## Wealth Management

Private Banking, Investment Decisions and Structured Financial Products

Dimitris N. Chomfas





r.J /Nr^V I CjfS.

AMSTERDAM • BOSTON • HEIDELBERG • LONDON NEW YORK • OXFORD • PARIS • SAN DIEGO SAN FRANCISCO • SINGAPORE • SYDNEY • TOKYO Butterworth-Heinemann is an imprint of Elsevier

## Contents

Preface

Part	1:	Private banking	1
1	Pri	ate banking defined	3
	1.1	Introduction	3
	1.2	Private banking clients	4
	1.3	Organizational challenges in private banking	7
	1.4	Security and secrecy requirements	10
	1.5	A private banking roadmap	12
	1.6	Household debt and private banking	15
	1.7	The ownership society's recycling pattern	18
	1.8	Synergy of private banking and institutional investments	20
	Kn	ow your customer and his or her profile	24
	2.1	• •	24
	2.2		25
	2.3		28
	2.4		32
		Why knowledge engineering can assist the investor	34
		A financial advisory expert system for currency exchange	37
	2.7		40
	2.8		43
	Bus	iness opportunity: fees and commissions from private banking	46
		Introduction	46
	3.2	Trades, investments and private banking customers	48
	3.3		51
	3.4		54
	3.5		57
	3.6	· · · ·	59
	3.7	Simulation of portfolio performance	62

3.7 Simulation of portfolio performance3.8 The impact of business risk

Risk and return with investments		68
4.1	Introduction	68
4.2	Basic notions of risk assessment	69

65

126

4.3	Mitigating the risk of losses	72
4.4		75
4.5		78
4.6	Risk and return with implied volatility	81
4.7	Risk-adjusted pricing: an example with credit risk	84
4.8	An introduction to stress testing	86
Part 2:	Asset management	91
5 Ass	set management defined	93
5.1	Introduction	93
5.2	Asset management and capital mobility	95
5.3	Asset allocation strategies	97
5.4		101
	Real estate property derivatives: a case study	103
5.6	Passive and active investment strategies	106
5.7	A critical view of alternative solutions	110
5.8	The portfolio's intrinsic value	112
Bu	siness models for asset management	116
6.1	Introduction	116
6.2	Choosing the investment manager	118
6.3	Don't kill the goose that lays the golden egg	120
6.4	The contribution to asset management by contrarians	123

- 6.4 The contribution to asset management by contrarians
- 6.5 Asset management as an enterprise

6.6	Hedging strategies followed by portfolio managers	129
6.7	Deliverables and performance in administration of assets	132

6.8 Past performance is no prognosticator of future results 134

7	Out	sourcing and insourcing wealth management	138
		Introduction	138
	7.2	Risk and return with outsourcing	140
	7.3	Internal control and security are not negotiable	142
	7.4	Custody only, mid-way solutions and discretionary powers	144
	7.5	Building up the investor's portfolio	148
	7.6	The option model of investing	152
	7.7	Efficiency in private banking and asset management	154
	7.8	The private banking profit centre	158

Trust duties and legal risk		163
8.1	Introduction	163
8.2	Trusts and trustee responsibilities	164

## Contents

	8.4 8.5 8.6 8.7	Legal risk and the case of tort Reasons behind legal risk and cost of litigation Legal risk and management risk correlate Mishandling the client: small cases that can lead to legal risk Big cases of legal risk: high-tech crime and identity theft Merck and Co.: legal risk with Vioxx	167 170 172 176 178 180
Part		Derivative financial instruments, structured products and	
	r	isk control	183
9	Deriv	ative financial instruments defined	185
		Introduction	185
		Derivatives and hedging	186
		Underlying and notional principal amount	189
		From notional principal to financial toxic waste Derivatives that became institutionalized	193
		Private banking derivatives and the paper money trauma	197 199
		Dr Alan Greenspan on derivatives and the case of	199
		hedge funds	202
		George Soros on derivatives	206
10	10.1	<b>tured financial products</b> Introduction Structured products and capital protection Structured versus synthetic products	<b>209</b> 209 210 213
	10.4	The role of strategists, traders and modelling controllers	216
	10.5	Aftermath of design factors on risk profile	219
		Structured investments are not liquid	222
	10.7	5	225
	10.8	Dynamic threshold mechanism	227
11		rolling the risk taken with structured products	<b>229</b>
	11.1 11.2	Introduction Credit risk and exposure at default	229 231
	11.2	Credit risk transfer and hazard rate models	231
	11.4	Credit risk volatility and bond spreads	237
	11.5	A case study on General Motors	241
	11.6	Liquidity risk in an ownership society	243
	11.7	General and specific market risk	245
	11.8	Stockmarket bubbles and damage control	248
	11.9	Risk management and the'Greeks' »	250

Part	t 4: Ca	ase studies with the three main classes of structured products	253
12	Fixed	income structured products	255
	12.1	Introduction	255
	12.2	Fixed interest structured products defined	258
	12.3	Constant proportion portfolio insurance	261
		FISP versus CPPI: a comparative study	264
	12.5	Borrowing through issuance of derivatives	266
	12.6	Capital protection notes and bondholders' risk	270
	12.7	Structured instruments with underlying credit risk	273
	12.8	Embedded derivatives for the ownership society	276
13	Practic	al examples with fixed income derivatives	279
10	13.1	Introduction	279
	13.2	Money rates, money markets and financial instruments	281
	13.3	Inflation-linked notes	284
	13.4	Stairway notes (step-ups)	288
	13.5	Callable reverse floaters	290
	13.6	Accrual notes	293
	13.7	Fixed and variable rate notes	296
	13.8	Bull notes	297
14	Fauits	-type structured products	300
11	14.1	Introduction	300
	14.2	Headline risk and the nifty-fifty	303
	14.3	Equity derivatives defined	306
	14.4	Players in equity derivatives	309
	14.5	Risks taken with analytics	311
	14.6	Criteria used for dynamic rotation	315
	14.7	Equity derivatives swaps	316
	14.8	The use of embedded barrier options	318
15	Ducati	al arounder with equity type dovivatives	322
15		cal examples with equity-type derivatives	322
	15.1	Introduction Equity index and basket structured notes	322
	15.2	Absorber certificates	
	15.3 <b>15.4</b>		326
		Early repayment certificates	328
	15.5	Enhanced yield certificates	330
	15.6	Reverse exchangeable certificates	331
	15.7	Potential share acquisition certificates	332
	15.8	EUR complete participation securities	334
	15.9	US dollar non-interest-bearing note linked to eauity	336
	15.10	The strategy of pruning the basket and reallocating securities	336

16	Curr	ency exchange structured products	338
	16.1	Introduction -	338
	16.2	Currency transactions and economic exposure	340
	16.3	Exchange rate volatility and risk control	343
	16.4	Mismatch risk and carry trades	346
	16.5	Forex rates and structured instruments	349
	16.6	Dual currency structured products	352
	16.7	•	354
	16.8	Conclusion	357

Appendix	Derivatives as a tax haven	359
A.I	Introduction	359
A.2	Wealth tax	359
A.3	Derivatives, offshores and private individuals	361
A.4	Companies have been masters in using derivatives and offshores	362
A.5	Shifting the risk with no return to the household sector	364
A.6	Cynics look at the private banking client as a cash cow	366

Index

369