CAPCO

ESSENTIAL SUCCESS FACTORS IN LAUNCHING A FEE-BASED CLIENT ADVISORY

Private banks face challenges on multiple fronts in the form of flat revenue growth, falling margins, and client defections to banks with better digital footprints. Even more pressingly, declining levels of client activity and changing investment attitudes threaten the traditional business model of private banking.

Many banks have been looking to reverse this trend by offering differentiated service models. While fee-based advisory service offerings have been available in the market for clients, they were mainly offered by boutique investment advisors. During the decade after the financial crisis, several large bulge bracket banks in Switzerland started offering such services. Other international and regional private banks have followed suit, rolling out their own versions of fee-based advisory.

So, given the myriad features, pricing models and client benefits offered by different banks, what constitute the essential elements for this advisory model to succeed?

SINGLE ALL-IN FEE SCHEDULE

The prevailing private banking advisory model remains based on transactional advisory, especially in Asia and other emerging markets. While advice is marketed as free to clients, the cost of that advice is bundled together in the products that are subsequently sold to the clients. As a result, clients view investment ideas as a value-add and possibly complementary to their own, but are often suspicious of hidden product commissions.

In a fee-based advisory model, private banks can achieve the goal of unifying advice and products under a single fee schedule. With a clear all-in fee schedule, investment advice and products are perceived by clients as one unified service. Clients are more inclined to accept the service without having to worry about potential conflicts between free advice and commission-based products.

TRANSACTIONAL ADVISORY

FREE SERVICE:

- Advice
- Investment ideas
- Portfolio reports

CLIENTS PAY TRANSACTIONS:

- Product commissions
- Trading spread
- Tax and duties
- Banking services
- Custody services

ALL-IN FEE BASED ADVISORY

SINGLE AND ALL-IN-FEE:

- Advice
- Investment ideas
- Portfolio reports
- Banking services
- Custody services
- No product commission
- No trading spread
- Absorbed taxes and duties

PRICING TRANSPARENCY

Since the 2008 financial crisis, clients' distrust toward complex investment products has grown due to obscure costs hidden within the price of products. The perceived lack of transparency in the commission structure of the traditional transactional advisory, and the misalignment of incentives between advisors and clients, has raised the question of whether advisors are meeting their fiduciary duty.

Whether mandated by regulators or demanded by clients, a commitment to improving transparency in service pricing is already evident. Fee-based advisory achieves that enhanced transparency and makes client's interest the first priority, but it must be implemented on the basis of certain first principles. Private banks adopting this solution must aim to:

- Explain the all-in fee structure upfront;
- Remove any commission structure that pays the advisor from product sales, e.g. removing equity trading commission, offering trailer-free funds;
- Offer products without additional spreads, e.g. remove bank's FX spread, bond spread;
- Absorb third-party cost (e.g. taxes, stamp duty, exchange levy) into the all-in service fee;
- Eliminate any unforeseen costs.

Without the conflict of interest arising from product sales commissions, clients will perceive the all-in fee structure directly with the benefit of this advisory service model. Clients' confidence improves and banks can achieve better profit margins.

SEGMENTED PRICING STRUCTURE

Banks which currently offer fee-based advisory typically design their multi-segment pricing structures on the basis of internal cost or manpower effort. It is observed that different tiers are derived from:

- frequency of client contact and portfolio review;
- availability of buy, sell, or switch investment ideas;
- portfolio risk monitoring and simulation;
- access to dedicated investment specialists.

Instead of product designs centred around internal profits, banks should offer this service based on client needs. In respect of those needs, banks have identified two categories of client that are attracted to this model:

- In the first category, clients do not have full faith in discretionary management. So although they do rely on investment advisors to monitor their portfolios, they still want to retain control and have the final say in every decision. They prefer a simplified fee structure, which allows them to retain the benefit of making every decision.
- The second category of clients believe they possess better investment skills than the bank, but are still willing to pay for an investment partner and to tap on the bank's research and ideas to complement their own.

When targeting a diverse range of potential clients, it is advised to highlight the different characteristics of products and services offered in each segment. To protect margins, banks are advised to run simulation models to determine the optimal all-in fee structures for each pricing segment.

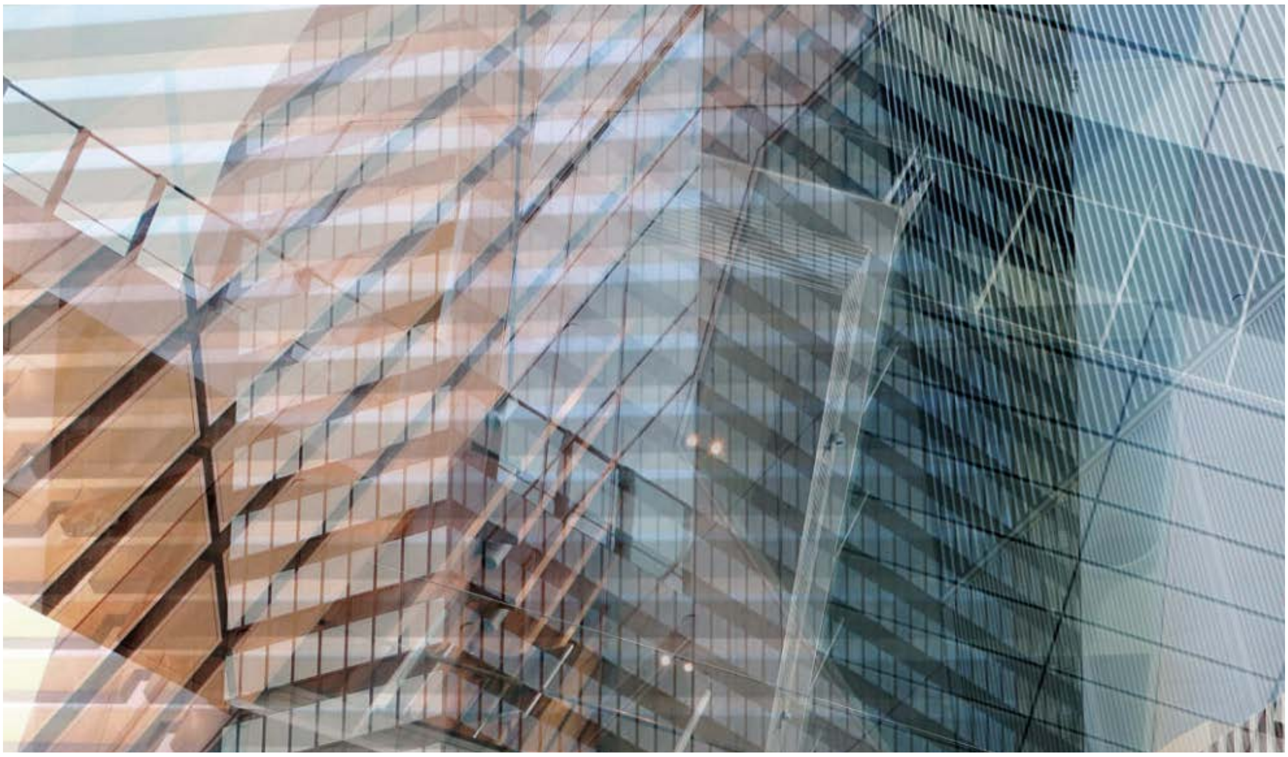
GOAL-BASED PORTFOLIO CONSTRUCTION

With a fee-based subscription model relationship, clients expect a higher and more consistent quality of service offering compared to those offered on a transactional advisory basis. This enhanced quality needs to be apparent from the very beginning of investment process, namely when constructing the investment portfolio.

The prevailing offerings by private banks continue to be asset-based within the constraint of a client's overall risk tolerance and capacity. Assessing a portfolio mix typically starts with client profiling questionnaires and restrictions, asset class preferences and risk tolerance levels. The client would then select a major asset allocation from a pre-defined list of models based on various risk levels, with the ability to amend the asset class weights to a degree. The asset classes would then be broken down to sub-sector classes or to economic regions prior to clients selecting individual assets. This asset-only approach ignores the liabilities in the client's life balance sheet.

Clients tend to have many goals across their lifetime, and each has its own time horizon and risk tolerance. For instance, a medium-term goal of funding children's college education in seven years' time will have very different characteristics from a retirement portfolio that will be accessed twenty to thirty years hence. These life-event goals form the implied liabilities within the life balance sheet of a client. Given the time horizon and various risk and return expectations, each goal should be served with a separate portfolio. Hence, wealth advisors need to identify the client's preferences for risk and return for each particular goal, rather than use their overall risk profile.

For a fee-based advisory solution to serve the client's actual needs, the portfolio construction process should integrate the implied liability at inception. Only after the goal-specific risk constraints and return expectations are clearly articulated should the process continue on to asset class and asset product discussions.



PERIODIC MONITORING AND REVIEW

Many fee-based advisory solutions offer periodic portfolio reviews. These differ across competitors in terms of the frequency of monitoring materials sent to the client, the breadth and quality of portfolio indicators covered in the review material, and the frequency of direct client contact with advisors. Accordingly, clients within different pricing tiers may be offered a review quarterly or semi-annually; may have access to static portfolio health indicators or dynamic scenario and sensitivity-based stress testing; and may have scheduled monthly or quarterly advisor contact or in some cases be offered that facility on request.

For fee-based advisory to be an effective offering, it is recommended that advisors utilize the monitoring and review to support the client's ongoing relationship with the bank, identify any new implied client liabilities due to changing needs, and enforce the service-oriented relationship (rather than commission-based product sales model).

LEVERAGE ON DIGITAL CHANNEL

There is no question that fee-based advisory solutions must leverage the digital channel in serving client needs in our connected world. Some banks provide dedicated digital channels for clients of fee-based advisory, while others leverage their existing digital banking platform. Technology capabilities may differ among banks, but any strategy involving digital channels and direct human interaction needs to be clear cut from the outset, so that those channels effectively complement each other rather than confuse clients. For those banks that are still behind on the technology curve, their priority should be to eradicate the teething issues, focus the improvement on client experience, and ensure the efficiency of information delivery to the clients.

In the lifecycle of advisory communications, information delivery to clients is part of the one-way communication, and may cover:

- client statement and letters;
- trade confirmation notes and advices;
- investment proposals and product idea offerings;
- voluntary corporate action selection;
- portfolio monitoring and periodic health-check reports.

These services should leverage an efficient digital platform, enabling the client to receive and act on the information without the need to contact the advisors. For example, when an urgent risk breach occurs in the portfolio, the digital platform alerts the client and suggests options, which the client can directly execute without additional human interaction.

Advisory services should increase the digital footprint by simplifying, standardizing and publishing their services to digital channel. This frees up the two-way communication between client and advisor to focus on issues when emotional or judgemental decisions play a key role. Depending on the pricing segments and the needs of the client, either a single advisor contact or an additional investment specialist channel can be the point of contact.

KEY TAKEAWAYS

Fee-based advisory will get the vote of some private banking clients. In order to distinguish itself from the competition, offering a service with transparent all-in fee structures is the right place to start. Segmented pricing tiers and a goal-oriented investment process are both key to developing scale and quality. In the digital economy, having an efficient digital channel has become essential to complement the established advisor-client relationship.

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