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European Private Banks Still Face Uncertainty As Operating Conditions Evolve

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European Private Banks Still Face Uncertainty As Operating Conditions Evolve

Europe's private banking industry will remain in transition for the next two years, Standard & Poor's Ratings Services believes. Profit margins among the region's private banks have weakened amid regulatory and other challenges over the past several years, and we believe this trend will continue. However, we consider the banks able to cope with these conditions, as indicated by our ratings, which are firmly in the investment-grade category ('BBB+' or higher).

Nevertheless, we note that as governments step up their efforts to remove the veil of secrecy surrounding private banking, competition for assets under management (AuM) will likely intensify. What's more, the cost of complying with tighter regulation in the EU will eat into banks' earnings.

Overview

- In our view, Europe's fragmented private banking industry will face ongoing uncertainty over the next two years.
- The main reason is the changed operating environment, owing to tax-evasion issues, costs of tighter regulation, and weaker revenues as competition intensifies and client behavior changes.
- We believe the private banks we rate in the region can withstand these hurdles, supported by their superior capitalization.
- Future growth of the industry will likely come from strengthening client relationships, branding and risk management, and an increase in business outside Europe.

Four key factors will likely change the way European private banks do business in the future, in our view. The most prominent is European governments' increased efforts to eliminate tax evasion, which has significantly heightened uncertainty about private banks' future business models. We expect to see renewed pressure on banks, given proposals for a global standard on the automatic exchange of tax-related information by the end of 2015. This is also in light of Credit Suisse's decision this month to plead guilty in a U.S. tax-evasion lawsuit and pay a hefty fine.

In addition, we believe tightening regulatory requirements will increase banks' complexity, resulting in material investments in risk management and compliance infrastructure that push up costs.

The third hurdle is how to generate net new money in light of fierce competition for onshore business, resulting in further erosion of margins. That said, we believe offshore business growth could come from opportunities in emerging markets, such as Asia-Pacific.

We also anticipate a shift in client behavior that could make competition even tougher. Clients could become less loyal, especially among the mass-affluent market segment. We expect to see clients increasingly demanding comprehensive advice, higher net real returns, and simpler, more transparent products.

Tax Evasion Issues Will Increase Legal And Reputation Risks

We believe Europe's wealth management industry will undergo significant changes over the next two years as authorities tighten measures to prevent tax evasion. The Group of 20 industrialized nations' recent decisions support the Organisation for Economic Cooperation and Development's proposal for a global standard to exchange tax-related information by the end of 2015. In our view, its implementation will increase legal and political risks for banks operating in other markets that don't fully comply. That said, we expect financial centers like Switzerland, the U.K., Liechtenstein, and Luxembourg to remain major hubs for European private banking because of several banks' long-standing reputations with clients.

Authorities worldwide have been keeping up the pressure on Switzerland and Liechtenstein to relax their stringent bank secrecy laws. In particular, the U.S. Department of Justice (DoJ) is investigating allegations that certain Swiss banks might have helped U.S. citizens commit tax evasion. We understand the banks' activities complied with Swiss law, but not U.S. tax laws. Last year, Switzerland agreed to participate in a voluntary disclosure program with the DoJ, and we expect this issue to be resolved over the next two years.

Nonetheless, some Swiss banks could face legal action and fines, as in the case of Credit Suisse, which was recently fined $2.8 billion by the U.S. government. In our view, this raises some uncertainty about the bank's future client relationships and operating conditions. What's more, for banks still under investigation, the final costs and the implications for their reputations are as yet unclear. Consequently, we factor these risks into our assessments of Swiss banks' risk positions, but expect the private banks we rate to be less affected than other banks. In our view, the risks could be lower for banks that have already taken measures to avoid tax-related offences, such as Bank Vontobel AG.

Tightening Regulation Will Increase Business Complexity And Costs

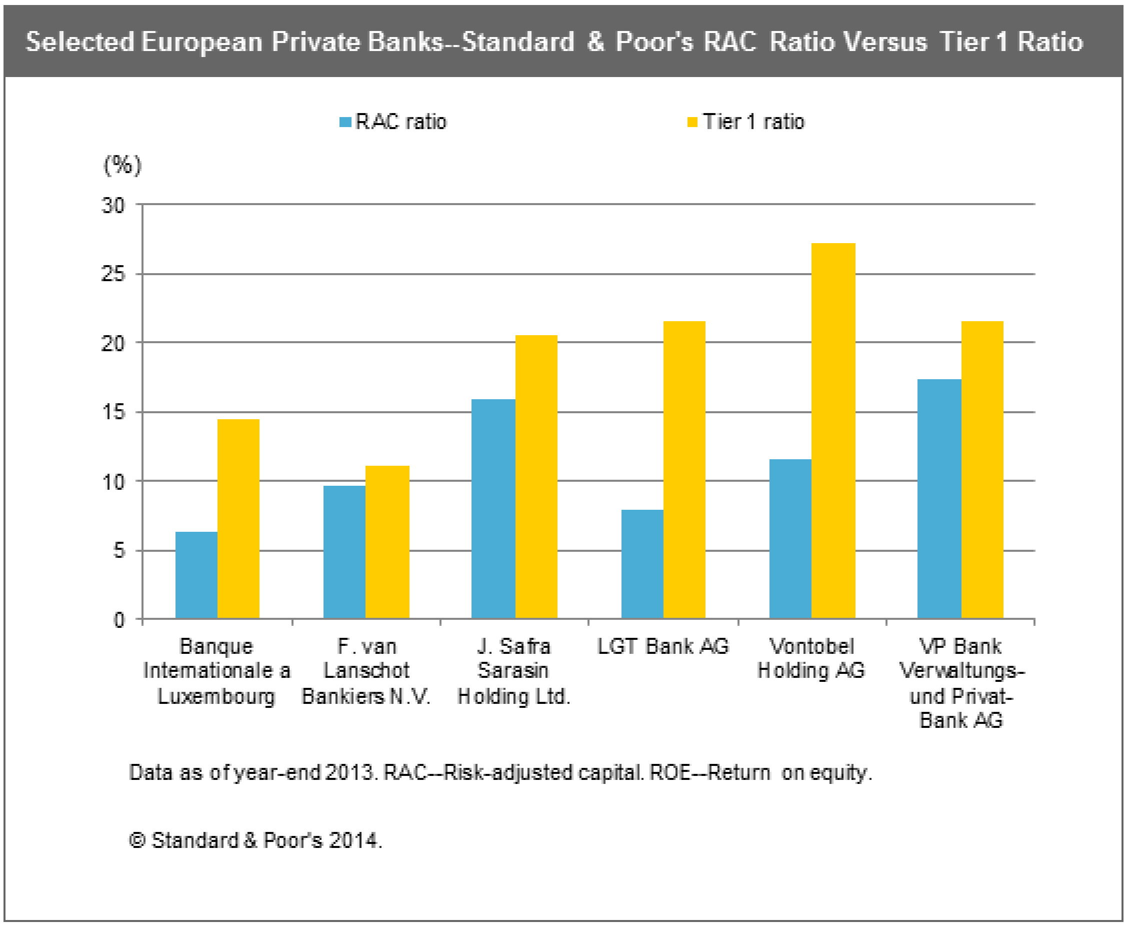
In our opinion, upcoming bank regulation across Europe will have a significant effect on the cost bases and future strategic decisions of private banks in the region. One example is the Markets in Financial Instruments Directive (MIFID) II, which we anticipate will come into force in 2016 at the earliest. As the successor of MIFID I, MIFID II aims to further integrate EU financial markets through increased transparency, investor protection, and controls.

What's more, the changes to ensure a higher level of security for investors will come at a cost. Private banks' operations will become more complex and therefore more expensive to manage. We anticipate that the resulting material investments in risk and compliance infrastructure could weigh on banks' future capital and financial stability. We also foresee more emphasis on cutting back office expenses to offset costs. The number of strategic bank partnerships to contain costs may also go up. VP Bank, for example, now shares several administrative and back-office functions with Liechtensteinische Landesbank, and other similar pairings may emerge.

On the other hand, European private banks we rate, particularly in Switzerland and Liechtenstein, have stronger capital levels than other private banks worldwide. Because private banks' business models are sensitive to investor confidence, the higher assessments reflect our view that the banks tend to maintain robust capital levels for reputation management. Moreover, we believe that, in many cases, historically strong legal and shareholder structures support banks' long-term stability rather than seek rapid returns, thereby aiding the buildup of equity buffers.

Nevertheless, our risk-adjusted capital (RAC) ratios are usually significantly lower than Basel II or Basel III ratios. This is because private banks face several potentially significant operational and reputation risks intrinsic to their wealth management operations. Our RAC framework therefore applies higher risk weights to private banks' off-balance-sheet AuM, leading to higher operational risk weights in our RAC calculations than under Basel II or III. Consequently, the RAC ratios for the six private banks we rate are much lower than the regulatory Tier 1 ratios, but still relatively high in a global context (see chart 1), which we consider a rating strength.

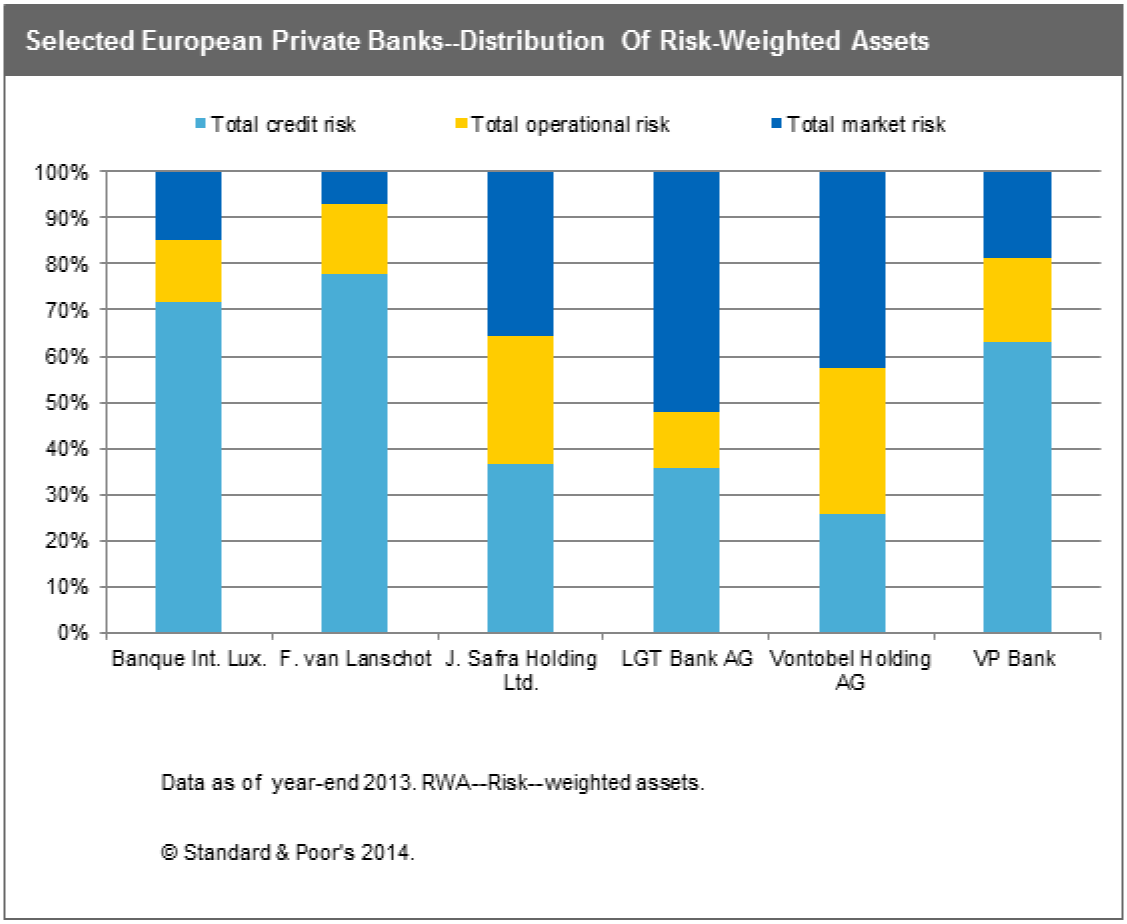
Chart 1



In general, we regard credit risk from private banks' lending activities as low. Most private banks' loan books are less sensitive to economic cycles because most of the loans are backed by securities. Our RAC framework does not fully capture the benefits from this kind of collateralization. Therefore, we incorporate it in a positive way into our assessment of a bank's risk position.

Nevertheless, private banks usually engage in complex financial transactions and face market risks that, in some cases, are more material than credit risk (see chart 2). Also, complex product structures and tailored products require considerable administrative and control functions, leaving banks susceptible to event risk. As a result, and considering the reputation risk inherent to wealth management operations, we don't usually classify private banks' risk positions as better than adequate.

Chart 2



Mergers And Acquisitions Could Increase As Net New Money Inflows Shrink

The ability to generate net new money to expand AuM portfolios is crucial for revenue growth in the private banking industry. But vulnerability to shifts in market sentiment exposes private banks to the risk of a sudden large outflow of funds in the current economic climate. For these reasons, we believe European private banks may increasingly seek mergers and acquisitions (M&A) as a way to expand, and to safeguard their financial position. We've already seen a few large M&A transactions over the past few years, among them the merger of Safra and Sarasin and the acquisition of Merrill Lynch's international wealth management business by Julius Bär.

However, in the highly fragmented Swiss market, in particular, we remain skeptical about any significant consolidation over the next two years. We believe many prospective buyers would avoid a costly acquisition because they would likely be wary of taking on undeclared client assets. In addition, few large and midsize European private banks have the financial capacity to participate actively in market consolidation.

That said, in light of unresolved tax issues, we expect that many small players could disappear from the European private banking market. One recent example is Swiss bank Wegelin & Co., which was indicted for complicity in tax evasion in 2012. Among other punitive measures, the U.S. government seized $57.8 million from Wegelin, leading to the bank's closure. For other banks, the increasing cost of regulatory compliance might outweigh the benefits of staying in business.

We Foresee Increased Spending On Client Relationships And Branding

Growth of AuM alone cannot ensure financial stability, in our view. Banks will have to strike the right balance between fee generation and cost containment to achieve higher profitability. And this will be increasingly difficult as clients have become more discerning over the past decade. The MIFID regime is therefore not the only driving force of greater transparency in the market.

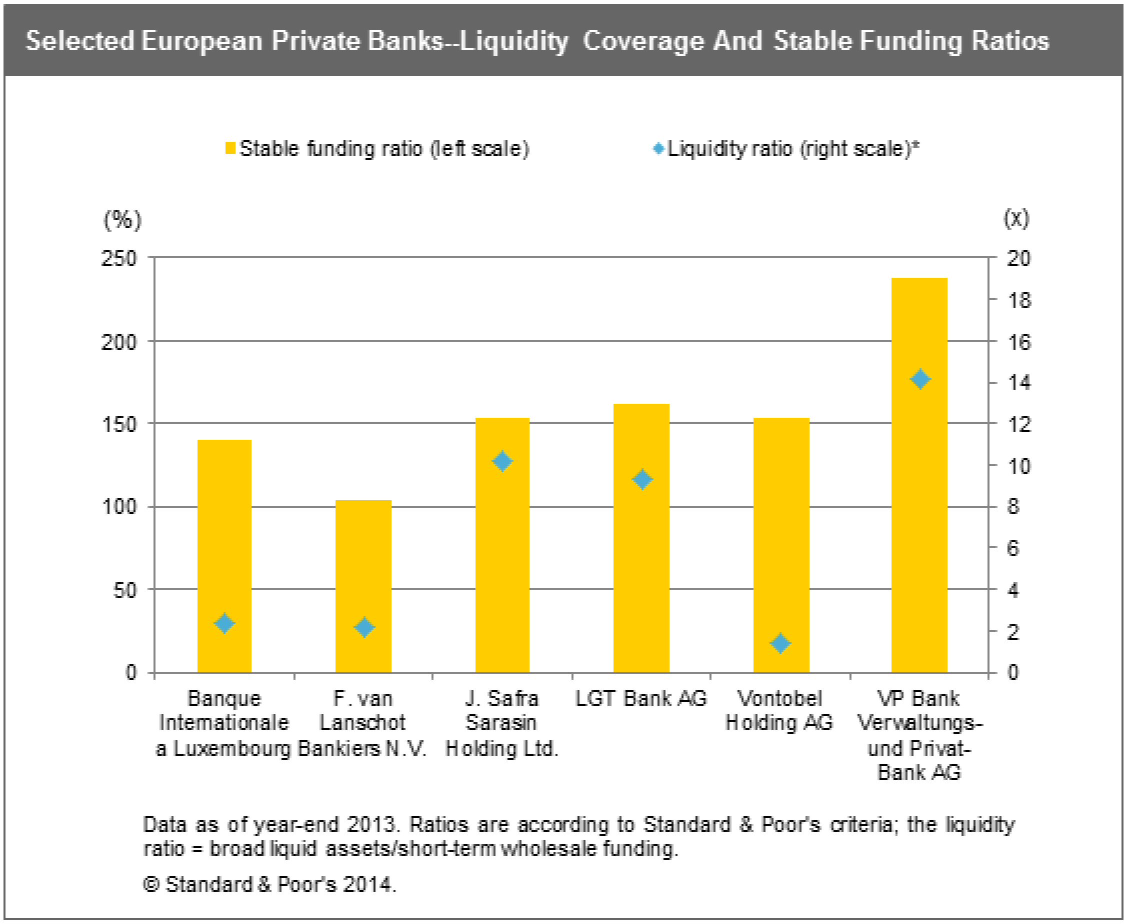
We've seen investors' behavior evolve and believe private banks will need to find innovative ways to cement client relationships. In our view, clients will increasingly demand clearly defined products and net positive returns, taking into account tax and inflation. Importantly, clients that have inherited or will inherit assets may be more investment savvy and keener to maintain tax-compliant accounts than their predecessors. Consequently, we expect the strong client loyalty private banks have enjoyed to diminish, adding to the pressure from competing banks.

As a result, we believe the European private banks we rate will continue to build on existing client relationships. This will likely involve investments in client service, less complex products, and a revamp of fee structures, mainly with the help of all-in-one fee and advisory models, especially in the high-net-worth segments. To maintain a competitive edge, the banks will likely invest material amounts in branding and services. In our view, these investments could boost the reputation of financial centers and thereby stimulate future growth of AuM. As an example, we see LGT Bank expanding strongly outside Europe, where Liechtenstein's standing and the bank's ownership by the princely family seem to play a crucial role in clients' decisions to place money with the bank.

So Far, Funding And Liquidity Are Not Under Threat

Overall, we envisage higher volatility of private banks' client deposits if capital market conditions improve and clients switch to other investments. Therefore, although our analyses show the private banks we rate to have superior funding metrics than those of many commercial banks, indicated by stable funding ratios at about 150% or higher, we usually assess their funding positions as only average (see chart 3).

Chart 3



The same is true for our assessment of the banks' liquidity position, which is usually nominally stronger than that of many commercial banks, but which we view as a neutral factor for the ratings. In our view, banks' liquidity depends heavily on clients' investment decisions, since a sudden shrinkage in client deposits might lead to a drop in their liquid assets. Nevertheless, we acknowledge that many private banks hold highly rated, liquid assets and have demonstrated access to the interbank market and repurchase facilities with central banks.

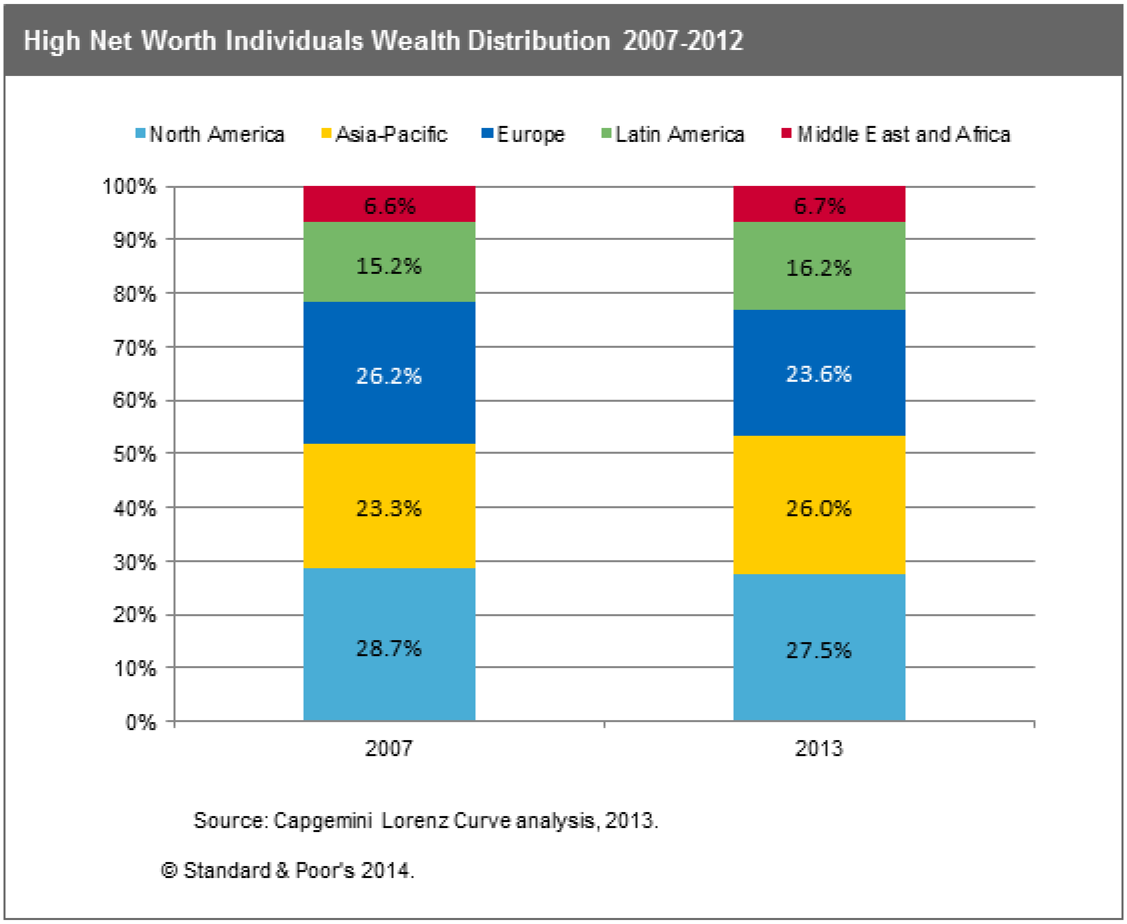
Ultimately, Size Won't Matter

Although all private banks focus on affluent and wealthy clients, there may be significant differences regarding client segments, markets, brand recognition, and operational efficiency. Although larger operations might be in a better position to weather the challenges ahead, they are not immune. In the private banking industry, brand name and reputation could mean the difference between success and failure. There is no quick fix for any of the problems these banks face, and only time will tell whether their strategies will be effective.

In our view, only banks that can achieve exceptional cost discipline and high efficiency will be able to cope with the increasingly complex and costly regulatory environment in Europe. Generally, we expect the larger European private banks to benefit from advantages of scale. However, the smaller, more exclusive players may be able to hold on to their profitable niche businesses.

Also, we think emerging markets in Asia-Pacific and Latin America will become more important for European private banks over the next few years, given increasing wealth in these regions (see chart 4). We believe investors there still regard offshore financial centers as safe havens.

Chart 4



On the other hand, we expect that tough economic conditions in many countries and continued volatility in the capital markets could dampen clients' activities, likely leading to even weaker margins for private banks and fiercer competition for onshore business. Small and midsize private banks will therefore need to consider whether they can service onshore clients cost effectively, if they decide to compete against the private banking subsidiaries of the large commercial banks.

We therefore expect private banks to continue to focus on maintaining good reputations, which alongside political stability in the financial centers should aid future AuM growth. In this regard, strengthening client relationships will become an important part of the banks' strategies for the next two years, in our view.

Appendix: Standard & Poor's Ratings On European Private Banks

The starting point for our long-term rating on a private bank, as for wholesale and commercial banks, is the anchor we derive from our Banking Industry Country Risk Assessment (BICRA) economic and industry risk scores. Because European private banks conduct little or no lending, their anchors represent our view of economic risk in their countries of domicile. Moreover, in our view, the geographic distribution of the banks' client AuM would not adequately reflect the economic risks for a private bank or wealth manager. For private banks with comparably larger loan books or substantial securities holdings in countries with higher economic risk, we may use a blended economic risk score, based on the geographic distribution of these exposures according to our criteria.

We rate six European private banks (see table). Each bank holds a banking license allowing them to take deposits and extend loans, and all are regulated in their respective jurisdictions. In general, Europe's private banking industry is quite fragmented, with few really large players, and the smaller institutions rely heavily on their reputations. We also rate many wholesale and commercial banks that have substantial private banking or wealth management operations, partly via dedicated subsidiaries. Such banks include Credit Suisse Group, UBS AG, and HSBC.

Standard & Poor's Ratings On European Private Banks

Rating factors	Banque Internationale a Luxembourg	Bank J. Safra Sarasin Ltd	Bank Vontobel AG	F. van Lanschot Bankiers N.V.	LGT Bank AG	VP Bank AG
Anchor	a-	a	a	bbb+	a-	a-
Business position	Moderate	Moderate	Moderate	Moderate	Adequate	Weak
Capital and earnings	Moderate	Very strong	Strong	Strong	Adequate	Very strong
Risk position	Adequate	Moderate	Adequate	Adequate	Adequate	Moderate
Funding	Average	Average	Average	Average	Average	Average
Liquidity	Adequate	Adequate	Adequate	Adequate	Adequate	Adequate
Stand-alone credit profile	bbb	a	a	bbb+	a-	bbb+
Country	Luxembourg	Switzerland	Switzerland	Netherlands	Liechtenstein	Liechtenstein
Systemic importance	High	Low	Moderate	Low	High	Moderate
Likelihood of government support	Moderately high	Low	Moderate	Low	Moderately high	Moderate
Potential long-term rating	a-	a	a	bbb+	a+	a-
Adjustment	0	0	0	0	0	0
Long-term rating	A-	A	A	BBB+	A+	A-
Outlook/short-term rating	Negative/A-2	Negative/A-1	Negative/A-1	Negative/A-2	Negative/A-1	Negative/A-2

Related Criteria And Research

Related criteria

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011

- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related research

- Credit Suisse Ratings And Outlook Affirmed After Guilty Plea To Charge Of Abetting U.S. Tax Evasion, May 20, 2014
- Switzerland-Based Bank Vontobel Long-Term Rating lowered To 'A' Following Government Support Review; Outlook Negative, May 13, 2014
- Liechtenstein-Based LGT Bank Outlook To Negative On Potential Government Support Reduction, 'A+/A-1' Ratings Affirmed, April 30, 2014
- Liechtenstein-Based VP Bank Outlook To Negative On Potential Government Support Reduction; 'A-/A-2' Ratings Affirmed, April 30, 2014
- J. Safra Sarasin Group, Dec. 19, 2013
- F. van Lanschot Bankiers N.V., Dec. 16, 2013
- Banque Internationale a Luxembourg, Nov. 20, 2013
- LGT Bank AG, Sept. 30, 2013
- VP Bank Verwaltungs- und Privat-Bank AG, Sept. 23, 2013
- Bank Vontobel AG, Sept. 11, 2013

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