank. This structure is typically seen in most regional banks, such as Mellon Bank Corp and BankOne Corp. Regardless of the structure, private banking products and services are not only confined to a bank's domestic headquarters. These services are also frequently offered to customers throughout any bank's global network of affiliated entities, including branches and representative offices in any region of the world, and offshore secrecy jurisdictions.

What kind of private banking products and services do these clients desire? Product offerings frequently extend well beyond the typical commercial bank offerings of deposits, credit and mutual funds. It is not unusual to find clients in offshore vehicles such as Personal Investment Companies (PICs), trusts or even more exotic arrangements, such as hedge fund partnerships or Payable Through Accounts (PTAs). Each of these products is explained in the Appendix. Private banking services almost always involve a high level of confidentiality regarding client information. Lending to high net worth individuals and their business concerns often takes on unique characteristics. The majority of private banking lending is fully secured. Nevertheless, extensions of credit to high net worth individuals even if secured should not result in compromising sound underwriting standards. Even if the collateral is cash, it may be subject to government forfeiture if it came from illicit activities.

Typically, private banking clients want to choose from the entire efficient frontier of investment choices and frequently are asking for higher yield products. This request for a broad portfolio balance typically includes alternative investment strategies that require extensive portfolio optimization analysis. The most elite private banks have invested heavily in technology to develop optimal asset allocation models tailored to meet their various clients' needs.

Investment management (discretionary) and investment advisory services (non-discretionary) are also highly sought by private banking clients as part of the wide variety of products and services they expect. For discretionary accounts, the bank's portfolio managers make the investment decision. These decisions are usually based on recommendations made from the bank's investment research committees. For non-discretionary clients, the banks typically offer investment recommendations subject to the client's written approval. Clients can choose to ignore the advice given by the institution and simply trade as they wish, making their own investment decisions. Both account types are governed under separate agreements between the client and the institution. However, before a banker can determine the proper asset allocation and design a portfolio, they must first identify the client's needs and constraints. A client profile is the primary source of this information. A client profile will identify the purpose of the relationship and whether the client wants discretionary or non-discretionary accounts. The client profile is also used to determine the client's investment objectives, investment knowledge; liquidity needs and risk tolerance.

What kind of due diligence is done to corroborate a client's source of wealth and business activities? Institutions have employed a wide array of sound practices to corroborate a client's source of wealth and business activities. It is not uncommon to seek out public information on very high profile clients that are frequently in the press. Lexus Nexus or similar standard database searches are used to gather this information. Visits to several private banks during the last year reflect that they are fully endorsing KYC. Private banking clients are also taking it very seriously. Client's privacy rights are always a concern. However, most clients realize that some of their privacy will necessarily be compromised if their relationship manager is going to provide a high level of personal banking services and fully understand their requirements.

How is the Internet impacting private banking? The Internet provides real advantages to investors; particularly same day pricing on exchange listed instruments. Previously, banks spent enormous sums on technology and management information systems to provide this platform to their most elite customers. Now it is available for free. Several online brokerage firms provide real time quotes for free if you trade with them. Other sites offer the same service with a 15 to 20 minute delay. These sites even provide option pricing although again with the same 20-minute delay. The Internet is bringing a vast amount of free information to everyone's desktop. SEC 10-K filings are also available either at no cost or for a small fee. Today, costly investment research can be had for a small fee, or you can wait the five minutes until someone posts the change in investment recommendations on a company investment message board or a similar site. Previously this type of information was only available to very sophisticated or institutional investors, and it was expensive. Some online firms even provide earning release dates in advance so that you can place your bet the day or week before in anticipation of better or less than expected earnings. Some online entities provide consensus-earning numbers and still others even provide so-called whisper numbers saying that the consensus may be too high or low. With all this information available to anyone at their desktop, it's a wonder if any information on publicly traded instruments can remain proprietary very long.

Why do banks want to grow their private banking business? First and foremost, it offers high returns. Most private banks target return on equity of at least 25%. That is considerably higher than that of the average commercial bank. Opportunities for off-balance sheet income are an additional incentive. Unlike depository accounts, securities and other instruments held in the clients' investment accounts are not reflected on the balance sheet of the institution because they belong to the client. However, the institution can earn substantial fees for managing client assets or performing other cash management and custodial services. To grow, private banks need to lure new wealthy investors away from direct investing or from investing with major mutual fund companies such as Fidelity or Merrill Lynch. Success is spotty, but those institutions that provide quality service, coupled with adequate investment performance, are doing extremely well. Several institutions in our district hold themselves out as private bankers. The most famous is The Northern Trust Corporation (NTC). It has managed to stay well ahead of the crowd by recognizing what is driving this market. Northern is keenly aware of the need to have a stellar technology platform, and they have invested accordingly. NTC also knows that clients are becoming more sophisticated and desire a broad spectrum of investment alternatives including tax advantaged accounts. They also recognize the inroads retail brokerage firms and investment banks are making in their business. As such they must keep expanding their breadth of services. They are now considered one of the most premier providers of personal fiduciary, master trust/custody and global custody services in the world. They are also a recognized leader in cash management services.

What are the primary private banking risks? Private banking embodies a number of risk factors: (1) operational risk, (2) reputation risk, (3) legal risk, (4) relationship risk, and (5) credit risk. The combination of more competition and increasingly complex products offering higher yields, which further exacerbates these risks. High-yield products serve to raise concerns as to the suitability and the adequacy of risk disclosures to clients.

Operational risk has the highest inherent risk for private banking entities. An example of operational risk is a corporate action that is not relayed to the client quickly enough for him to act. One example of a corporate action occurs during those periods when an entity makes a self-tender to purchase a portion of their stock back in the open market. Sometimes corporations use an auction type market to buy back these shares. Private banking entities must have systems in place to capture these windows of opportunity for their clients. Offering periods are usually short and tenders must be made during this brief period. If clients are not notified on a timely basis, they may miss an opportunity to sell a portion of their shares at these special price levels.

Reputation risk consistently represents a major risk factor for private banking firms. Negative publicity regarding an institution's business practices and clients, whether true or not, could cause a major decline in customer business and/or costly litigation. Past history reveals several high profile lawsuits that were brought against banks because they did not reveal the inherent risk to their clients from investing in highly leveraged instruments. Although most private banking activities are normally profitable for the client and the bank, they do not come without a high level of reputation risk to the bank should they fail to perform as expected.

Allocation of client assets, a major determinant of investment performance, also exemplifies reputation risk. Most wealthy clients are looking for a combination of investment performance and high level of service from private banking relationship managers. Those banks delivering sub-par performance and service will find clients seeking refuge elsewhere. The bank's reputation would be ruined along with the transfer of accounts. Private banking clients are a savvy group, always seeking out those banks that have the ability to offer an extended array of investment products to diversify their holdings. The private banks that don't offer an all-inclusive money management relationship, including investment portfolio management, financial planning advice, offshore facilities, global custodian services, funds transfer, and foreign exchange capabilities may find themselves relegated to the ranks of second tier providers.

Another example of reputation risk involves utilizing outdated assumptions in making investment decisions. For several years, it was recognized that small-capitalized stock funds outperformed larger-capitalized stock funds. The trend has since changed, and money managers that continued to invest client's funds in smaller stocks after the change now have clients with under-performing portfolios in comparison to returns of the larger capitalized stocks that make up the Dow Jones 30. Any extended period of poor relative performance will most likely have an adverse impact on the reputation risk of the investment manager, and ultimately, the private bank making these investment decisions.

Legal risk mostly occurs during the account opening and account monitoring process. Private banking firms must be able to balance a client's desire for secrecy and identifying those clients that are operating in a suspicious way, operating within the parameters of the law. Recently, several high profile cases involving private banking have appeared in the media. One of the most famous cases involved Citibank's relationship with Raul Salinas, brother of the former Mexican President Carlos Salinas. In this case, Citibank private bankers transferred more than $80 million for Salinas to Swiss Bank accounts. Swiss authorities moved to seize the funds, claiming they came from drug trafficking. This example provides elements of reputation risk as well as legal risk.

Relationship risk stems from the close interaction between the relationship managers of the banks and their clients. In private banking, most new accounts are generated on a referral basis, and it is not uncommon for each client to have a single point of contact assigned to them when dealing with the bank. This individual may be a salesperson or marketer and is commonly referred to as the relationship manager. Relationship managers strive to provide a high level of support, service and investment opportunities; therefore, they tend to maintain strong, long-term client relations and frequently take clients with them to other private banking institutions if they change employment. Thus, this type of action represents a potential threat against a bank maintaining its existing client base.

Credit risk is usually a minor risk factor for private banking firms. The extensions of credit to high net worth individuals by most private bankers is incidental to procuring the clients more lucrative investment management business. However, credit risk is often minimized, since the majority of private banking lending is often fully secured either by cash or securities.

What are the regulatory concerns of private banking on a global basis? Several U.S. banks and other entities continue to merge with international banks this gives rise to regulatory concern on a global basis. At least one banking regulator recently sited that an increase of private banking exposure by their banks could heighten political pressure to loosen banking secrecy rules. The foreign regulator is also concerned about the systemic risk that could result from this activity. This regulator wants their banks to increase shareholders' equity even though equity is already above international standards. Also on this front, two agencies, The European Union and the Organization for Economic Cooperation and Development have been asking authorities in at least one foreign country (Switzerland) to loosen their banking secrecy laws.

What is the future for private banking? Private banking at its best still requires an institution to have in place a highly sophisticated management information system to track all of its accountholders on a global basis. Private banks will also need to have a cadre of highly trained relationship managers that have the expertise to understand clients' diverse needs. These two elements of private banking will continue to set high barriers to entry and serve to limit the number of truly global players capable of supporting this activity. Investors today are highly sophisticated and very cognizant of their investment returns. There also appears to be a major generation shift in asset ownership by parents that grew up during the Second World War to their children. These "baby boom clients" currently are placing a greater emphasis on equity investment styles rather than invest in fixed income instruments, which was the choice of their parents. Still others desire to have their idle cash or principal protected deposits work harder for them. They frequently ask their private bankers to link their deposits to some type of equity index such as the S&P 500. Chairman Alan Greenspan noted in his recent testimony on capital hill, "that the retirement of the baby boom generation looms as one of our nation's most difficult challenges".[1] Hopefully, private bankers will make this transition easier. With overall fee income skyrocketing as a percentage of bank income is it any wonder that more banks and non-banks want to get a bigger share of the pie from private banking.

[1] Testimony of Chairman Alan Greenspan, " *On Investing the Social Security Trust Fund in Equities,*" Before the Subcommittee on Finance and Hazardous Materials, Committee on Commerce, U.S. House of Representatives, March 3, 1999.

APPENDIX

EXPLANATION OF COMMON PRIVATE BANKING PRODUCTS

What are Personal Investment Companies (PICs) and what are their characteristics?

One of the most complex of banking services is that of the PIC. Frequently PICs are managed in the domestic office of the private bank. Traditionally PICs are established for the client, the beneficial owner of the PIC by one of the private bank's affiliated trust companies in an offshore secrecy jurisdiction. The favorite PIC locale for U.S. clients is usually the Cayman Islands, whereas, the ideal haunt for a British citizen is customarily the Channel Islands. Several other popular offshore secrecy jurisdictions are the Bahamas, British Virgin Islands, and Netherlands Antilles.

- It is a shell corporation established by the bank's offshore trust company to hold the client's (the Beneficial owner's) investment assets.

- The PIC has its own legal identity, providing the individual confidentiality and tax benefits. As such the individual's name need not appear in any public registry.

- Trust employees are directors and authorized signers.

- Although the account is in the name of the PIC, the client profile is on the individual, the beneficial owner.

- Even if original documentation is maintained offshore, there should be enough information in the U.S. files to prove that the bank knows the client.

- Banks generate substantial fees at the startup and annually earn administration fees.

- Most importantly, anonymous relationships, or relationships using only account numbers for the name should be highly discouraged. While these vehicles may be used for legitimate reasons, examiners should make certain that the bank embraces KYC due diligence to avoid the appearance the account is structured to conduct illicit activities.

What is a Payable Through Account (PTA) and what are their characteristics?

- PTAs are transaction deposit accounts through which U.S. banking entities ("payable through banks") extend check-writing privileges to the customers of a foreign bank.

- The foreign bank ("master account holder") opens a master checking account with the U.S. bank and uses this account to provide its customers access to the U.S. banking system.

- The master account is divided into "sub-accounts", each in the name of one of the foreign bank's customers.

- The foreign bank extends signature authority on its master account to its own customers who may not have been subject to the same account opening requirements imposed on U.S. account holders. The number of sub-accounts permitted under this arrangement may be virtually unlimited.

- U.S. banking entities primarily engage in PTAs because they attract dollar deposits from the domestic market of their foreign correspondents without changing the primary bank/customer relationship and provide strong fee income.

- PTAs at U.S. banking entities generally have the following characteristics: they are carried out on the U.S. banking entity's books as a correspondent bank account, they involve high transaction volume, checks passing through the account have wording similar to: "Payable through XYZ Bank", and signatures appearing on checks are not those of authorized officers of the foreign bank.

What is a hedge fund and what are its characteristics?

  - For U.S. investors it is a private investment partnership.

  - For Non U.S. investors it is an offshore investment corporation.

- Considered highly speculative in that they can sell short stocks and other instruments, use leverage and use derivatives such as puts and calls, options and futures. Several hedge funds also utilize some form of arbitrage, such as those where they can take advantage of movements expected to occur in the stock price of two companies undergoing a merger or other similar event.

- A majority of investors in a hedge fund need to be accredited investors or those with a net worth of at least $1 million. Most hedge funds require minimum investments of at least $250,000 by each participant. Consequently, private-banking clients make up most hedge fund investors. Liquidity is also an issue, in that most investments initially have a one-year period where trading is not allowed.

Emerging Issues Series

A series of studies on emerging issues affecting the banking industry. Topics include bank supervisory and regulatory concerns, fair lending issues, potential risks to financial institutions and payment system risk issues.

These papers may also be obtained from the Internet at:
http://www.chicagofed.org/publications/workingpapers/emergingissues.cfm