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PRIVATE BANKS NEED TO RETHINK THEIR BUSINESS MODELS

Most institutions in the wealth management markets have experienced a decline in assets under management in the last year, and so have much lower revenues than were anticipated. Many are reviewing their business plans, and making adjustments to operations to get as near to acceptable financial performance as possible, but few are reconsidering the underlying business model being used. In particular, few institutions are asking what value the institution adds over excellent relationship managers with technology and the ability to procure services. If this question is not thoroughly addressed, large institutions will face new competition and erosion of their relationship base. In this article, I set out some of the key questions to address in determining how institutions add value.

The risk that medium to large institutions face over the next year or so is that they only make small adjustments to the existing business, perhaps deferring or reversing aggressive growth plans, rather than taking this opportunity to rethink the overall business model used for the wealth management market. Such adjustments include changing RM/client ratios, trying to take relationships from introducers, or initiatives to cross-sell to existing clients. Most of these initiatives have implications which are seldom considered at the outset.

The working assumptions appear to be that many of the underlying drivers of growth for the wealth management market are still valid, and what is required is that they 'hunker down' until the markets return. Implicit in this assumption is that the market will return at some healthier level, but in a similar form to previous, and business will continue as before.

First, it is unlikely that markets will simply return to pre- 'Lastminute.com' levels. Despite reports that the numbers of wealthy people will continue to grow, especially from certain segments such as sports and media, there is a lot of evidence that people are not keen to return to straight equities as an investment vehicle, and that the equity-based model of wealth management—which delivered returns during much of the 1990s, now looks dated.

The sustained depression on volumes should encourage PCAMs to take more urgent action.

However, whatever the **level** of the markets, there are several reasons to believe that **the market environment will be different** from the last 'bull run', in a number of ways.

- **Clients do not feel they have had good advice.** In many instances, clients feel that a model based on direct equity investments has not served them well, that equity oriented relationship managers need to broaden their game,

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and that 'brand' does not count for much if you've lost 30% of your wealth. So even for clients that are disposed towards equities, the incumbent institutions will carry some baggage, and at the very least will find difficulty with a cross-selling pitch for more assets.

- **The old equity market 'value' proposition is under pressure.** If hedge funds have achieved something, it is to question the value proposition offered by many active asset managers, ie that the level of activity, rather than returns, justifies the fees. No doubt hedge funds will restructure and evolve, but it is conceivable that the middle ground between index-tracking and hedge funds will become occupied by other, more active approaches to asset management, with a clearer relationship between cost and value delivered.
- **Competition is encroaching.** Various forms of professional adviser are building their own positions. In the affluent markets, IFAs (or rather IFPs) are building fee-based service propositions for clients in the £500k - £2m range which consist of wide-ranging financial advice and portfolio management priced to lever the firm's purchasing power. In the HNW markets, the tax accountants and lawyers more frequently occupy the 'Trusted Adviser' role, and certainly preclude the private banker/CRM from any notion of being the lead adviser.
- **Applications are favouring smaller firms.** Many of the new developments are focused on front-end applications, which offer more functionality than hitherto, and reduce the dependence on existing back office systems. PCAMs can now build functionality backwards from the customer and, if required, source back office functions from utility providers. Many large PCAMs are still struggling to integrate their legacy systems, but the economics of providing good customer-facing functionality now favour smaller, customer-focussed business models.
- **The industry structure is changing.** Sourcing is becoming more prevalent as web services become more reliable, whether it be for stock-picking, funds supermarkets or back-office functions. At first glance this can be seen as economic expediency - to cut costs or to add functionality at lower investment. Strategically it sets the conditions for specialization of the business around a narrower range of functions to build excellence. In practice, it prompts for a decision on where the institution will seek to build excellence.

One outcome from considering the future is to pose the question **how does the institution seek to add value to its clients over a network of relationship specialists with technology and a capability to procure services?**

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The provocation for large institutions is to contrast the institution with an assembly of specialist teams who excel at what they do, and contract, in a market context, with others as suppliers, customers and collaborators to provide a service to end clients. This is only a logical extension of what occurs in some contexts already: a family office works with lawyers and accountants, banks, trust companies, asset allocators, risk managers, investment analysts, fund administrators and stock-pickers to provide a service. If any link in the chain is weak, it can be replaced.

In other markets, institutions with brands package services for clients using the capabilities to hand, and charging in order to earn a return on capital. Weak links here may not be noticed, and cannot easily be changed. The challenge is that increasingly, these models will need to justify the economic rent they are charging, above the value that is delivered to clients.

There are several questions which can be used to generate some alternatives.

What economic rent is feasible? What will drive fee levels, and can current rates be supported? Must the existing business take the market rate, or can it charge a premium over market rates, and design a business that can generate ROI?

Where does the institution have real expertise? Where should the institution define its boundaries, and should it seek to meet all its clients' needs or provide a specialist part of a broader proposition offered with or through other firms?

The larger firms are likely to feel limited in the extent to which they can concentrate on a small part of the value chain, and may see themselves in the role of utility supplier. However, this requires a dramatic shift in mindset and new management and selling skills that will take time to develop.

On the buy side, large institutions have, in theory, more purchasing power, and so should get better deals from sourcing arrangements, but purchasing is a lowly profession, only recently arrived in financial services, and so such advantages may be slow to come through.

Can the institution attract better people? Large firms can attract talent, but often they have to pay for it. Their strength is that they may have the scale in key functions like asset management that support a talented team. In other areas, such as relationship management, the firm may not add much value to an experienced person who has clients.

The nub of the issue is likely to be participation in ownership, and geared rewards.

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Can the firm offer a superior client proposition? The nature of the service or product offered will be a crucial source of differentiation and will drive the firm's economics, but from a client perspective, personal relationship, and the nature of the guidance and advice given can be key.

The nature of the **advice** offered to clients, if any, is at the core of re-thinking the service offering, because it represents the extent to which the institution is prepared to address the client's real needs versus its own best interests. It also shapes the economics and the approach to in-house, or sourced manufacture. Large firms may have a conflict here, as they seek to routinise their processes, sell their own products and reduce their own exposure to risk.

The **tangible service** also plays a role. New product forms are emerging – fund structures, managed accounts, tax wrappers and so on, which have advantages in terms of tax efficiency, operating cost efficiency, performance measurement etc. which offer value to clients. These are as likely to be offered by specialists, on a market/wholesale basis and not be originated in the larger firms, except where very specialist capital markets expertise has been deployed such as in single equity position hedging, or where a large balance sheet is required.

Can they gather assets more effectively? Few asset gatherers are thorough in gathering new clients' assets, and RMs stay within their comfort zone of managing existing clients and building 'share of wallet'. Given the developments in the influencer/introducer behaviours, PCAMs would do well to put more effort into the marketing and sales process, supported by applications technologies, by focusing more determinedly on client segments generating new wealth and their other advisers. This is a route open to large and small alike, but the larger firms' brands may count for something.

The large retail banking PCAMs can, in theory, attract assets more easily than rivals, but that is not a point of value-added for clients.

Can the institution deploy technology to better effect? Larger firms most often have legacy issues which leave them disadvantaged if they wish to offer integrated services and reporting, or if they wish to evolve their service rapidly. Moreover, in the larger institutions, the business people and the IT people are more likely to have divergent agendas and perhaps less effective communication processes.

Nevertheless, the large firms can invest more heavily in front end applications, automate their back-end processes and invest in integration technologies to transcend legacy issues, but they will also have to consider the more complex cultural change that will also be required.

Does the institution offer better security? It might be asserted that larger firms are more secure, but it is likely that the scale effects occur at modest scale,

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and that there are diseconomies of scale, ie that large firms become so diverse and complex, that the compliance task becomes ineffective and costly.

What does the brand signify? At core, the well-known names provide a form of reassurance to clients, introducers and to staff that makes the larger PCAM effective in some parts of the process of managing wealth. This reassurance counts for little when performance is poor, and in the meantime, can hide some inadequacies. . Again, there are many smaller firms with excellent names in their fields, and brand value is frequently attached to individuals or to teams.

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It is likely that only a few institutions will take the opportunity to make a thorough review, to challenge their underlying business model, merely change the cost base of the existing one. The others will rely on the view that most clients will not move unless something **very** serious happens, and since most of their revenues are annuity-like, the 'hunker down' approach will be effective. From a shareholder perspective, however, that is not an attractive stance, since it will not be optimizing the investment made in the PCAM business.

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