1 Introduction

In this chapter we summarize the current challenges in private banking and explain why wealth managers need behavioural finance. The concepts and insights suggesting how to transfer the research results into practical solutions are discussed in great detail in the rest of the book.

1.1 THE PRIVATE BANKING BUSINESS

Private banking offers exclusive wealth-related services to high net worth individuals.[1] The term "private" refers to the more personalized and exclusive nature of the offer as compared to the mass-market services accessible for other individuals such as retail clients and also as compared to services offered to institutional clients.

Private banking services can be offered by any financial intermediary whose main activity is the supply of exclusive financial and advisory services to wealthy private clients. Such financial intermediaries call themselves either "private banks" or they have a separate "private banking" or "wealth management" department serving the needs of wealthy private clients.

Case Study 1.1: Swiss private banking

Many financial institutes all over the world provide private banking services, but Swiss financial intermediaries have an indisputable leading position. Private banking has been a Swiss competence for more than 300 years. Today, almost one third of the international assets under management are with Swiss private banks, which makes the country the principle platform for private banking.[2] With 9 % of global assets under management, Switzerland is also the third largest wealth management centre in the world behind the US and the UK.[3]

Several factors contribute to Switzerland's emergence as a leader in private banking. The country is famous not only for its neutrality and economic stability, but also for its liberal capital markets. In particular, private banking in Switzerland has a long tradition of confidentiality related to the Swiss banker's professional duty of client privacy.[4] Its outstanding reputation is also supported by the tradition of high-end services and committed staff. In Switzerland, a "private banker" is not simply an expert in a private

[1] Although high net worth is not defined, it generally refers to individuals with net worth greater than $1 million.
[2] See www.swissprivatebankers.com.
[3] See www.swissprivatebankers.com.
[4] The Swiss banker's professional duty of client confidentiality is rooted in Article 47 of the Federal Law on Banks and Savings Banks, which came into force on 8 November 1934.

Case Study 1.1: (Continued)

bank or in a wealth management department of a universal bank. The term refers to a specific definition in the Swiss Banking Law. In the words of Alfred E. Sarasin,

> "A private banker is an entrepreneur in the privately-owned banking sector who conducts his business using his own assets, assuming unlimited liability with his entire fortune and exercising his independent power of decision."

The Swiss banking sector plays also a very important role for the Swiss economy. At the end of 2005, banking balance sheet assets totalled 2.8 trillion Swiss francs, corresponding to six times the GDP of the country[5] and wealth management alone accounts for more than half of the banks' value–added.[6]

The long tradition in private banking has an important role for the success of Swiss private banks. In a recent study Cocca and Geiger (2007) compare different private banks in Switzerland and 10 other countries.[7] They find that Swiss banks surpass foreign competitors in Switzerland in profitability (compare return-on-equity ratios, ROE) as well as in operational efficiency (compare cost/income ratios in Figure 1.1).

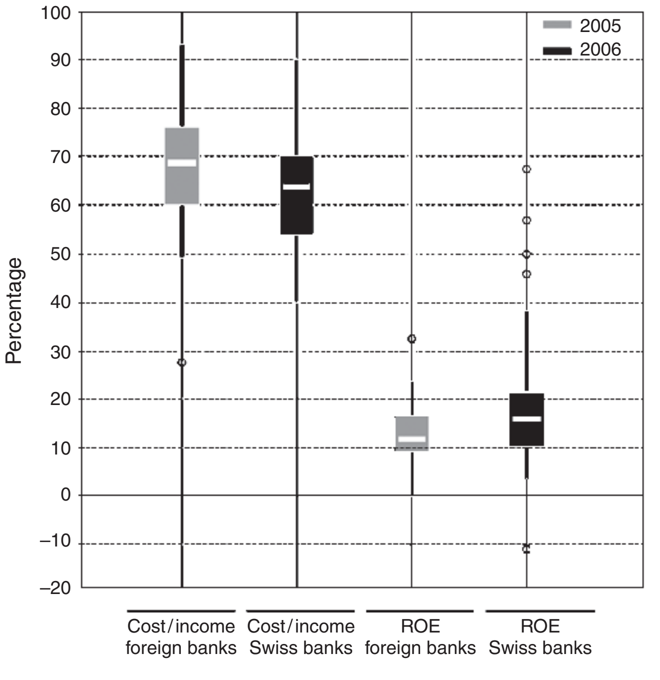

Figure 1.1 Efficiency and profitability of local and foreign banks in Switzerland

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[5] See www.snb.ch.
[6] See www.swissprivatebankers.com.
[7] "The International Private Banking Study 2007" by Cocca, T.D. and H. Geiger is available at www.isb.uzh.ch.

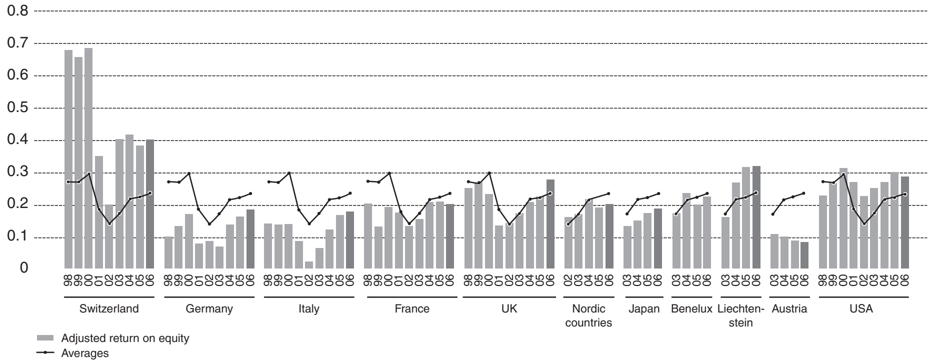


Figure 1.2 ROE weighted by the capitalization level of different countries

Compared to private banks in other countries, Swiss private banks are far more profitable. Their adjusted return-on-equity (return-on-equity weighted by the capitalization level of the country) remains far above the average for the last 10 years (see Figure 1.2).

On the one hand, the success of Swiss private banking in the future relies on external factors such as the Swiss banker's professional duty of client privacy, which recently has been under heated debate, particularly in the context of severe cases of tax evasion. On the other hand, the future of Swiss private banking depends on the banks' ability to keep improving the quality of professional services in a business where knowledge and intellectual advancement gain stronger recognition. To ensure the advancement of knowledge creation and of knowledge transfer for banks in Switzerland, the banking sector has created the Swiss Finance Institute, SFI, which supports the Swiss Universities in building up their finance departments to international excellence.[8]

As illustrated above, the Swiss business model belongs to the most important case studies in private banking. Other small countries like Luxembourg, Monaco, Austria, and Singapore, and even smaller entities like the British Virgin Islands, have already tried to emulate the Swiss model. Looking forward, however, there are some important challenges for all of them. While players compete aggressively, clients' expectations shift and regulatory pressures increase the need for financial centres to continue their transformation in order to sustain the growth potential of wealth management activities. The following section discusses these issues in more detail and argues that behavioural finance can help wealth managers to deal with them.

1.2 CURRENT CHALLENGES IN PRIVATE BANKING

In this section we refer to two recent surveys on private banking: The Global Private Banking/Wealth Management Survey 2007 by PricewaterhouseCoopers (PwC) and the World Wealth Report 2007 and 2008 by Capgemini and Merrill Lynch. The first one focuses on evaluating important industry trends from the perspective of senior management in private

[8] See www.sfi.ch.

banks, the second one surveys the behaviour of private banking clients. The main conclusion of these surveys is that private banking will probably continue to be a highly profitable business with strong growth. This is based on the observation that world wealth continues to grow despite fluctuations in markets and economic conditions. As clients demand comprehensive and tailor-made services, wealth managers are making strategic investments to differentiate themselves. In the resulting competition, the pressure on the firms to understand the essence of clients' needs and ultimately improve the quality of their advisory services is increasing. In this section we claim that wealth managers need behavioural finance to manage these tasks successfully. The rest of the book details the transfer of this knowledge into practical solutions.

1.2.1 Growth prospects

The business of private bankers depends ultimately on the size of the assets under management. Worldwide, there are 10.1 million high net worth individuals living predominantly in Europe (30 %), North America (33 %) and Asia-Pacific (28 %) (see Table 1.1). In 2007, the global high net worth wealth totalled \$40.7 trillion and is expected to reach \$59.1 trillion by 2012, growing at an annual rate of 7.7 % per annum.

Table 1.1 Total wealth of high net worth individuals worldwide (*Source*: Capgemini)

Year HNWIs	Total Million	Europe %	North America %	Asia Pacific %	Latin America %	Others %
1997	5.2	30.7	36.4	23.1	3.8	7.8
1998	5.9	31.0	36.2	22.4	3.4	7.0
1999	7.0	31.4	35.7	24.3	2.9	6.7
2000	7.0	35.7	31.4	22.9	4.3	5.7
2001	7.1	35.2	31.0	23.9	4.2	5.7
2002	7.2	34.7	30.6	26.4	4.2	4.2
2003	7.7	32.5	32.5	27.3	3.9	3.9
2004	8.3	31.3	32.5	27.7	3.6	4.8
2005	8.7	32.2	33.3	27.6	3.4	4.6
2006	9.5	30.5	33.7	27.4	4.2	4.2
2007	10.1	30.7	32.7	27.7	4.0	5.0

The growing pool of high net worth individuals means enormous profit potential for private banking firms. Most private bank players achieve net profit margins per asset of at least 25 basis points (bps) compared to net profit margins of 5 bps in the institutional asset management business. Table 1.2 gives an example from the annual report of Credit Suisse in 2007.

Given the profitability of the business and the increasing number of wealthy people, it is not surprising that private banking experts look ahead to strong industry growth. In the recent

Table 1.2 Wealth management versus brokerage (*Source*: Credit Suisse annual report (2007))

	Private Banking	Institutional Asset Management
Net revenues (million Swiss francs)	9583	2577
Cost/income ratio	59.6	82.2
Pre-tax income margin (%)	40.3	17.8
Gross margin (bps)	115	36
Net margin (bps)	47	5
Number of employees	14 300	3600

Wealth Management Survey by PwC, CEOs and wealth managers of 265 private banks expect the assets under management (AuM) in the industry to grow at 23 % per annum over the next three years. Surprisingly, both CEOs and financial directors expect their own businesses to grow at an even higher rate of 30 %. But how do the banks intend to fulfil these ambitious plans? Clearly, some of them either underestimate the growth potential of their competitors or overstate their own prospects.

1.2.2 Improving clients' experience and differentiation strategies

Overall, there are three strategies to increase the assets under management: through performance, through the acquisition of new clients, or through attracting new assets of existing clients. As the achievement of superior performance depends mainly on the advisors' view on the financial markets, which is not (and should not be) their primary domain of specialization, we focus our discussion on the last two strategies. The second strategy is probably more costly than the last one as the bank needs to hire and train more advisors who can take care of the increased number of clients. Hence, the most attractive growth strategy is the attraction of new assets from existing clients. Indeed, 96 % of the surveyed managers view increasing the shares of the existing clients' wallets as more important than gaining new assets through acquisitions, especially during the next three years. How can this goal be achieved? Clearly, banks need to convince their clients that there is no better placement for their assets. Hence, to gain a larger share of clients' wallets, banks need to improve the clients' experience and find a way to differentiate themselves from their competitors.

From the clients' perspective, the most important factor influencing them to stay with their wealth managers is the service quality. Furthermore, when choosing a wealth manager, high net worth individuals rely more on personal experience than on any marketing efforts. This suggests that wealth managers, who focus on the clients' needs when designing and implementing their advisory strategy, are expected to be more successful in improving clients' experience, thus increasing the share of clients' wallets.

Wealth managers see this point similarly. They perceive the difference among banks in the brand, the personal relationships, and the quality of the advisory services. In addition, the provision of a comprehensive, integrated planning approach is perceived as far more important than product development and investment performance (see Figure 1.3). In fact, as the wealth

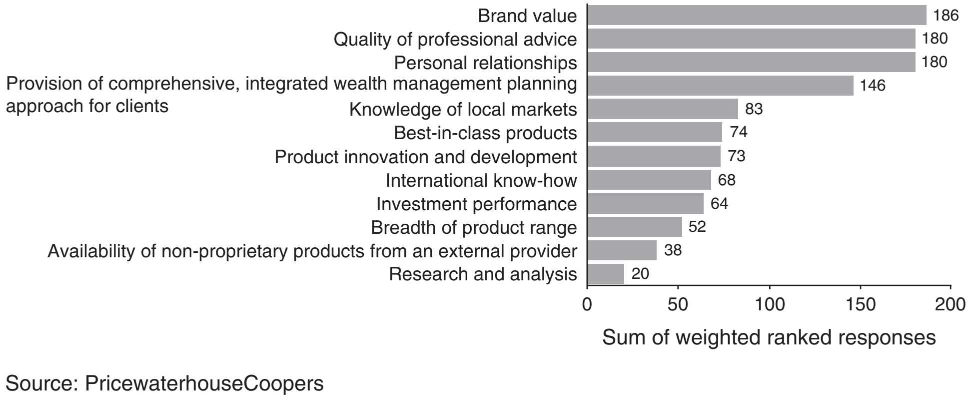


Figure 1.3 Differentiation drivers

management market matures and products are becoming more commoditized, differentiation strategies based on specific products are turning out to be less successful.

1.3 IMPROVING SERVICE QUALITY WITH BEHAVIOURAL FINANCE

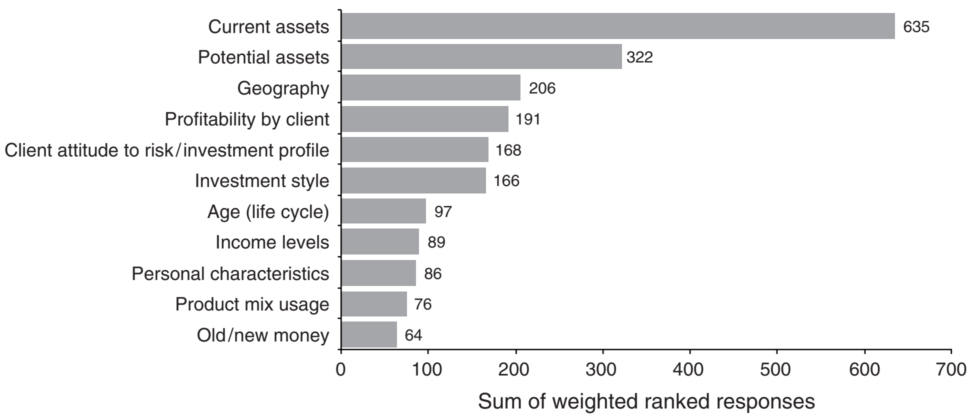
The recent surveys on wealth management and their clients point out a clear call for service quality along an integrated wealth management approach with a strong focus on clients' needs. Three factors play a significant role in its implementation: understanding, anticipation, and monitoring of clients' needs and behaviour. In the following section we also show that behavioural finance is of particular importance to them.

1.3.1 Understanding clients

In general, understanding the client means understanding the essence of his individual needs. Although needs are, by their nature, an individual circumstance and thus unique, most advisors try to reach a certain degree of standardization in order to keep the complexity of the advisory process low. One simple mechanism is to build different segments of clients. Clients within a segment build a homogenous group with similar needs and expectations toward the services of their advisor. Possible criteria are:

- geographic (e.g. place of domicile);
- demographic (e.g. income, education);
- psychographic (e.g. motives, ethical values, life style);
- client's profitability (e.g. assets, client's value);
- client's bankable assets (e.g. current and potential assets).

The most commonly used metric is, however, the current and potential assets as the PwC Wealth Management Survey documents (see Figure 1.4).



Source: PricewaterhouseCoopers

Figure 1.4 Segmentation criteria

While clients' wealth is important as a factor to help banks to differentiate clients and determine the intensity of the advisory relationship in each segment, wealth is less helpful to understand clients' needs and differentiate between clients' preferences. In fact, most economic models within traditional finance suggest the same solution for clients since preferences do not depend on their wealth. In other words, if the clients do not differ with respect to their aversion toward uncertainty, which is the main feature of their preferences, they should also receive the same advice independently on their wealth. Hence, to understand the clients' needs, advisors should take a closer look at the determinants of clients' preferences and the drivers of clients' financial decisions.

Clients' preferences are important in order to understand clients' needs because they determine how comfortable the clients feel with the outcome of a particular decision. Hence, knowing clients' preferences is important for advisors aiming to improve clients' experience. A crucial point thereby is the distinction between clients' decisions, which are driven by their preferences and those that are driven by psychological biases. This is also the reason why it is important for advisors to understand how their clients make financial decisions. At this stage, advisors can benefit enormously from the vast experimental and theoretical research in behavioural finance. Since the time when Vernon Smith introduced laboratory experiments into economics, experimental studies have amassed evidence that actual behaviour under uncertainty and risk contradicts the idealized behaviour postulated by traditional finance. Kahneman and Tversky have developed theoretical models of behavioural finance that can compete with traditional finance also on the analytical level.[9] Their prospect theory addresses the question of aggregation and segregation of assets, reference point dependent behaviour, loss aversion, asymmetric uncertainty aversion, and biased probability perception. A theoretical framework integrating these issues, such as prospect theory, provides a much richer foundation on which to assess clients' preferences than traditional finance models.

This perspective is important for establishing a link between the clients' needs and certain financial objectives because the typical perception is that traditional finance defines a rational benchmark, and all behaviourally motivated decisions of the clients are irrational. Hence, good advice is one that helps clients to reach this rational benchmark. However, this is not necessarily true. Some aspects of clients' behaviour are rational and other aspects are not. A good advisor helps clients make rational decisions, which are consistent with their needs and preferences but never forces them to accept the result of a theory that does not fit with the clients' understanding of a good investment. Once the advisors develop understanding on this important issue, they can continue with the next implementation step, i.e. the anticipation of clients' needs along a comprehensive wealth management planning approach.

1.3.2 Anticipation of clients' needs along the wealth management process

A comprehensive wealth management planning approach is seen by the managers as an important differentiation device (see Figure 1.3). As with every decision problem, its basic structure consists of the following three basic steps: assessment of the clients' profiles (needs, wishes, experience, financial strength), development and implementation of an optimal investment solution (in accordance with the clients' profiles), and monitoring of the match between the clients' profiles and the suggested solution. Thus, a planning approach can work as a differentiation

[9] In 2002, Daniel Kahneman and Vernon Smith received the Nobel Prize in economics for their extraordinary achievements.

device and serves to improve the clients' experience only if, in each step, the managers find the best way to define financial objectives based on clients' needs. This depends on two factors. The first one is the advisors' understanding of the clients as discussed in the previous step. The second one is the systematic acquisition and intelligent use of clients' information. This is of particular relevance for formulating investment advice that is not only theoretically correct but also optimal from the clients' perspective.

Behavioural finance provides clear advantages compared to traditional finance for managers aiming to reach this goal. The most important advantages are summarized as follows.[10]

First, traditional finance often works with overly simplified parametric models of risk attitudes such as the assumption that clients' risk aversion does not depend on their wealth. It is important to note here that this assumption does not follow from rationality considerations and thus cannot be used as an argument for using traditional finance as a rational benchmark. In contrast to this, behavioural finance develops a rich model of risk attitudes that is derived relative to reference points. Relaxing the assumption that the clients' risk aversion does not depend on their wealth, key aspects of behavioural finance – like loss aversion and asymmetric risk aversion – can be incorporated into a rational model.[11]

Second, traditional finance requires integrating all assets into one huge account so that a clever investor can always benefit from the diverging movements of the various components. An important aspect of behavioural finance is *mental accounting*. The basic idea of mental accounting is that the grand asset allocation problem can be split up into a couple of smaller problems across which the diversification may not be optimally adjusted. The question of whether mental accounting is irrational depends on whether the advantage of diversification is worth risking mistakes due to the increased complexity of the grand asset allocation problem. Additionally, the idea of mental accounting can be used to take into account the observation that clients may have particular financial goals. For these clients, an optimal advice does not maximize the overall performance of their portfolios as the traditional finance would suggest, but helps clients to make financial decisions that can be classified as optimal because they are designed to reach their predefined goals.

Finally, traditional finance has proposed variance as the unique risk measure. This is fine when markets are efficient and hence returns are normally distributed. However, the returns of stocks of individual firms or the returns of hedge funds, for example, deviate considerably from being normally distributed. Hence, other features of risk, in particular downside measures, come into play. Moreover, with downside risk measures like "Short Fall Probabilities" or "Conditional Value at Risk", holding more risk-free assets may actually increase the risk, if risk is measured as a fall below a target return that exceeds the risk-free rate.

These examples illustrate that the simple dichotomy that traditional finance equals rational finance and behavioural finance equals irrational finance, has to be taken with a pinch of salt. A good advisor will have to assess the various aspects of his clients' needs based on the background of the understanding that behaviourally motivated decisions are not always irrational. The advisor will then have to distinguish those aspects which are a matter of the clients' preference from those he has to correct because they are irrational and will be regretted by the client later on. This task has to be completed in each step of the advisory process in order to make sure that the clients' needs are anticipated extensively.

[10] The next chapter elaborates these points in more detail.

[11] Reference point based behaviour is not irrational when the reference points are given by aspiration levels and hence are determined by forward looking planning and not by backward looking considerations. This point is discussed in the following chapter.

1.3.3 Monitoring clients' behaviour

The final step of the implementation strategy is monitoring. Its aim is to supervise two features of clients' behaviour. The first one is the changes in clients' needs over time. Over the life cycle clients usually have different needs that have to be considered (e.g. marriage, children, house purchase, or unexpected job loss). Further, the needs of the clients might also change with the clients' experience with financial matters (e.g. after crises in the stock and mortgage markets). The second feature of clients' behaviour over time is related to its rationality. The rational benchmark is time consistency, i.e. clients' preferences should not change simply because the decisions are made at different points of time. In reality, individuals behave differently.

Behavioural finance provides useful insights into the drivers of time-inconsistent preferences and the determinants of individuals' financial decisions over time and over the life cycle. Using these insights, advisors will be able to help clients avoid irrational decisions and determine an asset allocation that is optimally adjusted to their changing needs over time. In particular, advisors will be able to judge whether it is wise to lock clients into investment products that adjust optimally over time and to determine how to design pension plans for clients with time-inconsistent preferences.

1.4 CONCLUSION

Private banking is a highly profitable business, which is expected to grow strongly with the increasing size of worldwide wealth. Looking forward, however, there is no lack of challenges. While players aggressively compete, clients' expectations shift toward higher service quality. The main success factor will therefore be the improvement of clients' experience by focusing more sharply on clients' needs. The goal can be reached only if advisors correctly understand what determines the clients' needs and drives their financial decisions. Clients' experience will barely be improved by guiding them toward decisions derived by nice analytical models but not necessarily motivated by rational considerations. Moreover, if advisors do not help clients to avoid irrational decisions, they are going to regret them and in their disappointment the clients may decide to withdraw their assets and change the advisor. Thus, an essential success factor in private banking is the development of an understanding of clients' behaviour. This understanding needs to be anticipated in all steps of the advisory process, from gathering the relevant information about the client to its intelligent evaluation. In fact, using clients' information in the wrong context is more dangerous than giving random advice as it generates potential for regret when clients face the result. Finally, clients' needs should be monitored over time as they are likely to change with the clients' life cycle and their experience. A failure to perform these tasks successfully will probably lead to a loss of clients to competitors in the mid- or long-term.

Behavioural finance provides valuable insights into the determinants of individuals' behaviour. These insights are particularly important for the advisor's understanding of his clients and the quality of his advice as perceived by the clients. The main reason is that not all psychologically determined decisions as documented by the behavioural finance research are irrational. Some of these decisions need to be taken seriously as part of clients' preferences; others need to be corrected because clients will regret them. This book helps the reader to understand the difference and to implement the knowledge gained in structuring the wealth management process in order to reach a solution that is in line with the clients' expectations.