

Introduction to Private Banking

Many savings associations offer “private banking” services with oversight provided by the trust department. These services may also be known as “wealth accumulation,” “wealth management,” “family wealth” or “private financial services.” For the purpose of this discussion, the term “private banking” will be used.

Private banking offers convenient, responsive and personalized service along with a special package of financial services designed to meet the credit and investment needs of individuals. In the past, private banking was exclusively for the very wealthy or for those seeking a safe haven offshore for their capital. It is now undergoing a massive change from a once quiet and discrete service to a highly dynamic and competitive business. Today’s private bankers are dealing with very active money, as shown by an increased movement of money from onshore to offshore.

There is no typical private banking client but generally they can be divided between the old-line, wealthy families (the traditional private banking customers) and the “nouveau riche,” that is, self-made millionaires who have profited from mergers and acquisitions, the dot.com revolution, lotteries or the real estate boom. After a decade of unprecedented economic growth, this second group is larger and more attractive as potential customers. The business of handling and managing personal wealth is growing between 15 to 20 percent each year.¹

The relative stability of client revenues and the lower level of credit risk is elevating private banking to the top of the financial industry’s list of target markets. The offering of these services is no longer the exclusive domain of large commercial banks. Competitors now include investment banks, thrifts, insurance companies, lawyers and accountants. Not only is it easier to make a profit on the large sums of money involved but private banking customers tend to remain loyal to trusted advisers.

Private bankers are starting to prepare for and cater to, a new generation of private investors who want to participate in the management of their money and receive high returns from diversified investments. The transformation of the client base is forcing private bankers to offer new investment packages and services. Clients want brokerage services, advisory services on investments, stock options, taxes, margin loans and off shore havens. They want quick and easy ways to obtain credit, advice on how to transfer money to family or nonprofit groups, checking accounts and other typical banking services, along with estate planning and trust services. These clients also increasingly want all these services in one place. Private banking has become a place where the wealthy have access to expertise on all lines of financial services as well as an elevated level of personal service. The goal of the private banker is to satisfy the needs and objectives of each client in the context of their life. The private banker not only offers advice on how to create and grow wealth, but also on how to protect, preserve and distribute wealth.

Private banking clients look for advice from people who deal with other wealthy individuals. Rather than having multiple bank representatives deal with a customer, a single private banking representative, commonly referred to as a relationship manager (RM), delivers most, if not all, of the private banking services to the client. The RM is the client’s primary contact and provides a high level of support and service to the client. The RM is generally charged with understanding and anticipating the needs of the client and recommending services and products. The RM strives to provide a high degree of confidentiality, support, service and investment opportunities while maintaining long lasting, strong relationships that provide a stable

¹ The Washington Post, November 26, 2000, H01, “The Private Banking Boom”

stream of fee income to the private banking institution in good times and bad. Because of this close relationship, clients often delegate a great deal of authority and discretion to the RM.

A major concern to the private banking operation is that RMs may take accounts with them if they change employment. Another is the shortage of knowledgeable individuals whose education, sophistication and personality make them successful private bankers. Adapting to the clients' changing expectations and tastes is also a major concern. The new breed of client not only wants expert advice and service but also wants to retain a tight grip. They want to be more directly involved and not just write a check. These clients need legal and financial advisers to not only assist with traditional tax problems, but to advise on nontraditional situations such as whether to take stock or cash during a buyout or whether to use derivatives to hedge against a fall in a stock's value.

Traditionally, clients learned of private banking services by word of mouth. As competition for these clients has increased however, financial institutions are using very specific marketing strategies such as seminars, advertising on web sites and in upscale magazines and even direct mailings to reach the market. Forming alliances with attorneys and CPA's is proving fruitful as are referral programs with affiliates and retail bankers.

Overview of Private Banking Products and Services

Private banking accounts may be opened in the name of an individual, a commercial business, a law firm, an investment advisor, a trust or a private investment company (PIC), among others.

Private banking products and services typically combine the wide array of commercial/retail banking services with services offered by the trust department. Some private banking products and services are described below.

Deposit Taking Activities

The private banking client's deposit account typically serves as the foundation of the relationship. It usually serves as the conduit for the client's money flow. The client's deposit account minimums and the fees assessed for retail banking services are generally much higher than those for a typical retail/commercial customer, as the private banking client will be provided a higher level of customer service.

Private banking often provides a broad range of deposit services that include check writing, deposit taking, withdrawals and wire transfers. A private banking customer may also need multi-currency deposit accounts if engaged in foreign securities and derivative trading activities involving foreign currency exchanges.

Credit Facilities/Activities

Private banking clients frequently request secured or unsecured credit to finance personal and business activities. Credit vehicles may include mortgages, lines of credit, letters-of-credit, bills-of-lading and credit cards.

Margin Loans

These types of loans are prominent in private banking operations. Margin loans are loans secured by margin stock. Margin stock encompasses equity securities, convertible debt or mutual funds that are registered or have unlisted trading privileges on a national securities exchange, or any OTC security designated as qualified for trading in the National Market System.

OTS chartered banks involved in margin lending are subject to registration and reporting requirements with the Federal Reserve and have certain lending restrictions. The Federal Reserve has opined that Regulation U applies to the activities of a bank/thrift when it is acting in its capacity as a trustee. If a savings association extends either \$200,000 in margin loans in any calendar quarter or maintains credit outstanding in any calendar quarter totaling \$500,000 or more, it must file Form FR G-1 with the Federal Reserve. For each credit secured by margin securities, the lender and the borrower must fill out Federal Reserve Form G-3 and the lender must maintain a collateral list for three years after the credit is paid off. The bank must file Federal Reserve Form FR G-4 at the end of each calendar year.

Funds Transfer

This service involves the transfer of funds from the private banking client to third parties, typically as part of bill-paying or investment services. Transfers are executed on the basis of client instructions.

Hold Mail

Private banking clients who elect to have financial statements and other documents maintained at the savings association rather than mailed to their personal residence may utilize a private bank's "Hold-Mail" or "No-Mail" services. These services should only be provided when an agreement is in place between the institution and the client that indicates the exact nature of the service and when the client will pick up the mail (at least annually). The "Hold-Mail"/"No-Mail" services may also include the delivery of the client's mail to some prearranged location.

Investment Management

Private banking typically provides both discretionary and nondiscretionary investment management services. In a discretionary situation, the RM, a portfolio manager from an affiliate or an investment officer of the savings association is assigned the task of managing the private banking client's portfolio. The RM, portfolio manager or trust investment officer buys and sells securities for the client based on established investment objectives that the client has established. For nondiscretionary accounts, the RM, portfolio manager or trust investment officer may render advice to the client or simply act in accordance with instructions received from the client or the client's third-party asset manager. At no time does he have discretionary authority over the client's investments.

Personal Trust and Estate Services

Trust and estate services may be an integral part of the private banking relationship. The savings association may serve as the executor or administrator of the client's estate or may be appointed by the client to act as trustee under a trust agreement or will for individual or charitable purposes. These relationships are often complex in nature and require special expertise to administer.

Custody Services

The saving association will also offer custodial services to private banking clients. These services may include securities safekeeping, as well as recordkeeping and accounting for the receipt and disbursement of dividends and interest. In a custodial relationship the client instructs the institution with respect to the assets held and the custodian follows those instructions. The actual ownership of the assets remains with the client.

Stock Options

Often the private banker is involved with tax planning with regards to the client's current compensation. This is especially true when the client has received large bonuses, awards or golden parachute payments as compensation. The private banker may be asked to lend advice or assistance regarding the tax treatment surrounding the exercise of stock options.

Web Sites

Savings associations are finding they have to invest heavily in technology to improve their administrative efficiency and provide private banking clients with new ways of receiving information. The client wants information quickly and accurately coupled with good, strong advice. A large segment of private banking clients want to use the internet to communicate with their bankers. Managing the blend of technology and old-fashioned personal service is probably one of the most important challenges private bankers face. The level of spending on information delivery through Internet services is not likely to decrease in the near term. Customers will start to shop around if private bankers do not provide the services they demand.

Payable Through Accounts

The payable through account, commonly referred to as "PTA," is a deposit account through which U.S. banking entities (payable-through banks) extend check-writing services to clients of a foreign bank. The foreign bank, the master account holder, opens a master checking account with a U.S. bank and uses this account to provide customer access to the U.S. banking system. The master account, maintained at the foreign bank, is divided into "subaccounts," each in the name of one of the foreign bank's customers, who may or may not be known to the U.S. bank. Consequently, the U.S. bank may have customers who have not been subject to the same account-opening requirements imposed on its U.S. account holders. These subaccount customers are able to write checks on, and make deposits at the U.S. banking entity. The number of subaccounts permitted under this arrangement is virtually unlimited.

Private Investment Companies (PIC) and Offshore Trusts

Private investment companies (PIC) and offshore trusts are often used by private banking to serve a client's global needs. These may be "shell" companies or trusts that are established in offshore jurisdictions such as the Cayman Islands, Channel Islands, Bahamas, British Virgin Islands and Netherlands Antilles. They are used to hold the client's assets and to provide confidentiality.

Private banking most often includes the above described services but may include additional services not listed here. All services offered should be governed by written policies and procedures and a strong system of internal controls.

Private bankers must use sound judgment and prudent banking practices, especially when they are assisting clients in establishing offshore vehicles. Establishing and following comprehensive policies and procedures are essential to minimizing the risks inherent in private banking. For example, the institution should

document that it has appropriate know-your-customer policies and procedures. Private banking departments should obtain information on each client and emphasis should be placed on verifying the source of the client's wealth. Policies should indicate the types of clients that the institution will accept and establish the level of authority needed to accept clients.

Client demands are forcing institutions to recognize that they cannot provide the best possible service if they try to do everything themselves. An increasing number are entrusting selected services such as account administration, investment management, custody and transaction processing to outside service providers. This has been one of the most significant developments in the private banking business in recent years. The increasing investment sophistication and the cost of transaction processing and back-office systems can pose an enormous constraint to private banking activities, particularly at smaller institutions. Private bankers are becoming aware that they have to offer the best available products and services even though they may not be from in-house resources. Outsourcing enables them to offer a wider array of products and services without investing vast amounts of capital. Most institutions are finding that costs are increasingly coming under the microscope of top management.

Management's Responsibilities / Oversight

Senior management of the private banking operation must establish a sound risk management and control environment and establish goals and objectives. They must also provide active oversight and create an appropriate corporate culture. Risk assessments should be an ongoing process and a separate compliance function should be established.

The savings association's board of directors should review the policies and procedures established for private banking on a regular basis. These policies and procedures, at a minimum, should address: know your customer concerns; offering of credit; documentation and due diligence; omnibus and concentration accounts; trust and estate administration (including estate and financial planning if these services are being extended); and monitoring and reporting suspicious-activity.

The savings association must also provide for adequate risk management and monitoring systems. Sound private banking operations emphasize information relating to the clients and due diligence where needed to verify information provided by the client or the client's representative. Systems should provide management with timely information necessary to analyze and effectively manage the private banking business, monitor accounts for suspicious-activity and report such activity to authorities as required.

Sound risk management processes and strong internal controls are critical to private banking activities. Management's involvement in ensuring the integrity of these processes has become increasingly important as new products and activities are introduced. The quality of risk-management practices and internal controls should be given significant weight in the evaluation of management and the overall condition of private banking operations. An institution's failure to establish and maintain a risk management framework that identifies and controls the risks associated with private banking should be strongly criticized, especially if the private banking operations are extensive.

The private banking function is exposed to a number of risks, including reputational, fiduciary, credit, legal, operational and market risks. Although effective management of all risks is crucial, reputational risk may have the most profound effect on the bank and its private banking operations. There is a potential that negative publicity concerning the bank's business practices and clients could cause a runoff in the customer base or costly litigation resulting in a large revenue reduction.

An effective compliance program should be developed for ensuring compliance with laws and regulations. Some institutions may have a distinct compliance department for ensuring compliance institution-wide while others may have a separate compliance function within each business line, including private banking.