Structural Analysis of the Swiss Private Banking Industry

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Prof. Dr. Urs W. Birchler
Dr. Christian G. Bührer

Daniel Ettlin

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Executive summary

The Swiss wealth management industry has been facing a host of different challenges in the recent years. Political pressure on banking secrecy and the international fight against tax evasion have called the traditional offshore business model into question. At the same time, the market downturn in the course of the financial crisis has significantly reduced the earnings base of Swiss private banking institutions. Unsettled by the strong drop in security prices in 2008 and the high degree of uncertainty in the markets, clients have shifted their assets towards low risk/return products and strongly decreased trading activities, thereby setting wealth managers' margins under pressure.

Having this highly dynamic environment in mind, this thesis pursues three distinct goals. Firstly, the impact of the latest turbulences on the industry shall be analyzed on a descriptive level and under consideration of possible performance differences between small (Assets under management (AuM) of less than 10bn CHF) and large (AuM of more than 10bn CHF) institutions (1). Secondly, an in-depth analysis of dynamics and cross-sectional dependencies of key performance ratios shall be performed in order to enhance understanding of success factors in private banking (2). Thirdly, selected analyses focusing on the period 2007 - 2010 shall provide additional insight into the state of the industry and allow for statements to be made regarding its future perspectives (3).

Goal (1) is achieved by defining a methodological framework for the analysis of key performance ratios in private banking. Using accounting data for 88 Swiss private banking institutions, the relevant indicators are analyzed for the years 2004 - 2010. Results illustrate that assets managed by Swiss private banks dropped by 25% in 2008 and have not found back to their pre-crisis level by year-end 2010. The decrease in AuM was accompanied by a significant deterioration in gross margins which fell from 75 basis points in 2007 to 61 basis points in 2010. As a result, per capita revenues dropped sharply and caused median cost/income ratio to rise from 66% in 2007 to a historically high level of 79% in 2010. Banks with AuM of less than 10bn CHF reported a median cost/income ratio of 85% and thus significantly underperformed their larger competitors (77%) in 2010. Data envelopment analysis (DEA) is applied to measure banks' relative efficiency in transforming inputs into output. It is thereby shown that the share of efficient banks in the market decreased from 38% in 2007 to 31% in 2010.

In order to investigate the research questions stated in goal (2), fixed and random effects techniques for the analysis of panel data are applied. Pursuing an explorative approach, within-bank and between-bank dependencies for the key performance indicators net new money per AuM (NNM/AuM), adjusted gross margin on AuM, cost/income ratio and DEA efficiency scores are analyzed.

With regards to NNM/AuM, results show that banks following a business model with a strong wealth management focus and a broad range of own investment funds are more successful in attracting net new money than their peers. More generally speaking, private banking clients appear to prefer specialized institutions with strong skills in private banking practice and investment management, distinct market positioning and a wide range of in-house investment opportunities when choosing a bank to entrust their money. Potential conflicts of interest arising in the context of self-managed funds hereby seem to be of secondary importance. Once a relationship between bank and client has been established, wealthy clients, which commonly have their assets split across multiple banks, tend to reward the bank for positive absolute performance by contributing additional net new money.

Besides being growth drivers, in-house funds also prove to have a positive effect on gross margins. This effect is particularly significant for large banks, while small banks appear to have difficulties in achieving higher margins through the distribution of own funds. In terms of costs, it is worth to mention that the increase in attractiveness and asset profitability associated with own investment funds does not come for free. In fact, it can neither be shown for large nor for small banks that managing a large portion of client assets in own funds has a significant positive effect on bottom line results.

Next to in-house funds, discretionary management mandates, which account for roughly 25% of total asset volume, can be regarded as margin drivers. However, the margin difference compared to advisory and transaction-only mandates has decreased in the past years. This may be seen as a direct result of the resolute persecution of tax evaders in countries like Germany or Italy. Driven by the fear of being identified as tax criminals, many non-tax-compliant, typically less price sensitive, clients with discretionary offshore mandate have withdrawed their money in the past years, thereby cutting off a traditionally highly profitable field of business for Swiss private banks.

In-depth analysis of size effects in private banking shows that size is not the only criterion when it comes to the distinction between efficient and inefficient banks. In fact, a bank's back-office-to-front-staff ratio appears to play an important role in defining its level of efficiency. The higher a bank's share of revenues generated by front employees (e.g. portfolio and relationship managers), the better is its efficiency. While small banks which cover large parts of the value chain by themselves are in general predestined to show high back-office-to-front-staff-ratios, some institutions with less than 10bn CHF in AuM follow a cost-oriented outsourcing strategy. This enables them to achieve a competitive back-office-to-front-staff- and, as a result, cost-to-income ratio.

In terms of geographic reach, results suggest that private banks operating two domestic branches report higher cost/income ratios and lower DEA efficiency scores than other institutions. Thus, banks aiming for domestic expansion have to keep in mind the fixed costs associated with operating a branch network, which are on average only profitably invested if the network includes more than two revenue generating entities. Operating foreign branches in Europe or the rest of the world appears to have no significant impact on efficiency, profitability or success in attracting net new money.

Regarding future perspectives of the industry (Goal 3), it is shown that some banks proved rather resistant to the latest turbulences and successfully increased their scale of operations within the past years. These banks, which are on average relatively large, operate rather cost-efficiently and appear to be well prepared for the future. Other banks were exposed to significant margin pressure and experienced strong net money outflows. While some of these institutions successfully adjusted their business model to the new realities and therefore managed to keep revenues and costs under control, others seem to stick to old paradigms. These banks, which on average lost 11% of their 2007 AuM through net outflows between 2007 and 2010, did not manage to adapt their cost structure to offset the strong decline in revenues. As a result, their competitive market positioning worsened significantly and they reported weak efficiency ratios in 2010. Given the fact that abnormal cost/income ratios are rather persistent over time, it is unlikely that these banks will improve their competitive positioning in the near future. In fact, evidence is strong that they will not be able to survive on a stand-alone basis in an industry characterized by increasing regulatory complexity (i.e. FATCA, double tax treaties), increasingly demanding customers and stronger global competition.