Private Banking Focused in Japan

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In Japan, domestic and overseas financial institutions are now on the way to reinforce private banking business. Domestic institutions that aim to improve commission revenues and overseas banks that hope to penetrate into Japanese market as well try to take affluent individuals as their client who have stronger needs for portfolio management under the continuous low interest rate environment.

Private banking business includes a wide variety of services, and strategies of Western institution are well diversified. This article introduces Western-style private banking business, examines latest movements, and explores its potential growth in Japan.

1. Domestic and Foreign Institutions Reinforcing Private Banking

Domestic and foreign financial institutions are on the move to reinforce private banking business in Japan (see Table 1). Not only city banks and trust banks, regional banks such as Chiba Bank, Shizuoka Bank and Musashino Bank are also heading, in a row, for setting up private banking department in their organization.

Some foreign banks, such as Citibank and Credit Suisse, have developed private banking business in Japan by themselves, while others seek to tie up with Japanese institutions. For example, one of main purposes of SBC's alliance with LTCB is to offer private banking operation for LTCB's customers who purchased its bank debentures. As well, French bank BNP intends to enter private banking business in Japan through cooperation with domestic financial companies.

Table 1. Major banks reinforce private banking business

Name	Description
Sumitomo Bank	*Established Private Banking Department in January 1997. *Increased the staff from 19 to 55 at the beginning of 1998. *Invited ex-Citibank planning director as executive director.
Fuji Bank	*Established Private Banking Department in May 1996 (with 3 staffs). *Target affluent customers with Yen 1 billion or more financial assets *Assumes medium sized corporate owners, lawyers and professional sports players to be customers.
Tokai Bank	*Targets affluent customers with Yen 100 million or more financial assets and/or those who have Yen 50 million or more annual income. *Adding portfolio management advisory to existing advisory services on inheritance, taxation, real estate administration and business succession.

Daiwa Bank	*Established Private Banking Department in April 1997. 60 Staffs at the beginning of 1998 *Targets to those who have securities worth of Yen 30 million or more and Yen 100 million or more financial assets, or Yen 20 million or more annual income. *Focuses on last will trust.
Yasuda Trust & Banking	*Established Private Assets Management Division in May 1997. Opened Private Banking Center to help branch offices in October. *Implemented "Unyo Monogatari" or wrap trust that accepts Yen 100 million or more assets.
Citibank	*Started private banking business in Japan in 1986. 120 staffs at the end of 1997（20 plus staffs at sales division where private bankers belong） *Yen 500 to 600 billion deposited assets. *Targets to those who have Yen 300 million or more net assets with Yen 100 million or more assets available for investment. *Highlighting time deposit with foreign exchange market condition as introductory product.
Credit Suisse	*Started private banking business in 1991. *Target criteria Yen 500 million assets. *15 private bankers（in October 1997）

Source: Compiled by NRI from newspaper reports, magazine articles and other sources.

2. Redefining Private Banking

1) Different Services

Private banking is to provide comprehensive financial services including portfolio management, tax consultation on business succession or inheritance, real estate planning for affluent individuals that have more than given amount of assets. Other services, such as selecting foreign school for customer's family, providing expert's opinion on artworks and antiques, and arranging business or private trip, are also undertaken on customer's demand.

However, the Western financial institutions in private banking business do not uniformly offer these services. The services offered are different according to the institution's scale or target customers.

Those who deal with private banking business in the West are largely divided into three groups: (1) private banking division of large banks, (2) medium sized banks that focus on private banking, and (3) small banks that specialize in private banking. The scale, dependency on private banking business, and operation details are considerably different among these groups[1].

Type (1) represents private banking operation of three major banks in Switzerland and that of large banks in the States and UK. Type (2) examples are Julius Baer Group in Switzerland and Coutts (now a subsidiary of NatWest) of UK, and U.S. Trust of the United States. Type (3) consists of partnership based private banks, many of which still flourishes in Switzerland (such as Pictet or Lombard Odier), and Brown Brothers Harriman in the U.S.A. The difference between these three types are well illustrated in the comparison of typical samples from Switzerland that represent the group respectively (see Table 2).

2) Different customer base

Customers of private banking services are also divided into three types: (1) customers with especially large assets, whose top priority is to keep their assets and focus on safety (Passive Super Riches), (2) Those who have large assets and actively invest them seeking for higher performance

1 Although there is a way to categorize them into two groups, a division of the bank with joint-stock corporation structure and organization and banks based on partnership, the author preferred to classify the institutions by scale and operation details.

Table 2. Three types of Swiss private banks

	SBC	Julius Baer	Clariden
Employees	4,300 （120 sites abroad）	1,535 （1,066 domestic workers）	288 （5 sites abroad）
Asset Management Income	SF 2.37 billion	SF 238 million	SF 96 million
Versus RP	22%	40%	70%

Notes: Above SBC employee figure is only for those working in private banking division.
Income includes the fees from asset management operation other than private banking.

Source: Compiled by NRI from respective annual reports.

(Active Super Riches), and (3) individuals who leaped into affluent group by making their own business public or executing his/her stock option (New Riches). In general, “Super Riches” are likely to have more than US$10 million worth of assets.

For the case of small banks that have a long history of specializing in private banking, such as Clariden, most of the customers are Passive Super Riches, who have been conventional customers of private banking business. This type of customers rarely includes corporate owners, while not a few of them are served for generations. These banks are not aggressive in obtaining new customers, with some banks even limit the new accounts to those who are introduced by existing customers, lawyers and tax accountants.

On the other hand, customer base for private banking division of large banks such as SBC or medium sized private banks including Julius Baer are relatively wide, as these banks are active in new customer development. In fact, the customers of their private banking divisions are supposed to be those who can invest Swiss Franc 250,000-500,000 (Yen some 35-45 million), that is not really high. These customers, however, are segmented by their total amount of assets, receiving different level of service as accordingly. In a Swiss bank case, those who want to apply discretionary account should at least have Swiss Franc 1 million. For those who fail to meet that requirement, the banks recommend them to diversify their assets by combination of several investment trusts.

Large banks, that also offers retail business, have their general requirements for target customers of private banking division, although the criteria are flexible. For example, private banking division may take care of a customer who fails to meet the minimum requirement at the moment, in the case that massive growth of his/her fortune is expected.

3) Different services

The above-mentioned difference in customer base naturally leads to different services.

Small banks that specialize in private banking, such as Clariden, do not undertake asset management for institutional investors. They do not provide corporate financing nor investment banking operation either, since they rarely have medium-sized corporate owners as their customers. Many of them refrain from proprietary trading, so that they can avoid potential conflicts with customer’s interest. Their core customer segment is Passive Super Riches, so they have strength in stable management, and some banks exclude derivative-driven investment from their menu due to high risk exposure. It is important for the banks of this type to provide additional services other than fund management or tax consultation. Request for additional services reflects strong connection between the customer and his/her bank, thus such request is considered as an evidence of customer's faith.

Meanwhile, medium sized private banks and large banks also provide asset management for institutional investors. As well, they offer mortgage and business loans for the customers of private banking business. As for medium sized banks that specialize in private banking, however, these financial services are just an extra operation for the customers of private banking business, which means that they may not be actively featured.

On the contrary, many large banks that offer comprehensive financial services take a strategy to strengthen synergetic effects of private banking and corporate finance for small and medium sized businesses owners.

4) Different administration system

As for small-scale banks, private bankers in charge of customer contact often take care of asset allocation or further operations. Large banks often adapt multiple manager system, where bankers in charge of customer contact and fund managers are separated.

It is noted that small-scale private banks do not insist on providing every possible type of investment measures; they employ outside fund management firms to meet their customer's request when they found that they have no strength in certain area of investment. For instance, Pictet source answered in an interview that they do not deal with hedge fund management by themselves, but monitor outside hedge funds so that they can introduce quality funds to their customers to meet their needs[2].

In contrast, large banks attempt to utilize their fund managers as much as possible.

3.Western Private Banking Changes

1) Performance-oriented customers are increasing

Historically, private banking business has developed by responding the needs of affluent citizens that want to protect their fortunes from wars, social unrest, drastic changes in politics, currency crisis and high inflation rate. Accordingly, it has been said that the essence of private banking business is not to accomplish higher performance in investing deposited assets but to conserve asset values.

However, increasing number of customer give emphasis to the performance recently. In particular, so-called the New Riches, who leaped into affluent group through the success of venture business in these days and benefits of stock option system, extremely emphasize the performance. Indeed, it is reported that some younger generation of Passive Super Rich group, who inherited the family's fortune, turn to seek for high performance in some cases. Moreover, many customers actively commit themselves in investment decision process, having their own information terminal devices to monitor .

2 "Private Banking, More than just champagne and peacocks", Euromoney, February 1998 issue.

2) Alternative investment spreads

In the circumstance where more and more customers actively invest their assets with focus on performance, it should be pointed out that alternative investment is getting in common use. Alternative investment is a new type of investment that is different from conventional investment measures or targets such as listed securities or government bonds. More specifically, it includes private equity financing, hedge funds and natural resource investment.

The customers need to invest in the assets that have less correlation to conventional investment targets, since risk diversification effect of international investment are diffused due to stronger correlation among major stock markets.

The customer needs for performance are also changing. In past, the customers were likely to measure the performance in comparison to the index. However, recent observation uncovered that some customers tend to seek for absolute returns, which is intact from entire market volatility. Since major stock market indices, in the States as well as in Europe, are hitting all time high one after another, many customers are afraid of stock price collapse. In turn, they focus on market neutral investment using derivative products.

Refinement of investment measures also contributes to the spread of alternative investment. In the West, there are hundreds of small portfolio management firms that attain high performance in specialized areas. Competition coupled with technical progress brings forward more sophisticated investment measures. These niche players are keen to promote themselves to private bankers with their successful track records.

3) Cutting additional services

In addition to portfolio management, tax consultation, inheritance consultation and real estate planning, private bankers offer additional services as a part of private banking operation, including selecting foreign school for customer’s family member, providing expert’s opinion on artworks and antiques, and arranging overseas travel. However, in these days, some large banks intend to cut these additional services as much as possible.

A private banker could take care of less number of customers when he/she is required to put more time to extra services. In principle, private banks are paid on commission for the asset balance under their management, and it appears that extra services are not subject to commission. This in turn means that more extra services lead to less productivity, which has negative impact to profitability.

However that may be, reducing extra services may invite adverse reaction by undermining long-term faith of the customers. As mentioned above, extra services are positioned as a part of key services at the small banks that specialize in private banking. Even large banks, although they are now on the way to cut extra services, are supposed to provide these services to the limited customers or the Super Riches.

4) Combination with investment banking operation

Recently, many privately owned companies are going public in the United States as well as in Europe. The banks expect stronger synergetic effects by introducing the New Riches, who became affluent by offering their shares for public subscription, to their private banking division. In order to address such environment, Chase Manhattan shifted their private banking division from retail department to corporate department. In the most recent cases, UBS and Credit Suisse moved executives in charge of corporate finance division to private banking division.

4. Profitability

Private banking business is highly profitable in terms of ROE. 1996 results show that ROE of private banking division at Barclays recorded 31%, and that of Chase Manhattan reached 30%. The ROE of private banking division at Credit Suisse, which discloses pro-forma division-wise capital allocation and results is as high as 70% (see Table 3).

Though as such, it should be noted that capital allocated for the private banking division is approximately half of that for commercial banking division. In terms of division-wise revenue per employee, there are no significant differences between other divisions except commercial banking division, which posted a loss due to bad debts depreciation. As most banks take 1% of the assets under management as commission, banks need to secure considerable amount of assets to make business profitable.

Moreover, recent technical progress forces the banks to invest massive amount in computer systems for portfolio management. In the case of Julius Baer, technology division personnel occupy the largest share in their head office staffs, resulting in considerably heavy overheads.

Table 3. Results by division at Credit Suisse (1996)

	Pretax Profit (SF 1 million)	Allocated Capital (SF 1 million)	ROE (%)	Employees (person)	Profit per Head (SF 1 million)
Private banking	1,360	1,950	69.74	6,150	0.22
Institutional Asset Management	195	400	48.75	1,254	0.16
Corporate and Investment Banking	1,875	9,600	19.53	11,000	0.17
Commercial banking	-950	3,950	-24.05	15,800	-0.06

Source: Compiled by NRI from Credit Suisse annual report.

5. Potential Growth in Japan

1) Potential customers

(1) Income distribution

It is often said that the gap between the poor and the rich is relatively narrow in Japan, where not many of the citizens are considered to be affluent enough to be targeted by private banking department. In fact, drawing a Lorenz curve, which measures the fairness of income distribution, evidences that Japanese social structure is highly impartial when compared with the States (see Figure 1). The households with more than Yen 20 million of annual income merely occupies 0.3% of the total.

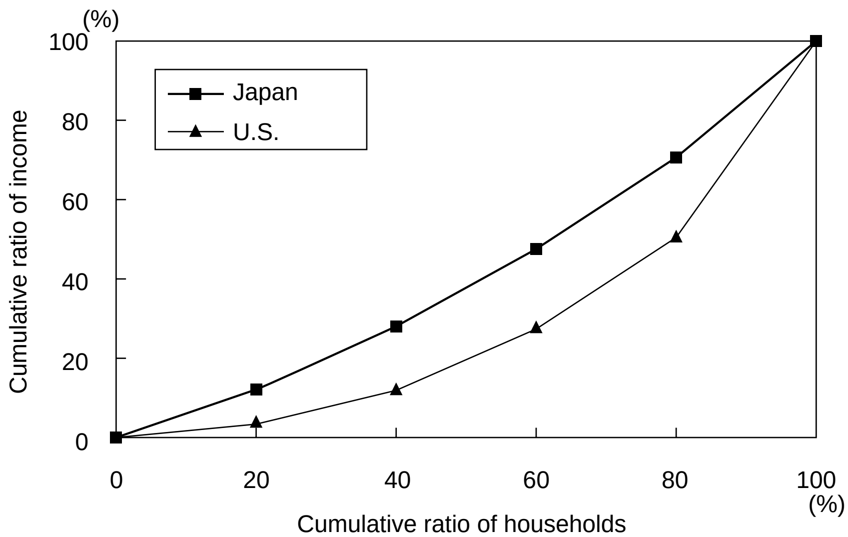
(2) The wealthy people

Needless to say, highly impartial income distribution does not always imply that there are no affluent citizens in Japan. Saving Behavior Survey indicates that some 8.5% of total household save more than Yen 40 million. Since there are some 44 million households in Japan, it is reasonable to assume that more than 3.5 million households are with Yen 40 million or more savings respectively, in aggregate Yen some 240 trillion.

It is often pointed out that typical portfolio of affluent Japanese citizens consists largely of real estate and stocks of their own company, both of which have little liquidity. However, average financial asset holdings of the household with more than Yen 40 million or more savings would reach Yen 69 million. Net financial assets, after offsetting the debts for real estate acquisition, would also be as large as Yen 62 million.

Closer view on the breakdown of their financial assets reveals that stock consists of no more than 9.1%. Some Yen 50 million worth assets are available for investment in average, even if all these stocks are those of their own company.

Figure 1. Japan and U.S. Lorenz Curve (1996)



Source: Nomura Research Institute from "Annual Household Survey" by Management and Coordination Agency and from Census Bureau, U.S. Department of Commerce

It is very difficult to grasp how many Super Riches (with more than US$10 million worth assets) exist in Japan through published survey and questionnaire results. A report from Small and Medium Enterprise Agency suggests that some 50% of large tax payers, who are charged with Yen 20 million or more, are the owners of Yen 100 million or more of financial assets[3]. As 1997 national list of large tax payers counted 31,616 individuals for paying more than Yen 20 million to the taxation office, there should be at least some 16,000 individuals who have more than Yen 100 million worth financial assets.

BOJ's survey on the amount of deposits by depositor revealed that 48,100 private accounts have more than Yen 100 million deposit outstandings (see Table 4). As the data was not summarized by depositor's name, a depositor may divide his/her money to several deposit accounts or a depositor may have two or more accounts with Yen 100 million or more deposit outstandings. Thus we have to be careful to handle this data, but it would provide the most valuable key for the banks. By the way, 30,100 deposit accounts out of 48,100 are at the city banks, which may suggest that the wealthy people are concentrated in urban areas.

2) Needs of the Riches

Dentsu, one of the largest advertising agencies, made a research by asking questions to the households with Yen 15 million or more annual income. The research uncovered that 85% of the respondents wanted to take initiative on their portfolio management (including those who expressed that "I would like to do so, if anything"), and that those who would entrust the financial institutions with their assets were only 15% of the total.

On the other hand, 75% answered that they "never want to use" or "would like to prefer not to use, if anything" the investment instruments without guarantee on principal. Therefore it is hardly possible to assume that most of affluent citizens can obtain high performance on their own during this low interest rates period. It is no wonder that affluent citizens are increasingly in favor of exploiting private banking services if they can offer high performance.

Table 4. Accounts and amounts of individuals by account outstanding(End Sept. 1997)

	Account (100 accounts)	Amount (Yen 100 million)
Less than Yen 500,000	8,142,138	370,117
Less than Yen 1 million	372,551	236,891
Less than Yen 3 million	404,863	588,832
Less than Yen 5 million	99,987	346,857
Less than Yen 10 million	39,477	245,320
Less than Yen 30 million	37,730	507,029
Less than Yen 50 million	2,874	102,099
Less than Yen 100 million	1,278	78,785
Less than Yen 300 million	434	58,490
Yen 300 million or more	47	26,252

Source: "Monthly Economic Statistics" by Bank of Japan.

3 Effective correspondents were, however, only 16.1% of the total.

Japan institute for Securities Information and Public Relations asked the reason why for those who had never experienced stock investment in “National Survey on Securities Savings” for 1997. 34.0% of the respondents with Yen 20 million or more annual income told that they “have not enough knowledge”, 17.0% implied that they “do not want to be nervous on the stock price “, and 9.4% confessed that they “did not know which stocks to buy” (inclusive of one or more answers). This result also suggests there is potential need for advisory services on portfolio management.

Although it is somewhat old, Nikkei Industry and Consumption Research Institute’s 1989 survey outlined that affluent citizens in Japan feel that they need to prepare for the future (82.1%), and that their tax burdens are heavy (95.5%). They significantly want to inherit their assets such as real estate (65.6%) or financial securities (46.6%) to the generations to come (inclusive of two or more answers).

It is sometimes said that Japanese are not familiar to the idea to pay commissions for the services such as asset management. In fact, consultation on business succession or inheritance, which was largely undertaken by the banks, were positioned as an extra operation, and were likely to charge no commission.

In the West, however, private banking operation charges commissions as according to the amount of deposited assets. The commission rate is reportedly 1% or so. Provided that Japanese financial institutions adapt similar commission system as in the West, customer’s assets will grow when the institution realized the performance with more than just 1% growth. Then the customers are not likely to put off the idea to pay commissions for private banking services.

6. Prospects

The most critical aspect in conducting private banking business is to have right target customers. Clear customer segmentation will naturally tell which service to provide and/or enhance.

The Japanese financial institutions are barely standing at the start-line to make full-scale entry to private banking business. So they are not likely to be able to provide the services abroad against the Western competitors. Their target should be the wealthy people in Japan.

It seems that the number of Passive Super Riches is not so large in Japan. Similar to U.S. financial institutions that also got a late start in private banking business than the Europeans, Japanese institutions will have the New Riches for their core customers.

By that time, the most critical task would be re-segmentation of the customers. In other words, the services for those who have relatively “small” amount of assets (with Yen 50-100 million financial asset holdings) should naturally be different from the services for those who have larger fortune. In Japan, as well, the institutions will propose the customers with “small-sized” assets to consider diversified investment via combination of investment trusts. In the case of those who have given amount or more, they will recommend portfolio management using stocks and derivative instruments. In short, Japanese institutions must get rid of obsolete idea of providing universal services for entire customers.

Moreover, many corporate owners are the wealthy people and this situation parallels to the West. Consequently, collaboration with investment banking division will be a critical key to develop private banking business.

Japanese financial institutions may, for the time being, develop private banking business with focuses on the area of their strength. Securities companies would seek their opportunities in portfolio management while banks and trust banks would exploit customer's needs for inheritance or business succession. However, the essence of private banking business is to provide comprehensive financial services for the affluent clients. Strategies to outsource the operations in less competitive area may well be effective, however, it is difficult to coordinate outside services in a profitable way and to build faithful relationship with the customers. Thus the domestic financial institutions are required to seek for complimenting current weaknesses by trying every possible means including capabilities of group companies, so that they can anticipate the "Big Bang" that will lift the barriers between banks, securities companies and insurance companies.

Amended Foreign Exchange and Foreign Trade Law is already in effect, however, affluent citizens are not likely to be active in shifting their money to overseas accounts, as considerable disadvantages are imposed on them in the aspect of taxation due to higher marginal tax rate. In addition to media reports in connection to Foreign Exchange and Foreign Trade Law amendment, low interest rates, adverse results and disgraceful affairs of domestic financial institutions lead to considerable attention on foreign financial institutions. It is also remarked that how the Western institutions, who have been at private banking business longer, will develop their operations in Japan.