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Maldives instead of kickbacks

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Many banks and asset managers continue to collect retrocessions, although they are frowned upon. This creates conflicts of interest that are not in the best interests of clients.

Anyone who books a holiday to the Maldives through a travel agent without having to pay a fee knows that the service provider does not live on love and air alone. They receive reimbursements from hotels and airlines to cover their wages and expenses.

It's different in the world of finance. In 2006 the Federal Supreme Court issued its first landmark ruling. It ruled that kickbacks or retrocessions of any kind belong to the client, regardless of whether the service is asset management or investment advice. Subsequent court rulings have confirmed and clarified the decision.

Anyone who thinks that the financial sector has now been cleaned up and that there are no more kickbacks is mistaken. According to experts, it is common for 80–90% of banks and "independent" asset managers to charge retention commissions on investment funds, structured products, hedge funds, private equity, infrastructure and real estate products. In addition, there are one-off distribution fees, reimbursements on stock exchange transactions and finder's fees for funds that asset managers refer to selected banks on behalf of their clients. It is believed that billions of dollars in kickbacks are still being paid in Switzerland. How is this possible when there are high court rulings that have long banned this practice?

Unlike the more restrictive MiFID II rules in the European Union, the acceptance of retrocessions is not explicitly prohibited in Switzerland, but is legally uncertain and often contestable. The local financial industry successfully lobbied against a general ban on retrocessions by highlighting the maturity of investors. Many banks and asset managers have simply amended their "general custody terms and conditions" and contracts so that the client agrees to waive the fees owed to them.

Like a mild drug

Excerpts quoted from UBS's fundamental contractual conditions are representative of many other financial actors: "UBS typically receives monetary benefits from these product providers on a periodic and/or upfront basis, such as distribution fees/retention commissions, rebates and similar benefits, as payment for the distribution and/or custody of these financial instruments." And further: "Benefits may create conflicts of interest for UBS. They may provide an incentive for UBS to favour certain financial instruments with higher benefits over other financial instruments with no benefits or financial instruments with lower benefits."

It is clear from the major bank's separate information sheet that these "benefits" or "kickbacks" are not marginal. The retrocessions they receive can be up to 2% per annum on bonds, equities, investment strategies, private equity, real estate and hedge funds. These are huge maximum rates, sometimes several times the transparent fee charged to the client. For structured products, the reimbursement comes with a one-off "upfront fee", which can be up to 3%.

> "Kick-backs eat through portfolios like cancer."

Hidden and non-transparent fees, as well as the kickbacks paid for them, eat away at bank clients' portfolios like a cancer. They act like a mild drug, with the "patient" barely noticing how they are being slowly and almost imperceptibly bled dry – who actually reads their bank's "general custody terms and conditions" in detail, which now run to dozens of pages? Hubert Schwärzler, CEO of Liti-Link, which specialises in the recovery of retrocessions, was quoted in "Finanz und Wirtschaft" on 23 January 2021 as saying: "Swiss banks collect retrocessions as if there had never been a Federal Court ruling." It is clear that kickbacks are not ultimately paid by the product providers themselves, but by the end clients, which also has a negative impact on their performance.

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In a legal grey area

Those who collect retrocessions operate in a legal grey area. This is illustrated by the following sentence in UBS's fundamental contractual provisions: "The client acknowledges that this arrangement differs from the reimbursement obligation set out in Article 400 paragraph 1 of the Swiss Code of Obligations and any other legal provision with similar content." Clearly, the bank is aware that it is behaving at odds with current law. That is precarious at the very least. In the United Kingdom and the United States, kickbacks are prohibited. The most important currency in the investment business is trust. When you entrust your money to a bank or asset manager, you assume that it will be handled in your best interests – it's no different from going to the doctor. However, this fundamental cornerstone of trust is now being undermined by the inherent conflicts of interest that kickbacks create.

Those who collect retrocessions are not independent and are often under pressure to meet the ambitious and bonus-driven sales and profit targets of senior management. It goes without saying that this is not in the best interests of clients. How can a client trust their banker or asset manager if they are constantly in a conflict of interest?

Pressure to sell creates false incentives

A money manager is only truly independent if he or she lives solely on client fees, has no perverse incentives and does not collect retrocessions. This is the only way to ensure that their actions always put the client's interests first and negotiate the best possible terms for them. Otherwise, there is a latent risk that they will be sold the products with the highest margins and kickbacks. Let's not forget that kickbacks of up to five percentage points were paid to brokers for Madoff funds and Lehman products. This stinks to high heaven and should have raised red flags from the start.

The primary goal of a banker or asset manager must be to manage clients' money without conflict of interest as if it were their own – this is a matter of morality and integrity. According to German author Gerhard Schick ("Die Bank gewinnt immer" / "The Bank Always Wins"), accepting kickbacks is like being represented by a lawyer employed by the other side.

Anyone who thinks that an invitation to a luxurious golf event is a generous gesture from their banker to thank them for their loyalty to the financial institution is deluding themselves. On closer inspection, the client is actually paying for the event through the purchase of expensive products – usually several times over.

Investors who rigorously avoid high-margin products and do not allow their financial advisers to receive kickbacks will achieve better performance – and with the money they save, they can treat themselves to a "free" holiday in the Maldives.

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