Foreword – Upheavals in private banking

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The fundamental components of the private banking business model need to be redefined. All the players need to reconsider the basic elements of private banking: what type of customer, on which market and how to serve them. At the same time, the financial institution will also need to assess its own organisation to ensure that it is still suited to the new business model. This exercise is crucial to ensure the financial institution's survival. It is therefore an existential task which, in addition, will have to be concluded in a relatively short time. Some financial institutions have already reviewed their activity, but others are only just beginning this strategic exercise. In the lines that follow, we remind ourselves of the two causes of this upheaval.

This first is the new awareness of the significance of the risks associated with cross-border activity and the obligation to comply with regulations in target countries. Some countries have restrictive regulations that preclude prospecting in the customer's country or serving customers remotely, or indeed entering into a business relationship with a resident without having the appropriate licences for that country. This is also true when selling financial products: depending on the distribution method, both the financial intermediary and the financial product must obtain a licence in the investor's country.

These cross-border rules have existed for decades. The international agreements (General Agreement on Trade in Services (GATS) and relevant codes of the Organisation for Economic Co-operation and Development (OECD)) concluded in the 1990s did not succeed in removing these protectionist barriers. Quite the contrary, restrictions have increased over time, as evidenced by the European directives on the subject. Those active in the private banking sector know, of course, that each country where they canvass has its own rules about market penetration from abroad and that those rules can be very restrictive. Financial establishments have operated for many years without paying heed to these constraints. The often passive attitude of regulators both domestically and in the target countries has helped sustain the lack of concern shown by financial intermediaries. Further, the danger of being reported if the customer did not comply with tax regulations was low.

However, the attitude of the regulators changed abruptly following the 2008 financial crisis, particularly the UBS affair in the US. Banks and other financial intermediaries finally realised that breaking market penetration rules is an important risk that must be considered when defining the business model. The supervisory authorities responsible for these financial establishments also woke up to the situation. In October 2010, the Swiss regulator issued a paper asking the financial establishments under its supervision to take these constraints into account and in particular to define standards of behaviour for each target country. Other regulators have since followed suit. We are thinking in particular of the regulators in Liechtenstein, Luxembourg and Hong Kong.

Whatever the attitude of the regulator in their home country, most banks realised that they needed to mitigate regulatory risk and if possible seek effective institutional solutions (requests for cross-border licences that would allow them to target a country without having to set up a branch there or opening a representative office) or modify their operational methods, for example by avoiding active solicitation directed at certain countries or restricting their offer to specific services and products.

In addition to the purely regulatory implications (administrative sanction or criminal penalty decided by the authorities in the target country), violation of cross-border constraints sometimes affects the validity of contracts concluded with customers or investors. The financial contractual risk should not be ignored! Even when there is no breach of cross-border rules, it should be noted that, in some countries, customers could contest the jurisdiction fixed contractually as the place where the service provider has its head office and impose their own home jurisdiction, particularly if the activity targets their country. Finally, depending on the character of the solicitation, customers may take advantage of their own national consumer protection law, which relates particularly to the duty of information and the content of contracts. A service provider with an international customer base must therefore not only redefine its market penetration methods in the target country in the light of cross-border rules but, in some cases, adapt its contractual and informational documentation country by country.

The second cause is the tax question. The world is moving towards the automatic exchange of information between tax authorities. At the same time, almost everywhere tax evasion is becoming a crime that comes before money laundering. This being so, in the near future banks will or may only be allowed to have customers who comply with the tax rules. This change implies a new way of thinking about banking and private banking activity. A tax-paying customer will want tax optimisation solutions that are acceptable to the tax authorities in his or her country. The customer will therefore be looking for tax advice alongside the traditional financial services offered by private banking. The bank will therefore need to create a network of specialists to whom it directs its customers and who will be able to advise them on tax-compliant structures that meet their needs (trusts, insurance, etc.). Note that some financial markets, such as Luxembourg, are aware of this challenge, and thus are working to ensure that the country is in a position to offer such a dual service to wealthy customers.

A customer who pays tax then expects advice and wealth management that takes account of the tax impact of the financial products that are offered or included in the managed portfolio. The bank must understand their impact and examine whether it is better to serve the customer directly or only indirectly via structures (for example, insurance). Given the difference in financial products' fiscal impact from one country to another, banks must be aware that centralised management and producing single lists of recommendations for all customers will no longer be possible. If a bank is not capable of managing the fiscal impact, it will need to call on outside specialists. For customers in some specific countries, this should not exclude delegating management. The bank must also be in a position to deal with its customers' withholding tax refund claims in application of double taxation agreements. Here too the complexity of the task could mean seeking support from outside specialists.

Finally, the financial establishment will be obliged to provide customers with information that will allow them to produce tax reports within the timescales laid down by the legislation in their country. Buying or developing specially tailored IT applications seems to us to be unavoidable. Taken together, tax constraints raise the question of banks' ability to serve customers from a large number of countries. Here too, a redefinition of the business model as it applies to customers' country of origin seems necessary.

Rethinking the business model in the light of these two factors is a difficult process, which will also require heavy investment. But it has the advantage of giving the bank the ability to operate in a complex regulatory world. Financial institutions that engage in this strategic exercise will find themselves in a better competitive position than other market players. And, of course, a competitive advantage has no price…

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