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Strains from credit crisis may split the industry

By Steve Johnson
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Once upon a time banks were seen as solid, dependable and attractive partners for any self-respecting asset management house. (PDF)

But, if industry soothsayers are to be believed, the "unreasonable behaviour" of some of the world's hitherto most upstanding banks could trigger a number of messy divorces.

And while this may prove liberating for asset management houses it brings its own challenges; the banks may get government funding to keep a roof over their heads but their fund management arms may have to raise their own capital from the private sector in order to keep the wolf from the door.

These are some of the predictions as to how the financial services sector may be redrawn by the cataclysmic events of recent weeks. The industry that existed BC (before the crunch) may look very different AD (after deleveraging).

"The new industry model is not yet understood by most of the players because they are all looking backwards. It is clear that the biggest casualty is going to be risk taking in investment banking and risk taking in lending," says **Ray Soudah**, founder of **Millenium Associates**, a Swiss advisory firm.

Todd Ruppert, chief executive of Baltimore-based T Rowe Price Global Investment Services, adds: "We will no doubt see more consolidation and the disposal of asset management subsidiaries by banks and insurance companies. This is positive for independent asset managers."

So far the disposal trend has been limited. Spain's Santander, now the largest bank in the eurozone and one of the few that cannot be accused of unreasonable behaviour, has put its asset management arm on the block, but this is an isolated example. However, there are forces afoot that may change this picture. Until now, one of the benefits of running a diversified financial group is that the same capital can be made available to each arm. But in the wake of the credit crunch, with the capital strength of the banking sector coming under unprecedented scrutiny, this model may no longer work.

"Most important is the ring fencing of capital, rather than double counting and multiple uses of capital," says Mr Soudah.

In the brave new world: "the capital cannot be fungible, each division will have to have its own capital," so universal banks "might as well" spin off their private banking and asset management arms.

Mr Ruppert concurs with this prognosis, arguing it is "a lot cleaner to be independent" given the uncertainty as to how capital is allocated in diversified organisations.

He further argues that with asset management companies trading on higher price/earnings multiples than banks it would make sense for parent companies to crystallise some of that value by selling, and that by striking out on their own fund managers can avoid any "backlash" against the banking sector, or any undue scrutiny of banking activities.

Beat Wittmann, head of investment products at Julius Baer, the Swiss bank, believes financial institutions can never again be allowed to become "too big to fail".

As a result, he foresees a separation of activities, with standalone asset managers and private banks, which have very light capital requirements, gaining clients from universal banks.

However the garden may not be so rosy for asset managers. Mr Soudah believes large institutional investors such as sovereign wealth funds will start to ask awkward questions about the financial strength of fund managers and private banks.

"The Chinese state will say 'I don't want to put $10bn-$20bn with a commercial bank, I want it with an independent asset manager'," says Mr Soudah. However, the likes of Beijing might insist the independent manager has a capital cushion in case of unforeseen circumstances such as the mis-selling claims that are emerging in the structured products arena.

"It's nearly zero the capital you need for asset management. It's frightening when you think about it," he says.

"Private banks have capital of 1-2 per cent of assets under management. It is nothing. Maybe we will go to 5 per cent. They will need dedicated capital.

"People will favour the bigger private banks, there is no question. This thing will move very quickly, in three to five years."

The future is "independent and independently capitalised", adds Mr Soudah. "Asset management will recover but it will need more capital, more clearly independent companies."

Mr Ruppert agrees that cash may be king. "Our former chief executive used to say in asset management your balance sheet does not matter until it matters. The wherewithal to continue to invest throughout down periods makes that balance sheet extremely important."

Indeed, investors have already had a taste of this new reality, in which the capital strength of the parent company becomes paramount.

A series of asset managers have bailed out their money market funds, which would otherwise have produced losses for investors, or "broken the buck", but Reserve Management Corporation of New York was unable or unwilling to do so. A need to carry greater capital on a balance sheet has obvious knock-on effects for the industry's return on equity. Mr Soudah believes some participants may respond by raising their fees. "To have a safe private banking account might cost more in the future," he says.

Change is also afoot in terms of the type of products shellshocked investors may be persuaded to buy.

Amin Rajan, chief executive of Create Research, a consultancy, argues that with fear likely to remain the dominant emotion for some time to come, there will be a flight to products that embrace "simplicity, quality and safety", with features such as transparency, liquidity and capital protection. With the hedge fund and private equity models coming under pressure, and newer innovations such as long/short 130/30 funds disappointing.

Mr Ruppert also sees the need for the asset management industry to "get back to basics, with no or low leverage, lots of transparency and, perhaps, protection".