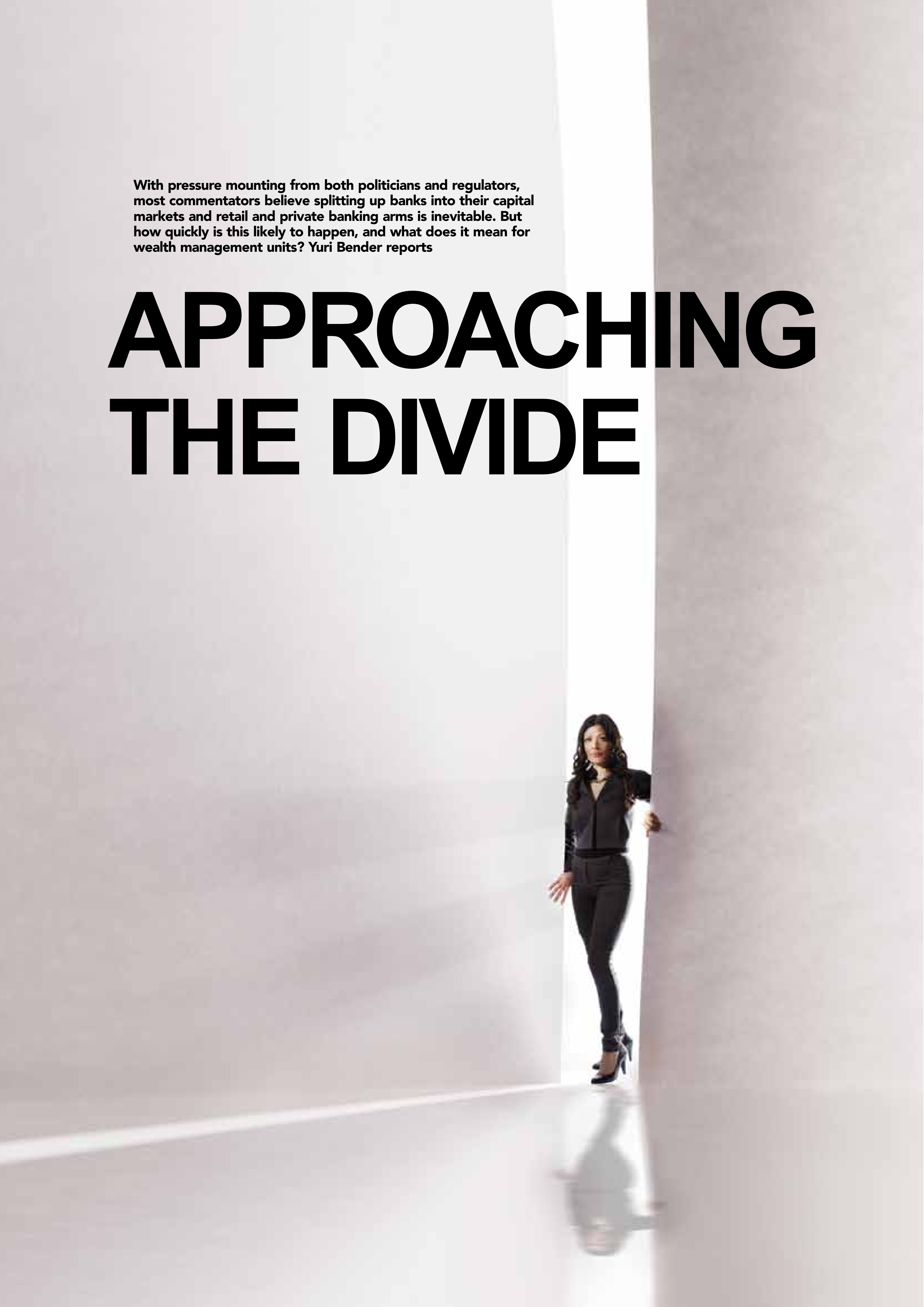
With pressure mounting from both politicians and regulators, most commentators believe splitting up banks into their capital markets and retail and private banking arms is inevitable. But how quickly is this likely to happen, and what does it mean for wealth management units? Yuri Bender reports

APPROACHING THE DIVIDE



Enforcing the split of banks into their risk-taking capital markets arms and more benign retail and private banking units would be a big mistake, the CBI, which represents major employers in the UK, warned recently. Their fear is that such regulations would knock the UK off its privileged perch in global finance and bankers would be allowed to carry on their activities unhindered elsewhere.

The regulators have a different view, with the Bank of England calling for a split, backed by some leading politicians. This would prevent the growth of juggernauts, judged in the last crisis as "too big" or "too important" to fail. The argument is that the man on the street's mortgage and savings, alongside wealthy individuals' investments, could be preserved in stressful times, while allowing structured vehicles – sometimes unethically created by risk-taking speculators – to go to the wall.

The Independent Commission on Banking will make recommendations in April, but whatever happens in London and other financial centres such as New York and Zurich, the industry and major clients of institutions will have their own thoughts. Wealthy customers of UBS, for instance, voted with their feet after the financial crisis, making net withdrawals of more than SFr200bn (€152bn) in the two years following the start of the 2008 crisis. Most of this was due to loss of confidence in the bank. Clients were harbouring concerns that the chaos of the capital markets division would somehow encroach into wealth management, denting the value of their assets. Moreover, some banks, including ING and Commerzbank, have been forced to sell off private banking units to raise funds to repay taxpayer subsidies.

It is a thorny issue affecting the very fabric of the wealth management world, which is divided between those in favour of and against such a change in model. But most commentators believe it will happen, though not with any real immediacy. Ray Soudah, a former high ranking banker with both Citigroup and UBS, and now head of Swiss M&A consultancy, Millenium Associates, believes a split between different banking disciplines is not just desirable, but inevitable.

"Few large institutions will remain conducting both investment banking and commercial banking and those with marginal investment banking operations will slim down or sell them," claims Mr Soudah, previously on record saying that only the strong and large-scale houses will survive on either side of the divide.

'Few large institutions will remain conducting both investment banking and commercial banking'

Ray Soudah, Millenium Associates

"They will then be able to focus on commercial and domestic quasi-investment banking services in their home country, to protect core clients, until they are finally obliged to totally exit investment banking, which has evolved as a global service handled only by a few majors." The "Swiss majors" – and he means Credit Suisse and UBS – will escape this trend and maintain multiple product lines, while UK banks are more likely to be sacrificed to the fashion for political and regulatory zeal.

"The split is already happening," confirms Amin Rajan, CEO of the Create consultancy, citing recent examples of Citi and Morgan Stanley divesting part of their wealth businesses. "However you look at it, investment banks are seen as heavily conflicted and clients are fleeing in droves."

Yet the interdependence of various banking units in the "integrated" banking model may put the brake on an accelerated carve-up. The likes of BNP Paribas and Credit

'Offshore clients will increasingly be seen as a legacy issue and even a liability, rather than a source of profits'

Shelby du Pasquier, Lenz & Staehelin

'The regulators are telling the banks that if they want to carry on all of these activities, they need a lot more capital than Basel III requires'

**Adrian Darley,
Ignis Asset Management**

Suisse, for example, always state the advantage of having an investment bank in the same structure as the private bank. It is no secret that in many banks, private banking clients have been seen by bosses as little more than a distribution outlet for structured products.

"Each feed off the other, so it is difficult for them to operate as stand-alone units. The demand for structured products has been artificially propped up but this is an unhealthy relationship," admits Mr Rajan. "It will be at least 10 years before any significant decoupling will occur. In the meantime, there will be more talk and less action."

PERIODIC MUTATIONS

This current, volatile era in the evolution of banking is just the beginning of one of the industry's periodic mutations, believes Shelby du Pasquier, a prominent financial services lawyer at Lenz & Staehelin in Geneva, who has been closely involved in Switzerland's negotiations with US authorities about tax, confidentiality and the future of Swiss banks' quest for a lucrative, North American clientele.

While he agrees pressures on existing models are both commercial and regulatory, he expects wealth management rather than capital market operations to bear the brunt of changes, with banks increasingly seeking tax compliant onshore clients, rather than offshore customers, who no longer enjoy the confidence of regulators or operations bosses. "Offshore clients will increasingly be seen as a legacy issue and even a liability, rather than a source of profits," he believes.

These reputational concerns, coupled with financial pressures, will lead to some European groups exiting private banking, as they will no longer regards it as a core activity. "These combined factors are driving down the price of M&A transactions in the banking sector, which is today a buyer's market," he says. While it is unlikely the new legal and regulatory climate will lead to dismantling of universal banking groups such as Credit Suisse and UBS, disparities in profitability of various businesses within a group could ultimately result in the spin-off of wealth management units, adds Mr du Pasquier.

Disposals are now likely at any institution recognising its wealth arm is not making a significant contribution to group profits, says Seb Dovey, head of consulting at wealth management think-tank Scorpio Partnership. "Prices are still very mixed, but we do see an increasing trend towards a rational market place of 1.5 to 2.25 per cent of AUM and typically, this is for the better businesses."

Private banking customers, now driven by performance and pricing factors rather than the old aphrodisiac of confidentiality, will increasingly flock to a smaller number of groups such as HSBC, Citigroup and UBS, which are able to fund an onshore presence in a large number of jurisdictions, says Mr du Pasquier. "This move is likely to continue as tax compliance becomes the new motto."

This faultline in the banking world will only be aggravated by the so-called "Swiss finish", which imposes higher regulatory costs and stricter capital adequacy ratios on banks based in Switzerland than their rivals in other jurisdictions.

This new concept is a sign that Swiss regulators have moved on from the initial knee-jerk debate about splitting commercial from private and retail banking, says Adrian Darley, head of European equities at Ignis Asset Management, and a keen follower of the continent's banks. "Shareholders would like a break-up of Credit Suisse and UBS, but the regulators and management don't. Instead, the regulators are telling the banks that if they want to carry on all of these activities, they need a lot more capital than Basel III requires. Whether they like it or not, Swiss banks will have to do this. They are already operating with far higher levels of capital than their competitors in the UK and US, now this will go even higher. The Swiss are showing the way on this issue."

The UK is now toeing an insular line. "If we wind back the clock to the immediate aftermath of Lehman, there was a huge outcry about the big banks, but now, in most areas, the dust has settled," says Mr Darley. "Most regulators have tempered their views as a result of pragmatism," partly due to the realisation that freewheeling investment banking was not always the cause of banks going down, with risky mortgage lending leading to casualties such as Northern Rock.

Both shareholders and clients, according to Mr Darley, prefer the "pure play" wealth management model followed by Zurich's Julius Baer, which exited capital markets, before splitting off its funds house from the core private banking operation in 2010.

"We have been shareholders of Julius Baer for 18 months; they have much excess capital and were able to buy the ING private banking franchise," he says. "Some competitors – such as UBS and Credit Suisse – would argue that Baer ended up where they are because their loss-making experience of broking and trading was not a very good one. They sold these businesses and returned to their core competencies of wealth management. But their shares have been much more stable performers than UBS, Credit Suisse or other competitors. Investors tend to prefer this business model."

FACTS ON THE GROUND

The major players are also developing 'facts on the ground' to make a split more difficult, with separate divisions becoming more interdependent and cross-disciplinary groups used to exploit synergies between private and investment banking.

A key ingredient in Credit Suisse's boosting of inflows has been its reliance on Solution Partners, a highly motivated 90-strong team sitting in the private banking department, but acting as an interface with investment banking and asset management to source group products for wealthy customers.

Similarly at UBS, the 2500-strong Investment Products and Services (IPS) unit supplies " investment content" from all three divisions to private clients.

Emerging markets will play a much greater part in defining and developing future trends, says Kaha Kiknavelidze, managing director of emerging markets hedge fund group Rioni Capital, and a former investment banker at UBS. "In the emerging world, looking at Russian and Chinese markets, they are developing universal banking," says Mr Kiknavelidze. "VTB has built a leading investment banking business in Russia and Sberbank is reportedly in discussions to acquire one. The Bank of China is doing securities business and developing a brokerage too."

He expects the integrated model to prevail, despite recent discussions of splitting capital markets from retail and private banking activities. "The further we move away from the crisis, the more likely the urgency to make these changes will disappear."

FINDING THE RIGHT MODEL

How to harness an internal capital markets capacity in the wealth management sector remains a key issue for universal banks, says Seb Dovey, head of consulting at wealth management think-tank Scorpio Partnership.

Although there is a desire to make the links work, packaging up or refining investment banking elements to make them commercially viable to wealthy clients presents a sometimes insurmountable challenge. "At times, it seems a little like investment banking is the HAL computer, when all the private bankers want is the equivalent of a Samsung tablet," he ventures.

Yet Mr Dovey is convinced wealth management groups can survive and provide a healthy service to private clients, in both the high and ultra high net worth individual spaces, without an investment bank imbedded in the group structure. The likes of JP Morgan and Citigroup claim banks cannot succeed in serving the wealthiest clients without an integrated model.

"The fact that two banks take this line does not mean the entire industry must follow," says Mr Dovey. "The difficulty often lies in mixing up too many different segments and model approaches in one context."

A client with \$100m (€73m) to invest has very different investment needs to one with \$10m, he believes. "But often they are served in the same group or talked about in the same breath."

'The further we move away from the crisis, the more likely the urgency to make these changes will disappear'

Kaha Kiknavelidze, Rioni Capital