Negative interest in private banking

Existential threat to a venerable tradition or strategic opportunity for the business model?
Increasing income in a negative interest environment

It is on account of their balance sheet structure that banks specialized in asset management are hit particularly hard by negative interest compared with competitors with other business models. As a result, negative interest can only partially be passed on to customers. Negative interest impacts fundamental components of a private bank’s service rendering process. However, a range of effective short and medium-term countermeasures are available. In particular, measures such as active management of the balance sheet structure and launching new services & products for customers can still give impulses with the desired effects. Owing to the highly disparate alignment and situation of individual private banks, each institution has to find its own solution. Tight integration of a bundle of operational and strategic measures is of central importance, while factoring in the long-term business strategy, the customer structure and the service packages currently offered.

We hope you enjoy reading our take on the subject and look forward to discussing it with you. Please do not hesitate to contact us should you require additional background information, or wish to ask any questions or discuss specific aspects in greater depth.

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1. Private and foreign banks are especially affected by negative interest

Private and foreign banks that specialize in the private banking sector have endured several negative market trends over the last few years, such as the softening of bank secrecy, decreasing margins in private banking and increasing costs for regulatory compliance and legal provisioning.

These very banks found themselves exposed to the next adverse shock with the announcement on 15 January 2015 of a negative interest rate of 0.75% on sight deposits held with the Swiss National Bank (SNB).

This interest rate is binding for all banks that hold sight deposits with the SNB. However, negative interest is only applied on amounts in excess of 20 times the legal minimum reserve. Despite the interest rate cut, the change in sight deposits held by Swiss private banks has been negligible, as can be seen from the figure below.

Figure 1: Development of sight deposits in 2015 (source: Swiss National Bank)
Although the interest rate applies to all banks, not all are equally affected. Because retail and wholesale banks have to hold higher minimum reserves due to their business models, they are allowed a higher exemption limit. Only few of these banks exceed this exemption limit, and where it is exceeded, the amounts involved are small. Private banks, however, provide a contrasting picture.

Because their activities mean that they have to hold lower minimum reserves, they also have a lower exemption limit. Due to the traditionally sizable sight deposits held by private banks, most exceed their exemption limit and are therefore compelled to pay interest on the surplus. A structural increase in liquidity is emerging as private customers in particular have substantially reduced their investments in securities in response to the current interest situation, opting instead for liquidity.

In the private banking sector, private banks are in direct competition with retail and wholesale banks. The latter, however, are still able to keep their liquidity with the SNB at a zero interest rate. Accordingly, these banks can still take in liquidity at zero interest or low negative interest, and do attractive business with customers on top. This means that private banks can only pass on the negative interest to customers to a limited extent for fear of losing their business, and therefore directly bear a large portion of the negative interest.

Some private banks are attempting to pass on part of the negative interest. One major private bank, for instance, charges negative interest on deposits in excess of a defined threshold, while other private banks charge negative interest to institutional investors. However, it has not been possible so far to pass on negative interest indiscriminately.

Based on current sight deposits, negative interest burdens private banks with costs of CHF 680 million per annum, only a small portion of which can be passed on to customers. Given that all private banks have together generated profit before tax of CHF 2.61 billion per annum on average over the last four years, negative interest poses a significant threat to this bank cluster.
2. Options for avoiding negative interest

In the current competitive environment, it is not possible to indiscriminately pass on negative interest to customers. This would only be possible if, for instance, the SNB were to reduce the exemption limit. As a result, the sector is looking for alternatives. In the following, we present an overview and discussion of possible options:

Option 1: Keep cash in the vault

The first logical alternative is to store and insure surplus liquidity as banknotes. Banknotes can be acquired from the SNB directly or through the money market. Many market participants are actively pursuing this course of action, despite it being in clear contravention of the SNB’s intent in its introduction of negative interest.

However, this is subject to a number of problems in practice. Firstly, acquiring banknotes in the volumes required is proving difficult. Secondly, the acquisition, storage and insurance of cash is associated with costs estimated at 20 to 40 basis points.

This approach therefore only helps reduce the core problem of negative interest but fails to resolve it.

Thirdly, even if it appears contradictory at first glance, cash in large volumes is illiquid. If liquidity is needed, cash has to be converted to book money, which takes time and involves transport costs. This problem can be reduced through standardization, certification and securitization of cash amounts, and their storage at an independent location. This would essentially permit the sale of the vault contents whenever liquidity is needed, thereby reducing transaction costs.

These difficulties mean that the storage of cash can at most only serve as short-term relief to the problem, but not as a robust long-term solution. In any event, securitization solutions should be given preference over simply storing cash.
Option 2: Convert CHF deposits into foreign currency

By investing part of the sight deposits in a foreign currency that is subject to no or only a small negative interest (e.g., euro or US dollar), it is possible to effectively avoid the negative interest regime. This can either be done through the bank – i.e., the bank continues to accept deposits in Swiss francs and invests in euros, for instance – or directly by customers – who exchange their Swiss franc deposits for euro deposits.

In practice, both approaches are only partial solutions. Customers choose a specific currency based on their risk preference. So banks that pressure customers to exchange deposits to another currency are not necessarily acting in the interest of the customer and are therefore failing to provide customer-centric advice.

At most, only those customers for whom exchange into a foreign currency makes sense in view of their asset allocation can be persuaded to convert their investments. Such customers will likely tend to be the exception.

The alternative – i.e., the bank investing customers' CHF deposits in a foreign currency – exposes the bank to a high currency risk. Such a risk would have to be hedged in the interest of the bank's customers and owners. Owing to interest rate parity, however, the cost of complete hedging would offset any interest advantage from a foreign investment.

In other words, banks investing their customers' CHF deposits in foreign currency is an approach fraught with difficulties in actual practice.

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Option 3: Prolong duration of CHF investments

Another approach is to invest savings in investments with long terms and low risk profiles. This solution takes advantage of the currently steep yield curve. In fact, it is even possible to obtain positive nominal returns from low-risk mortgage bonds with terms of five years or more.

That said, this approach is not without a number of difficulties. The CHF bond market is limited in size and illiquid. Indeed, the total volume of non-government bonds adds up to about CHF 390 billion, with mortgage bonds accounting for CHF 98.6 billion of that amount. With that kind of market depth, even an investment of only CHF 20 billion in the bond market would cause major upheaval.

This problem could be mitigated by investing in the more liquid USD and euro bond markets and hedging these amounts using currency swaps.

However, private banks would thereby expose the assets side of their balance sheets to high duration risks. Since the liabilities and equity side of a private bank's balance sheet has a shorter term structure than that of a retail bank, equity would be exposed to a very high interest rate risk. This is not consistent with low-risk governance.

Consequently, prolonging the duration of CHF investments is an option involving substantial difficulties.
A sensible alternative could be to expand or establish the Lombard lending business with the aim of reducing liquidity. The issue of (additional) Lombard loans reduces sight deposits. Some private banks with a very large Lombard credit business are not or, at most barely, affected by negative interest. Many private banks do not offer such a service, or only to a limited extent, despite the fact that wealthy customers frequently have a clear need for this form of credit.

A successful and low-risk Lombard credit business requires effective risk management, robust risk systems and a qualified sales team. If these conditions are satisfied, Lombard loans are a very effective means of placing liquidity while creating customer benefits.

Many banks are rethinking the strategic options in their business models and are currently considering establishing or expanding business with Lombard credit facilities. There is an appreciable increase in interest in the development of credit risk systems, provision of white-label Lombard solutions and their efficient integration in existing systems. **In our experience, it is possible to build up the technical and administrative platform for a rudimentary Lombard lending business within a few weeks.** Greater effort is needed to secure a high level of operational efficiency and to build up effective risk management as well as, in particular, to integrate Lombard products in the advice process of sales staff.

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**Option 4: Expand credit business, focusing on Lombard lending**

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The mortgage and corporate lending business is a market that is still largely untapped by Swiss private banks. In contrast to other countries, such as Germany, where asset-managing banks extend significant loans to their customers, only very few Swiss private banks are active in the mortgage business, or indeed, in commercial lending. However, mortgages in particular are very attractive at present, measured by margin. Even in transactions involving impeccable credit ratings and larger volumes, it is possible to extract margins to the SWAP/LIBOR of 130 basis points (based on data as of 20 August 2015), which translates to a very attractive risk-adjusted return on equity with favorable refinancing.

The problem here is mainly in the ambit of expertise: private banks typically lack employees in front, middle and back office with experience in mortgage lending as well as corresponding systems.

Several solutions are conceivable in practice, however – from buying in expertise and systems to joint efforts to build up solutions for several private banks. The latter factor is particularly relevant if the aim is to target not only own customers but also third-party customers.

Building up an in-house mortgage lending solution can make sense in the context of a holistic customer strategy. Over the last several months, we have seen a significant increase in interest from private banks in the mortgage business and the corresponding operational components needed. In our experience, it is possible to establish a mortgage business within an appealing time frame.

Option 5: Build up lending/mortgage business
Option 6: Arrange credit for customers

Apart from issuing loans, banks can play the part of intermediary between their customers and borrowers. Given the current, larger margins that can be obtained in the mortgage business, mortgage lending to institutional or wealthy private customers is very attractive at present – be it through securitized credit packages or 1:1 securitization. This approach can also be used to reduce customers' liquidity, but without entailing a credit risk for the bank.

The added income for banks taking this approach would essentially stem from the reduction of the negative interest payable and the generation of fees for the arrangement and management of loans. This option again requires investment in risk management, system modifications and coaching of customer advisors. Additionally, in some cases it may only be possible to reach required lending volumes in collaboration with partners.
Option 7: Sell derivative financial products to customers

Another approach is to sell investment products. Customers with a high amount of equity should be sold investment products that are compatible with their risk appetite to the extent possible. Derivative products are a conceivable solution here. Account products have certain attributes as regards security, availability of liquidity and quality of underlying assets, particularly in risk-averse times. With derivatives, it is possible to address specific risk profiles and develop bespoke pay-out scenarios. Although downside risks can be covered, it is generally not possible to replicate the attributes of account products with non-negative profitability, unless additional risk factors are accepted.

In addition, the choice of specific derivative financial products has to take into account several factors, including the risk profile of customers, their understanding and knowledge of the chosen derivatives, the financial capacity to absorb potential losses as well as the strategic asset allocation of customer portfolios. All of these considerations combined mean that derivatives can only ever serve as a partial substitute for account products.
3. Summary

The figure below presents a comparison of the options described above from five perspectives: income enhancement, the time needed to implement, the implementation cost involved and suitability as a short-term or long-term measure.

<table>
<thead>
<tr>
<th>Option</th>
<th>Income enhancement</th>
<th>Time to implement</th>
<th>Cost to implement</th>
<th>Fit for short term</th>
<th>Fit for long term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Keep cash in the vault (without securitization)</td>
<td>+</td>
<td>⏰</td>
<td>⏰</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Keep cash in the vault (with securitization)</td>
<td>+</td>
<td>⏰</td>
<td>⏰</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Convert CHF deposits into foreign currency</td>
<td>+</td>
<td>⏰</td>
<td>⏰</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Prolong duration of CHF investments</td>
<td>++</td>
<td>⏰</td>
<td>⏰</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Expand credit business, focusing on Lombard lending</td>
<td>+++</td>
<td>⏰</td>
<td>⏰</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Expand credit business, focusing on mortgage business</td>
<td>+++</td>
<td>⏰</td>
<td>⏰</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Arrange credit for customers</td>
<td>+++</td>
<td>⏰</td>
<td>⏰</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Sell derivatives</td>
<td>+</td>
<td>⏰</td>
<td>⏰</td>
<td>✓</td>
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4. Conclusion

Private banks face a tough task on account of the introduction of negative interest. The challenge can be mastered with the right mix of the measures discussed above. Lending should form a central component of any solution, either acting as an intermediary or direct lending. This approach can be flanked by the conversion of CHF deposits and the sale of derivatives.

The unique particulars of each bank have to be factored into the solution development and implementation process. Such particulars include the long-term business strategy, customer structure and the currently offered service packages. Other parameters such as current risk management, IT systems as well as the risk capacity and risk appetite also have to be taken into account.
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