

CREDIT WHERE CREDIT'S DUE

By David Maude

In the first of a series of articles adapted from his recent book, *Global Private Banking and Wealth Management: The New Realities*, David Maude looks at lending – a key growth opportunity for many private banks.

Surprising as it may seem, the rich are, like most people these days, in debt. Wealth and liquidity do not always go together. Indeed, demand for lending services is picking up, reflecting low interest rates, changes in asset and client mix, and greater overall client sophistication. For example, between 2001 and 2004, the debt of the wealthiest 1% of US households grew in real terms by 21% a year on average, according to Federal Reserve estimates.

Some wealth managers are old hands at the lending game, but many others have only just started to dip their toes in the water. This article puts forward the rationale for lending, describes the main types of products, and outlines some of the key practical issues for those players seeking to raise their lending penetration.

Rationale

Why should wealth managers consider adding a lending proposition? Above all, when executed well, lending to the wealthy has a very attractive risk-reward profile; losses are extremely rare. There are also three other important reasons.

First, a lending capability, and the associated capital commitment, is what many clients increasingly want and expect. This is particularly the case among entrepreneurs and the more active Asian and Middle Eastern clients. Hence, going forward, those players not offering this service will find it more difficult to acquire and serve these clients effectively.

Second, as part of a well-run credit due diligence process, the wealth manager gains a broader understanding of the client's balance sheet and objectives. That, in turn, offers opportunities to deepen the relationship. As Citigroup's wealth management CEO recently remarked, "A lending relationship allows you to understand the picture better. We find on average that if we give \$1 worth of loan, we get [over time] \$4 back in assets."

Third, lending is a highly effective client retention tool. It increases client loyalty and relationship stickiness, and is a further way for wealth managers to achieve trusted adviser status.

Credit Suisse was among the first private banks to push this facility, starting in the mid 1990s. EFG International is also particularly active, with lending representing around 10% of AuM as of mid 2006. Other examples include UBS, HSBC, Merrill Lynch and JP Morgan.

Lending penetration differs significantly across and within business models. Universal banks typically have relatively high lending penetration, linked to their large balance sheets, captive funding bases, and well-developed lending skills. Investment banks, by contrast, have historically been less willing and able to leverage their balance sheets in this way. Overall, top-performing players have managed to make lending a significant contributor to profitability, obtaining around 15% of their total revenue from lending, compared to around 3% at bottom-quartile players. This is a direct consequence of much higher product penetration, particularly among lower wealth-band clients.

Lending therefore represents a significant growth opportunity, particularly for non-universal banks. Julius Baer, under its new management, is a good example of a bank actively seeking to boost lending penetration. In the first half of 2006, its lending expanded at an annual rate of 20%, compared with AuM growth of 2%. Lending now represents around 5% of its AuM.

Lending Products

Typically, lending services cover two main areas:

1. *Lending to finance lifestyle purchases*, such as real estate, private jets, racehorses, art and yachts. Borrowing to buy big-ticket items can free up, or plug gaps in, cashflow. At heart, these lending products are largely conventional, though they are often heavily tailored or tweaked to give them a ‘HNW feel’. A typical product is the ‘jumbo’ mortgage. It is fairly common for clients to demand greater flexibility in repayment terms.
2. *‘Strategic debt’* – a range of collateralised loans and other private financing solutions. The most common and widely known facility is the so-called Swiss Lombard or margin loan. This can be used to bridge clients’ short-term liquidity requirements, and also for leveraging various asset positions. In addition, such lending can be used to diversify single-stock exposures. These loans are backed by pledging securities, bank deposits or other liquid financial assets. Income and any voting rights from the pledged assets are retained by the pledgor. Pledged assets can be switched at any time, subject to the lending limit. The loan can take the form of a revolving overdraft facility, or that of a fixed advance, and is available in most of the major currencies.

Other types of lending include loans for lawyers and partners in other professional firms to fund capital contributions. Another popular lending product is the humble credit card. But while most people these days qualify for gold and platinum cards, private banks have developed distinctive cards targeted at genuine HNWIs, often on an invitation-only basis. Typical benefits include concierge services, exclusive events and comprehensive travel benefits. These cards include the American Express Centurion card, the Stratus card (which offers clients the opportunity to earn free private-jet flights), and Coutts' World Signia card. One of the most exclusive is the Citigroup Chairman's card. Offered by personal invitation only, it offers access to any airport lounge and a free companion ticket for any airline ticket purchase. It was described by its wealth management CEO as "by far the coolest, sexiest card out there today. You want one."

A key feature of developments in the provision of lending products is the wider array of collateral that can be used to back such loans. Coutts, for example, has introduced a service for landowners that enable them to pledge a portion of land as collateral and draw down credit lines. Various banks now offer a host of lending services based on the valuation of illiquid assets – including art, livestock, property, family business wealth, etc.

Practical Guidance

There should, in principle, be almost no limit to the type of assets that can be pledged as security for such lending. The trick for wealth managers is to ensure that they have the expertise in valuing the often illiquid assets in question, and in assessing their own and clients' risk tolerance to such business. A key issue for private banks here is concentration risk, linked to large exposures to a relatively small number of individuals. The recent trend for banks to lend money to clients for hedge fund and private equity investments (which are, recall, highly leveraged themselves) represents another key risk. If a hedge fund goes into a steep decline, the bank could be forced to protect itself by liquidating the investment to pay back the loan. That could be costly for both the bank and the client.

Key pointers for those wealth managers seeking to add a lending capability to support or round out an existing proposition, or to develop a dedicated lending business, are as follows:

- Get the proposition right – bundled or otherwise.
- Develop the necessary infrastructure, including strong risk management (risk assessment, monitoring and reporting), and a slick application and approval process. JP Morgan, for example, is reported to have developed a patented system to assist it in its HNW lending decision making.

- Actively educate relationship managers on the benefits of lending. Lending has been known to take many RMs out of their comfort zones. The best performing banks therefore provide their RMs with dedicated training and may set formal penetration targets.
- Target clients proactively, based, for example, on a well-designed campaign. Pre-approvals, for qualifying clients, can also be very effective.
- More ambitious players should actively develop third-party channels – such as mortgage brokers, property companies and their marketing agents – subject, of course, to client quality.

* * *

Driven by client demand, lending is becoming a key component of any solid wealth management proposition. Lending complements the investment offer – and, when executed well, helps boost client acquisition, development and retention efforts in its own right.

David Maude is an independent consultant specialising in wealth and asset management. david_maude@lycos.co.uk