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FINANCIAL TIMES

FT REPORT - FUND MANAGEMENT: Private banks face their own challenges

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Published: Jan 21, 2008

The global private banking sector enjoyed a record year in 2007 in terms of revenues, profits, net new money inflows and assets under management, based on results for the first nine months. According to analysts at Bear Stearns, the sector is currently the fastest growing in the financial services market.

Moreover, both new money inflows and assets under management remained robust during the third and fourth quarters despite the problems affecting global credit markets in general and banks exposed to the US subprime market.

Indeed, the sector performed so strongly during 2007 that some analysts and commentators have put forward the view that private banking might provide a countervailing force to the woes affecting the rest of the banking sector.

The numbers certainly look compelling at first glance. According to Boston Consulting Group, rich and affluent people worldwide owned an estimated $97,900bn (£49,731, €66,982bn) of investable assets at the end of 2006. Estimates vary but the likelihood is that more than half of this is under management at private banks.

So this should leave substantial scope for growth. Assume an annual management fee of around 1 per cent of assets and an extra $10,000bn of assets would boost private banking revenues by $100bn.

Unfortunately, however, this thinking is naïve for a number of reasons. The first, and probably most important, is that the private banking sector is a small element of the global financial system.

If financial markets buckle, the sector will be affected at some stage, not least because its revenue stream is intimately linked to asset values. And if the credit crunch precipitates a bout of asset deflation then private banks will suffer accordingly. Furthermore, if the credit crunch precipitates a recession, then this will impair the volume of new money coming into the sector as well as denting client confidence. The bursting of the dotcom bubble at the beginning of the decade was salutary in these respects for private banks.

But even if the sector could be insulated from the effects of a credit squeeze it is unlikely it could expand significantly to take advantage of the opportunities on offer. The sector is currently working at near full capacity, especially given the available supply of relationship managers, as most headhunters active in the sector will confirm. And relationship managers play a pivotal role in the client acquisition and money garnering process.

So what will happen during 2008? Given that the sector's health depends upon the behaviour of asset markets generally, this is a difficult question to answer with any certainty.

But the outlook is not inspiring. Notwithstanding the hard-learned lessons about portfolio diversification, UK wealth managers found it difficult to outperform cash during 2007 according to the ARC Private Client Indices . UK managers are not necessarily representative of the market as a whole, but this does not bode well for 2008 if markets really do take a tumble.

And according to some insiders the sector could face another mis-selling scandal. It was not just banks, hedge funds and pension funds that invested in subprime debt. Private clients have almost certainly done so, possibly in the form of funds that offered enhanced returns. Undoubtedly the private banking arms of large investment banks will come under scrutiny and questions will almost certainly be asked (again) about the probity of operating an investment bank and private bank on a "One Bank" basis, an increasingly popular business model over the past two years.

But according to Daniel Truchi, the head of SG Private Banking, the damage could affect a much wider range of banks and precipitate a flight to quality as a consequence.

In turn this could act as a catalyst for a burst of restructuring. According to Ray Soudah of Zug-based Millenium Associates , banks seriously affected by the subprime crisis will almost certainly consider disposals, with the exception of UBS and Credit Suisse where wealth management is the core business line.

Overall, profits look set to be squeezed, which could ease pressures in the recruitment market. But as Mr Soudah points out, recruiting more relationship managers is still the cheapest way of acquiring more clients.

The silver lining for the sector is that there is still a lot of wealth to be managed. But securing custody of those assets will be challenging for private banks.

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