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TRANSFER PRICING MODELS IN THE PRIVATE BANKING INDUSTRY

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Characteristics of the industry and their impact on transfer pricing

In this article, the authors share their perspective on how the co-entrepreneurial operating model in private banking affects transfer prices and they analyse how the tax and regulatory changes in the past decade forced a transition from traditional transfer pricing models to profit/revenue sharing models.

1. PRIVATE BANKING

1.1 Description. Private banking is a sector of the banking industry and covers banking, investment and financial services that are provided to high net worth individuals (HNWI) with investable assets of more than USD 1 million. The service offering largely covers traditional banking services (e.g. deposits, custody), brokerage, investment-related advice, discretionary asset management, credit solutions (e.g. lombard loans, mortgages), and financial planning services (e.g. philanthropy, succession planning, wealth structuring).

The term *private* in private banking refers to services provided on a more personal basis as compared to the affluent or retail banking segment. Each client is assigned a relationship manager [1] who is responsible for maintaining the relationship and providing investment-related advice. Investment and product specialists, wealth planners, traders and portfolio managers typically support the relationship managers.

The private banking market is competitive and highly fragmented, and the market participants include many international banks headquartered in the US, Switzerland, the EU or Asia as well as local banks and boutiques in selected countries. Even the largest competitors only have a relative global market share of 4% or less.

1.2 Operating model. Banks active in (cross-border) private banking often operate with a dual structure, consisting of one subsidiary in country A with a limited advisory licence (hereafter "advisory office") and a second subsidiary in country B with a full banking licence (hereafter "booking centre"). The subsidiaries are either a separate legal entity or – as is often the case in the banking industry due to regulatory capital requirements [2] – a branch. The booking centres are typically domiciled in major banking hubs [3] *(Figure 1)*.

Advisory offices employ relationship managers who are responsible for introducing new clients, maintaining client relationships and providing investment-related advice. Depending on their size, advisory offices may employ additional specialists who support the relationship managers. In order to operate the business, advisory offices need a licence from the respective regulator in their country. The licence requires them to be properly organised and have adequate risk management and internal controls.

The booking centre is the group entity with whom the relevant account for a client is maintained and which provides all banking-related services such as deposits, custody, brokerage and credit solutions. The booking centre is effectively the bank and must hold a full banking licence from the regulator. To obtain such a licence, sufficient equity capital, a guarantee of irreproachable business activity by qualified participants, an effective risk management and an internal control system are requirements. Booking centres assume the inherent financial risks of the banking business (e.g. financial market risks, treasury risks, credit default risks).

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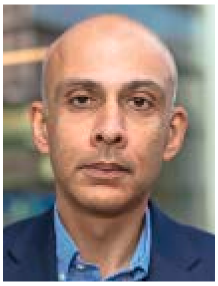

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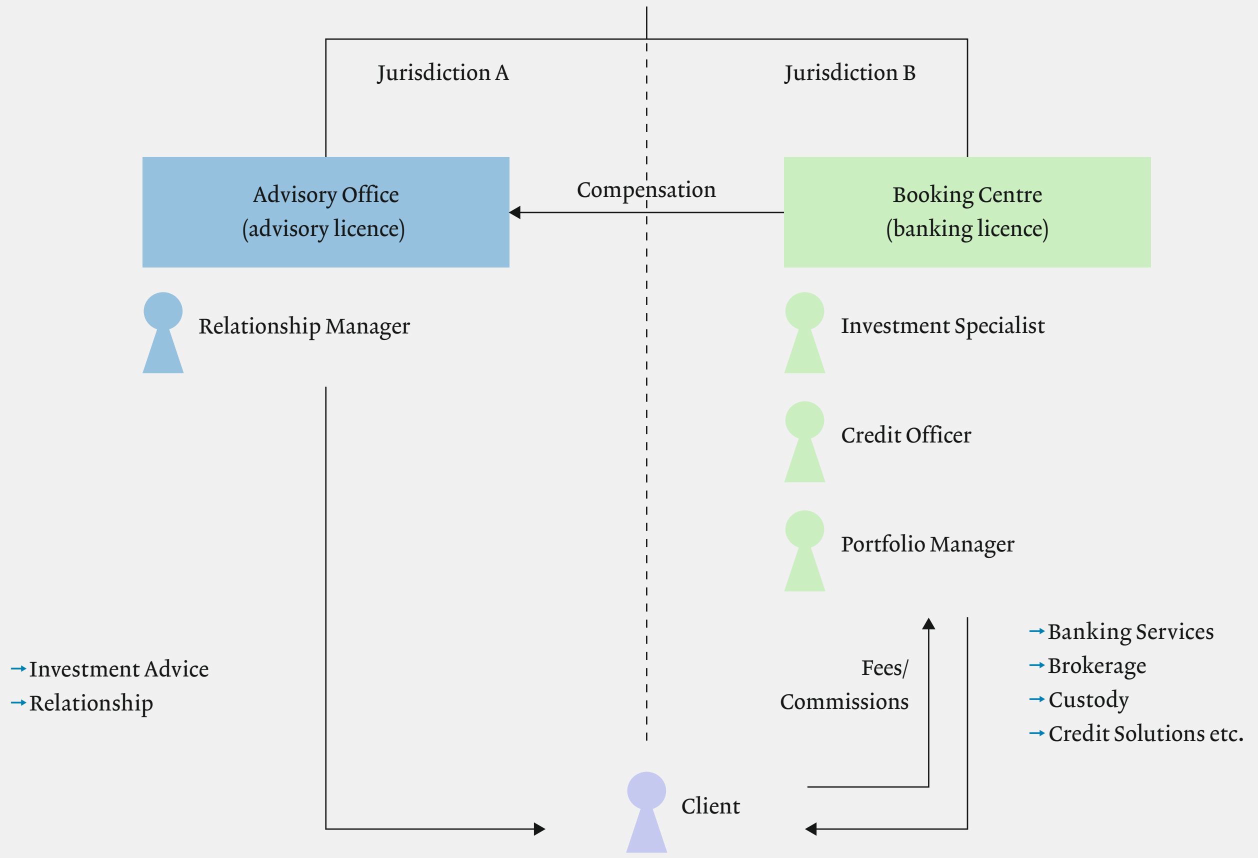
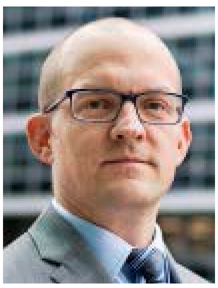
Figure 1: **PRIVATE BANKING OPERATING MODEL**



For efficiency reasons, banks in the private banking industry often have a large geographic presence with many advisory offices, but only a limited number of booking centres. Depending on the regulatory framework, clients managed by an advisory office can choose between several of the group's booking centres, resulting in a complex web of intercompany relationships and a highly integrated global value chain *(Figure 2)*.

Principal structures with central ownership of high-value functions (assets and risks on the one hand and contract manufactures/low-risk distributors on the other) as commonly used in the non-financial service industries are rare within private banking. In private banking, both advisory offices and booking centres typically perform non-routine functions, assume economically significant risks and make unique and valuable contributions in serving the client, i.e. they act as co-entrepreneurs *(Table 3)*.



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In line with common practice, the fees for services provided by both the advisory offices and the booking centres are collected from the clients by the booking centres. From a transfer pricing perspective, the booking centres then have to compensate the advisory offices.

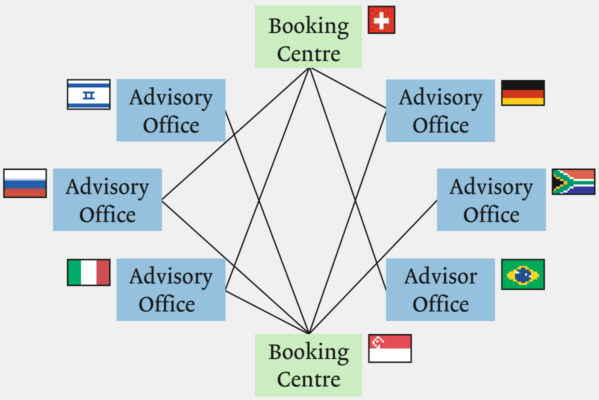
1.3 Value drivers. The profit of the private banking industry is driven by both external and internal factors.

Even though there is a trend in the private banking industry towards new fee models (e.g. fixed yearly fees, performance-based fees), the majority of fees are still based on the volume and nature of the transactions (e.g. equity transactions) or are a fixed percentage of the assets under management (advisory, discretionary management). As a result of this compensation model, the turnover and ultimately the profit in private banking is highly dependent on the financial markets. In times of rising prices (bull markets) and/or high volatility, clients are often more active and assets under management increase, while in times of low volatility and/or falling stock markets (bear markets), the opposite is generally true.

Private banking is a business based on trust and long-term relationships between clients and their banks. It is therefore crucial for a bank to have a long-term, diversified, growing client base that is based on:

- relationship managers who develop, enhance and maintain the relationship, and

Figure 2: **WEB OF INTERCOMPANY RELATIONSHIPS**



→ the technical expertise of relationship managers, investment specialists and portfolio managers.

Since banks offer complex, technical products, they started simplifying their message over the last decade by creating highly differentiated, authentic wealth management brands [4]. The DEMPE functions related to such brands [5] are typically performed in the bank's headquarters in order to achieve a consistent brand message. The brand value is also shaped by the bank's reputation and strong capital base.

Private banking is less driven by a distinctive business offering or R&D functions. While banks have always had significant technology expenses, technology has traditionally been viewed as a necessity for running the bank (i. e. providing the required infrastructure to effectively deliver banking services and stay abreast of the market), rather than as a competitive advantage that will build the bank [6]. However, technology (e. g. mobile banking software, robo-advisors, algorithmic trading models, brokerage platforms) is changing the banking industry ever more rapidly. In the near future, it may be prudent to differentiate between routine back-office infrastructure and new value-driving technology.

2. TRANSFER PRICING METHODS

2.1 Overview. The transfer pricing methods described in the OECD Transfer Pricing Guidelines (hereafter "TP Guidelines") [7] include:

→ traditional transaction methods such as the comparable uncontrolled price (hereafter *"CUP"*) method and the cost plus method, and

→ transactional profit methods such as the transactional net margin and the transactional profit split method [8].

The TP Guidelines also allow for the use of other methods as long as they satisfy the arm's length principle [9].

The selection of the most appropriate transfer pricing method focuses on finding the most appropriate one for a particular case, and, although the general operating model within the private banking industry has historically remained fairly consistent, transfer pricing in the industry has evolved in response to major changes in the tax and regulatory environment in the past decade.

2.2 A historical perspective. Towards the end of the 20th century, companies in the private banking industry commonly relied on the use of one-sided methods such as the cost plus method (i. e. evaluate the cost plus return on the provision of certain services) or the CUP method (i. e. evaluate the fee applied for certain intercompany transactions) to determine the arm's length nature of their intercompany dealings. Specifically, companies in the industry would typically provide a cost plus return to the advisory offices with the residual residing at the level of the booking centres. Depending on the level of relative value deemed to be provided by the advisory offices, the mark-up applied could vary within the sector. It is also noteworthy that one-sided methods had the added benefit of being more pragmatic from an ease of implementation standpoint *(Figure 4)*.

2.3 Tax and regulatory environment in the past decade. The financial service industry, including the private banking sector, has witnessed a series of changes over the past 10–12 years following the 2007–08 global financial crisis. These changes have increased complexity from a tax and regulatory perspective and have materially affected the approach to transfer pricing within the industry.

For example, in 2010 the OECD published its PE Report [10] with special considerations for banks. The purpose of the report was to address the considerable variation in the interpretation of the general principles governing the attribution of profits to a PE under article 7 of the OECD Model Tax Convention and ensure a more consistent application of the rules of the article while avoiding double taxation of profits attributable to PEs.

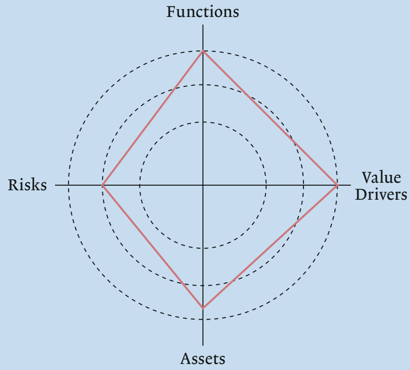
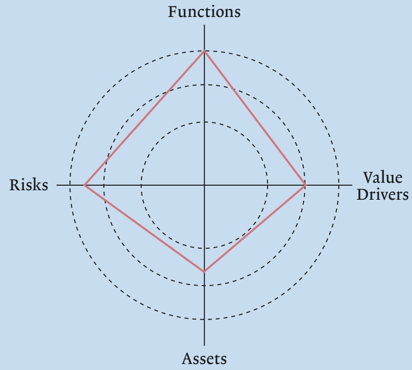
In 2015, the OECD launched its 15-point Action Plan as part of its efforts to mitigate base erosion and profit shifting (BEPS), which was aimed at aligning taxation with the economic activity that generates profits. This Action Plan is fundamentally reshaping the international tax and transfer pricing landscape. It is also worth noting that unilateral tax law changes across the globe have followed from the BEPS initiative [11]. In 2017, the OECD updated its TP Guidelines to incorporate various elements and output from the BEPS initiative.

In 2019, as part of the ongoing work of the G20/OECD Inclusive Framework on BEPS, the OECD released a Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy.

From a regulatory perspective, the Basel III capital adequacy framework as well as changes such as the Markets in Financial Instruments Directive (MiFID II) and the Alternative Investment Fund Managers Directive (AIFMD) are affecting the industry as well.

2.4 Impact on transfer pricing models. The myriad changes in the past decade have been a trigger for companies within the private banking sector to revisit the appropriateness and defensibility of their transfer pricing models.

Table 3: **SIMPLIFIED FUNCTIONAL ANALYSIS OF PRIVATE BANKING**

	Advisory Office (advisory licence)	**Booking Centre** (banking licence)
Profile		
Functions	→ Introduction of new clients → Client relationships → Investment-related advice	→ Investment and product expertise[1] → Discretionary portfolio management[1] → Custody, brokerage, deposits → Credit solutions → Banking operations and treasury
Risks	→ Strategic risks → Operational risks	→ Financial market and treasury risks → Credit default risks → Operational risks
Assets	→ Client relationships → Knowledge	→ Knowledge → Client deposits → Assets under management
Value Drivers	→ Relationship managers → Investment expertise → Reputation	→ Investment expertise → Reputation

[1] Depending on the size, may also be performed by the Advisory Office

2.4.1 Impact of the PE Report (2010). Transfer pricing within the private banking sector was greatly affected by the PE Report released in 2010, even though the latter focused on profit attribution to PEs and not directly on transfer pricing. Specifically, two of the fundamental principles associated with the attribution of profits to PEs are the concepts of significant people functions (hereafter "SPFs") and key entrepreneurial risk-taking functions (hereafter "KERTs"). SPFs are used in general for attributing risk assumption and economic ownership of assets [12], and KERTs, specifically in the financial services industry, for attributing the core financial assets and, therewith, the associated opportunities and risks, to the PEs.

Given the aforementioned importance of the relationship managers in the business model (introduction of new clients, relationship management, investment-related advice), the PE Report, with its focus on SPFs and KERTs, had a profound effect on most companies in the industry with regard to their transfer pricing models and overall attribution of value. Specifically, it highlighted the increased relative importance of the high-value individuals who typically staff the advisory office as part of the group's operating model.

As a result, the banking sector predominately operated via some form of profit/revenue split for several years following the PE Report. In fact, one of the most common transfer pricing models implied that the advisory offices would receive a cost plus floor as well as a share of the profit/revenue.

2.4.2 Impact of the BEPS initiative (2015). Building on its PE Report and on the concept of SPFs and KERTs, one of the important transfer-pricing-related hallmarks of the OECD's BEPS initiative is related to the effect that Actions 8–10 [13] have had on transfer pricing models. One of the key focus areas concerns the importance of people functions – particularly the relative importance of people functions as compared to, for example, legal ownership of assets or the provision of capital. Having requisite individuals who can perform key functions and manage and control key risks is central to value creation analyses post BEPS. Similar to SPFs and KERT functions, the type of people functions that are most relevant/critical in a company's operating model may vary by sector and by company within a sector.

Within the private banking industry, while Actions 8–10 supported the industry's use of profit/revenue split models to attribute value to advisory offices, they put some pressure on the use of profit/revenue split models with regard to booking centres. Actions 8–10 (and the corresponding TP Guidelines issued in 2017) introduced the notion that capital and the profits associated with financial risks should be entitled to *"no more than a risk-free return"*. The effect was the potential decrease in

Table 4: **TRANSFER PRICING MODELS**

	Advisory Office (advisory licence) ← Compensation — Booking Centre (banking licence)
Historical Models	→ Mostly one-sided, traditional transaction methods → Booking Centres to compensate Advisory Offices, typically based on a cost-plus return → Focus on pragmatism and ease of implementation
Current Models	→ Two-sided, transactional profit methods → Booking Centre and Advisory Office to apply a transactional profit split model (revenue sharing, with cost plus remuneration of routine functions and a brand licence fee) → Focus on significant people and KERT function (relationship managers, investment specialists), risks/capital (credit default risks, financial market risks, treasury risks) and regulatory requirements

the relative importance of capital and, by extension, the relative importance of booking centres, the impact of which would theoretically provide a cost plus return to the booking centres with the residual residing at the level of the advisory offices.

However, a look at the market shows no departure from the use of profit/revenue split models within private banking as a result of the BEPS initiative. This is likely due to the following two factors:

Firstly, Actions 8–10 of the BEPS report specify that:

"While the basic concept that a party bearing risks must have the ability to effectively deal with those risks applies to insurance, banking, and other financial services businesses, these regulated sectors are required to follow rules prescribing arrangements for risks, and how risks are recognised, measured, and disclosed. The regulatory approach to risk allocation for regulated entities should be taken into account and reference made as appropriate to the transfer pricing guidance specific to financial services businesses in the [PE Report]" [14].

It therefore follows that, given the strict regulatory requirements in the financial service industry and the importance of financial assets and bearing/managing financials risks in the private banking industry, a cost-plus-type return to booking centres with the residual residing at the level of the advisory offices may not be arm's length.

Secondly, within the financial services industry and the private banking sector specifically, the regulators and tax authorities continue to place a high degree of importance on contractual arrangements, regulatory licences, financial risks and capital. In this regard, private banks have not, nor are they likely to, follow suit on focusing solely on people functions as the key entrepreneurial function and limiting the return to capital and financial assets.

As such, even in a post-BEPS environment, we continue to see profit/revenue split models predominating in private banking, with a cost plus return for routine IT and corporate centre functions as well as a brand licence fee (*Table 4*).

2.4.3 Impact of the regulatory environment. From a regulatory perspective, we have also seen certain regulators starting to review transfer pricing policies, intercompany agreements and transfer pricing documentation as part of their on-site visits. Thus, it is critical to ensure consistency between the regulatory and tax positions and the messaging to both tax authorities and regulators [15]. The 2017 TP Guidelines also acknowledge the significance of regulation in the financial services industry and refer to the guidance of the PE Report [16].

Furthermore, the interaction between tax and regulation is becoming more complex, and, in general, regulatory and tax changes (as well as potential structural changes, such as those surrounding potentially new value drivers in the business) are increasing the complexity of what used to be more straightforward transfer pricing policies. Examples of recent topics of discussion include whether a revenue sharing model is in line with the inducement ban under MIFID II, whereby advisors shall not receive any monetary benefits (from third parties), and whether the net interest margin shall be included in the revenue sharing basis.

3. MODEL CHARACTERISTICS

Taking the above into consideration, a present-day transfer pricing model for a dual structure in private banking typically possesses the features outlined below. It is also worth noting, however, that it is important that each transfer pricing model reflect the characteristics of the bank in question and its specific business operations.

Based on our experience, tax authorities generally accept transfer pricing models in private banking with a revenue split instead of a profit split. The revenue base normally includes all fees, commissions and net interest margin collected from clients under a specific intercompany relationship (booking centre and advisory office). Conversely, since banks that are active in the private banking business often have a web of many intercompany relationships between advisory offices and booking centres, it would be highly challenging to determine the correct profit for each such relationship, especially considering the correct allocation of direct and indirect costs.

Historically, tax authorities would often accept a standard split for all intercompany relationships between booking centres and advisory offices and, based on our experience (and depending on the company's relevant facts and circumstances), this split would generally fall within the range of 40–60%. More recently, we have observed a trend within the market towards models with individualised splits depending on the company-specific capabilities of the advisory offices. Whereas smaller advisory offices may only have core capabilities (relationship managers), larger ones may have additional capabilities (investment specialists, portfolio managers) and a broader service offering. Following a tick-the-box approach, several key functions in the value chain should be identified and evaluated (e.g. investment specialists, discretionary portfolio managers), each with a separate split. In general, the more high-value functions an advisory office performs, the higher the total split. With several key/high-value functions, the more complex the model is likely to be and the more difficult it may be to explain to internal stakeholders, tax authorities and regulators. The individual split for the functions can be benchmarked using the internal or an adjusted external CUP method.

The model should also be flexible in its operational implementation so it can adapt to any changes in the group (e.g. new capabilities in selected advisory offices due to hiring of specialists, new intercompany relationships between booking centres and advisory offices) or regulatory requirements (e.g. exclusion of certain revenue components from the revenue base).

4. FORWARD-LOOKING CONSIDERATIONS

There are also structural changes within the industry that may require companies to revisit their value chain and transfer pricing model. One example concerns the use of technology in the banking industry. As alluded to earlier, technology is changing the banking industry more rapidly every day (e.g. mobile banking software, robo-advisors, algorithmic trading models, brokerage platforms). Traditionally, IT services and technology have been viewed as a non-core contribution to value creation with the industry; however, industry participants will be required to segregate routine back-office infrastructure from new value driving technology. This will also align with the OECD's Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy and directionally support the use of profit/revenue split models with technology potentially considered to be a value driver.

5. CONCLUSION

The discussion here illustrates the operating model and value drivers within the private banking industry and the transfer pricing impact within the industry over the past 10–12 years. This impact was largely a result of various tax and regulatory changes, and the characteristics of the present-day transfer pricing model within the industry generally reflects this. Based on our experience, having a defensible and globally consistent model is paramount, as well as ensuring that the model has a sufficient level of flexibility so as to allow a company to react (if necessary) to potential forward-looking changes in the group's value chain. ■

Notes: 1) Other terms used in the industry: RM, financial advisor, client relationship officer. **2**) Hug, Thomas: "Die steuerliche Kapitalallokation bei Bankenbetriebsstätten", in: Expert Focus 4/2020, pp. 240–246. **3**) E.g. Germany, Hong Kong SAR, Luxembourg, Monaco, Singapore, Switzerland, the UK, the US. **4**) Deloitte: "Innovation in Private Banking & Wealth Management – Embracing the Business Model Change", 2017, p. 16. **5**) Hug, Thomas: "Das DEMPE-Funktionskonzept am Beispiel der Konzernmarke", in: Expert Focus 8/2019, pp. 589–594. **6**) Deloitte: "Financial Services Transfer Pricing – Sector Trends & Global Developments", 2019, p. 22. **7**) OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administratons, Paris, 2017 (herafter "TP Guidelines"). **8**) Hug, Thomas: "Die transaktionale Gewinnaufteilungsmethode im Verrechnungspreisrecht", in: Expert Focus 1–2/2020, pp. 50–56. **9**) TP Guidelines, para. 2.9. **10**) OECD: Report on the Attribution of Profits to Permanent Establishments, Paris, 2010 (hereafter "PE Report"). **11**) For example: Diverted Profits Tax rules in the UK, Multinational Anti-Avoidance Law in Australia, the European Union Anti-Tax Avoidance Directive, the Base Erosion and Anti-Abuse Tax ("BEAT") in the US. **12**) PE Report, p. 15. **13**) OECD: Final Report on Actions 8–10, Aligning Transfer Pricing Outcomes with Value Creation, Paris, 2015 (hereafter "BEPS Report"). **14**) BEPS Report, p. 185. **15**) Deloitte: "Financial Services Transfer Pricing: Changing Landscapes", 2018, p. 5. **16**) TP Guidelines, para. 1.56 ff.