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Private banking, a dip or a spiral?

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Money is jurisdictionally ambivalent. Money does not care about the number of days of sunshine. Money does not prefer a sandy beach or judge the quality of the restaurants. Money does not play golf, own a yacht or charter a private aircraft. Money does however move.

According to the Jersey Financial Services Commission, the number of banks in Jersey declined from 42 to 33 between the end of 2013 and the end of 2014. Total deposits fell by just over 5% in the same period and are now in excess of 1/3rd down from their pre-crash high. Guernsey's decline, whilst less pronounced, also shows a long term fall with deposits dropping 18% between March 2012 and September 2015 and a reduction in the number of banks from 35 to 29. In Gibraltar comparative figures are not currently publicly available but the significant downscaling of Barclays, the departure of Norwich & Peterborough and the decision by Credit Suisse to divest their operations indicate that the story there is not dissimilar. The Isle of Man appears, according to the IOMFSC's annual report, to be bucking this trend with an increase in deposits between 2014 and 2015 although this was preceded by a larger decline the previous year.

Yet this comes at a time when the global assets of the major private banks are growing due to increased wealth in the emerging markets. So what is happening? Is this a short term phenomenon reflecting the ongoing impact of the banking crisis or are we seeing a long term trend away from the use of traditional private banking, in the smaller, particularly (but not uniquely) European, international financial centres?

I say "not uniquely" because the European pattern is not unique. Cayman had 193 banks by the end of the third quarter 2015, compared to 234 at the end of 2011 and 198 at the end of 2014. However in Cayman's case it is important to remember that the jurisdiction continues to be ranked the sixth largest banking centre in the world, based on the value of cross-border assets with US$1.365 trillion (June 2013: $1.503 trillion) and fifth in terms of cross-border liabilities $1.347 trillion (June 2013: $1.487 trillion).

This article will argue that, for a number of reasons, the decline is not temporary but rather that the nature of private banking in these centres in undergoing a fundamental shift. This does not mean a terminal demise of the sector but rather its adaptation. This is an adaptation which will have winners and losers on both a bank and a jurisdictional level.

The article focuses on private banks which, for the sake of clarity, are banks which provide financial services such as wealth management for predominantly high net worth individuals. This includes financial planning, tax advice, brokerage and portfolio investment. I am therefore not referring to the domestic banks in these centres. These have different dynamics and a greater resilience. An example of this has been the new Gibraltar International Bank which opened in May 2015 and which, despite a limited range of initial services, had opened over 5000 accounts and gained over £120m in deposits by the year end.

The reasons for the downward trend in private banking fall into three core areas, external environmental (such as FATCA and the Savings Tax Directive), economic (including changing attitudes to risk) and innovation (such as the growth of the family office and the ability to consolidate in fewer

jurisdictions). There is a fourth reason, which is the loss of trust in the banking sector due to the plethora of scandals, such as those relating to LIBOR and FX. However this has, in the main, increased the sectors vulnerability rather than led to a contraction itself.

Let me begin by stating the obvious. The development of much of the "offshore" private banking sector was originally driven principally by the exchange controls that, at the time, existed in the UK and elsewhere, together with tax, or rather the reduction, avoidance and evasion of tax. To deny this, would be both untrue and unbelievable. Therefore, once international initiatives such as the EU Saving Tax Directive and US FATCA began to bite, the ability to use private banking to hide assets vastly diminished. As a result part of the deposit base was either repatriated (some under various countries tax amnesty arrangements) or remitted onwards to less cooperative jurisdictions.

Furthermore, the complexity, cost and potentially punitive sanctions, particularly of US FATCA meant that some banks chose to simply close their doors to citizens and residents of certain countries rather than risk the chance of an accidental infringement. This risk minimisation not only resulted in a downturn in the existing volume of business but also cut banks off to new business from those areas which previously could have been used to smooth the natural ebb and flow of customers generally.

The resultant hit on profits led on to the second causal factor, economics. Banks began to react by centralising functions such as fund administration. Whilst this primarily affected staffing rather than the size of the book, some centralising did have a greater effect. One was the geographical segmentation of clients. Under this, specific offices were given sole responsibilities for clients in a certain location (eg Latin America). Offshore offices, which historically had a geographically diverse client base, found themselves limited to client relationships solely emanating from certain countries. This further undermined their profitability. Inter office rivalry exacerbated this in some banks, as larger offices in bigger centres sought to protect their position by poaching business from their smaller contemporaries.

As I mentioned earlier, the major growth in private banking is now outside Europe. Therefore, with segmentation, the need for a presence in the smaller European international financial centres is even more questionable. Where is the advantage of servicing Brazilian clients out of Jersey, when London is far easier to market to potential clients as a financial centre?

To this must be added the shrinking of many bank balance sheets. Modern minimum capital requirements have resulted in banks studying closely their profitability and margins in wherever they operate. If capital held in a subsidiary is unusable due to regulatory restrictions, why not close the subsidiary and release the capital to somewhere where it can be used?

The increased regulation over the last eight years has resulted in direct (regulatory fees) and indirect (additional compliance staff and systems) costs spiralling. Operating in multiple jurisdictions in turn multiplies these costs. Where returns are falling these costs have an impact on an institution's decision to remain in a location. Similarly, when its clients can be equally served through fewer locations, an overly zealous or inefficient regulator can lead a bank to decide that a continued presence in a jurisdiction is no longer in its interest. Individually these factors are insufficient but the combined affect can make small increases in cost or frustration with the regulatory approach tipping points.

After the crash clients attitude to risk also changed. Whilst this would have benefitted those banks whose profits derive from lending deposits (and therefore could be seen as less risky), private banks derive the majority of their income from client transactions and the fees this generates. As clients now held more of their assets in safer instruments, so the volume of transactions decreased and fee income dropped. Whilst this was cushioned to an extent in those places with no stamp duty (and therefore remained attractive for the transactions which did continue), the negative effect was inevitable.

Turning to innovation, whilst crowd funding and shadow banking have had a limited impact to date, the growth of the family wealth office is proving material. These offices will use a multitude of banks and portfolio managers and will move between them to benefit from comparatively small margins. They are also more likely to challenge fees than an individual wealthy client did when the bank itself acted as his or her "wealth manager". The impact of this is likely to increase with the development of "multifamily" offices, servicing several clients.

Innovation also makes centralisation easier. As clients expect less physical contact with their banker, so activities can be done at remoter distances. A client transacting his investments online is unlikely to know (or even care) if the server and administrative support are in Basel or the Bahamas.

Collectively all these changes have presented a continuous wave of challenges and have resulted in the declines detailed above. The figures do not reveal the extent of the decline which is attributable to private banks rather than other types, but concluding that it is significant is a reasonable assumption.

Looking forward the picture looks no better. The EU Common Reporting Standards Directive comes into being in 2016 (replacing the Savings Tax Directive and UK FATCA) and the OECD Common Reporting Standard ("Global FATCA") will cover those clients untouched to date. This will create further costs, especially as US FATCA will remain and there are differences between the two.

There will be more regulation generally, some of it ill thought out, all of it costly, which will also place further pressure on banks to centralise still further.

It would be reassuring to end on a positive note, to conclude that the impact is temporary and the historic adaptability of smaller centres to change will overcome the challenge. Well, the centres themselves will adapt, they will develop new products and services, and they will continue to play an important role in the global financial community. For private banks however the picture is grimmer. In the years ahead they will be smaller and located in fewer locations. Their services will be sold at finer margins. There will be more mergers. Some of the banks will develop new profitable lines, for example by growing their institutional client base. But in this area, like others, they will have to compete with other financial institutions in a way they did not have to historically.

In the end the ones which flourish will be those who can remain relevant in the changing financial landscape. To do so will require a renewed emphasis on the quality and added value of the service they give to their clients and to prove that they have once again earned their clients trust and remember how important it is to keep it.

The views expressed above are those of the author and are not intended to represent the opinion of any organisation of which he is a director or officer.