

# Performance

A triannual topical digest for investment management professionals, issue 11, May 2013



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The challenges of the private pension market in view of low interest rates and their impact on the investment market in Brazil

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Insurance linked securities — Showcasing the convergence of traditional reinsurance with capital markets

Confessions of an IT Manager  
Changing distribution models for the New Affluent Wealth Management client

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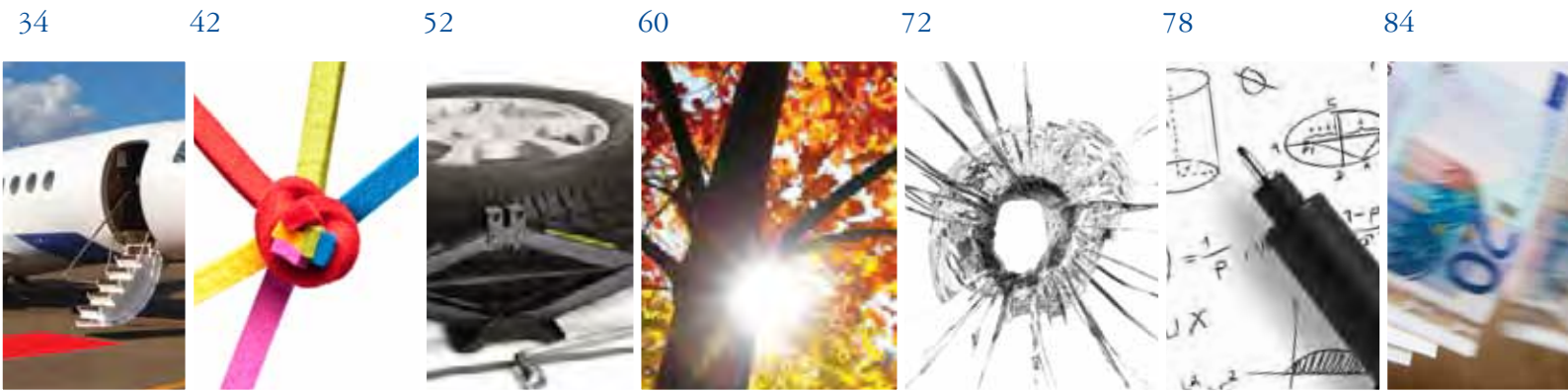
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# Foreword



Dear investment management practitioners, faithful readers and new-comers to our magazine,

Welcome to the 11<sup>th</sup> edition of *Performance*, Deloitte's unique worldwide sectorial publication from investment management professionals and practitioners from around the globe.

Despite the on-going Eurozone debt crisis and the slow paced economic recovery in the United States, the financial markets have actually been improving since 2009. The challenges are still considerable, but surmountable. In this context, we still have to grapple with uncertainty: can the U.S. find a sustainable solution to the fiscal cliff and will the governing bodies of the Eurozone find a resolution to the debt crisis? With that said, we are still confident the recovery will continue and new opportunities are abound for investment managers as they focus on three key areas: adapting to an evolving regulatory landscape, exploring non-traditional growth opportunities, and shifting more of their attention back to operational efficiency.

As a global practice, we are aware that the challenges and opportunities impacting the industry have become inextricably global. To face this future and to respond to the demand for innovation in our industry, Deloitte has made the commitment to be the best professional services firm at delivering solutions to the global investment management industry — a global practice that can offer a perspective that is vital to designing new solutions that will help the industry prepare for the unforeseen. What we can offer the industry is simple — an unrelenting commitment to deliver service excellence that adds value across global organisations.

Without giving away too much information, we are happy to announce that *Performance* will feature a new concept giving industry executives the chance for more in-depth participation in the industry's thought leadership and interaction with managers across different jurisdictions, with varied operating models. Our success story still continues to grow giving us the required motivation to further enhance our publication.

We trust you will enjoy reading edition 11.

**Vincent Gouverneur**  
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Management Leader

**Damien Leurent**  
EMEA Co-Leader  
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EMEA Co-Leader  
Banking

*Performance is a triannual magazine that gathers our most important or 'hot topic' articles. The various articles will reflect Deloitte's multidisciplinary approach and combine advisory and consulting, audit, and tax expertise in analysing the latest developments in the industry. Each article will also provide an external expert's or our own perspective on the different challenges and opportunities being faced by the investment management community. As such, the distribution of *Performance* will be broad and we hope to provide insightful and interesting information to all actors and players of the asset servicing and investment management value chains.*

You are currently reading a paper or electronic version of edition 11 of *Performance*, Deloitte's unique worldwide sectorial publication covering hot topics for Investment Management professionals. As it has been mentioned on several occasions, *Performance's* success has exceeded our expectations considerably. Keen to avoid resting on our laurels, we decided to get straight to work on updating the concept of the magazine. We will not go into any details at this time, but rest assured the new concept will push *Performance's* leading position in industry thought leadership even further by increasing the role and contribution of our external writers.

In this edition, we are delighted to be able to bring you articles concerning regulatory challenges such as European Market Infrastructure Regulation (EMIR), Alternative Investment Fund Managers Directive's (AIFMD) remuneration aspects and financial transaction tax, growth trends in Brazil's pension market and insurance linked securities and perspectives on distribution activities of wealth managers, the concept of a universal management company, as well as solutions to optimise trade management cycles.

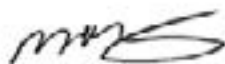
We are also delighted to announce that we will further enhance the magazine's intercontinental footprint by expanding contributions of our Americas and Asia-Pacific Investment Management practices. This is a key step in the consolidation of our global 'as one' strategy and makes our division one of Deloitte's leading practices in this international coordination effort.

Thank you again for your support and consistent feedback; as this is what drives us to continue making *Performance* a unique forum for worldwide Investment Management practitioners.

Sincerely,



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Editorialist



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# Optimisation of the trade management cycle in the investment industry

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The world of the investment management industry is in full motion: new and increasing regulations, enhanced perspectives in the market environment and new technologies are the only constants in today's world. These developments follow each other rapidly, in shorter cycles, with new continuously changing requirements for investment managers to deal with.

Their current operating models, core processes and supporting software are in many cases insufficient, disorganised and not exploited to the full, and will prevent them from achieving operational outperformance. The capacity of today's investment managers to cope with these challenges will determine whether or not they survive the next decade.

Inefficiently organised operational processes will lead to inaccurate internal records on trading and settlement activity. Organisations are exposed to uncertainty in

their trading position, affecting the accurate prediction of settlements, and weakness in verifying securities and cash held with custodians. Operational costs arising from activities such as reconciliation, accounting and reporting will consequently be excessive, resulting in a direct negative impact on overall company profits. Therefore investment managers' success can not depend solely on their investment expertise but also on the organisational capacity to adapt to their environmental service needs, without losing sight of the primary defined investment goals and profitability.



### Environmental developments

It is generally expected that the industry will have to face massive changes in the economic and investment landscape. Numerous opportunities are anticipated in emerging markets and major challenges will arise in existing developed markets. Increased market volatility and aging societies (and outflows from pensions and life insurance funds) in diverse parts of the Western world will test if investment managers are capable of tackling these changes in an efficient manner.

Besides these market driven challenges, there are also considerable changes taking place from a regulatory point of view. For example, regulations such as the Foreign Account Tax Compliance Act (FATCA), Alternative Investment Fund Managers Directive (AIFMD), European Market Infrastructure Regulation (EMIR) and Dodd-Frank Act all affect an investment manager's execution costs and margins.

All these 'revolutions' will have an impact on investment managers' ability to transform their business models, investment strategies, (risk) policies and procedures and accounting with the aim of creating an increasingly agile and requirement-fulfilling operational organisation.



### Back to the 'roots'

Given these enormous shifts, the market belief is that investment managers have to return to their roots—their primary investment objectives—by rethinking their strategies. These 'new' defined strategies will be focused on absolute returns, accepting minimal risk with an extended investment horizon in a quest for long-term results.

To cope with these changes on a strategic level, investment managers will have to reconsider their fund structures, fee models, asset allocations, valuation cycles and organisational structure, bringing these in line with each other.

Dealing on a practical operational level, we can introduce the 'trade management cycle', covering the core process of an investment manager. The 'trade management cycle' basically embraces the entire (automated) operational process, enabling investment managers to remain in full control of cash and investment positions at all times.

This requires up-to-date internal records on portfolio modelling, trading activity, confirmation, settlement, reconciliation, valuation, accounting, NAV calculation, reporting, performance management and risk management. Operational processes should be fully aligned with the newly defined investment strategies, current market standards and best practices. In this way, expected future developments can easily be followed as challenges are experienced market-wide instead of by a specific investment manager. By making use of best-in-class market systems in the original design and related usage of data, investment managers will be able to improve efficiency and agility in order to meet all environmental demands: delivering operational outperformance towards clients and regulators at optimised costs.

### Market initiatives for market standards

The redefined strategies, initiated by various market developments, have a direct impact on the 'trade management cycle' and processes of investment managers. Historically developed structures are not able to deal with these new developments. Perspectives have been changed drastically—for example, the front, middle and back offices are no longer considered as separate departments when discussing the operating model. Increasingly, order and trading staff are aware of downstream processing, avoiding trade exceptions and settlement or reconciliation failures.

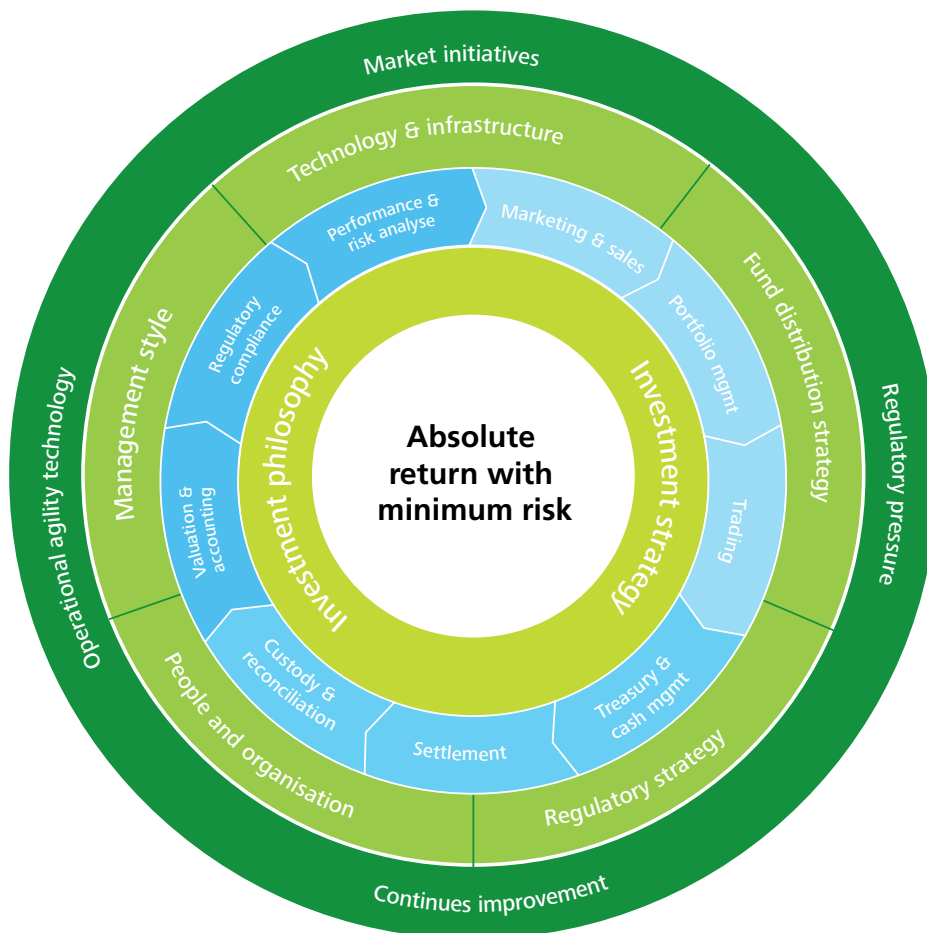
Worldwide initiatives addressing best practices and related market standards have already been launched. These are focused on improving and standardising the industry's operational infrastructure for investment managers and other types of financial institutions. Examples are the International Securities Association for Institutional Trade Communication (ISITC), Securities Industry and Financial Markets Association (SIFMA) and International Swaps and Derivatives Association (ISDA).

These associations are mainly focused on removing bottlenecks by building robust, stable market standards enabling increased transparency, flexibility and simplicity within the benefits of facilitating Straight-Through-Processing (STP) among investment managers. These market best practices should therefore be the starting point for changes based on processing, organisational structure and other supporting areas within the investment manager's organisation.

### Optimising the trade management cycle

Investment managers capable of implementing an optimised, fully automated 'trade management cycle' supported by market best practices will have the greatest chance of survival in the long term. Despite the fact that market conditions, regulations and financial frameworks are 'in principle' similar, it will be a different 'journey' for every investment manager. As mentioned before, the investment philosophy, investment strategy, organisational culture and long-term vision will influence the exact steps taken by each investment manager.





## Dealing on a practical operational level, we can introduce the ‘trade management cycle’, covering the core process of an investment manager

The expectation is that one of the following strategic approaches will be pursued:

**Collaboration with an innovative (software) partner**  
 Investment managers will investigate possibilities and solutions which are currently not available on the market but will lead to significantly higher efficiency in the ‘trade management cycle’. These systems are consequently in line with current market best practices and expected new protocols.

This strategic approach is characterised by intensive collaboration with an innovative software vendor which has an in-depth knowledge of the specific and complex market developments. The advantage is that both parties, with their own background perspective and specialties, investigate and analyse the market and combine their results into one solution. A possible drawback may arise if the collaborating parties do not agree with the overall solution based on their own analyses: an unclear direction may eventually lead to the investment manager adopting an inefficient operational process.

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## Investment managers must be prepared to adapt to structural shifts in the markets, regulations and investment landscape while focusing on their investment philosophy and strategies

### **Innovation by internal developments**

Another possibility is that investment managers push to change the structure by establishing an internal software department or platform charged with redesigning and rebuilding the required functions into the 'trade management cycle'. The challenge for this department is to stay in line with current and future market developments and standards: where standards and best practices are identified too late, these must then be reverse engineered into the solution which has already been chosen and designed. This can lead to unforeseen and increased organisational expenditure, especially in this constantly changing and complex market. Another challenge for this strategic approach is that operational departments should focus on their key operational objectives and not be distracted by redefining the solution's business requirements.

### **Standardised software**

Currently a more common strategic approach is the implementation of business-specific applications which support the 'trade management cycle', known as off-the-shelf solutions. These business solutions, often offered by well-known vendors, are specialised in a part of the operational process of the complex investment management market. The advantage is that the software vendor will follow market developments based on their specialised experience and a wide range of clients' requirements. However, there may also be disadvantages, such as if the software vendor is overly specialised in one (small) part of the 'trade management cycle' and therefore cannot foresee the challenges on the complete process level. Furthermore, when discrepancies between software packages and protocols appear, specialist vendors will be reluctant to change their own structure or processing and are likely to advise other vendors to do so.

### **Outsourcing**

The last and increasingly used strategic approach is to outsource secondary organisational processes, thereby allowing organisations to focus exclusively on their primary objectives and processes. In the case of an investment manager, the primary process functionalities are portfolio modelling, trading activity, confirmation, settlement, reconciliation, valuation, performance management and risk management. The supporting processes, such as transaction and security processing, NAV calculation, accounting and reporting, are not directly part of the primary processes of an investment manager. These secondary processes in the 'trade management cycle' will generally not differentiate an investment manager from competitors. Outsourcing could lead to operational efficiencies and reduce costs associated with technology, staff and real estate. When new instrument classes, products or services are requested in the future, these must be enabled by the service provider without any extra implementation costs in terms of the outsourced processes. However, with this strategic approach, it is in the best interest of both parties to have a close partnership based on mutual collaboration so that possible (transition) problems can be tackled successfully should they arise.



## Conclusion

The past few years have proven to be turbulent times for investment managers. These financial service organisations were not fully equipped to respond effectively to highly volatile financial markets while simultaneously achieving the investment objectives agreed with their clients under difficult circumstances. Investment managers should be prepared to adapt to structural shifts in the markets, regulations and investment landscape while focusing on their investment philosophy and strategies. In order to effectively support these primary processes, the 'trade management cycle' should be aligned with both current and future market standards and best practices.

Two strategic approaches are advisable in order to optimise the 'trade management cycle'. Given the significant developments in environmental and technological areas, it is the expectation that the investment management sector will be strengthened by intensive long-term mutual collaboration with innovative software partners or outsourcing parties. This enables the optimal implementation of solutions which are technologically and functionally best-in-class. Intensive mutual collaboration ensures that both parties are committed for the long term, improving the delivered quality of the 'trade management cycle'. Realising an operational investment management process, which is based on accurate, timely and fully accessible financial positions, facilitates the right investment decisions and the achievement of absolute returns benefiting clients in the long term.

### To the point:

- The investment management organisations that will be best equipped to survive are those that can quickly react and adapt to the environmental, regulatory and technological developments of the next decade
- Well-developed investment strategies and philosophies are essential but investment managers should also focus on improving their trade management cycle; optimising operational efficiencies to deliver sustainable cost savings reduces overheads and pressure on the investment portfolio's absolute returns
- There are two suitable strategies for optimising the trade management cycle; both focus on developing long-term mutual collaboration with specialised and enhanced partners. The first option is collaboration with an up-to-date software vendor which can support the optimal trade management cycle by implementation of 'best of breed' software. The second option is collaboration with a specialised outsourcing partner who has experience across the sector in resolving the complex challenges presented





# The challenges of the private pension market in view of low interest rates and their impact on the investment market in Brazil

For decades, interest rates on Brazilian government securities were among the highest in the world, but now, with the reduction in interest rates, new investment opportunities have opened up for the private pension market in Brazil, with important repercussions for the investment market.

**Gilberto Souza**  
Partner  
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### Context—The size of the pension plan market in Brazil

The closed private pension market is one of the most important of the Brazilian economy. Although the amount of pension funds has reduced in recent years, as can be seen in Graph 1, the volume of resources under the administration of these entities continues to grow annually. Furthermore, in view of the growing tendency to include less favoured social classes and investments in infrastructure, it is an important source of investment for Brazil. In view of this, the gradual reduction of interest rates on government securities over the past few years presents a major challenge for managers of pension entities in Brazil that have obligations to pay their participants due to additions of retirement and social security benefits.

Several large-scale infrastructure projects are currently a priority for Brazil. This is a unique moment for the local economy, not only on account of the country's economic growth, with constant challenges in terms of oil, mineral and agricultural production, but also due to the major events to be hosted by Brazil in the coming years, such as the World Cup and the Olympic Games. Pension funds occupy a prominent position in this scenario, with demands for significant investment and, as a consequence, the development of investment solutions such as equity funds and real estate funds, among others.

### The size of the market and the impact on GDP

According to the Central Bank of Brazil, local gross domestic product (GDP) reached R\$4,403 trillion in 2012—approximately US\$2,158 trillion—and, as shown by Graph 2, has been growing steadily over the past few years despite the global credit crisis. A major portion of Brazil's GDP is generated by its pension funds, which accounted for about 20% of GDP in 2011. This demonstrates the importance of pension funds for the Brazilian economy.

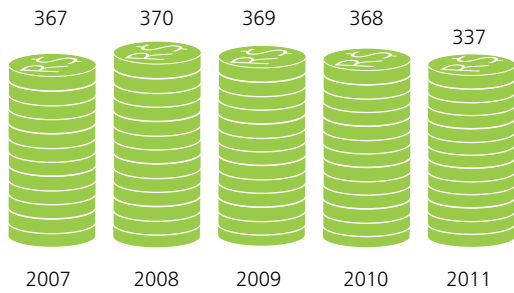
On the other hand, a considerable portion of these pension fund resources is invested in Brazilian Federal Government bonds, which have traditionally offered interest rates above the inflation rate, making them very attractive. However, as shown in Graph 3, the reference interest rate for government securities, known as the SELIC rate, began to continually and gradually fall as of 2011, as part of a monetary policy strategy aimed at reducing the financial costs of the Brazilian Government.

Pension funds, therefore, have always played a key role in the Brazilian economy because while they are an important source of funding for the Federal Government due to their purchases of government bonds, they also contribute significantly to financing various projects related to infrastructure, basic industry, highways, railways, agricultural companies, ports, hotels and other important segments of the Brazilian economy.

Consequently, Brazilian pension funds that used to primarily focus their investments in those assets as well as in shares of Brazilian companies are now faced with a major challenge, namely to find other forms of long-term investment with maturities (durations) that match their pension obligations.

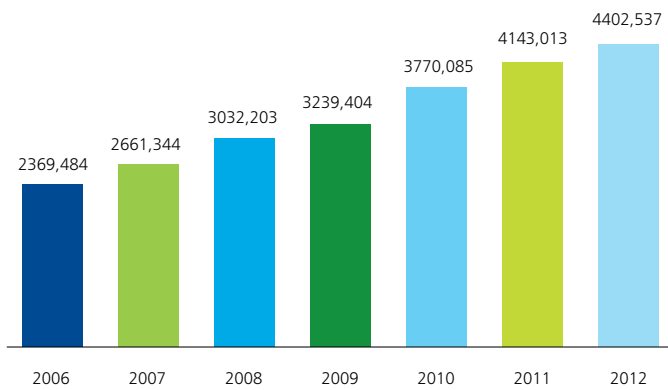
It is important to note that there are still large Brazilian pension plans which offer defined benefits to their members, where the value of the liabilities of the mathematical reserves is predetermined. Thus, the actuarial risk management assessment and impact caused by the reduction in interest rates has become increasingly challenging for their managers.

**Graph 1: Quantity of pension plans in Brazil**



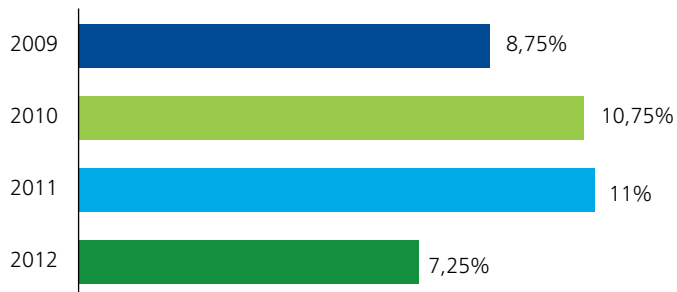
Source: National Superintendence of Pension Plans

**Graph 2: GDP - Expressed in trillions of Brazilian Reals (R\$)**



Source: Research Deloitte (based on information provided by the Central Bank of Brazil)

**Graph 3: Selic rate evolution (%)**



Source: Research Deloitte (based on information provided by the Central Bank of Brazil)



**The opportunity for asset managers—  
Develop new alternatives for the market, matching  
the financial costs for the major events and  
infrastructure demands**

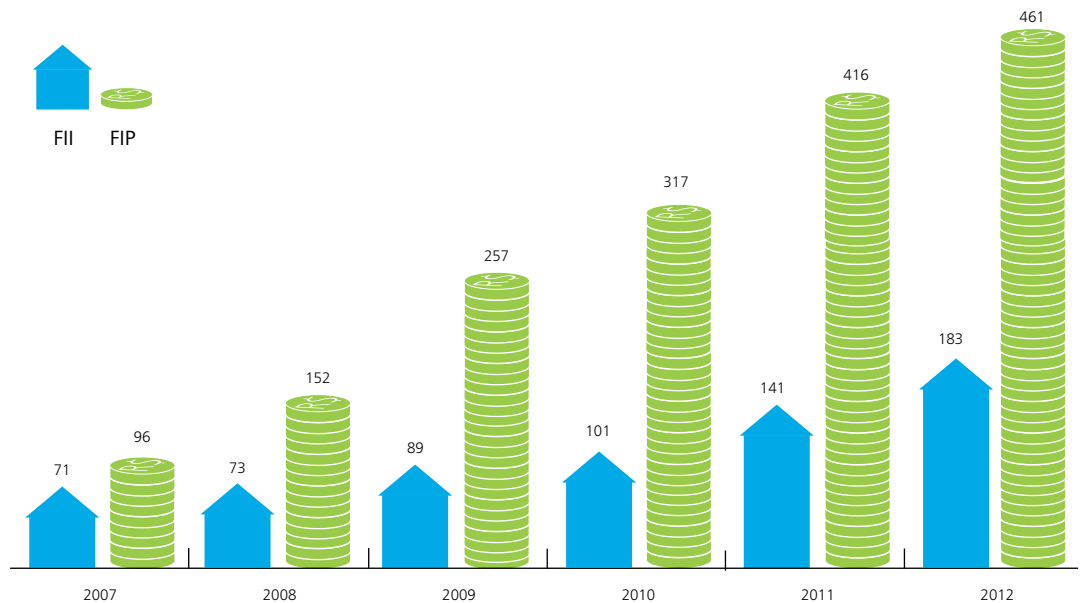
As a result, more elaborate forms of investment have been developing rapidly in the investment fund market, where large asset managers and specialised asset management companies have been swiftly identifying, developing and offering equity and real estate funds to the market and Brazilian pension funds. These strategies both combine product offerings to pension funds that come with certain risks and the promise of attractive returns and, at the same time, foster demands for financial solutions to the challenges posed by major events and modernisation projects in terms of Brazil’s infrastructure base.

A significant increase in the amount of equity funds (known locally as FIPs) and real estate investment funds (FIIs) has therefore been observed in Brazil, as evidenced by Graph 4 below.

These investment funds combine customised solutions for institutional investors, including pension funds, with a clearer assessment of tax effects, which is always an important profitability assessment factor given the high tax burden, and attractive returns that are consistent with the actuarial cost of the pension funds, obviously depending on established modelling.

Of course, there are also additional investment alternatives for pension funds, such as foreign financial investments, private credit issued by Brazilian companies and also on the Brazilian stock market, which always offer upside potential in times of falling interest rates. However, all these investment alternatives are directly related to the development of the capital market in Brazil, as a result of the reduction in interest rates on government securities and also in the increase of companies listed on the São Paulo Stock Exchange (BM&FBovespa).

**Graph 4: Selic rate evolution (%)**



Source: Research Deloitte (based on information provided by the Brazilian Securities and Exchange Commission)



**Conclusion—There is room for more solutions for pension funds following the fall in interest rates in Brazil**

We should consider that employment levels in Brazil are relatively high and the population's average age is relatively young compared to elsewhere, especially European countries, in addition to the fact that the provision of social security benefits in Brazil is an important factor in retaining talent in both public and private companies. Thus, the conclusion is that demand for pension funds should remain high.

We should also consider that low interest rates in Brazil are likely to persist for a considerable period of time. Thus, the search for investments that combine market risk with returns that are consistent with the actuarial costs and durations of benefit plans will be a key theme in the pension market, with visible reflections for asset managers in Brazil in the coming years.

**To the point:**

- The size and offer of solutions for retirement plans for Brazilian citizens will increase for the next years
- The decrease of the interest rate of the public bonds will also increase the demand not just for corporate credit bonds but also for equity and real estate investment funds
- The demand for infrastructure projects and the mega events in Brazil as the Football World Cup and the Olympic Games will also generate financial solutions as equity and real investment funds



# FOCUS!

## A new trend in the international supervisory approach

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Last year, the Dutch Central Bank (DCB) introduced a new supervisory approach, FOCUS! This approach is the result of the DCB reform process, which was based on an evaluation of the DCB and external organisations such as the International Monetary Fund (IMF) and mainly aimed to integrate a more effective and powerful supervision. This new approach includes a transition from a national-oriented supervisory approach to an international one, in line with the EU model

FOCUS! has two key characteristics. Firstly, it includes a more qualitative analysis of the risks of financial institutions, based on concepts such as strategy and business model, risk appetite and risk culture. Secondly, FOCUS! is able to monitor implementation of, and compliance with, (new) international rules and regulations including IORP II, AIFMD and FATCA.

The impact of FOCUS! is mainly reflected in the supervisory scope of the DCB which, before the introduction of this new approach, was essentially focused on monitoring core quantitative ratios such as solvency and liquidity.

As part of its expanded capabilities, the DCB will also be able to evaluate qualitative aspects, for example the institution's strategy, risk culture and risk appetite. This means that Dutch financial institutions have to make these less tangible aspects explicit, to be able to include them in their internal control systems and explicitly report on them.

Deloitte's recent benchmark of Dutch pension funds and asset managers demonstrates that a fast majority of the respondents have not yet taken sufficient notice of these new developments, despite potentially a more than significant impact on organisational design, day-to-day execution and reporting.



This benchmark applies to the Dutch pension fund and asset management market, however FOCUS! is aligned with the supervisory approaches of other regulators such as the UK, Australia and the EU supervisory model. It is therefore relevant on a global basis.

### FOCUS!

FOCUS! enables the DCB to perform a qualitative assessment of a newly defined set of risk drivers. Managing and monitoring these risk drivers adds an extra dimension to the pension and asset management market, because most of a pension fund's activities are outsourced to pension service providers (pension administrators, asset managers, etc.). The board of a pension fund continues to be accountable for the outsourced activities and therefore also continues to be responsible for the management and monitoring of the FOCUS! risk drivers throughout the entire pension value chain.

The most important qualitative risk drivers are:

- Macro economic and sectorial developments. What is the impact of these developments on the pension funds when these developments are related to internal (inherent) risks? Is the board able to form an integral vision on how to manage and respond to these external and internal risks adequately and effectively?
- Business model and strategy. Are the business model and strategy realistic and in line with current market perspectives?

- Translation of the business model and strategy into a sound and clear risk appetite, which is formulated explicitly by management and implemented throughout the business including risk indicators and limit setting
- Governance structure, risk culture and level of integrity of the pension funds and pension service providers

Future supervisory evaluations will be based on the outcome of the assessment of these risk drivers. The main challenge is how pension funds manage these risk drivers and take responsibility for effectively integrating them into their risk management system, given that most of their activities with embedded risk are outsourced to pension service providers.

The development and use of qualitative risk drivers as part of the supervision of the DCB is in line with an international trend. As indicated earlier, FOCUS! is in line with supervisory approaches used by other regulators such as in the UK, Australia and Canada. In addition, the newly developed FOCUS! approach is also in line with the EU supervisory model, which is applicable to financial institutions and sets the standards for a European pension funds regime.

### How to act

The question of 'How to act?' is a legitimate and complex one. Pension funds and pension service providers have to redesign their current risk management system to enable pension funds to assess macro economic risks as well as internal risks and combine these assessments in order to (periodically) determine compliance with their risk profile.

The result is that the current level of information, as reported under SLA's and contracts, will prove to be insufficient, because this information is mostly quantitative and addresses qualitative elements to a lesser extent. Given these developments, pension funds will ask for more detailed information with regard to the qualitative risk drivers, but also to the design of the risk management system of the pension service provider, in order to be able to integrate their risk management activities into the risk management system of the service provider and vice versa. Furthermore, the pension fund will also increasingly require the pension service provider to deliver periodic or even ongoing assurance about the operational effectiveness of their risk management system, enabling the pension fund board to rely on the risk management information of their pension service provider.

In addition, pension funds will translate their strategy and long term goals into a risk appetite and test the strategic boundaries of macro economic developments. Eventually their risk appetite will have to be cascaded down into the pension value chain through the implementation of risk indicators and risk limits into the business of the pension service provider. Pension service providers are obliged to adopt these limits and report to the pension fund about the current risk levels in relation to the limits set by the pension fund.

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## FOCUS! enables the DCB to perform a qualitative assessment of a newly defined set of risk drivers

Finally, the pension service providers will be held accountable for the way they ensure that the risk culture and integrity of their organisation is aligned with the risk profile desired by the client. To this end, the management of the pension administrator should identify and implement control activities which enable them to actively influence the culture of their organisation.

We believe that the relationship between pension funds and pension service providers needs thorough adjustments in order to rebalance and integrate their current risk management systems in light of the FOCUS! risk drivers. A holistic approach is required.

### Conclusion

In conclusion, the supervisory body has developed a methodology that looks beyond ratios and model calculations. This new way of thinking requires the industry to establish a vision of how to manage their inherent risks and relate this to macroeconomic and industry developments, but also actively manage the human element, which is essential for effective risk management.

If the industry does not adopt these key characteristics in their risk management system, pension funds will receive lower supervisory ratings and will experience difficulties with the implementation of future legislation.



Pension funds will ask pension service providers to integrate their risk management system with the risk management requirements of the pension funds. If, for example, an asset manager does not proactively adapt their systems to these future requirements, each client will expect their individual requirements to be met by their asset managers, resulting in multiple reporting and governance structures and significant cost increases. For this reason it is key for asset managers to develop their system in such a way that it will account for all (future) client requirements.

With the introduction of FOCUS!, the regulator is ready for the future. It is now up to the market to adopt this new way of thinking and make this the standard for market practice in the near future.

**To the point:**

- A majority of the pension funds and asset managers have not yet taken sufficient notice of the new developments regarding FOCUS!
- Pension service providers will be held accountable for the way they ensure that risk culture and integrity in their organisation is aligned with the risk profile desired by the client
- With the introduction of FOCUS!, the regulator is ready for the future. It is now up to the market to make this the standard for market practice



# Insurance linked securities

## Showcasing the convergence of traditional reinsurance with capital markets

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Historically, there has been a symbiotic relationship between capital markets and the insurance industry, with the insurance company seeking good investment managers to help boost profits and the investment manager considering large reinsurance companies with their excess investable capital as much sought-after customers.

While these relationships continue to this day, there have also been recent developments which make these relationships more complicated and potentially more profitable for both groups. It is also fair to say that many of these developments have been concentrated in a few select jurisdictions that cater to both the capital markets and the reinsurance industry.

In the past, an investor's ability to participate in the insurance or reinsurance business was limited to buying shares in a publicly traded insurance or reinsurance company. There is undoubtedly overlap in the insurance and reinsurance business, with some insurers writing both insurance and reinsurance business. In the context

of this article, let us consider a reinsurance company as simply one insurance company that provides insurance to another insurance company. Also, it is common practice for reinsurance companies to be set up in jurisdictions with favourable tax rates and efficient regulatory environments, such as Bermuda and the Cayman Islands, to provide the most cost-effective use of capital. Bermuda in particular will also have a high level of quality service providers familiar with the very specific operating requirements common in the reinsurance markets. In recent years, there have been a number of developments in investment products that have enabled investors to invest directly in the underlying risks inherent in an insurance contract.



This has also served to transfer risk away from the insurance companies into the capital markets; which one could argue is a positive development and a more efficient use of capital given the relative size and ability of the capital markets to absorb losses when a major catastrophic event such as a hurricane or earthquake occurs.

#### Insurance-linked securities

As residents of Florida were cleaning up the aftermath of Hurricane Andrew in 1992, unbeknownst to them, a new market was coming to life to help cover the insured costs of such natural disasters and to provide capital markets a chance to participate in the risks and rewards associated with catastrophe-based insurance. At the time, Hurricane Andrew was the costliest hurricane in United States history, causing insurance and reinsurance entities to seek new ways to raise capital and to cede some of the risk related to these catastrophes.

The ultimate result of this search was to securitise this risk into an investible product, which as a broad asset class, are commonly referred to as insurance-linked securities, or ILSs. The general characteristics of an ILS involve a specific insurance/reinsurance policy or group of policies with a similar underlying risk, such as a Florida hurricane, packaged in such a manner that the premiums from the underlying policies are offered as returns to investors. Of course, the downside risk is now also transferred to the investor.

The notion of ceding this risk into an investment was first enacted through opaque, over-the-counter transactions. However this has evolved into catastrophe or cat bonds. Cat bonds have arguably become the largest element of the ILS spectrum and are certainly the most transparent element regarding pricing information, underlying risks ceded to the investment public and market size.

In investment terms, cat bonds are bonds whose principal payments depend on the non-occurrence of a predefined catastrophic event or other measurable risk. A cat bond is conceived when an entity such as an insurance or reinsurance company, the sponsor, wishes to cede a specified insured risk. The risk will generally be transferred to a Special Purpose Vehicle (SPV) via some form of reinsurance contract. The SPV then floats a bond to the investment public. This bond will differ from a typical bond in that the risk of default does not lie with a credit event at the underlying company, but instead is based on a specified triggering event, such as a California earthquake.

If this triggering event occurs, then, for the losses under policy under the terms of the reinsurance contract, the SPV pays the ceding reinsurance company the full national value of the bonds. In return for taking on this focused risk, investors in this catastrophe bond are compensated by above-average interest rates. A typical catastrophe bond includes a floating interest rate, calculated by a base rate such as the U.S. Treasury Bill rate plus a spread, which is typically between 5-15%.

Although the industry saw its seeds begin to grow in the early to mid-1990s, the major surge in the industry came after the 2005 hurricane season. Hurricanes such as Ivan, Frances, Katrina, Rita, Wilma and Emily contributed over \$80 billion in insured losses. In response, rating agencies increased their capital requirements for reinsurance companies. As a corollary, these entities found themselves in need of further sources of capital, and at the same time, a decrease in the market capacity for further ceding of risk via typical means. Investors, on the other hand, were drawn to this market based on the prospective high rates of return, with the returns being non-correlated to general market returns.

The market continued to grow and diversify in its offerings. Alongside cat bonds came instruments such as industry loss warranty, a form of further packaging risk into a contract which no longer covered against risks under a specific contract, but instead covering against industry wide losses.

On the investor front, specialised ILS funds were emerging. Their funding was heavily drawn from institutional investors such as pension funds. The draw towards high returns linked with low correlation proved to be desirable for investors in search of longevity in their returns. During the 2008-2009 credit crisis, the ILS sector proved its resilience, with annual returns of 3.92% and 9.11% respectively, according to the Eureka ILS index. During this same time span, the S&P 500 lost 34.5% in 2008 and gained 35.0% in 2009. The low, if not zero, beta characteristics of the ILS field prompted a further influx of professionally managed capital seeking safe havens from uncontrollable market fluctuations.

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In the context of this article, let us consider a reinsurance company as simply one insurance company that provides insurance to another insurance company

There are risks associated with investments in ILS that should not be overlooked. These risks include (but are not limited to):

- Investors may lose all or a portion of their investment in the ILS if a triggering event occurs
- In some cases, the maturity date of the ILS may be extended without the prior consent of the investor
- The ILSs may be redeemed before their maturity date at the issuer's option
- Investment in ILSs may have unforeseen accounting and tax consequences for investors
- If the issuer of the ILS becomes insolvent, investors may lose a portion or all of their investment
- A limited secondary market
- Ratings are subject to revision by the credit rating agency

#### Current market

2012 concluded the second largest historical year of issuance with approximately \$6.3 billion of bonds, behind only 2007's record notional issuance. This highlighted the peak interest from all participants in the ILS market for its continued growth. The best example of this showcased the largest single catastrophe bond issuance in history. The Everglades Re catastrophe bond, originally announced at \$200 million, was upsized shortly after announcement to \$250 million, and subsequently to \$500 million. Due to investor demand, the float of this bond eventually settled at \$750 million. Investor demand was understandable, as the bonds carried a coupon of US Treasury Bill rates plus 17.75%. The issuer, Citizens Property Insurance Corporation, found a way to transfer a portion of their Florida specific hurricane risk from their books, while investors were generously compensated for this focused risk.

The ILS market has developed beyond a niche market for insurers attempting to raise capital after extreme events to become a fundamental programme in a reinsurance companies risk management process, while providing a unique asset class for investors. Pension funds and retirement schemes lead the way in terms of new investors in this space. The flow of pension fund investors is expected to escalate over the next few years, pushing this market further.



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Although the industry saw its seeds begin to grow in the early to mid-1990s, the major surge in the industry came after the 2005 hurricane season



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## At a basic level, given the large reserves a reinsurance company must maintain to pay future claims, one could argue a reinsurance company is just an investment company that also writes insurance providing access to large pools of cash

Many ILSs are listed on a stock exchange, with the Cayman Islands and Bermuda competing for much of the new business. In 2012, there were 27 special purpose insurers set up in Bermuda to handle new issuances of cat bonds. Meanwhile, the Cayman Island Stock Exchange had cat bonds and other ILS vehicles listed with a market value of nearly \$10 billion. The Chicago Board of Trade offered exchange traded catastrophe derivatives and investors may now invest in exchange traded options and futures.

An indication of the growth can be shown by the previously mentioned issuance of approximately \$6.3 billion in cat bonds in 2012, with over \$1 billion listed on the Bermuda Stock Exchange (BSX) in the last six months of 2012 alone. Jurisdictions such as Bermuda and the Cayman Islands are well-placed to host this business as they have a unique blend of investment management and insurance talent operating in a regulatory environment already actively serving the world's ILS market.

### Forming your own reinsurance company

Further evidence of the convergence of the insurance and alternative investment universes can be found in the trend of hedge fund managers, including those at Third Point, Greenlight, SAC and Paulson & Co., setting up offshore reinsurance companies. A partial driver for these transactions is the potential tax deferrals afforded under the existing U.S. taxation rules of reinsurance companies set up in offshore jurisdictions. This is not a new concept, with Warren Buffet being the most notable investor to see the opportunities of merging his investment expertise with the huge investment portfolios generally maintained by an insurance company as early as the 1960s.

Buffet saw the opportunity to make money from the investment returns of the accumulated insurance premiums, or float, that an insurance company must maintain in order to pay future claims. At a basic level, given the large reserves a reinsurance company must maintain to pay future claims, one could argue a reinsurance company is just an investment company that also writes insurance providing access to large pools of cash.

What is unique about the current crop of reinsurance starts-ups is that the investment managers are not investing in an existing reinsurance company, although that may still happen, but they are choosing to capitalise the reinsurance company with their own capital. This immediately turns the investment into an equity investment which would generate long-term capital gains when the investment is ultimately sold. This could be years down the line, hence the potential tax deferral. While investors in cat bonds are essentially taking a gamble that a single triggering event will not occur, an investment in a reinsurance company provides a more balanced investment approach with the risk spread in line with the company's underwriting philosophy. Once the company is set up and starts to write reinsurance business, both the excess capital and float of the reinsurance company are invested back into the sponsoring fund. The fund is then able to collect fees from managing this money while at the same time the fund manager is able to control the investment strategy of the company it effectively owns.



### Future state

The continued development of the market has led to some fast-paced innovation in the space. Not only in terms of how the trigger event may be measured on a cat bond but also in the types of risks being insured. Historically, the risks covered by these instruments were more commonly associated with catastrophic events, such as hurricanes. This is not expected to change as demand for natural catastrophe coverage is expected to remain strong, but it is anticipated that demand for protection against other risks, such as pandemics and life, will become more common-place and further fuel the space.

At the same time, existing products, such as cat bonds, are finding new issuers beyond the typical insurance/reinsurance entities. Entities such as workers compensation boards in earthquake prone areas, or even lottery companies have issued catastrophe bonds over the past year.

From humble beginnings following the aftermath of a major natural disaster, the overall size of the ILS market, including cat bonds, ILWs, sidecars and collateralised reinsurance arrangements is now estimated by Conning and Company as approximately 15% of the total property and catastrophe market, equating to about \$35 billion in market size. In addition to the capital allocated by the dedicated ILS fund managers and the infusion of capital from the traditional hedge fund managers, the convergence of alternative asset management and insurance is undeniable.

### To the point:

- An examination of this relatively new market and products expanding under the insurance-linked securities
- ILS appeal to institutional investors due to its nature as a low or zero correlation asset class when compared with traditional investment classes
- Like any investment, there are risks
- Reinsurance start-ups are beginning to take hold as an alternative for large capital market participants as a direct participation method into the ILS field
- Transferring risk away from insurance companies to capital markets as a new means of transferring risk to willing market participants
- Future growth potential for this industry is showing some very promising signs due to new launches and the size of those launches




# Confessions of an IT Manager

An insider speaks on technology  
challenges and opportunities for  
asset managers

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They say that information is power, and this is particularly true in asset management. The very core of the business is about gathering and analysing information to then turn it into market-beating performance. Many investment houses refer to their investment functions as 'manufacturing', but there is no factory, no stock: information is both the raw material and the output. This really is the peak of the 'information economy', so do we pay enough attention to the way we handle information?

Until recently, I led a major technology function for a leading UK asset manager, giving me a broad view of the firm and that of my peers. In this article I will discuss some of the issues that drive and challenge the IT functions in asset management houses. I will also look at how firms can get more from their IT than they otherwise might.

#### Two teams divided by a common department

Broadly, IT functions are divided into two parts: the 'run' and 'change' teams. This division is usually more marked in IT than in other operations functions, often due to the way the change function does its accounting (it creates assets that need a capital value assigned to them, whereas the run function just spends money). This creates a variety of challenges, as the two areas require different skills and different ways of working, and yet it is essential that they work together. This difficulty is compounded (and perhaps caused) by the fact that the two fields attract different sorts of people; the demographics, education and skills required are quite different. Social interaction between the teams is rare, and it is even rarer for individuals to move between the two. This challenge isn't unique to asset managers, but it does have implications that we need to be particularly aware of, which come out in several areas.

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In this article I will discuss some of the issues that drive and challenge the IT functions in asset management houses. I will also look at how firms can get more from their IT than they otherwise might

#### The amateur vendor manager

In the same way that the industry as a whole has turned to an increasingly outsourced model, IT has become much more about integrating disparate external service providers into a coherent and effective package for use by the manufacturing and distribution functions. The rise of 'cloud computing' is the latest incarnation of this trend, but we have been doing this for a long time. Twenty years ago it was considered risky to have a third party collect and store backup tapes in a 'safe' offsite location. Now it is still risky, but commonplace. Chief Technology Officers (CTOs) are looking to outsource activities that were once thought of as being absolutely core, including 'high-touch' services like the people who sit next to fund managers to ensure their trading screens have exactly the right layout, and the business specialists who live in workshops, thrashing out the detail of exactly how a middle-manager in the investment risk team wants to present VaR on a daily report.

Critical individual roles and entire functions like system testing, datacentre support and network management are now provided by organisations that are better at those technical competencies than an asset manager can ever be. This creates a new challenge, as those providers have to manage discrete pools of people who are technical specialists while retaining a breadth-of-view and holistic 'client outcomes' view. Many struggle to do this, however, which only makes life harder for the amateur vendor manager.

The challenge here is that vendor management is a genuine discipline in its own right. It is like driving a car: everyone thinks they're better than average at it, but it's also easy to do badly, which has increasingly significant consequences. Most asset managers aren't large enough to have a dedicated vendor management function, and if they do, it's typically focused on the key business outsourcing providers like transfer agency and investment operations.

Even these functions are often staffed by the best subject-matter expert, not the best vendor manager. Introducing a third party plays into the run/change challenge by allowing an external body to become the focal point of disagreement between the way an outsourcing project was designed to work and the way it actually works.

Vendor management is not featured in any IT training catalogue, or in HR career planning worksheets. It might now be time to reconsider this position.

Asset managers often find themselves gathering research on some of the larger service providers from their investment management and IT teams. Firms should ensure that – as far as is appropriate – customer due diligence and investment research are merged.



### Blue-sky thinking

Almost all businesses have now heard of – and likely buy – cloud computing in some form. Cloud is simply the current buzzword for IT services purchased and delivered from outside the consuming organisation (although in one variant called ‘private cloud’ a firm may still use servers in its own datacentre, albeit managed by a third party).

Asset managers are keen on this trend, as medium-size organisations are particularly drawn to the opportunity to reduce fixed costs and improve predictability. However, being a buzzword, it is much misused and misunderstood. The fact is that most houses have been using ‘cloud computing’ ever since they installed their first Bloomberg terminal, and internet email has always depended on ‘the cloud’. So a lot of the froth is just that, even if it emphasises the same ‘old’ vendor management challenge outlined above.

So what is new here and why do asset managers care? I have noticed some trends:

**1. Tablet computers**—Board members are increasingly having their board papers delivered and used on iPads and the like. This is wonderful news for trees, but exposes very sensitive material to new risks, including ‘hidden’ cloud services which store and deliver documents over the internet to these tablets and of course the risk of the device being lost or stolen. Distribution teams are also finding that their customer relationship management systems—that contain sensitive client information and strategies – are now accessible ‘on the road’ via tablet and the cloud. Few appreciate the new confidentiality risks this creates.

**2. Commodity systems** such as email and word processors that used to require a large up-front purchase are now available ‘to rent’. These services are much more cost efficient and have started to become ‘industrial strength’, with large organisations starting to make the switch. Medium-sized firms are particularly attracted to the switch from fixed ‘buy and upgrade every three years’ costs to variable ‘hire per user’ costs. Although it might sound trivial, it also reduces the electricity bill, as firms are finding the cost of running their own servers to be increasingly uneconomical and environmentally unfriendly. The cloud can provide servers at a much lower financial and green cost.

**3. Core activities** like risk analytics and hosting of the Security Reference Master are increasingly moving into the cloud. Risk analytics is a popular candidate for cloud-hosting as it requires heavy processing power—which is expensive—and usually sits idle for much of the day once opening positions have been run. Providing this in the cloud also makes interactive decision support using risk analytics viable, as the computing horsepower is on tap 24/7. For medium-sized firms, this has allowed risk to move from a disabler focused on rules and limits imposed on an investment function to an enabler allowing fund managers to exploit their full risk budget in pursuit of alpha.

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This really is the peak of the ‘information economy’, so do we pay enough attention to the way we handle information?



### Speed is everything...

Aside from spending vast sums on attracting and retaining 'star' investment talent and hoping the alchemy works, there are few ways for firms to build a sustainable competitive advantage. The underlying capability to consistently deploy new products to the market quickly and to trade new financial instruments is one of the ways they can do this. It has driven a rapid take-up among asset managers of so-called 'agile development' techniques in preference to the old style 'Waterfall' method.

Much of this is driven by the apparent consistent failure of any IT organisation (asset management or otherwise) to deliver IT projects on time. Often, firms complain of monolithic change programmes with lofty goals and potential benefits which quickly drop off the radar, lose their way and have to be gracefully shut down or trimmed back to deliver something – anything – in a meaningful timeframe.

Agile techniques are intended to get around the 'big project' mindset in a number of ways, but the most visible is that the IT teams are now encouraged to embrace gradual or 'late-breaking' requirements for a system. It values useful systems over documentation, and is summed up by the objective of 'continually delivering useful software'. This is a big paradigm shift for IT departments and the people who engage with them on large scale change, creating new skill requirements, performance management approaches and results. For very small firms, these techniques legitimise many of the 'hidden' old practices that weren't exposed to auditors, and for large firms it creates a new level of responsiveness. Medium-sized firms struggle to make the switch as it can be hard to run both systems at the same time in an IT department of less than around 100 people, and a 'big bang' move is highly risky. However, there are some agile techniques that can be used selectively in a waterfall environment with dramatic results.



### ...so take a moment to plan

As mentioned earlier, IT projects often create an asset, so their costs can be capitalised and depreciated in P&L accounts. This encourages IT functions to assign an internal cost to their employees' time, and charge it to a budget. This neatly forces the project prioritisation debate, because a certain cash budget is available for all projects and only some will make the cut. It also exposes poor management as budgets overrun and the numbers are hard to hide. Often, IT departments hire and retain a dedicated project management capability at significant expense (good project managers will typically be some of the highest-paid staff in the department). They may also be subject to oversight from a Project Management Office (PMO).

Most significant asset managers have mature IT project management capabilities, but relatively few have a corresponding business change management function. This is odd, because many of the same firms struggle to make transparent and long-lasting prioritisation decisions on anything other than the really 'big ticket' projects like business model transformation, outsourcing, etc. They also struggle to coordinate projects which often require attention from the same few people at the same time and may cause problems for each other or the daily operation of the business. Furthermore, much of the IT planning effort can be wasted if it is not carried out in the context of an overall business plan, which can effortlessly derail months of IT work with an apparently minor change to the target operating model.

Perhaps most concerning, a lack of a firm-wide change management function leaves management unsure as to whether the firm is operating at its optimal change capacity, reducing judgement to anecdotes with no reliable metrics for progress (simple project milestones are often too blunt and insufficiently granular, and easily 'gamed' by a savvy project leader).

Some firms are establishing firm-wide PMO functions which at minimum expose the firm-wide change agenda on a regular basis and at most will provide a 'hands dirty' challenge and support to project managers. This has a number of immediate and significant benefits:

- Management have a clear view of all changes, impacted areas and likely outcomes
- Lines of accountability are clarified by describing interdependencies and risks in public, in a common and readily-understood format
- Cross functional activities share a single plan. Each team's efforts can be easily aligned with each other, and the impact of apparently small issues can quickly be escalated and understood in the context of the firm's overall change agenda

One of the other few remaining sources of sustainable competitive advantage for asset managers is the ability to change quickly. One source of that agility is this simple firm-wide project prioritisation and planning capability, allowing leaders to plan and execute change with confidence.

#### To the point:

- Vendor management is a discipline in its own right, treat it as such
- The cloud isn't new – it has old risks – but it can transform costs and benefits
- Projects don't have to be slow. IT people may want to try new techniques like 'agile development'
- Technology projects are usually just one part of a business project, why do we plan and manage the detail but not the big picture?

# Changing distribution models for the New Affluent Wealth Management client

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Wealth Managers are currently facing significant uncertainty in servicing their clients, and change is needed now to meet this challenge. Whilst, upper end Private Banking has maintained personal relationship based advice between clients and banker as the primary distribution method, there has been a changing dynamic in affluent clients using Wealth Management services, both in what they expect from their providers, and how they use them.

For large banks looking to provide distribution and product manufacturer services, the opportunity presented by new clients is compelling; the assets of the world's wealthy households are expected to double between now and 2020, with this growth anticipated across all wealth management segments (Deloitte and Oxford Economics Research).



### Connecting with clients

The last five years have strained clients' trust in their banks, and ongoing research suggests little has changed (Deloitte SentsCheck). Many global banks have worked hard to change their clients' perceptions of them from product-oriented to service-driven organisations.

Regulatory initiatives such as the Retail Distribution Review in the UK have contributed to the gradual change towards advisory distribution models with a holistic view of client requirements. MiFID II will lead to similar trends across Europe.

### More regulation on the way

With regulation almost certain to be stepped up, banks are making significant investments in their infrastructure. With regulatory breaches being a major risk for firms, executives are committing sizeable resources to regulatory-compliant change and processes that ensure compliance on an ongoing basis.

### Unlocking data

As greater restrictions are now being placed on wealth managers' business and the products they sell, banks are increasingly looking for ways to better use customer data to analyse the profitability of the client base and unlock future value.

### New demographics, new ways of talking to clients

Recognising changing behaviours and demographics is vital for wealth managers, as profiles move from traditional, old money clients to a new, younger clientele, and responding to the changing preferences of these clients also means embracing new distribution technologies.

Changing client profiles require a multi-channel approach, including digital channels and social media, moving away from the traditional face-to-face model. Meanwhile, higher expectations of quality and expertise have made banks more conscious of the need to address service quality and understand where key 'moments of truth' are found in the value chain, throughout the client lifecycle.

#### A time for change...

Banks are therefore increasingly finding that they need to spend more on infrastructure if they are to maintain their market position, to take into account regulation as well as new distribution channels and higher service expectations, with greater expertise required of client-facing staff.

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Changing client profiles require a multi-channel approach, including digital channels and social media, moving away from the traditional face-to-face model

The challenges of increasing investment requirements and the rising cost of doing business have to be met at a time of growing market competition. In parallel, there is intense pressure on revenues, with cash remaining a significant asset class for a largely risk-averse client base.

#### ...in the mass affluent market

The traditional distribution model which focused on upfront advice as the sole form of interaction with clients is unlikely to survive. While this is true across all segments, higher net worth clients are typically more relationship-driven and multi-banked in approach. The need for change will therefore be most significant in the mass affluent market, which is generally defined as individuals with US\$100,000 to US\$500,000 in investable assets, who normally bank within their domiciled country.



How can wealth managers reconnect with their affluent client base and service their needs in an efficient manner, while taking into account the new regulatory environment and changing distribution models?

### 1. Introducing optimised client propositions

*Wealth managers need to use regulation to work for them, forming propositions that build on regulations, instead of purely aiming to comply*

Current regulatory themes are directing wealth managers towards holistic advice and away from product-focused recommendations, to better align bank's and customer's interests.

As an example of this thinking, the United Kingdom's regulator (FSA) oversaw the implementation of the Retail Distribution Review (RDR) at the end of 2012.

The aim was to ensure that distributors deliver investment products, typically traditional funds and associated products, as part of a fee-based advisory approach, thereby eliminating external commission as the primary remunerator. The retail-to-mass affluent marketplaces have been the major areas targeted by this type of reform. A curious by-product of this change, however, is the growing realisation that consumers would be reluctant to pay fees, perceiving they had received free advice before the reforms, and believing that services offered by banks, in particular, do not necessarily warrant a fee. In response to these anticipated changes, and given that the ongoing cost of regulation is a concern, many large UK banks have marginalised their advisory divisions for retail customers, focusing advisory services on clients willing to pay for the service.





A clear correlation exists: the greater the amount of assets a client holds, the more complex the need and therefore the more likely the client will be willing to pay for advice. As an example, clients in the UK with US\$80,000 or more in investable assets are four times more likely than the average client to pay for advice (Deloitte research 'Bridging the advice gap, post RDR').

Understanding the need to offer a high quality advisory experience, wealth managers are moving their affluent propositions towards a risk-controlled, transparent, fee-based pricing model. They are also adopting a more centralised investment offering, taking decision-making away from the individual advisor, by proving core fund-based investment portfolios aligned to risk profiles and client objectives.

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**If you are not looking after your client, someone else is, so understanding clients has always been the key to wealth managers' success**

As a reverse of the old product-driven advice model, innovative, one-off products should complement this core fund-based approach.

It also helps mitigate risk in the event of advisor attrition, by keeping expertise in-house, and provides flexibility through a range of tax efficient wrappers, most notably pensions. This process can also be used to manage a firm's risk, especially in the event of a client complaint, by understanding not only what has been advised (using a transparent client menu) but by placing clear emphasis on risk profiling and appropriate portfolio re-balancing. Client service is also improved, with a more client-centric proposition for a pre-agreed fee.

A distributor trend is developing where smaller boutique firms have started to target higher net worth clients to keep a hand in the advisory market and distributor banks and product manufacturers are well placed to use their data to help understand their clients better.

## 2. Improving profitability by unlocking client data

*Wealth managers need to create efficient customer service models, leveraging data analytics for idea generation and recommending the next-best-action approach*

If you are not looking after your client, someone else is, so understanding clients has always been the key to wealth managers' success. Granular data insights go much further than the traditional front office 'know your client' (KYC) process, which is based solely on the advisor perspective.

This can help build a segmented business model, more accurately targeted at client and product profitability. Data insights can also deliver superior client service by informing next-best-action recommendations to predict the client's future preferences, thereby unlocking value profitability potential and improving 'wallet share.'

We have seen this with telecommunications companies, where focused product recommendations, using past purchases and data on future product/service preference, have proved highly successful. Retail banking has also started to look at unlocking this potential.

Next-best-action is a pioneering approach aimed at helping banks understand how to use their data to unlock customer value and boost sales, including retaining, servicing and educating clients. It also looks to implement data insights into the everyday practices of marketing departments, effective conversations with clients, significantly improving client experience. Measurable benefits were obtained on a recent client assignment in retail banking, with a 30% increase in sales, along with noticeable improvements in the client experience (Deloitte client case study).

The use of data can be of particular benefit to wealth managers in the mass affluent sectors, which are often single-banked and quick to respond to change, especially the younger demographic.

### The 3 themes driving Next Best Action (NBA)

Predicting client behaviour to drive value	Managing multi-channel interactions	Operating as an insight driven business
<b>Cross sell/up-sell</b> Predicting each client's likelihood to respond to certain products	<b>Multi-channel approach</b> Using existing behaviour to influence on-going multi-channel interactions	<b>Operational insight</b> Providing key divisions the information they need to facilitate high quality service
<b>Retaining clients</b> Understanding the root cause of client churn, predicting which clients to retain and at what cost	<b>Real time decisioning technology</b> Considering the entire context of the interaction, the clients' segment, and journey	<b>Ongoing insights for value</b> Interactions between analytics and the client strategy produce insights that are both actionable and measureable
<b>Client centricity</b> Developing a clear measure to evaluate client experience enables a client centric approach	<b>Strategic approach to client management</b> Prioritising interactions which add value to the organisation	



Data analytics also provides targeted analysis to support the advisor in understanding their customer without the need for labour-intensive, personal interaction. Using contemporary CRM interfaces to display next-best-action results in engaging form factors—such as tablet technology—clients are being introduced to a new level of service that places them at the centre. Ideally, this is combined with the ability to generate rule-based, automated investment advice that is built on customised investment strategies, taking into account client risk appetite and capacity and other personal preferences such as sectors, industries or niche investment themes. Such an engine with multi-channel distribution capability will allow the bank to create much more frequent high-value interactions with the client.

Data analytics may also effectively be used for wealth customers looking to self-manage, bridging the gap for those unwilling to pay for advice. In particular, it provides the asset management industry with a highly effective platform to offer alpha and beta products in an interactive online platform. Product offerings such as ETFs can benefit enormously from this, as they can satisfy a number of suitability functions at a competitive price point for wealth management platforms.

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Many global banks have worked hard to change their clients' perceptions of them from product-oriented to service-driven organisations



### 3. Embracing new distribution models

*Wealth managers need to connect with their customer base via social media and digitise their product offering in order to manage cost and cover the new generation's channel preference*

It is commonly expected that up to 30% of consumers' banking relationships will be exclusively mobile within the next ten years. Embracing this medium is key to engaging with clients and is also vital to maintaining market competitiveness.

To implement a cohesive digital strategy, an agile operating model should be created that is scalable to different clients and transaction volumes, while product offerings should be flexible. Wealth managers should also be looking to enhance their client service through a mobile offering. This can be viewed in two ways:

- Enhancing the relationship advice model—helping front office advisors provide a seamless service, with digital offerings giving clients extra functionality, or out-of-hours service
- Primary direct model—by providing best-of-breed mobile solutions tailored to 'on the move clients' short on time, but receptive to leading-edge suggestions delivered in an engaging, user-friendly format. Recent market innovations include an app that allows investors to customise options trading or a password-free dashboard that provides account holders with information in an easy-to-read visual display

In delivering a digital solution, it is likely that the tablet will form the primary interaction point. While mobile phones offer similar interfaces, they may lack the proportions suitable for managing investments and so may be positioned as complement to a core tablet proposition. Tablets also provide a superlative form factor adept at displaying financial information clearly and succinctly and in a manner that encourages clients to explore investment scenarios further and ultimately execute on investment decisions.

Wealth managers can also expect a much greater share of wallet, especially with self-managed clients, by offering a broad range of products within one direct offering with superior analytics and next-best-action interfaces driving the service. A high-quality direct offering based on a strong platform and transparent pricing also minimises the need for clients to seek multiple providers, giving them little reason to shop around.

#### To the point:

To gain market advantage, wealth managers that transform the way they interact with their clients are best placed to unlock future value by:

- Delivering a service proposition that benefits from regulatory change by offering transparent pricing and advice, and placing client experience at the core of the offering
- Using insights to drive growth, combining service expertise with client data, thereby unlocking value for both the provider and client at every touch point
- Establishing the multi-channel interaction process, providing the 21<sup>st</sup> century client with the opportunity to receive advice, and even transact through digital channels

Wealth managers looking to stay ahead in this market should embrace these changes at the earliest opportunity.



# Universal ManCo

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Partner

Advisory & Consulting

Deloitte

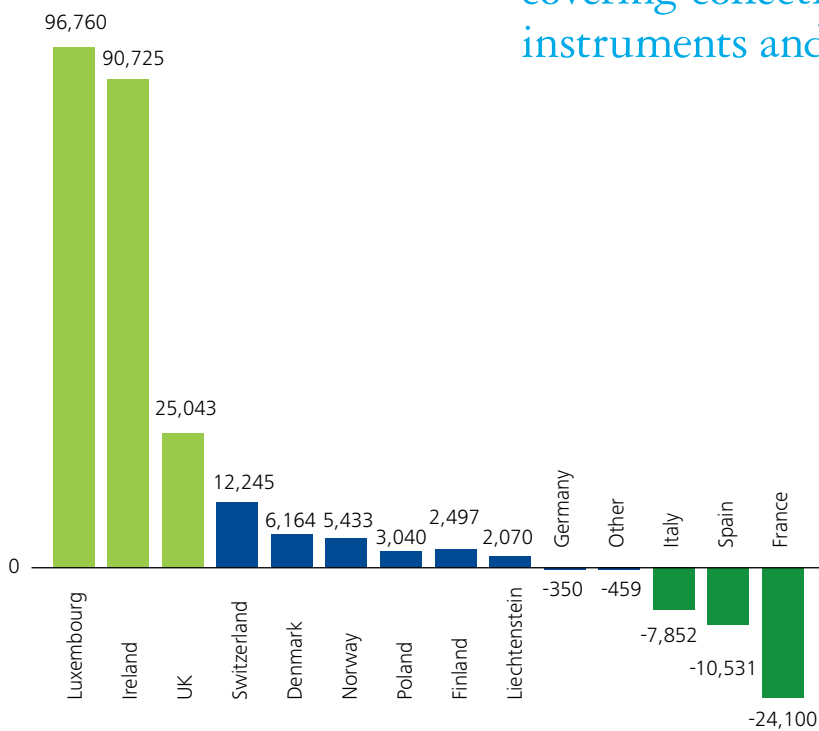
In 2012, managed asset growth recovered, with a 12.4% improvement. Eighty percent of this increase is attributable to the turnaround in financial markets, with net subscriptions amounting to €200 billion compared to negative flows in 2011 (€90 billion). However, not all products are equal in relation to sales flows. Country of domiciliation is a major contributing factor. Luxembourg, Ireland and the UK lead the way by far in this classification, with Italy, Spain and France bringing up the rear. It is true that all the indicators are negative in France, for both institutional (mainly pension fund losses) and retail (risk aversion) investors. Significant measures were taken to streamline product ranges and the search for critical size is a major objective for mid-sized entrepreneurs (managed assets of less than €3 billion).

New clouds are also on the horizon, as these countries must soon apply (January 2014) the Financial Transaction Tax (FTT), which is likely to create, assuming policy does not change, new disruptions for Asset Management in these countries (contrary to Luxembourg, Ireland and the UK which are in the non-FTT zone). To recap, the application of this new tax is likely to result in negative yields (considering current monetary market returns) for short-term UCITS and the disappearance of this investment segment that represents more than 30%<sup>1</sup> of French collective funds.

<sup>1</sup> Source: AFG (The French Asset Management Association)

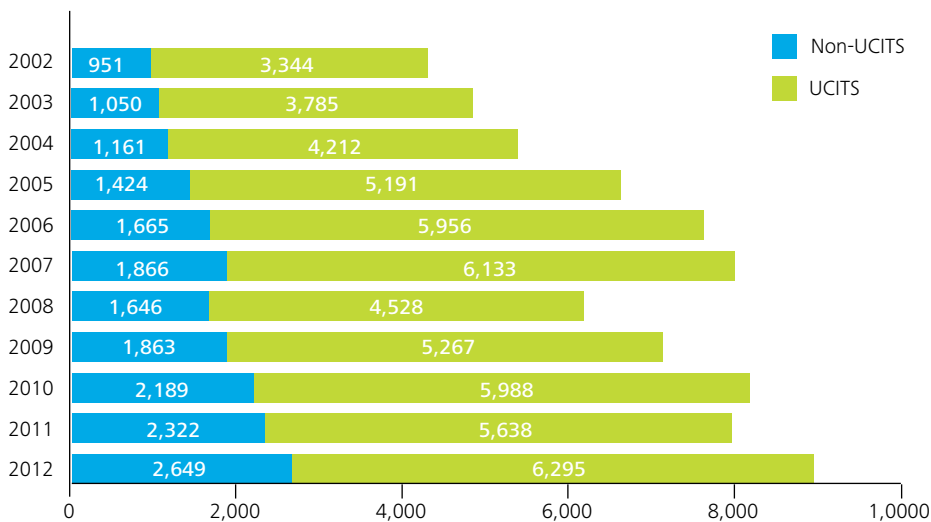
The asset management industry follows two directives: UCITS IV and MiFID covering collective investments in financial instruments and mandates, respectively

Net sales of UCITS  
(€ millions)



EFAMA Quarterly Statistical release N°52 (Fourth Quarter of 2012)

Net assets of European Investment Funds  
(€ billions)



### Comprehensive regulatory coverage

The asset management industry followed two directives: UCITS IV and MiFID covering collective investments in financial instruments and mandates, respectively. The AIFM Directive will supplement this framework in July with the supervision of management companies managing and/or marketing uncoordinated general purpose vehicles, hedge funds and private equity and real estate funds. Without disrupting their basic organisation, this Directive will enable management companies to embrace the competitive environment by creating a new organisational model. Under the current and future regulatory measures, cross-border entities could be set up:

- Since the UCITS IV directive came into force in July 2011, the creation of a management company passport has enabled authorised management companies in one Member State to act as the management company of a UCITS in another Member State. This passport provides asset managers with flexibility in terms of the country of domiciliation and fund administration

- When the AIFM directive comes into force in July 2013, an intra-European passport will be set up for European managers of European AIFs. AIFMs will be able to obtain authorisation from the relevant European authorities to sell their managed funds to professional investors in Europe

### Need to set up a European distribution as a minimum

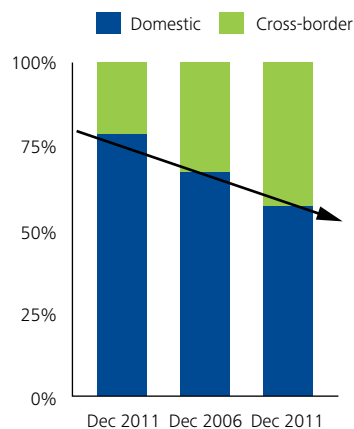
What with the decline in operating margins and the increased competition due to the arrival of new players in a contracting market, the only possible way forward for the model is to expand the client base. By way of illustration and until recently, French entities were largely satisfied with a French market representing almost 20% of the European market. Recently, international market penetration and marketing have become a priority in order to remain competitive with European counterparts.

In this environment of increasing competition and regulatory change, management companies must optimise and streamline their organisation and business model in order to stay competitive.

This optimisation may have the following prerequisites:

- Economies of scale and elimination of duplication by pooling support functions
- Creation of standardised sales teams implementing a common strategy based on strengthened and dedicated resources
- Flexibility with regard to local interpretations between distributed product types and rules governing private and collective investment
- Improved governance and solid risk management
- A strong recognised brand associated with major vehicles symbolising expertise

### Industry shifts to cross-border



Source: Lipper European Fund market review 2012

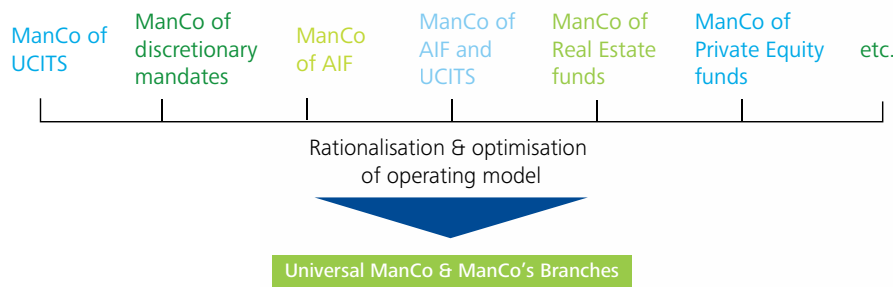
### Universal ManCo concept

Management companies are organised according to their authorisation. Each authorisation covers activities classified according to the following hierarchy:

- Principal activities
- Secondary activities
- Related services

The regulator seeks to smooth out status incompatibilities and harmonise company performance capacities.

Market observation reveals a multitude of asset management groups comprising several management companies domiciled in Europe and distributing several fund types.

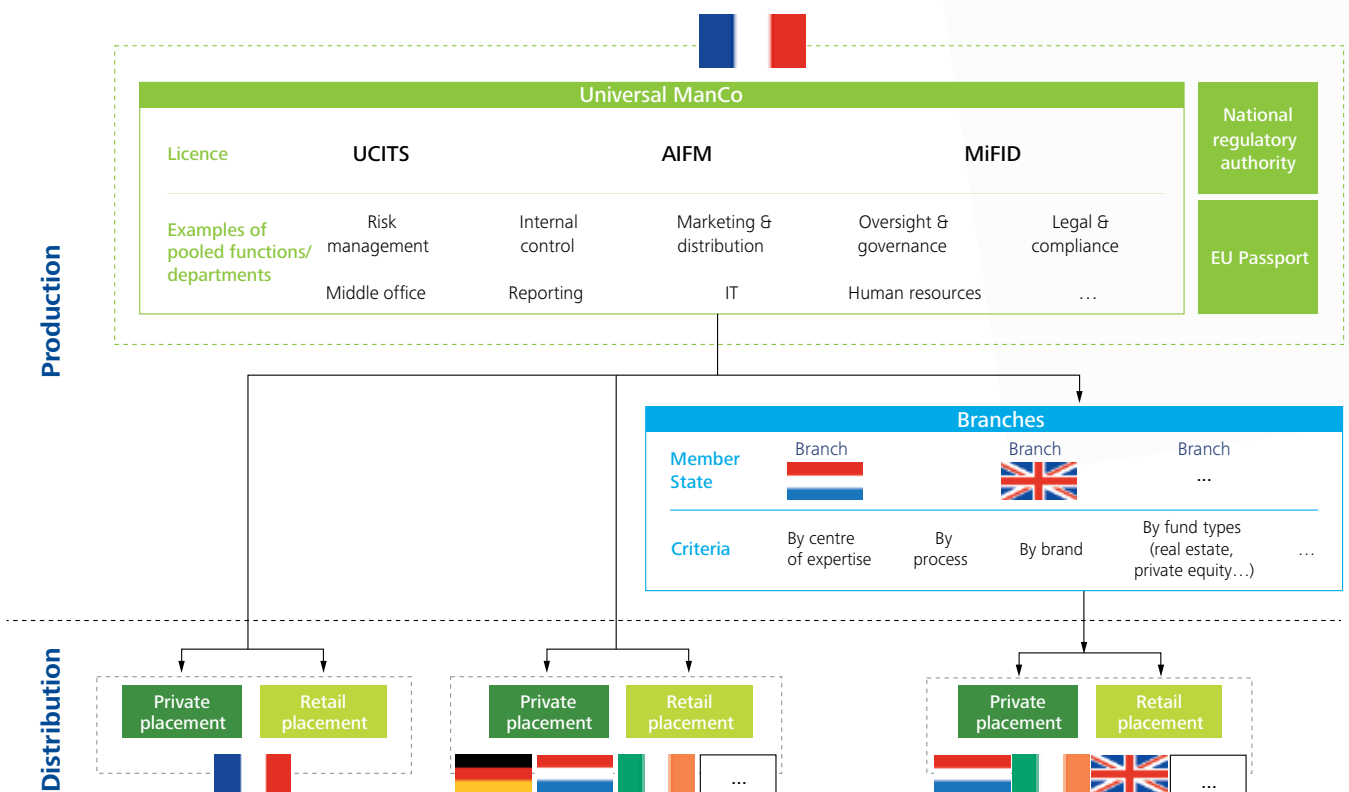


In this environment of increasing competition and regulatory change, management companies must optimise and streamline their organisation and business model in order to stay competitive

In this environment of increasing competition and regulatory change, management companies must optimise and streamline their organisation and business model in order to stay competitive

To optimise and pool the Group's resources and generate economies of scale, an analysis of Universal ManCo will now be necessary. Universal ManCo will be domiciled in an EU country, the selection criteria being the current country, taxation, strategy and group ambitions, international investments and offshore vehicles, etc. It will have the necessary authorisations for its main activities within the community. Where needed, Universal ManCo branches could be set up to distribute high added-value products or services requiring specific competencies and processes (e.g. private equity, real estate) in order to adapt to any local restrictions.

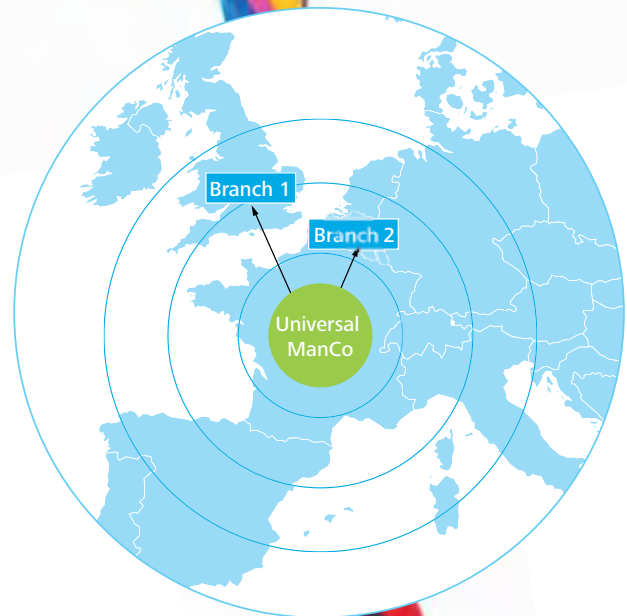
By way of example, Universal ManCo could integrate the following functions: risk management, reporting, internal control, monitoring and governance, compliance, etc.





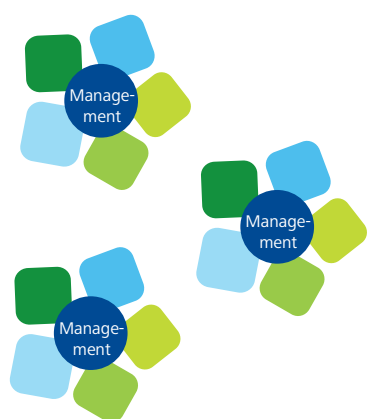
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The Universal ManCo  
concept provides great  
flexibility and numerous  
advantages

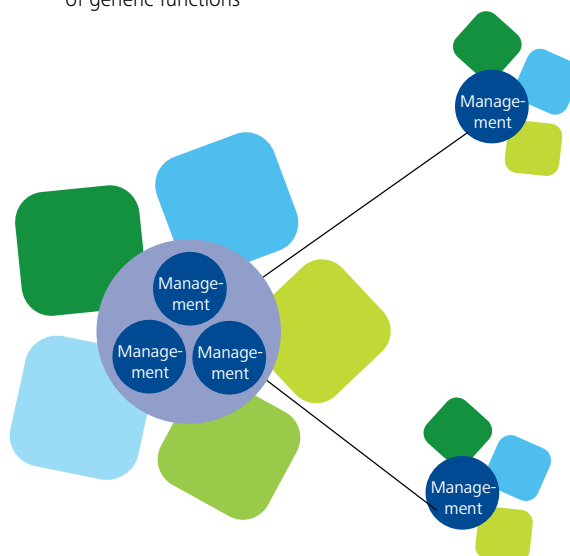


The goal is to integrate and pool the support functions and general departments in order to generate economies of scale, eliminate duplications and ensure better monitoring and governance of the entity. This streamlining will also generate indirect impacts such as efficiency gains by improving decision-making processes or the enhanced use of asset management talents.

Decentralised organisation, juxtaposition of entities without streamlining functions (segregation of management companies/ geographic sectors)



Integrated organisation with streamlining of generic functions



Support functions	Risk functions	Transversal functions	Commercial functions	Marketing functions
<ul style="list-style-type: none"> <li>- Creation of shared service centers for value (pricing, complex products, security transactions, etc.) and product databases</li> <li>- Reorganisation and mergers of middle office transactions/cash and reconciliation</li> <li>- Launch of performance calculation/attribution and reporting platforms</li> <li>- Trading table</li> </ul>	<ul style="list-style-type: none"> <li>- Optimisation of centralisation processes for market risk monitoring and reporting and monitoring of operating risks for local offices or group entities</li> <li>- Improved functioning of compliance and ethics departments, pooling of regulatory monitoring processes</li> </ul>	<ul style="list-style-type: none"> <li>- Pooling and streamlining of IT expertise: developments, security, assistance and facilities management</li> <li>- Transformation of the finance function: data reporting and recording, management control and steering</li> <li>- Harmonisation of group practices regarding HR and related processes</li> </ul>	<ul style="list-style-type: none"> <li>- Creation of pooled cross-border marketing platforms</li> <li>- Set-up of centralised services for tender bid responses</li> <li>- Pooling of marketing expertise for global institutional clients</li> <li>- Creation of open architecture distribution platforms</li> </ul>	<ul style="list-style-type: none"> <li>- Harmonisation of the product creation process</li> <li>- Pooling of strategic marketing expertise: streamlining of the product range and overall management of the brand portfolio/invention process</li> <li>- Creation global CRM tools/ harmonised identification of liability flows</li> <li>- Optimisation of document management</li> </ul>



The Universal ManCo concept provides great flexibility and numerous advantages.

From a product point of view, the creation and innovation process could be standardised. For standard products, the production of management processes or low added-value products could be automated by Universal ManCo to generate economies of scale. The goal would be to conserve and standardise a full range of products while adapting the product offering based on the specifics of each network. Conversely, specific or dedicated processes and products (private equity, real estate) will be developed at the branch level, the objective being to foster significant and recognised expertise with high added value. It will then be possible to identify and define expertise by brand and initiate processes and functions that are appropriate to requirements.

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## The Universal ManCo model will evolve based on regulatory changes (AIFMD, UCITS V & VI, and MiFID II)

Moreover, the streamlining of marketing and distribution functions at the Universal ManCo level will enhance client follow-up and service. In fact, integrating the client database at the Universal ManCo level would enable the structuring of enhanced client knowledge, and provide a response to the complexity of requests in terms of product-related services. In addition, the creation of vertical integration for retail clients would improve consulting services through closer client relation and monitoring.

This organisation will focus the best resources on the development zones, facilitate the application of a group policy and integrate human expertise at the heart of operating processes. Lastly, the size effect would generate economies of scale and lower overheads, thus boosting margins.

The significance of the tax options and the distortion of competition they generate, ultimately reinforced by the emergence of distinctive business zones with respect to financial transaction taxes, should thus benefit holders.

The Universal ManCo model will evolve based on regulatory changes (AIFMD, UCITS V & VI, and MiFID II). In addition, the potential savings generated by optimisation and streamlining will depend on the group's size, and above all the fund collection objectives.

However, several issues will require an in-depth analysis prior to an operational phase. Administrative hurdles, as well as local interpretations and practices will have to be fully considered with respect to the activity, culture and strategies of the management company.

The use of a management company passport could result in governance problems between the requirements and practices of the fund's member state and the management company's country of domiciliation.

The management company's consolidation could generate significant operating costs due to the closing of management companies (liquidation costs), employee relocation, the upgrade of processes, procedures and systems, reporting to investors, or the renegotiation of service provider agreements.

**Impact analysis:**

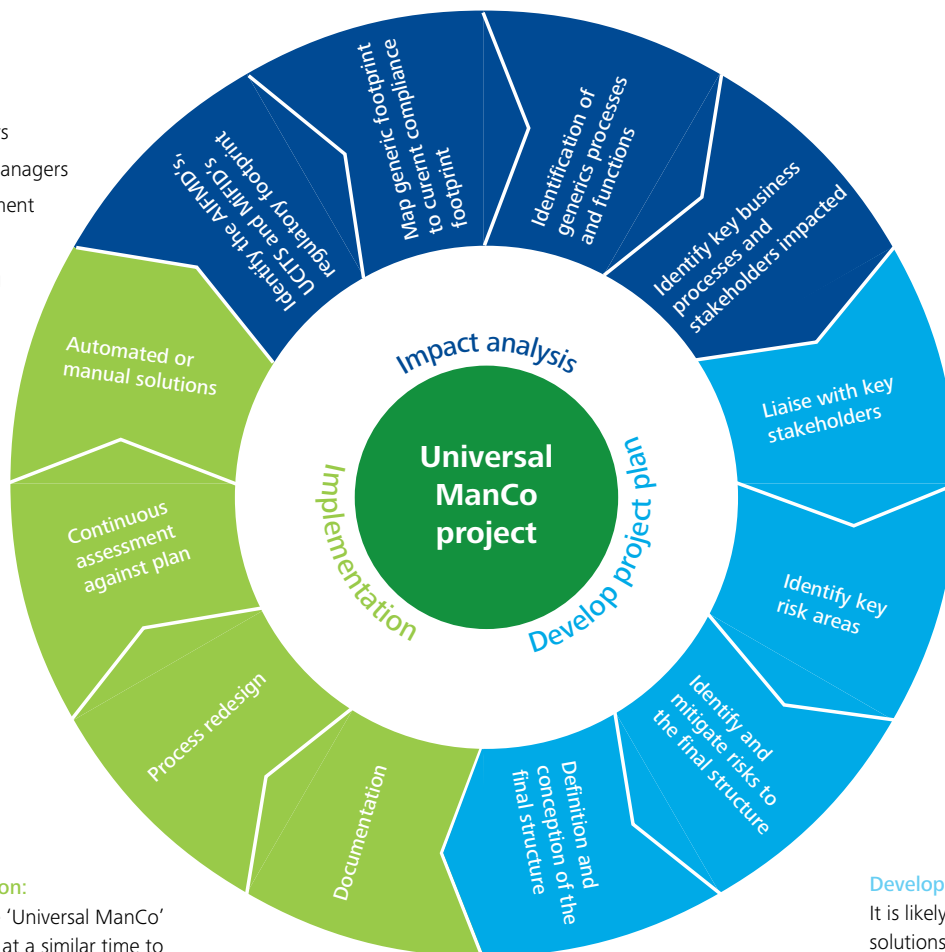
One of the first steps is to identify the universe of funds that are within the scope of the AIFMD, UCITS and MiFID, etc.

An effective impact analysis relies on a strong understanding of how regulated activities map against its functional framework.

The impact analysis will need to cover all business areas:

- Technology
- Compliance
- Distribution
- Internal control
- Service providers
- Sub-portfolio managers
- Client management
- Governance
- Internal training

Finally, outstanding questions remain: What margin of manoeuvre will there be regarding the choice of service providers and specifically asset servicers? What is the tax impact on the funds, the group and the investors? How will the change be perceived by investors, and by certain Member States who risk the relocation of their industry? How will Universal ManCo communicate the benefits of the new operating model to investors and distributors?



**Project implication:**

It is likely that the 'Universal ManCo' project will occur at a similar time to other regulatory changes being Implemented; resource scarcity may be a significant project risk.

**Develop project plan:**

It is likely that technological and manual solutions will be identified. It will be critical to understand the costs/benefits and how technological solutions to regulatory reporting in the EU work.



**To the point:**

- Management of Universal ManCo's equity: a consolidated management company requires less significant equity due to the absence of duplication, as found in connection with several independent entities, and the convergence of the AIFM and UCITS directives on this subject
- Management on a substantial basis: in connection with the AIFM directive, a management company should not delegate its functions to the extent that it becomes a 'letter-box entity'. As Universal ManCo combines both the primary and support functions in one entity, it could demonstrate the substantial basis of its management
- Management of a management company and its branches would enable better monitoring and governance of the entity
- Common policies and practices covering remuneration could be set up, in compliance with the UCITS, AIFMD and MiFID directives
- Conflicts of interest could be better supervised and managed through policies that are common to the group
- Service providers and delegated agents could be better managed via the introduction of selection and monitoring procedures



# Tax controversies and the family office

## An ounce of prevention is worth a pound of cure

**Julia Cloud**  
Partner  
Tax-Private Company Services  
Deloitte

In 2009, the Internal Revenue Service (IRS) announced the formation of a Global High Wealth Industry (GHWI) group to increase the focus on certain matters related to high-income taxpayers, as well as to strengthen the rigor of its audit processes in this taxpayer segment. The IRS has stated that this focus on high income taxpayers will continue.

There is no formula that can reliably predict whether your family office will be subject to some type of examination or what may happen if you are. Each situation is unique and the resources available vary. What is consistent from situation to situation, however, is the advantage you can gain from being prepared.

### How likely is an examination?

Available data indicates that as Adjusted Gross Income (AGI) rises, so does the likelihood of examination. Individuals with income of US\$1 million or more are much more likely than those at lower income levels to be subject to an exam. According to the 2011 Data Book, during fiscal year 2011, IRS examination coverage for individual taxpayers with US\$100,000 to under US\$200,000 in AGI was just 1%. For individual taxpayers with US\$1 million to under US\$5 million in AGI, that percentage jumped to 11.8%. For taxpayers with US\$10 million or more of AGI, examination coverage was nearly a third of all returns filed, at 29.93%.

### What is the IRS's Global High Wealth Industry Group?

In late 2009, the IRS announced the creation of the GHWI group to provide closer scrutiny of high-wealth individuals and their related entities, which often involve an international component with interests in foreign assets. This IRS industry group is charged with strengthening the examination process for high-income individuals, or those that the IRS states have tens of millions of dollars in assets or income.

To fulfil this purpose, the GHWI group has adopted an 'enterprise examination' audit approach that involves the consideration of the entire group of entities controlled by a high-wealth individual instead of the former approach of analysing each return as a separate exam with little impact on related parties. This enterprise examination approach may involve a larger team of revenue agents, including specialists in targeted technical disciplines as well as IRS attorneys assigned to advise the revenue agents. More significantly, it poses the potential for an audit in one area to open doors to the examination of other related entities and/or individuals.

Notably, this group resides in the division responsible for examinations of large businesses and international taxpayers, meaning that the agents are more experienced in examining large enterprises, have more sophisticated training, and are familiar with more complex issues such as valuations and wealth planning.

### How has the level of audit activity changed since the GHWI group's inception?

Statistics acquired by the Transactional Records Access Clearinghouse (TRAC) at Syracuse University under a court order indicate that in the first 29 months since the programme's inception (October 2009 to February 2012), the GHWI group completed 36 total audits of individual taxpayers with US\$1 million or more of income.<sup>1</sup>

The GHWI group now has eight teams and a total of approximately 100 agents assigned to focus on this area. Although the completed examination numbers are still relatively low with regard to number of cases closed, there is significant activity in progress and evidence that the examination teams are becoming more focused and organised in their approach.

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There is no formula that can reliably predict whether your family office will be subject to some type of examination or what may happen if you are. Each situation is unique and the resources available vary

### What results has the programme produced?

According to the data received by TRAC, in the 36 GHWI examinations of individual tax returns completed as of February 2012, agents concluded that an additional US\$47 million in taxes were owed. Notably, a third of all completed GHWI examinations over this period produced no change in taxes owed. This rate is significantly higher than the no change rate for field exams shown in the 2011 Data Book and may indicate difficulty on the part of the IRS to select returns that have the most potential for adjustment.

<sup>1</sup> 'Few Millionaires Audited by IRS Global High Wealth Group,' TRAC IRS, April 10, 2012



### What have we observed about the group's approach through activity to date?

We are now seeing some shifts in process as well as in focus. Agents regularly ask for organisational charts and examinations are expanding to related individuals and entities at a quicker pace. It is now common for a related individual or trust to receive an exam notice within weeks of the original examination. The most recent statistics indicate that the GHWI has 500 returns under examination, suggesting that for each return started, it is extending the examination to four to five related entities. The IRS has indicated that more emphasis will be placed on partnerships and Form 1120-S returns related to high-wealth individuals in the future.

In addition, the group is involving IRS specialists more often, enabling examination teams to identify issues more quickly. Depending on the return(s) involved, teams may include financial products specialists; estate, gift, and trust attorneys in cases involving significant wealth transfer; or engineers and appraisers for matters involving valuation issues. Valuation issues, in particular, require careful preparation to facilitate ready access to all the necessary supporting information.

Finally, agents appear to be doing a better job of preparing information requests, which were initially broad in nature but now are often focused on more specific issues. The Large Business & International Division (LB&I) has been making efforts to confirm that document requests are more focused in case a summons for information may be needed in the future.

### What are the common tax issues arising in the GHWI's enterprise reviews?

Enterprise examinations, in general, should involve the most significant taxpayers within the structure of related parties. Some examinations start with individual income tax returns (Form 1040s), although some begin with flow-through entities, including partnership (Form 1065) and subchapter S corporation (Form 1120-S) returns. Data obtained by TRAC, however, indicates that, while the GHWI group targeted increased numbers of partnership and S corporation returns (75 in FY2011 and 96 in FY2012), it completed relatively few examinations: a total of 18 partnership examinations and six large S corporation examinations until February 2012. Additionally, while the IRS historically has not devoted a lot of attention to examining trusts, we are starting to see more GHWI exams pick up on trust issues or examine trusts as related entities.

Areas likely to get particular scrutiny include valuation issues (such as those related to wealth transfer or charitable contributions), management fees paid by related entities, private foundations, and off-shore holdings, especially those involving financial instruments. Passive foreign investment companies are also attracting more attention in examinations.

One of the common areas of focus for the IRS is to examine compliance with reporting requirements for foreign accounts, including those related to the Report of Foreign Bank and Financial Accounts (FBAR), new foreign asset reporting under the Hiring Incentives to Restore Employment (HIRE) Act, and other foreign information returns related to investments in foreign entities.

Note that there are treaties and tax information agreements in place between the United States and other countries and that the IRS can and does automatically exchange information with other countries. This access to information has been evident in some of the questions posed during examinations, even before implementation of the new Foreign Accounts Tax Compliance Act (FATCA) rules. This access to information suggests the need to be particularly diligent in this area.

### What can be expected with a GHWI examination?

Most examinations begin with a letter or call to schedule an initial appointment. Often, examiners do not provide much notice and they likely will want to meet at a site relevant to the entity involved to interview the individual(s) most closely associated with the issue at hand and to tour business facilities.

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Available data indicates that as Adjusted Gross Income (AGI) rises, so does the likelihood of examination

Following initial interview(s), the agents will re-scope the examination to define the material issues, and then you can expect to see a number of information requests. Under the GHWI group's audit approach, it would not be unusual to receive document requests from more than one agent. Revenue agents are under pressure to complete an examination as quickly as possible and, accordingly, expect quick turnaround on their requests.

GHWI examinations have IRS attorneys as well as agents assigned to them. Having counsel involved can elevate the level of the examination, which is another reason for implementing a proper level of care in preparation and conduct of the examination. That said, with just 100 agents, the GHWI group does not always have teams or individuals available in proximity to the individuals or entities being audited. Accordingly, some GHWI exams take place primarily by correspondence. This can create issues, particularly when the examination requires an exchange of large numbers of documents.

### What are some keys to managing an examination effectively?

Managing a tax controversy situation is as much an art as it is a science. It can involve much more than just responding to information requests and following up to determine the status of the examination. A family office will need to make some critical decisions that may have a bearing on the outcome, most of which are matters that the family office executives and staff do not manage on a recurring basis.

How will you obtain the necessary information and how quickly? Which documents must be provided to the examiner to respond to the agent's request, but what are the implications for other parties? Who is best suited to present your arguments on technical issues when the law is not agreed upon? When is it beneficial to consider an alternative resolution approach? How will you communicate with others; within the family office, with advisors, and with related individuals and entities? Open communication is particularly important under the enterprise audit concept, where related parties are increasingly becoming part of the examination.





### How do GHWI information and document requests typically work?

Initially, your family office may receive an inquiry with the letter confirming the initial conference to request documents to verify items on a tax return. In some cases, the preliminary information requests may be broad. In others, where the IRS has defined the particular issues involved, requests may be relatively specific; for example, substantiating a large charitable contribution on a tax return or partnership income that does not match with the Schedule K-1 provided. It is not unusual for the IRS to ask for information it already has – such as tax returns for a prior or subsequent tax year – during an examination.

These requests usually require a response within a short period of time, often within 14 to 21 days. Based on the response, the IRS should make its determination on the issue or may follow up for additional information.

Responding to an information request can be demanding on a family office and may interfere with their ability to perform regular responsibilities. Regardless, it is important to respond within the timeframe requested. If the agent does not get the information from your office, he or she may turn to other sources for information or issue summonses. In these situations, you may lose control over the information the examiners ultimately acquire and consider, as well as your opportunity to manage the information flow.

Finally, while it is important to be responsive to requests, you should be diligent in understanding what information you are required to provide in response to the specific questions posed and the preferred way to communicate with the agent. Carefully review the information you are providing and be aware of potential exposure to others of providing certain information.

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## Enterprise examinations, in general, should involve the most significant taxpayers within the structure of related parties

### How long do GHWI examinations typically take to resolve?

Historically, the average time to complete a traditional individual examination has been 12 to 18 months, although the timeframe depends on the complexity of the issues involved. Under the GHWI group's enterprise examination approach, examinations appear to be taking, on average, 18 to 24 months to close depending on the issues and number of entities involved.

### What can you do to improve your preparedness for an examination?

It is helpful to perform a periodic risk assessment of the returns your family office oversees before the IRS initiates an examination, or to conduct an audit readiness assessment. From these assessments, you should be able to identify material issues that could be a focus during an examination and whether you have a system in place for handling any information requests you will receive. For example, selling a business should be your cue to gather relevant information and make sure it is easily accessible.

### How should you prioritise your preparation efforts?

While the GHWI group has not publicised its selection model and the extent to which it selects returns based on AGI or other factors, its stated focus is on the 'most significant' taxpayers. The IRS approach is to consider 'expanded income'. Under this approach, the IRS would focus resources and effort on returns that have the greatest level of total income, including tax-exempt income, rather than simply those with the highest AGI. There is not an answer for this, but within your office you may be able to prioritise any examination readiness assessments that need to be completed while keeping this in mind.

Of course, careful record keeping is important. Tax laws include minimum periods during which a filing may be subject to an exam. At the very least, your family office should take care to retain tax documents and records for the minimum statutory period, but there may be some you should retain longer; for example, income tax returns should be retained for at least three years, but if there are foreign tax credits involved, a different 10-year statute may apply and require access to prior year returns.

As any entity should, your family office should also establish specific procedures and formats for retaining tax-related documents, as well as intervals for document destruction. There will be some documents that require retention of physical copies, but electronic storage does reduce physical space requirements and enables access from multiple locations. The IRS increasingly asks for electronic books and records in conjunction with information requests, but to date it has not mandated electronic record keeping.

### What is the outlook for GHWI programme?

Announcement of the GHWI programme promised a 'game-changing strategy', but it is not clear whether the programme is producing the level of change intended. In its Audit Plan for FY2012, the Treasury Inspector General for Tax Administration said that it will review the programme to review IRS progress in this group.

### What else should family offices be aware of in 2013 and beyond?

Your family office should be aware of and plan for two new taxes targeting earned and investment income of high-income individuals as of 1 January 2013.

First, beginning in 2013, an additional 0.9% Medicare Hospital Insurance tax (HI) tax applies to wages of an employee or earnings of self-employed individuals that exceed specified thresholds. Also beginning in 2013, unearned income received by wealthier individuals – such as interest, dividends, capital gains, annuities, royalties, and rents, other than such income that is derived in the ordinary course of a trade or business and not treated as a passive activity – will be subject to a 3.8% 'net investment income tax.' Notably, the investment income tax and the 0.9% additional HI tax on earned income apply independently.

Consult the *2013 Essential Tax and Wealth Planning Guide* for more detail and planning tips.

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Historically, the average time to complete a traditional individual examination has been 12 to 18 months, although the timeframe depends on the complexity of the issues involved

**To the point:**

- For fiscal year 2011, IRS examination coverage taxpayers with \$10 million or more of AGI, examination coverage was nearly a third of all returns filed, at 29.93%
- Statistics indicate that the IRS is extending examinations to four to five related entities and the IRS has indicated that more emphasis will be placed on partnerships and Form 1120-S returns
- Areas likely to get scrutiny include valuation issues, management fees paid by related entities, private foundations, off-shore holdings, and passive foreign investment companies
- The IRS is commonly examining compliance with reporting requirements for foreign accounts, including those related to FBAR and new foreign asset reporting under the HIRE Act
- Family Offices must be carefully review the information they providing and must be aware of potential exposure to others of providing certain information
- Family Offices can prepare by doing periodic risk assessments or by conducting an audit readiness assessment
- Family Offices should establish specific procedures and formats for retaining tax-related documents, as well as intervals for document destruction



# Meeting the retirement challenge

## New approaches and solutions for the financial services industry

**Sam Friedman**

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In 2012, the Deloitte Center for Financial Services conducted a survey among nearly 4,500 consumers from a wide range of ages and income groups. The goal was to generate insights into how financial institutions might develop new approaches and solutions by better understanding the attitudinal and behavioural constraints preventing consumers from achieving better retirement outcomes.



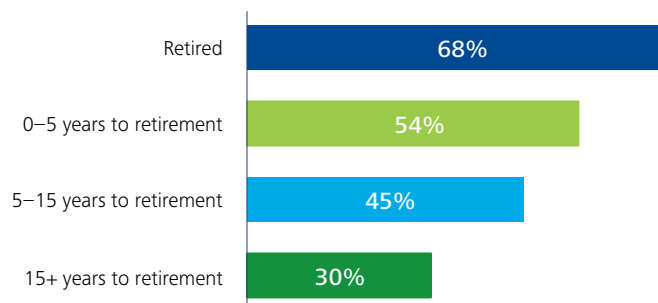
Analysis of the survey data revealed five main barriers inhibiting many Americans from taking a more disciplined approach to setting retirement goals and putting in place the required mechanisms to achieve a secure future. These interconnected barriers are:

- 1. Conflicting priorities:** while retirement is a leading concern for a majority of the survey respondents, many cited difficulty balancing such long-term needs with other priorities
- 2. A failure to communicate:** financial institutions struggle to effectively reach those who may need retirement planning advice and solutions, and they do not effectively integrate consumers' retirement needs as part of a broader financial plan
- 3. A lack of product awareness:** many consumers are simply not familiar with their retirement product options
- 4. Distrust of financial institutions and intermediaries:** a significant number of individuals do not trust the financial industry to provide objective advice and deliver on its promises
- 5. The 'do-it-myself' mentality:** many consumers either do not want or do not feel they need professional advice on retirement planning

#### Reality check: planning makes a big difference

According to Deloitte's Retirement Survey, a majority of Americans—58%—do not have a formal retirement savings and income plan in place. This planning gap widens the further the respondent is from their expected retirement date, rising to 70% among those who do not expect to leave the work force for 15 years or more (Exhibit 1).

Exhibit 1: Percent having a retirement plan (by proximity to retirement)



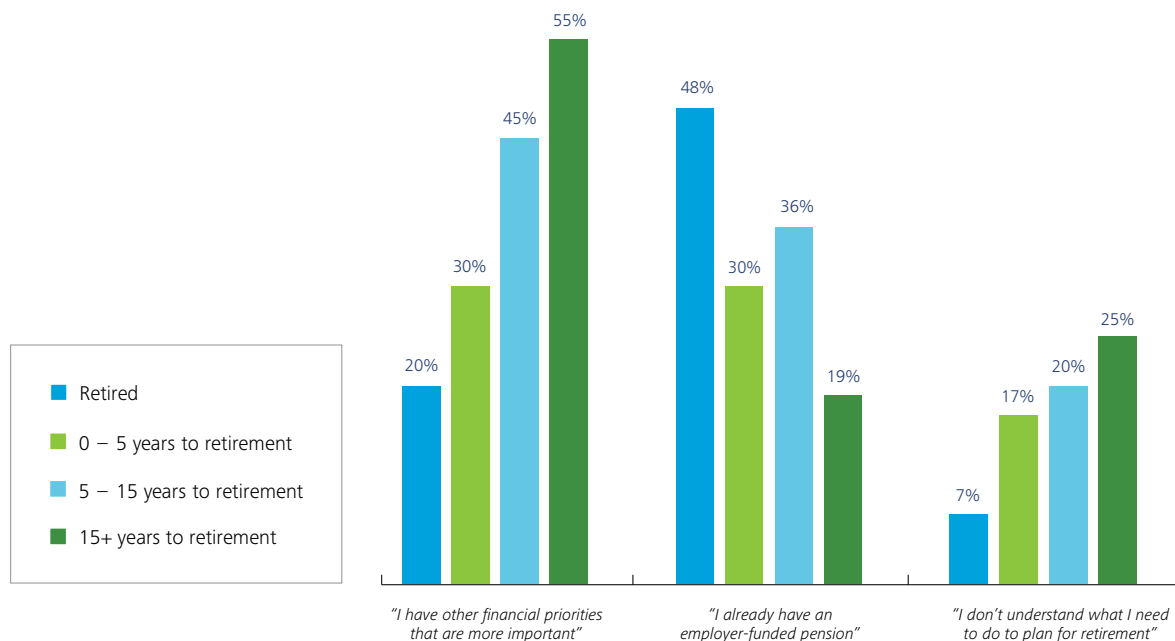


Our survey reveals that even among those with household incomes of over US\$100,000, 43 percent have no formal retirement plan. These numbers get worse as we go down the income ladder. Among those with household income between US\$75,000 and US\$100,000, 57 percent do not have a retirement plan, rising to 61 percent in the US\$50,000 to US\$75,000 bracket.

**Why does planning matter for retirement security?**

According to research conducted by Professor Annamaria Lusardi of Dartmouth College, ‘planning matters for savings.’ This is particularly the case among lower-wealth households and those with less education.<sup>1</sup> Other research supports these findings. A paper by Ameriks, Caplin and Leahy (2002) shows *“that those with a higher propensity [to plan] spend more time developing financial plans, and this shift in planning effort is associated with increased wealth.”*

**Exhibit 2: ‘Other priorities’ cited as top reason for not having a formal retirement plan (by proximity to retirement)**



Accordingly, planning for retirement can have a significant impact on savings and wealth accumulation behaviour.<sup>2</sup>

Planning also helps individuals feel more secure about their retirement. Our survey bears this out. Respondents with a formal plan to generate retirement savings and income were four times more likely to feel very secure (52%) about their retirement compared to those without a formal plan (only 13%). Deloitte’s survey also suggests that there is a relationship between the use of professional advisors and retirement security. The survey found that 40% of those using financial advisors felt very secure about their retirement, versus only 22% of those who do not seek professional advice. In addition, 66% of respondents with a financial advisor have a formal plan for retirement savings and income, versus only 28% of those without an advisor.

## According to Deloitte’s Retirement Survey, a majority of Americans - 58 percent - do not have a formal retirement savings and income plan in place

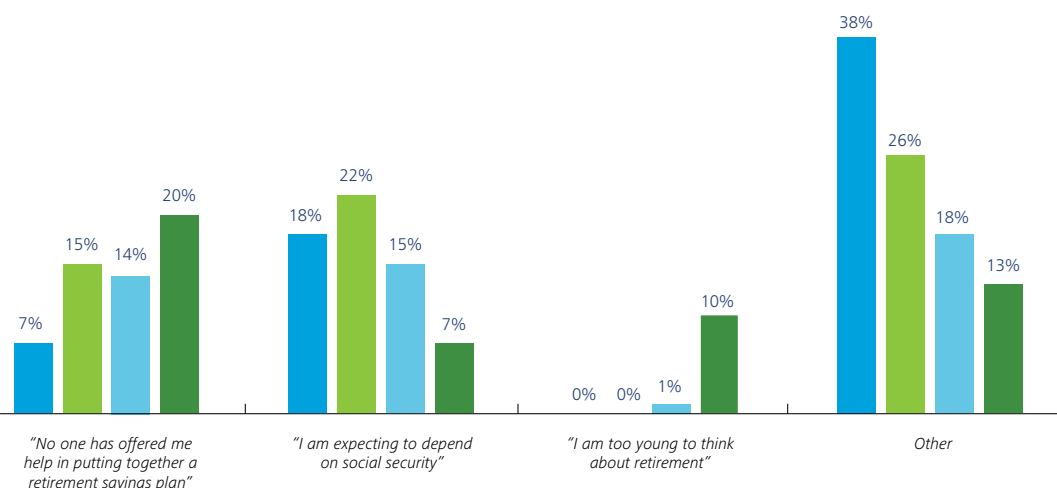
### Retirement game plan: what are the barriers, and how might they be overcome?

#### 1. The ‘conflicting priority’ barrier

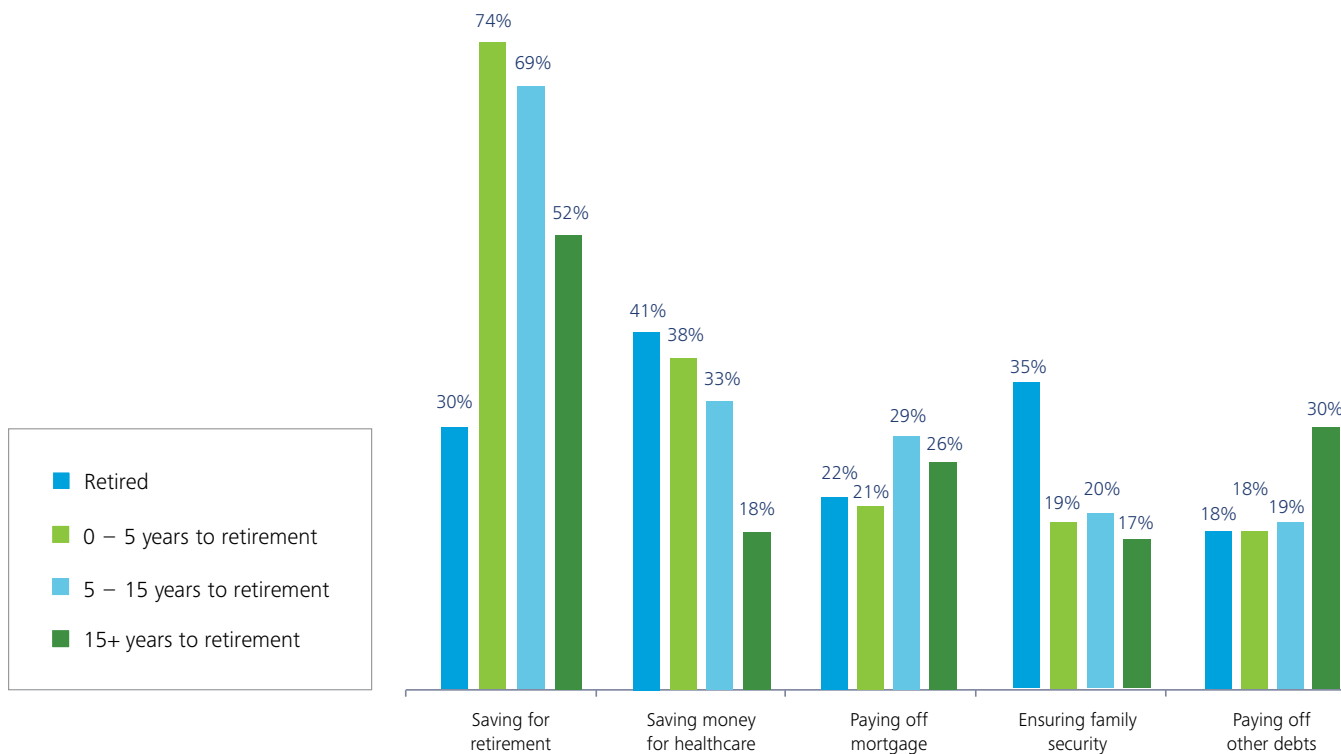
The survey found that saving for retirement is by far the most highly ranked financial goal, even among those who are years away from retiring.

For those who do not anticipate retiring for 15 years or more, just over half cited retirement savings as their first or second priority, dwarfing other considerations such as paying off a mortgage (26%) or closing out other debts (30%). Retirement savings become more important as people get closer to their anticipated retirement—it is a first or second priority for 69% among those between 5 and 15 years from retirement, and 74% among those within 5 years of retiring. Yet the most common reason for not being able to save for retirement, cited by about 40% of respondents, is that other financial priorities get in the way—including paying off a mortgage, student loans and other debt, or saving for their children’s education. This is particularly the case among the younger respondents (Exhibit 2).

- 1 Annamarie Lusardi, “Preparing for Retirement: The Importance of Planning Costs,” 2002, Working Paper, Dartmouth College
- 2 John Ameriks, Andrew Caplin and John Leahy, “Wealth Accumulation and the Propensity to Plan,” NBER Working Paper No. 8920, May 2002



**Exhibit 3: Importance of financial goals (by proximity to retirement)**  
 Percent rating as the top two goals



Next to retirement, the second most important financial priority, especially among older respondents, is saving money to pay for healthcare costs (Exhibit 4). This is not surprising, considering that 70% of those surveyed said they expect their medical expenses to increase during retirement.

A smaller number of respondents listed a related concern—long-term care expenses—as a top two priority as well. These findings are in line with a study from the Insured Retirement Institute showing that “confidence in meeting long-term care costs appears to decline with age.”<sup>3</sup>

Concern over medical costs also appears to discourage the retirement planning process itself. One-third of respondents within five years of retirement surveyed by Deloitte said that no matter how well they prepare, they are concerned that healthcare and/or long-term care expenses could overwhelm their retirement savings and income goals. The percentage of doubters increases to 40% for those more than five years from retirement.

**Overcoming the ‘conflicting priorities’ barrier**

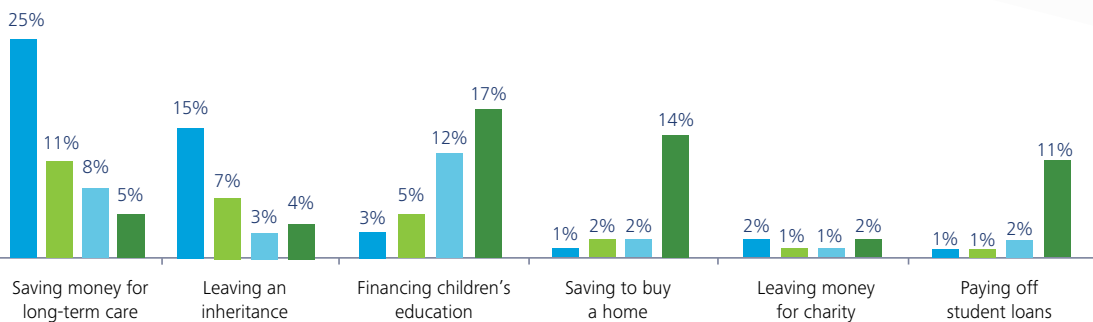
A way to overcome this barrier is to address the conflicts up-front and show consumers that you are prepared to help them through a prioritisation process. By broadening the discussion beyond investments and retirement and including issues such as health care, long-term care and debt, you can begin to have very meaningful conversations on how to get people saving.

**2. The communications barrier**

Six in ten surveyed by Deloitte say they have not had interactions in the past two years with any financial institution about their retirement savings and income needs, whether via in-person meetings, phone conversations, email communications or seminars. This disengaged percentage rose to about three out of four among those aged 45 and younger. Even half of the respondents between ages 56 and 64 said no one had been in touch with them on this subject. And fewer than one in four with a 401(k) plan says they have been contacted by the plan provider to discuss their retirement needs.

<sup>3</sup> Insured Retirement Institute, “The Long-Term Care Challenge,” November 2012. <https://www.myirionline.org/eweb/uploads/November%202012%20Report%20LTC.pdf>

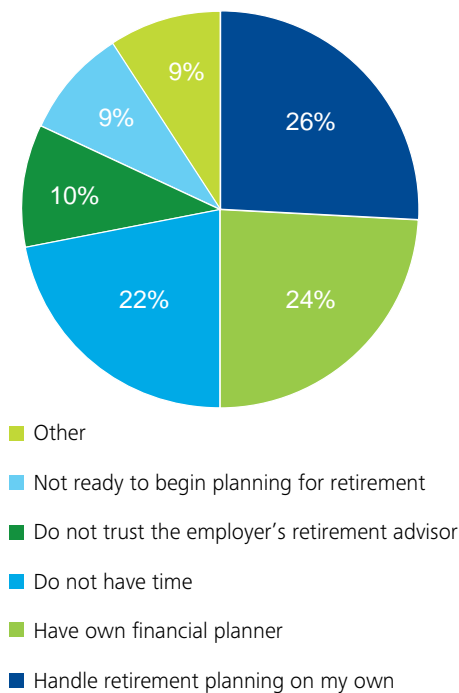




The workplace is a natural venue to communicate with the widest range of consumers about their retirement needs, given that for many Americans, a work-based 401(k) may be the primary retirement vehicle beyond social security. Four in ten between the ages of 26 and 45 surveyed by Deloitte cited affiliation with their employer as one of the reasons for choosing a financial institution to meet their retirement needs. However, it appears that financial services institutions have not been able to fully tap the potential of workplace marketing.

According to research conducted by Professor Annamaria Lusardi of Dartmouth College, *“planning matters for savings”*

**Exhibit 4: Why don't employees seek advice via workplace plan providers?**



### Overcoming the communications barrier

The workplace is one of the most effective vehicles for reaching consumers, therefore asset managers with retirement offerings should work to enhance these efforts. The first step is to make sure they have the plan sponsor's agreement for their communications efforts. Educational retirement planning seminars offered in person or via technologies such as internet, video and text messaging are also viable ways to reach more consumers. Some financial institutions are also experimenting with new technologies such as social media, texting, web and podcasts to reach consumers. The reality is that the way people communicate has radically shifted as technology has evolved, and firms that do not embrace the new technologies risk being left behind.

### 3. The product awareness barrier

Accentuating the challenge for financial institutions is the fact that many consumers do not know enough about the most common products marketed to help address retirement savings and income needs (Exhibit 5).

For example, six in ten either do not know anything about target date mutual funds (48%) or say they have heard of the product but do not understand how it works (12%). The percentages showing lack of awareness are consistently high across age and income segments.

This lack of product knowledge extends to annuities and non-term life insurance as well. Nearly 40% surveyed by Deloitte do not know anything about annuities or understand how they work, with the percentage even higher among younger respondents. 25% either do not know about non-term life insurance or, if they are aware of it, do not know what these products can do to bolster retirement savings and income.

---

## Concern over medical costs also appears to discourage the retirement planning process itself

### Overcoming the product awareness barrier

Product design that is straightforward and accessible will help overcome the product awareness barrier. Asset managers should also consider streamlining their product lines and only offering targeted product sets to certain consumers in order to help them avoid being paralysed by too many choices.

### 4. The trust barrier

Lack of trust is another major reason why a large segment of consumers may be reluctant to allow financial services providers to help them with their retirement planning. The survey found that trust in all types of financial institutions is quite low, with no more than two in ten of all respondents having a high degree of trust in any type of financial institution (Exhibit 6). Intermediaries did not fare any better, with only 15% expressing a high degree of trust in financial advisors, and only 11% finding insurance agents and brokers to be highly trustworthy. This is illustrated by the finding that 20% of those surveyed by Deloitte indicated they do not trust intermediaries (such as financial planners and insurance agents) to provide objective advice to address their retirement savings and income needs.



Exhibit 5: Familiarity with investment products

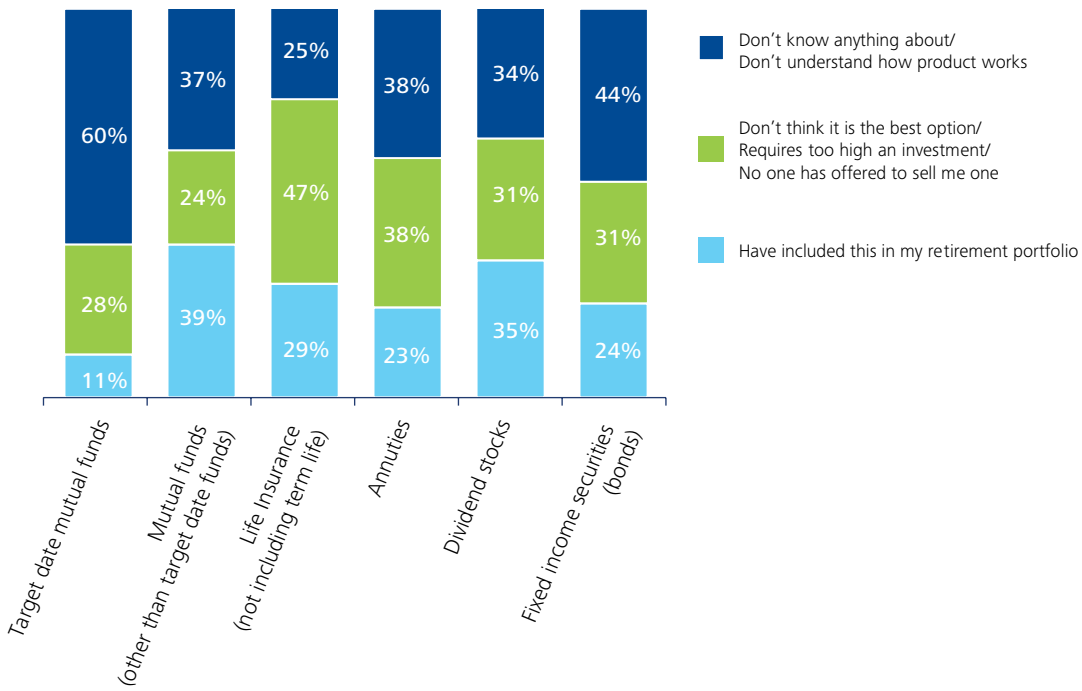
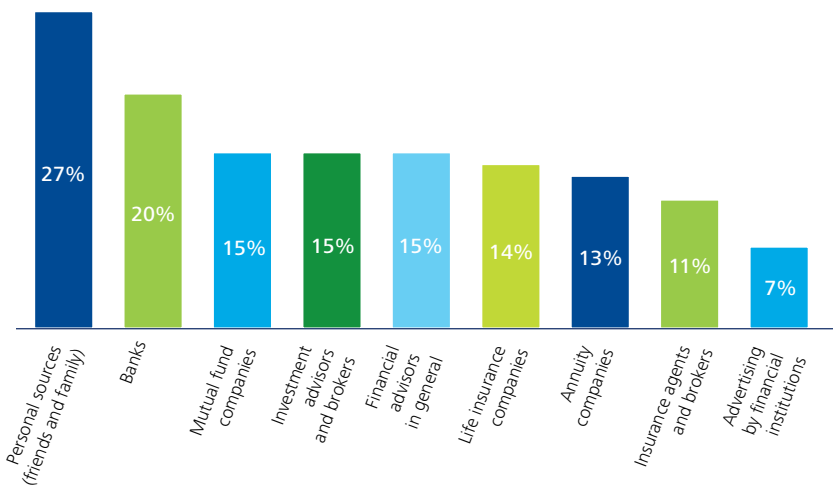


Exhibit 6: Who do consumers trust on retirement?  
Percent cited as highly trustworthy



Gaining such trust is imperative. The Deloitte survey found that among respondents with formal plans for retirement, 83% of those who have a high level of trust in advisors used one to help put their plan together, compared with only 32% of those who have a low level of trust in such intermediaries.

The trust barrier likely influences product choice as well. For example, three in 10 respondents in Deloitte's survey said they do not trust institutions promising guaranteed income in terms of being able to deliver on their commitment when they retire.

Complicating efforts to overcome the trust barrier is the widespread scepticism towards advertising about retirement products and services, with only seven percent of those surveyed characterising ads from financial institutions as highly trustworthy.

### Overcoming the trust barrier

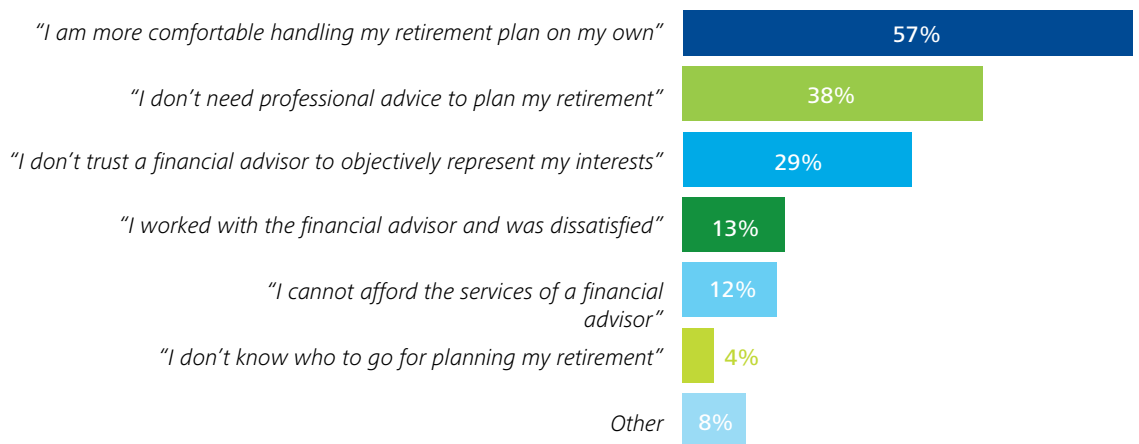
There is no easy or quick way to build something as complex and multifaceted as trust, and firms cannot expect overnight changes. However, highlighting success stories and profiling examples of content customers can be very effective. Also, talking about retirement in the context of lifestyle goals rather than in purely financial terms can be powerful. Finally, using technology to reach out to younger consumers and to build 'virtual' face-to-face relationships is an interesting area to explore.

### 5. The 'do-it-myself' barrier

Nearly two-thirds of those surveyed by Deloitte (and about three-quarters of those who are 15 years or more from retirement) do not consult with a professional financial advisor for their retirement needs. Relatively few (13%) say that this is because they have had a bad experience with an advisor. Fewer think price is an issue, with only 12% saying they cannot afford an advisor's services.

So, what's holding most people back from seeking professional advice?

**Exhibit 7: Reasons for not consulting a financial advisor**





Beyond the trust issues already addressed in the prior section of this report, there are a number of reasons why many choose not to consult with an advisor (Exhibit 7). But the main reasons for many represent two sides of the same coin—their higher comfort level in handling retirement planning on their own (Exhibit 8), and the belief that they do not need professional advice.

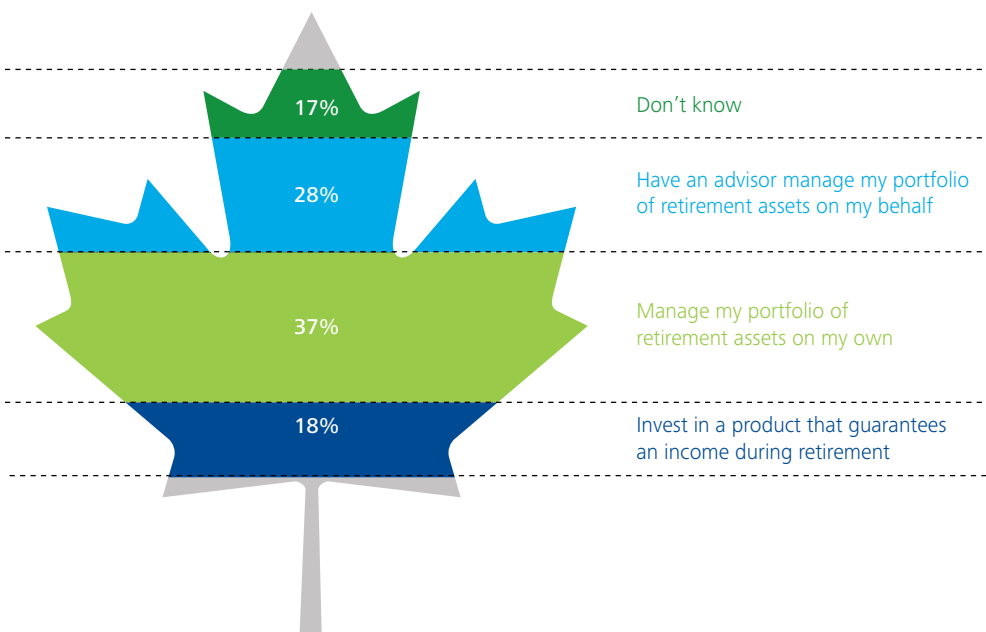
#### Overcoming the 'do-it-myself' barrier

One of the most powerful ways to overcome this barrier is to use data, such as from the Deloitte survey, that show that people using expert advice are better prepared for and more comfortable with their retirement planning. Another good strategy is to offer a range of advisory solutions such as serving as facilitators and enablers rather than only full service advisors for consumers who wish to remain in control of their retirement portfolio. Finally, institutions can highlight to consumers that managing retirement income is a far more complex process than managing retirement savings accumulation and that they are ready, willing and able to provide the necessary expertise.

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The reality is that the way people communicate has radically shifted as technology has evolved, and firms that do not embrace the new technologies risk being left behind

Exhibit 8: Preferences for managing retirement assets



### Conclusion: meeting the retirement challenge

The retirement challenge facing many Americans seems increasingly daunting. Efforts to help consumers meet these challenges appear to have resulted in limited success, judging by the general lack of preparation among survey respondents, knowledge about the options available and trust in financial institutions and professionals offering retirement solutions.

This state of affairs, despite the billions of dollars spent by the retirement industry on sales, marketing and advertising of retirement products and services, indicates that the industry needs to change its approach.<sup>4</sup>

The good news is that Deloitte believes that significant progress can be made by financial institutions that are willing to closely examine their organisations and are committed to change. New technologies present possibilities that did not exist in the past, and the need for retirement education and advice is tremendous.

We invite those interested in a more detailed discussion to read the full survey results which can be found at:

[http://www.deloitte.com/view/en\\_US/us/Industries/Insurance-Financial-Services/e8b8d86e6161d310VgnVCM2000003356f70aRCRD.htm](http://www.deloitte.com/view/en_US/us/Industries/Insurance-Financial-Services/e8b8d86e6161d310VgnVCM2000003356f70aRCRD.htm).

<sup>4</sup> 10 2012 Ad Age Insights Trends Report on Financial Services Marketing. <http://gaia.adage.com/images/bin/pdf/AdAgeFinancial%20ServicesReport2012.pdf>

### To the point:

- Respondents with a formal plan to generate retirement savings and income were four times more likely to feel very secure (52%) about their retirement compared to those without a formal plan (only 13%)
- 40% of those using financial advisors felt very secure about their retirement, versus only 22% of those who do not seek professional advice; 66% of respondents with a financial advisor have a formal plan for retirement savings and income, versus only 28% of those without an advisor
- Retirement savings are a first or second priority for 69% among those between 5 and 15 years from retirement, and 74% among those within 5 years of retiring
- Six in ten surveyed by Deloitte say they have not had interactions in the past two years with any financial institution about their retirement savings and income needs
- 48% had not heard of target date mutual funds, nearly 40% surveyed by Deloitte do not know anything about annuities or understand how they work and 25% either do not know about non-term life insurance or, if they are aware of it, do not know what these products can do to bolster retirement savings and income
- Nearly two-thirds of those surveyed by Deloitte do not consult with a professional financial advisor for their retirement needs
- Among respondents with formal plans for retirement, 83% of those who have a high level of trust in advisors used one to help put their plan together, compared with only 32% of those who have a low level of trust in such intermediaries

### About the survey

The data presented in this report are from an online survey conducted by Harris Interactive on behalf of the Deloitte Center for Financial Services. The survey was conducted during the last two weeks of August 2012 and had a total sample of 4,491 respondents. Survey respondents were required to be at least 26 years of age and be responsible for financial decisions in the household. Respondents were distributed across various geographic regions, income levels and age groups. The sample also included nearly a third of respondents from households with income above \$100,000 per annum.

The sample was weighted to represent the broader U.S. adult population. The information obtained during this survey was taken 'as is' and was not validated or confirmed by Deloitte.



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The good news is that Deloitte believes that significant progress can be made by financial institutions that are willing to closely examine their organisations and are committed to change

# EMIR

## Key business impacts for asset managers

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Partner  
Audit  
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**Patrick Rooney**  
Manager  
Investment Management Activity  
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The OTC derivatives market is facing considerable changes not only in Europe but across the world, as new regulations are introduced to tackle the fallout from the financial crisis.

In September 2009 the G20 leaders agreed that: *"all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."* (G20 Leaders Summit Statement, 2009)

In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) aims to fulfil the G20 commitment that all standardised OTC derivatives should be cleared through a central counterparty.

In Europe, the European Market Infrastructure Regulation (EMIR) provides the framework for implementing the bulk of these new requirements.

The four main pillars of EMIR are:

- All standardised OTC derivatives will be cleared through Central Counter parties (CCP) or clearing members
- A harmonised framework for the provision of clearing services within Europe
- Non-cleared derivatives will be subject to more extensive risk management requirements, including the need to collateralise positions
- All OTC and exchange traded derivatives will be reported to trade repositories

While the intended benefits of EMIR are clear (enhanced transparency, reduction in counterparty risk, reduction in operational risk, increased market stability, reduction in systematic risk) the cost of compliance with these new regulations is likely to be significant and could have a real impact on a firm's trading strategies.





### Who do the regulations apply to?

The regulations apply to both financial counterparties to OTC derivative contracts authorised and/or regulated in the EU (banks, funds, insurance companies, etc.) and non-financial counterparties established in the EU. Non-financial counterparties will only be in-scope where the level of OTC derivative transactions exceeds a certain threshold, and there will also be carve-outs for genuine commercial hedging. Furthermore, 'Third Country Firms' will also be subject to the regulations if they trade with EU counterparties and if they would have been subject to the regulations had they been established within the EU. This is an anti-avoidance clause, to prevent market participants from structuring contracts outside the EU to avoid the regulations.

### Which contracts are in-scope?

All standardised OTC derivatives contracts will be required to clear through a CCP. The process for determining what is sufficiently standardised to be eligible will follow a two-pronged approach. The CCPs themselves will determine which derivatives to clear with the approval of their national supervisors ('bottom-up approach').

In addition, the European Securities and Markets Authority (ESMA) has the power to direct whether clearing obligations should apply when no CCP offers a product class for clearing ('top-down approach'). In both instances, ESMA will conduct a public consultation before a final decision is made. ESMA will also establish an online public register to identify the OTC derivative products subject to the clearing obligation, which will include details on authorised CCPs and the dates from which the clearing obligation takes effect.

The purpose of the requirement to report transactions to trade repositories is to address the concern that regulators have not had a full picture of the exposures of the firms they regulate and the possible systemic implications these may pose. A number of trade repositories have been established and others are in the process of being set-up.

### The time to act is now

EMIR entered into force on 16 August 2012. However, the implementation of EMIR required further clarification through Regulatory Technical Standards (RTS), developed by ESMA. In December 2012 the European Commission adopted the RTS which subsequently entered into force on 15 March 2013.

The deadline for the trade repository reporting requirement with respect to credit and interest rate derivatives is July 2013 (for existing trade repositories, otherwise it is 90 days from the date of registration). The deadline for all other types of derivatives is January 2014. The reporting requirements relate to all derivative contracts in place on or after 16 August 2012. Firms will have to start clearing OTC derivatives through CCPs as early as Q1 2014.



It is therefore imperative that asset managers assess the impact of EMIR on their business now so that they can determine the level of change required and how this change will need to be managed. This may be achieved in five main steps:

1. Perform an impact analysis on how EMIR will affect your business in respect of the following key areas: investment performance, business model, operational processes, risk management, reporting requirements and collateral management
2. Based on the results of the impact analysis, consider whether any strategic changes to investment or business strategy are required
3. Once the investment and business strategy has been determined, identify the gaps in your current processes, policies and procedures compared to the new regulatory requirements
4. Develop a project plan to achieve compliance
5. Review and confirm the updated policies and procedures

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All standardised OTC derivatives contracts will be required to clear through a CCP

### Investment performance implications of EMIR

The cost of compliance with the new regulations will very likely make trading more expensive for managers. Cleared OTC transactions will be subject to increased transaction costs, new reporting obligations and strict collateral requirements. For un-cleared OTC transactions the cost will also increase, as EMIR is likely to require margin to be exchanged by both parties on a gross basis. Collateral collected as margin cannot be re-hypothecated or re-used. Firms will also be required to maintain new mandatory risk management processes. The impact of these increased costs will affect performance.

For smaller managers the cost of compliance with EMIR – along with the various other new regulations such as the Foreign Account Compliance Tax Act (FATCA) and the Alternative Investment Manager Fund Directive (AIFMD) – could become a significant barrier to entering the OTC markets. For larger managers, the increased cost will reduce performance by at least a few basis points. Managers need to consider whether they will continue to use these instruments and if not, how this will affect their product offerings to clients.

It is likely that the expanded requirements for certain types of collateral will also result in an increase to the cost of this type of collateral, putting further pressure on performance.

### Business model implications of EMIR

The implications of EMIR on an asset manager's business model will also raise some questions.

How do we select the right clearing counterparty? It is important that the CCPs selected are the most appropriate for a firm in terms of margining levels and fees.

Do we have the in-house capability to manage collateral effectively or would it be more efficient to outsource the process? Ensuring sufficient and appropriate collateral is available at the right rate will be crucial in the operational and cost management of OTC derivatives.

Should we outsource the trade repository reporting requirements to a third party service provider? Existing service providers are likely to provide this product offering.

### Operational impact of EMIR

There are numerous operational impacts of the new regulations that firms should consider. The following points are examples of what firms will need to do:

1. Analyse their derivatives portfolio to identify those that will be subject to centralised clearing and those that will not have to be centrally cleared. This analysis is an important step in determining the level of impact EMIR will have on your business, especially in the context of collateral management as discussed below
2. Establish appropriate risk management processes for non-cleared derivatives
3. Put new contractual agreements in place with clearing counterparties and also consider whether they need to update existing agreements with their brokers and collateral managers to take account of central clearing
4. Review their IT infrastructure and whether it is capable of performing automated execution, confirmation, trade processing and margin calls, and reporting associated with derivatives being cleared over an exchange
5. Consider what is required to be reported to the trade repositories and build the daily reporting file to be sent to them
6. Develop and monitor two separate processes for dealing with cleared and non-cleared derivative transaction

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**Managers need to consider whether they will continue to use these instruments and if not, how this will affect their product offerings to clients**



### Risk management impact of EMIR

While the regulators are pushing for more instruments to be centrally cleared, it is accepted that there will always be a universe of products that will not be standardised. EMIR introduces specific requirements aimed at strengthening the risk management of non-cleared trades, namely through the requirement for timely confirmation of trades, portfolio reconciliations, portfolio compression analysis and agreed valuation models.

**Confirmations:** The regulations set out when confirmations should be received by product type, with transitional measures in place. However, the end result is that by August 2014 all financial counterparties are required to have all non-cleared transactions confirmed by trade date plus one. Firms must report all trades that have remained unconfirmed for greater than five business days to their competent authorities on a monthly basis.

**Portfolio reconciliations:** Portfolio reconciliations must be performed by the two counterparties to trades at least each business day when counterparties have 500 or more OTC derivative contracts with each other or once a week for portfolios of 51 to 499 contracts. For portfolios of less than this, reconciliation must be performed quarterly.

**Portfolio compression:** EMIR also requires all counterparties with 500 or more non-centrally cleared contracts with a single counterparty to analyse the possibility of performing a portfolio compression exercise at least twice yearly. Financial counterparties must also mark to market the value of outstanding contracts on a daily basis, with the movement impacting the variation margin that firms will be required to post. Mark-to-model can be used in certain circumstances (e.g. inactive markets). We expect a reduction in the volume of non-standardised OTC derivatives traded and the risk management procedures required will be more onerous for many firms.

### Reporting requirements

OTC and exchange traded derivative contracts – whether cleared or otherwise – must be reported to a trade repository no later than trade day plus one following the conclusion, modification or termination of a contract. For cleared trades executed on an exchange (where the identity of the counterparty is unknown) the CCP must report.

The reporting obligation will be phased in for different classes of derivatives:

- Credit and interest rate products will need to be reported from 1 July 2013 if a registered trade repository exists for that class of derivative by 1 April 2013. If no registered trade repository exists at 1 April 2013, then the reporting obligation for these classes of derivatives will be 90 days after a trade repository has been registered
- Other classes of derivatives will need to be reported from 1 January 2014 if a registered trade repository exists for that class of derivative by 30 October 2013. If no registered trade repository exists at 30 October 2013, then the reporting obligation for these classes of derivatives will be 90 days after a trade repository has been registered

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While the regulators are pushing for more instruments to be centrally cleared, it is acknowledged that there will always be a universe of products that will not be standardised

### Collateral management

Having determined the level of derivatives that will centrally clear and those that will not be centrally cleared, firms will need to assess the additional funding requirements in the context of the new regulations.

While collateral is currently required for OTC derivative transactions, the new regulations have specified the level and type of collateral to be posted. The type of collateral that will be required for initial and variation margins for standardised OTC derivatives must be highly liquid with minimal market and credit risk. This will include cash, gold, freely transferable securities and money market instruments. The collateral must be segregated and not re-used and the positions will have to be fully collateralised for the duration of the contract. It is expected that there will be a shortage of this type of collateral, resulting in higher costs.

Clarity is still required on the type and level of collateral that will be required for non-cleared derivatives, but it is expected that initial margin will have to be exchanged by both parties on a gross basis with the variation margin being calculated daily. Optimisation of collateral will be crucial in managing costs and firms that do this well will gain a competitive advantage. Given the importance of this activity, firms will need to assess whether they have the right tools to efficiently manage and monitor their collateral requirements so that collateral can be optimised and costs kept to a minimum.

### Other considerations

Clarity is still required over certain elements of the regulations. For example, what derivatives will have to be centrally cleared? From when exactly will firms be required to centrally clear derivatives?

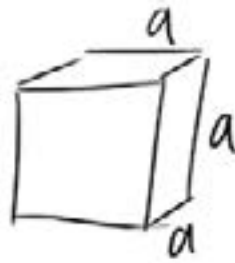
Furthermore, EMIR is not the only set of regulations that will impact the trading of OTC derivatives. Firms must also consider the requirements, where appropriate, of MiFID the UCITS regulations, AIFMD and Dodd-Frank.

### Conclusion

It is clear that EMIR will have a significant impact on the asset management industry. While clarity is still required on certain elements of the regulations, managers should act now to scope the impact of these regulations on their business. The regulations will not just affect the back-office and IT infrastructure of your business but could also more fundamentally impact your investment and trading strategies.

#### To the point:

- The cost of compliance with EMIR is likely to impact investment performance
- Effective collateral management will be critical to fund performance
- Managers may need to consider the impact of EMIR on their business model as well as on their operations and procedures
- Managers may need to establish connections with the most appropriate CCP for their business in terms of margining levels and fees



A hand-drawn diagram showing a triangle with a shaded area under a curved line. The letter 'A' is written to the left of the triangle.
$$E(x) = \frac{1}{p}, \text{var}(x) =$$

$$\frac{x^2 y}{x^2 + y^2}$$
A hand-drawn diagram of a bell curve (normal distribution) on a coordinate system with an upward-pointing arrow.

# Investment Funds' performance and Financial Transactions Tax

## An equation with multiple unknowns

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On 14 February 2013, the European Commission published its revised proposal for an EU Financial Transactions Tax (EU FTT)<sup>1</sup>, which is expected to generate approximately €30 to 35 billion per year

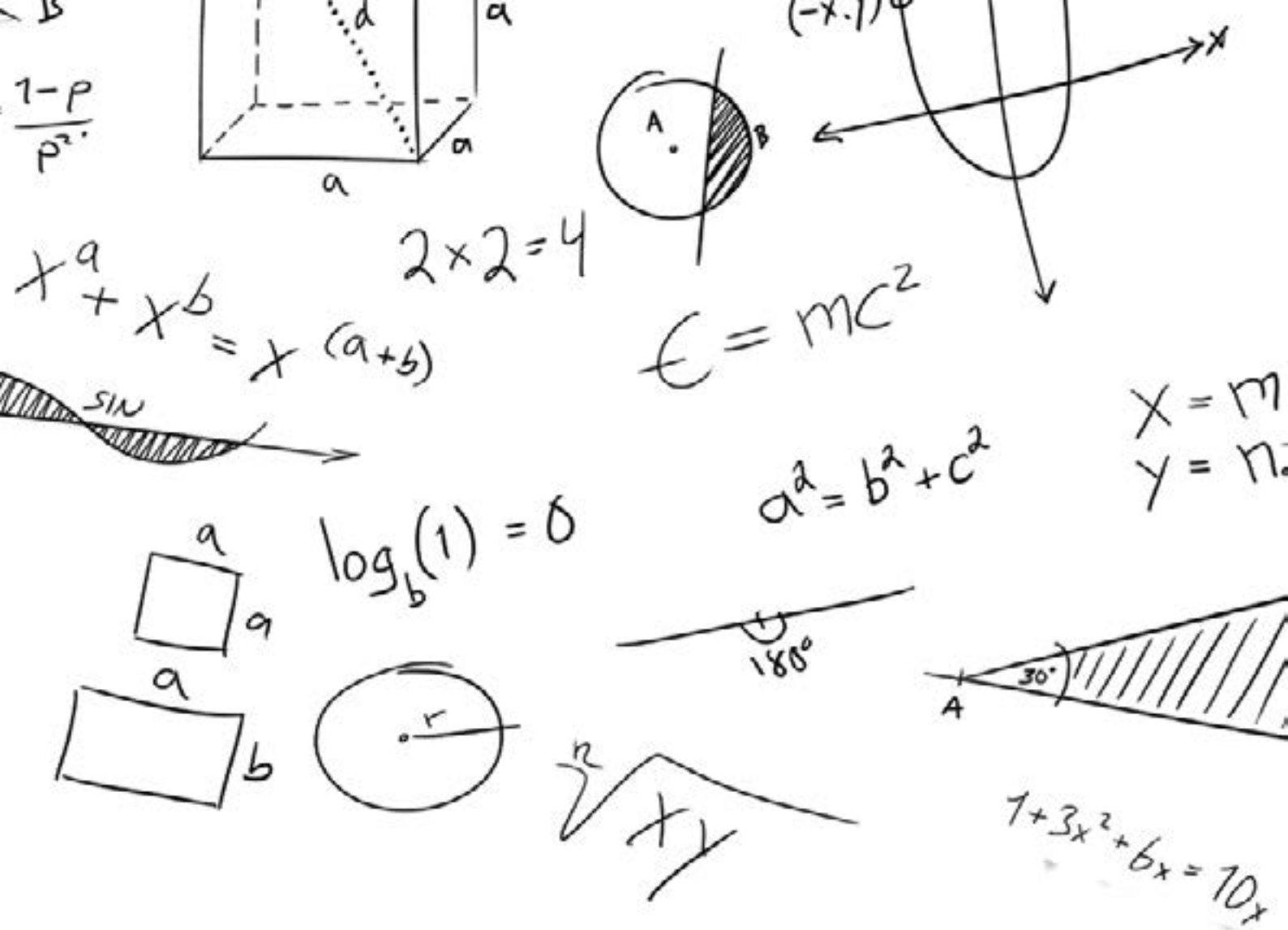
This draft directive provides for the introduction of a tax on financial transactions at a minimum<sup>2</sup> rate of 0.1% for transactions other than derivatives and 0.01% for derivatives transactions<sup>3</sup>. While the FTT is proposed to enter into effect on 1 January 2014 (now possibly postponed to a later date due to UK's legal challenge against the FTT), the timetable will obviously depend on the European Council reaching an agreement on the proposal.

The introduction of an EU-wide financial transactions tax is likely to have a significant impact on fund industry performance and attractiveness. Below we detail the key characteristics of the Commission's proposal and its potential impacts as far as investment funds are concerned.

<sup>1</sup> COM(2013) 71 final

<sup>2</sup> Participating Member States would be free to apply higher rates if desired

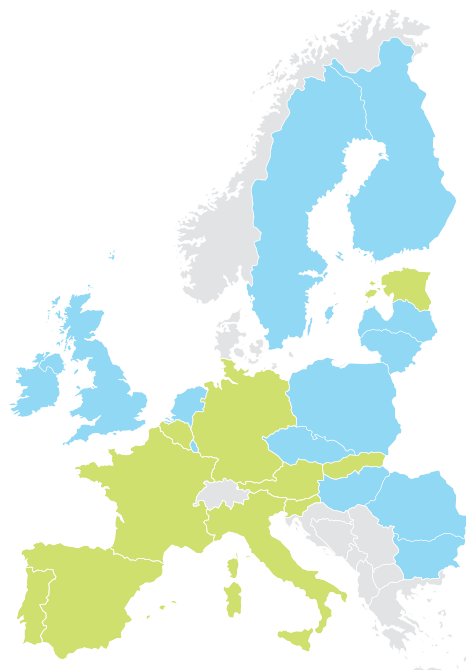
<sup>3</sup> While the taxable amount would in principle be the consideration paid or owed from the counterparty for financial transactions other than those related to derivatives contracts, the taxable amount in case of financial transactions related to derivatives contracts would be the notional amount referred to in the contract



### Background

#### From consensus to enhanced cooperation

The original draft directive<sup>4</sup> released by the European Commission in September 2011 gave rise to tensions between EU member states, which advocated diverging positions with respect to an EU-wide implementation of the tax. The difficulties in reaching a consensus within the EU led to the request, by a limited number of EU member states, to proceed using the so-called Enhanced Cooperation Procedure (ECP)<sup>5</sup>. The ECP is a procedure that allows a subset of at least nine member states to establish closer cooperation between themselves, without involvement from the other members states. The member states concerned can thus move forward at different speeds and/or towards different goals.



- Participating Member States (FTT zone) as of today  
 Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain
- Non Participating Member States (Non FTT zone) as of today
- Third countries

<sup>4</sup> COM(2011) 594 final. Please also refer to our previous article in Performance n°7 (January 2012): "Financial Transaction Tax – Something in the air", Raymond Krawczykowski and Dany Teillant

<sup>5</sup> [http://europa.eu/legislation\\_summaries/institutional\\_affairs/treaties/amsterdam\\_treaty/a28000\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/treaties/amsterdam_treaty/a28000_en.htm)

Handwritten mathematical notes and diagrams:

- $\frac{m^2 y^2}{x^2 + m^2} = \frac{m^2 x}{x^2 + m^2}$
- $\cos 2x = \cos^2 x$
- $x + y - 2 > 2$
- $(P + \frac{av^2}{v^2})(\frac{v}{v} - b)$
- $2x^2 - 1 = x$
- $\phi^2 = \psi^2$
- $\pi = 3,1415$
- $2ab + b^2$
- Diagrams: A triangle with vertices A, B, C and a shaded circle; A square with side 'a'; A right-angled triangle with a 30-degree angle and a shaded area.

In October 2012, eleven EU member states – representing two thirds of EU GDP – formally expressed their intention to move ahead with the implementation of the tax at an EU level. These countries are: Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain (the 'FTT zone' or the 'Participating Member States'). However, the cooperation remains open to the inclusion of any other member state at a later stage if it wishes to do so. The Netherlands has already confirmed that it may be interested in joining the FTT zone provided, notably, that pension funds are excluded from the scope of future legislation. Under the current proposal however, pension funds remain subject to the tax. Following the approval of the European Parliament in December 2012, the green light to proceed under the ECP was granted at the ECOFIN meeting held on 23 January 2013.

The proposal has still to be reviewed and approved by the Participating Members (see below our comments regarding the UK's legal challenge). All 27 member states may participate in the discussions and the European Parliament will also be consulted.

**Due to the fact that the UK Government lodged a formal legal claim at the ECJ, more doubts are casted on the likelihood of the EU FTT being introduced on 1 January 2014, as originally planned**

### Overview of the proposal

The base of the tax is extremely broad, covering transactions carried out by Financial Institutions on the vast majority of Financial Instruments once the existence of an economic link to the FTT zone has been established.

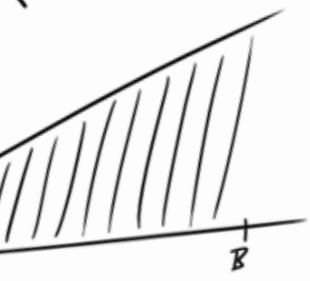
- Taxable transactions are broadly defined as: acquisition and disposal of transferable securities such as shares and bonds, money-market instruments<sup>6</sup>, units/shares in collective investment undertakings, derivative contracts, securities lending, repurchase transactions, etc. The scope of the tax is not limited to trade in organised markets, such as regulated markets or Multilateral Trading Facilities (MTFs), but also covers other types of trade including Over-The-Counter (OTC) trade.

The FTT will however not apply to day-to-day financial activities relevant for citizens and businesses such as lending, payments, insurance, deposits, spot currency transactions, etc. In order not to affect refinancing opportunities for financial institutions and member states, financial transactions with the European Central Bank, national central banks, the European Financial Stability Facility, European Stability Mechanism and the EU should also be excluded from the scope of the tax.

- The concept of a financial institution is also broadly defined and effectively includes banks, insurance and reinsurance undertakings, investment firms, collective investment undertakings – including UCITS and Alternative Investment Funds – and their managers, pension funds and their management companies<sup>7</sup>. Even holding companies and any other undertakings or even persons carrying out certain financial activities with a significant annual average value of financial transactions may be considered as Financial Institutions for FTT purposes<sup>8</sup>.

Central Counterparties (CCPs), Central Securities Depositories (CSDs), International Central Securities Depositories (ICSDs), member states and public bodies tasked with managing public debt are not in principle deemed to be financial institutions





Handwritten mathematical notes including:

- $\cos x - \sin x$
- $a^2 = b^2 + c^2$
- $x = \frac{1}{n} \sum_{k=1}^n x_k$
- $Ax^2 + Bxy + Cy^2 + Dx + Ey + F = 0$
- $x = y^2$
- A sine wave graph with the label 'SIN'.
- A partial equation  $x^2 + x^2 = x(a+b)$ .

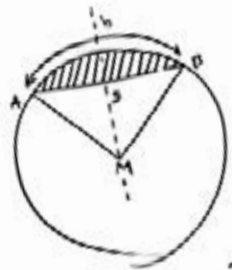
- Finally, the territorial application of the proposed FTT is primarily based on the *residence principle*. In essence a financial transaction would be taxable provided that one of the parties to the transaction is established in a Participating Member State. The sale of shares by a French Bank to a German UCITS would then be subject to FTT on both sides of the transaction, i.e. in France (seller's side) and in Germany (buyer's side).

Under the residence principle, financial transactions entered into by a financial institution located outside the FTT zone would not be subject to FTT, unless the other party to the transaction is established in the Participating Member States. The sale of shares by a UK Bank to a German UCITS would be subject to taxation twice in Germany: while the German UCITS would be liable to pay the FTT on the acquisition, the UK Bank would be deemed to be established in Germany for FTT purposes and would also be liable to pay the tax there.

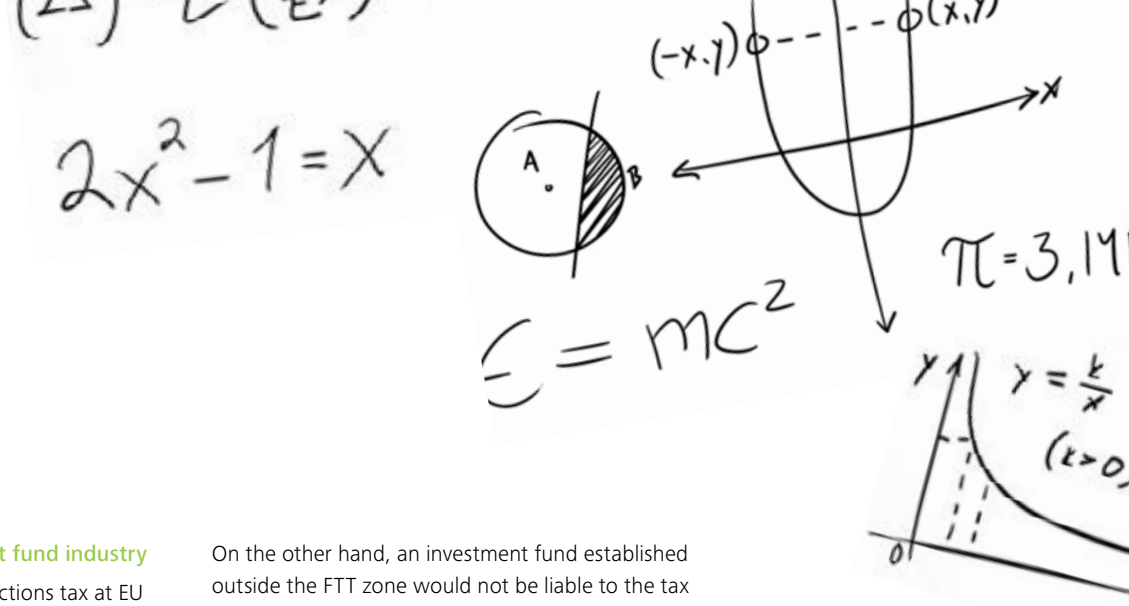
To further prevent avoidance of the tax, the EU Commission added the *issuance principle* to its proposal. Qualifying financial transactions entered into by two financial institutions both located outside the FTT zone would therefore be subject to taxation provided that they involve financial instruments issued in one of the Participating Member States. The sale of shares issued by a Belgian resident company between a UK Bank and US Bank would be subject to FTT twice in Belgium: indeed both parties to the transaction would be deemed to be established in Belgium for FTT purposes.

Most recently, on 18 April 2013, the UK Government lodged a formal legal claim at the European Court of Justice against the introduction of the EU FTT under the ECP. This claim is based on the grounds that the existing proposal will impact countries not taking part to the initiative. This legal challenge casts doubts on the likelihood of the EU FTT being introduced on 1 January 2014, as originally planned by the EU Commission.

## The introduction of an EU-wide financial transactions tax is likely to have a significant impact on fund industry performance and attractiveness, where fund's domicile will clearly become a key differentiator



6 With the exception of instruments of payments  
 7 Article 2.1(8)  
 8 Article 2.1(8) j. The present proposal sets the threshold at 50% of its overall average net annual turnover of the entity/person concerned



### A real challenge for the investment fund industry

The introduction of a financial transactions tax at EU level will likely have a great impact on the fund industry. Indeed, aside from the effect of the tax on portfolio transactions, the distribution of units/shares by funds would also be impacted. In this way, the domicile of the investment funds will potentially become one of the key drivers to be carefully considered by fund promoters.

#### At portfolio transaction level

An investment fund established in the FTT zone would be taxed on each qualifying financial transaction. On the other hand, an investment fund established outside the FTT zone would not be liable to pay the tax as long as the counterparties to the financial transactions are not established in a Participating Member State and the financial instruments traded are not issued in the FTT zone.

The impact of the tax on funds' investment portfolios will essentially depend on their Portfolio Turnover Rate (PTR). Typically money-market funds whose PTR is often higher than the average would be more impacted than long-term equity funds whose investment and trading strategy may in principle be less dynamic, causing the FTT to have an extremely uneven impact as most 'conservative' products would suffer from a higher tax rate than more aggressive ones.

#### At fund distribution level

The European Commission has extended the primary market exemption, meaning that the issuance of units/shares by investment funds would not be subject to the tax. However, the redemption of units/shares in investment funds would not be exempt as these transactions are not covered by the aforementioned exemption.

Consequently, any redemption of units/shares by an investment fund established in the FTT zone would be subject to taxation. The total effect of the tax would be even higher if the beneficial owners were institutional investors<sup>9</sup>.

On the other hand, an investment fund established outside the FTT zone would not be liable to the tax at the time of redemption except when the investor – whether retail or institutional – is established in a Participating Member State.

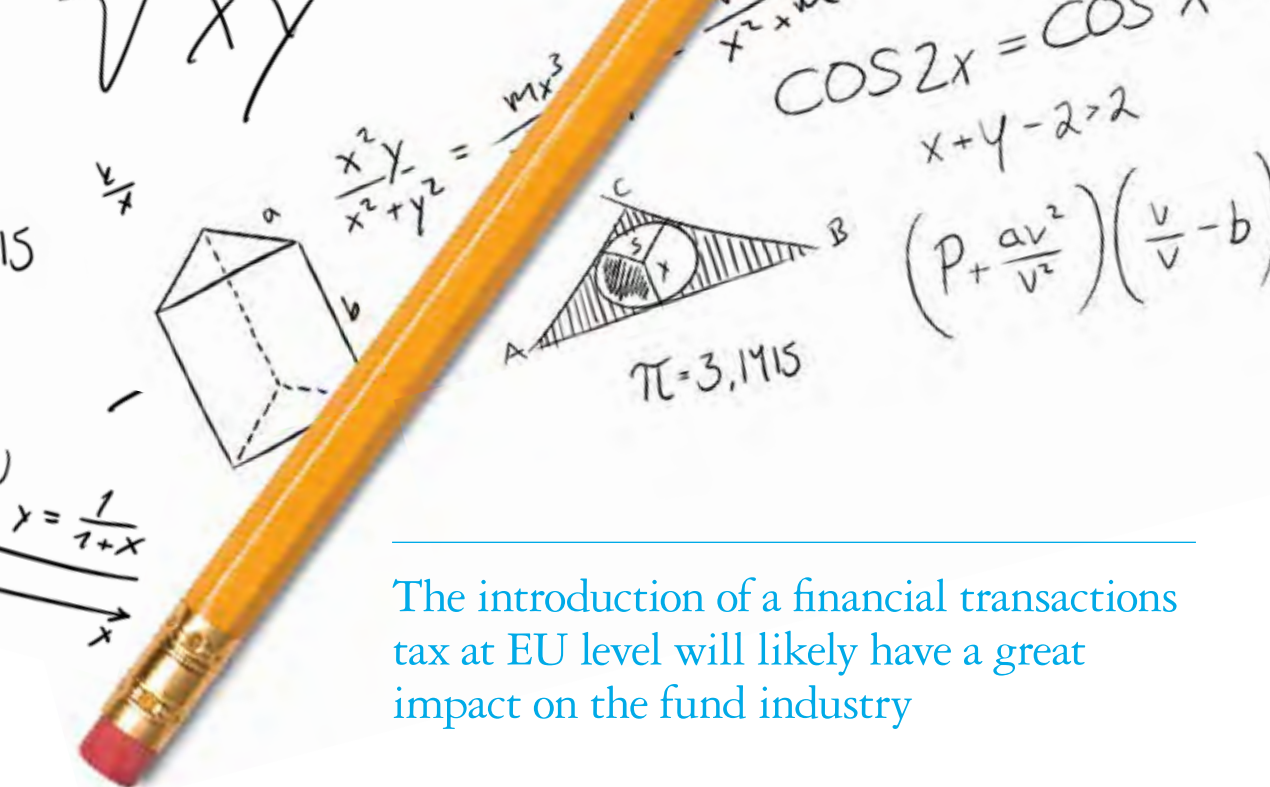
As a consequence, a Fund of Funds would potentially suffer from a cumulative effect caused by the FTT as they will be taxed at the level of the Master Fund portfolio as well as the Target Funds' investment portfolio for funds established within the FTT zone.

The overall cost of the FTT for UCITS investment funds will eventually be borne by fund investors through reduced fund performance and an 'exit tax' on redemption. This would have a very negative effect on vehicles that are designed and used for long-term retail investor savings. It would also be completely contrary to the original objective of the FTT, which was to reduce short-term speculative trading; identified as one of the accelerating factors in the financial crisis.

#### EFAMA's view

On the basis of the European Commission's original proposal, dated September 2011, EFAMA<sup>10</sup> estimated that the potential annual impact of the FTT on the UCITS industry<sup>11</sup> would have reached €38 billion if applied at the start of the year 2011. Following the release of the revised draft directive in February 2013, EFAMA published a new impact assessment<sup>12</sup> where the total impact of the FTT would have reached €13 billion assuming that the tax had been applied at the start of 2011, all other variables remaining unchanged. This amount comprises €7.3 billion attributed to FTT zone countries and €5.7 billion attributed to the non-FTT zone.

	FTT on gross redemptions of units	FTT on total portfolio transactions	FTT total annual revenue
<b>FTT ZONE</b>	3,054	4,289	7,343
<b>NON-FTT ZONE</b>	1,235	4,448	5,683
<b>TOTAL</b>	4,289	8,738	13,026



## The introduction of a financial transactions tax at EU level will likely have a great impact on the fund industry

However, derivatives transactions are not taken into account in this impact analysis, and EFAMA acknowledges that the potential impact of the FTT could be significantly higher as many UCITS use derivative instruments to cover their currency or market risks.

This new estimate released by EFAMA differs from its previous impact analysis for the following reasons which we have also detailed above:

- Portfolio transactions carried out by UCITS domiciled outside the FTT zone would not be subject to tax as long as the counterparties to the transactions are not established in a Participating Member State and that the transactions do not involve securities issued from the FTT zone
- The issuance of units/shares by UCITS would be exempt from tax under the primary market exemption
- EFAMA expects a lower FTT impact on redemptions of UCITS domiciled outside the FTT zone assuming that they are mainly distributed to domestic investors with the exception of Luxembourg domiciled UCITS, which according to EFAMA would be impacted to the extent they are distributed to investors based in the FTT zone
- Finally, EFAMA believes that the impact on portfolio management of money-market funds would be reduced due to the exemption of primary issuance

9 As long as the 'institutional investor' is considered as a 'financial institution' as defined by the Directive.

10 European Fund and Asset Management Association

11 <http://www.efama.org/Publications/Public/FTT/EFAMA%20impact%20analysis%20on%20Commission%20proposals%20on%20FTT.pdf>

12 [http://www.efama.org/Publications/Public/130313\\_FTT\\_Impact\\_Analysis\\_2013.pdf](http://www.efama.org/Publications/Public/130313_FTT_Impact_Analysis_2013.pdf)

Fund promoters and asset managers must follow the developments in relation to the EU FTT closely, as the current proposal is likely to impact the performance and the attractiveness of their fund products. In this respect, they must carefully consider where their funds are domiciled, analyse how their portfolio transactions are structured, revisit their investment strategy and also consider the risk that retail and institutional investors may move their savings to exempt products, such as savings deposits or life insurance products. This equation is not an easy one to solve, as there are various elements to be taken into account.

### To the point:

- The introduction of a financial transactions tax at EU level will likely have a major impact on the fund industry
- The base of the tax is extremely broad, covering transactions carried out by Financial Institutions on the vast majority of Financial Instruments once the existence of an economic link to the FTT zone has been established
- The domicile of the investment funds will potentially become one of the key drivers to be carefully considered by the fund promoters
- Fund promoters and asset managers must follow the developments in relation to the EU FTT closely, as the current proposal is likely to impact the performance and attractiveness of their fund products



# AIFMD Remuneration

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## The main objectives of the Directive, as far as remuneration policies are concerned, are to ensure that three key issues are covered: governance, risk alignment and transparency

### Context and scope

#### Context and objectives

A number of guidelines and recommendations have been issued in recent years by various authorities on the improvement of remuneration policies in the financial sector. The Alternative Investment Fund Managers Directive (AIFMD) establishes, inter-alia, a set of rules which have largely been inspired by the provisions of Directive 2006/48/EC (CRD). Alternative Investment Fund Managers (AIFMs) must comply with this Directive when defining remuneration policies.

The AIFMD framework introduces stringent requirements to ensure that the remuneration policies and practices of AIFMs are consistent and promote sound and effective risk management. The main objectives of the Directive, as far as remuneration policies are concerned, are to ensure that three key issues are covered: governance, risk alignment and transparency.

In February 2013, ESMA published the final guidelines on remuneration policies under AIFMD. The following requirements need to be implemented by AIFMs by 22 July 2014:

- **Governance:** AIFMs shall establish a remuneration policy and, where 'significant' in size (depending on their AUM and number of employees), appoint a remuneration committee. A supervisory function must oversee the policy implementation and control functions and must ensure regular reviews

- **Risk alignment:** Variable remuneration is performance-based and risk-adjusted notably through deferral, payment in instruments and claw-back measures. It can even be reduced to zero
- **Transparency:** AIFMs shall disclose quantitative and qualitative information on remuneration policies and practices. While aggregated remuneration amounts must be published in the AIF report, detailed information does not necessarily have to be made public

#### Scope

ESMA's guidelines will apply to managers of alternative investment funds including hedge funds, private equity funds and real estate funds, as well as managers of other non-UCITS regulated funds which are managed or marketed in the EU. It also applies to companies to which some functions have been delegated by the AIFM.

While EU AIFMs are subject to full remuneration requirements, non-EU AIFMs managing EU AIFs and/or marketing AIFs in the EU will only be subject to disclosure requirements until 2015 after which full remuneration requirements may apply (e.g. if a marketing passport is available and has been requested).

The concept of remuneration shall be understood in its broadest sense (fixed and variable, cash and fringe benefits, incentive plans, etc.). Carried interest schemes also fall into the scope of the requirements (with the exception of co-invest schemes, i.e. return on an actual investment).



## Governance

### What are the requirements?

The Directive introduces the requirement for management companies to set up an internal governance structure responsible for the design, implementation and supervision of an AIFM remuneration policy.

This governance structure should ensure the adequacy and appropriateness of remuneration. As a reminder, remuneration policies must be sound and prudent, and avoid conflicts of interest that may lead to excessive risk taking. Remuneration policy should therefore align the interests of both investors and fund managers. Remuneration policies shall be reviewed at least annually and updated when necessary.

The governance of remuneration includes the creation of a supervisory function. The supervisory function shall rely on controls performed internally (by risk managers, compliance officers, human resources, etc.)

In order to avoid conflicts of interest, this supervisory function is performed by relevant persons or bodies.

The supervision function could be performed by the management body of certain AIFMs, depending on their size, internal organisation and activities.

Significant AIFMs shall also implement a Remuneration Committee (RemCo), which is composed of non-executive members of the management body and enables the competent and independent consideration of remuneration of identified staff, including senior management. The chairperson of the RemCo should be an independent, non-executive member of the management body. With regard to proportionality criteria, ESMA gave some clarifications concerning minimum total assets and employee number thresholds (€1.25 billion and 50 employees respectively), below which the RemCo will not be mandatory.

AIFMs which are subsidiaries of credit institutions, banking/insurance groups and investment groups of financial conglomerates may rely on the group RemCo.

## The AIFMD framework introduces stringent requirements to ensure that the remuneration policies and practices of AIFMs are consistent and promote sound and effective risk management

Some EU jurisdictions already have general guidelines concerning company governance, including remuneration principles. Those guiding principles are mainly in line with AIFM guidelines as regards conflict of interest, the remuneration committee, independence of stakeholders, period.

### What does this mean for AIFMs?

- Each AIFM should determine who will be in charge of the supervisory functions, especially in order to avoid conflict of interest
- In the absence of precise guidelines regarding the number of persons/bodies that will compose the supervisory function, AIFMs should also define the appropriate number of members
- Significant<sup>1</sup> AIFMs would most likely appoint external consultants in the remuneration process: implementation of remuneration policies, supervision, etc. In this instance ESMA guidelines<sup>2</sup> require that the “*name of the external consultant whose services have been used for the determination of the remuneration policy [be] disclosed*”
- The AIFMD should enforce/strengthen existing professional guidelines/good practices

<sup>1</sup> Significant size, internal organisation and nature, scope and complexity of the AIFM's activities

<sup>2</sup> ESMA's final report - Guidelines on sound remuneration policies under the AIFMD, dated 11 February 2013



### Risk alignment

#### What are the requirements?

The AIFMD requires the AIF to establish a remuneration policy promoting sound and effective risk management. The Directive differentiates between general and specific risk-alignment requirements.

General requirements include the following:

- Guaranteed bonuses should be exceptional, must occur only when hiring staff and be limited to the first year
- Severance payments must not reward failure

- Employees must not use personal hedging strategies to circumvent remuneration requirements
- Discretionary pension benefits should be paid in instruments and be subject to a retention period of five years minimum

These requirements are only compulsory for Identified Staff but ESMA strongly recommends that they are applied to all staff. AIFMs must be able to demonstrate why they apply the requirements only to Identified Staff (staff having a material impact on the AIFMD risk profile) if they decide to do so.

Specific requirements are applicable to the remuneration of Identified Staff and include the following:

- There should be an appropriate balance between fixed and variable remuneration
- Variable remuneration should decrease as a result of negative performance (down to zero where appropriate). Performance assessment criteria used to determine the amount of variable remuneration should be defined upfront and include both quantitative and qualitative elements (notably related to risk management)
- At least 50% of variable remuneration should be paid using instruments such as units or shares of the AIF or equivalent
- At least 40% to 60% of variable remuneration should be deferred over a minimum period of three to five years, and vest no faster than on a pro-rata basis
- Variable remuneration should be subject to overall financial performance and downward adjustment by way of malus (pre-vesting) or claw back (post-vesting) adjustments

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Some EU jurisdictions already have general guidelines concerning company governance, including remuneration principles

### What does this mean for AIFMs?

The AIFMD requirements create a number of challenges for AIFMs. The main following impacts can be identified at this stage:

- AIFMs will have to identify 'Identified Staff' for the purposes of the remuneration rules. The following must be considered as Identified Staff, unless it is demonstrated that they have no material impact on the AIFM's risk profile: members of the governing body of the AIFM, senior management, other responsible staff, members of controls functions and other risk takers as well as staff within the same remuneration bracket as that of the senior management
- AIFMs may need to change the form of rewards so that they are paid in Fund units (or equivalent). In addition, the practicality of making rewards of units in the AIF will need to be considered
- AIFMs will need to define how to value the carry for the purposes of assessing the deferred proportion of variable pay
- AIFMs may have to increase their use of deferred remuneration (e.g. deferring bonuses) and the tax implications of this deferral will need to be reviewed
- Malus provisions (ex-ante adjustments) will need to be implemented in addition to the commonly used claw back provisions (ex-post adjustments) for carried interest

### Transparency

#### What are the requirements?

AIFMs will face new disclosure duties as regards remuneration. This information will have to be disclosed externally (to investors/prospective investors), and internally (to the AIFM staff members).

The total remuneration of AIFM staff must be disclosed in the annual report. However, additional qualitative and quantitative information regarding the decision-making process to determine the remuneration policy, supervision function, the connection between pay and performance, and performance criteria are to be disclosed at least annually, whether in the annual report or any other form (e.g. a remuneration policy statement).





For AIFMs that have a RemCo, its members and their respective roles are also to be disclosed.

These requirements mean that AIFMs need to explain and justify their remuneration practices, potential evolutions and the management of conflict of interest inside the AIFM. They therefore become part of the AIF's risk profile assessment that each (prospective) investor should fully understand.

However, while disclosing the above information, proportionality principles may be observed, and confidentiality and data protection principles apply. This means that the level of detail will vary for small or non-complex AIFMs, and according to EU jurisdictions.

The remuneration disclosures are the responsibility of the management body of the AIFM.

In addition, the AIFM must ensure all of their employees have access, as a minimum, to the same level of information which is disclosed externally and also to the AIFM's remuneration policy.

#### **What does this mean for AIFMs?**

- *Investor protection:* Remuneration policy is disclosed to investors and is considered to be a part of the AIF's risk profile assessment
- *Verification issue:* Information disclosed in the annual report should be reviewed by the AIF's auditors, while information disclosed in any other form may not be checked
- *Homogeneity and granularity:* A varying level of detail is to be expected for remuneration disclosures, according to jurisdictions and laws concerning data protection and confidentiality, as well as proportionality principle interpretations

### Proportionality

The proportionality principle allows AIFMs to disregard some of the requirements. Nevertheless, a detailed assessment should be performed on each requirement.

The following factors should be considered together to assess how the proportionality principle can be applied for AIFMs:

- *AIFM size* – Capital, value of assets under management of the AIFs that the AIFM manages or the liabilities and risk exposure of both, number of staff, number of branches or subsidiaries
- *Nature, scope and complexity of the AIFM activities* – Type of authorised activity, type of investment policies and strategies of the AIFs the AIFM manages, national or cross-border nature of business activities, additional management of UCITS subject to authorisation under the UCITS directive
- *AIFM internal organisation* – Legal structure of the AIFM or the AIFs it manages, complexity of the AIFM's internal governance, listing on regulated markets of the AIFM or the AIFs it manages

In the final guidelines, ESMA has clarified that only the following requirements can be disregarded:

- Payment of variable remuneration in instruments
- Retention periods
- Deferral requirements
- Malus/clawback provisions
- Appointment of a remuneration committee

ESMA has stated that, while these features can be disregarded, they may only be disregarded in their entirety, i.e. it will not be possible to apply lower thresholds based on proportionality.





To the point:

The Directive introduces stringent requirements as regards remuneration governance, risk-alignment and disclosure. We believe that these requirements may represent significant change and challenges for the industry as a whole. In particular:

- The requirements are far reaching as they apply to a wide range of entities (EU-AIFMs and AIFMs managing and/or marketing AIFs in the EU, in addition to delegated entities) and to the remuneration elements concerned within those entities (notably carry and some co-investment)
- A governance of remuneration has to be implemented in each AIFM, which entails challenges in terms of independence and conflict of interest for those involved
- Remuneration risk-alignment criteria will represent implementation challenges for the AIFMs, notably to define 'Identified Staff' and value carried interest for deferral purposes. Tax implications of deferral, malus and claw back measures will also need to be considered
- The remuneration guidelines will also force AIFMs to justify and adapt their remuneration policy and place the AIF's risk dimension at the very heart of the remuneration process
- AIFMs may entirely disregard certain requirements by applying the proportionality principle. Nevertheless, a detailed assessment should be performed on each requirement

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ESMA's guidelines will apply to managers of alternative investment funds including hedge funds, private equity funds and real estate funds, as well as managers of other non-UCITS regulated funds which are managed or marketed in the EU

**ECJ Case : C-275/11 – GfBk Gesellschaft für  
Börsenkommunikation**

VAT exemption for investment advisory services for funds confirmed.

On 7 March 2013 CJEU published its decision in the case C – 275/11 *GfBk Gesellschaft für Börsenkommunikation mbH*.

**Dispute**

In this case, *GfBk Gesellschaft für Börsenkommunikation mbH* ('GfBk') was providing investment advisory services to a management company that was managing a retail investment fund. GfBk advised the management company "*in the management of the fund*" and "*constantly to monitor the fund and to make recommendations for the purchase or sale of assets*". Within its role, GfBk undertook to "*pay heed to the principle of risk diversification, to statutory investment restrictions ... and to investment conditions ...*".

The CJEU was in this respect asked whether such investment advisory services can be VAT exempt as "*management of special investment funds*" according to the VAT Directive

**Decision**

The CJEU ruled that such investment advisory services should be exempt from VAT as they fall under the definition of "*management of special investment funds*".

Considering the above mentioned, services consisting in giving recommendations to purchase and sell assets are intrinsically connected to the activity characteristic of a management company which consists in the collective investment in transferable securities of capital raised from the public.

The fact that such investment advisory services do not alter the fund's legal and financial position (which is a general condition for financial services to be exempt from VAT) is not contradictory to the qualifying such services as "*management of special investment funds*".

**Impact**

If this decision confirmed the current practice in many EU countries where these investment advisory services were already VAT exempt, the other EU Member States that considered such services differently in the past, would have to amend their VAT legislation accordingly.



### Wheels Common Investment Fund Trustees Ltd (C-242/11) - Defined benefit pension funds

On 7 March 2013 the CJEU also published its decision in the case C-242/11 Wheels Common Investment Fund Trustees Ltd.

#### Dispute

The case concerns an issue whether the management of pension funds can qualify for VAT exemption. Within the dispute, Wheels Common Investment Fund Trustees Ltd., a trustee of occupational pension schemes' assets, was arguing that pension funds should be regarded as "*special investment funds*" for VAT purposes and thus the management of pension funds should be VAT exempt under the "*management of special investment funds*" provision.

The concerned pension schemes provided for pensions to a category of former employees, calculated by reference to the final salary of the members of the scheme and their length of services with the employer. During the employment, the members of the scheme, which is open to all employees (but not compulsory), pay contributions of a fixed amount deducted from their salary. The employer also makes contributions, in an amount sufficient to ensure funding for the remaining cost of providing pension benefits. Such funds are referred to as defined benefit funds.

#### Decision

The CJEU concluded that the defined benefit pension funds do not meet the same needs as those mentioned in the Directive and following this they cannot be considered as a "*special investment fund*" within the meaning of the EU VAT Directive. As a consequence, the management of such funds cannot benefit from the VAT exemption.

The reasons for that were the following:

- i. Defined benefit pension funds are not open to the public
- ii. The members of such funds do not bear any risk from the management of the pension fund (the pensions do not depend on the performance of the pension fund)
- iii. The employer is not in a comparable situation as an investor of an investment fund since the contributions paid by him are a means of his compliance with the legal obligations towards the employees

The decision is concerning only the VAT treatment of management of defined benefit pension funds.

The application of VAT exemption on the management of defined contribution pension schemes will be analysed in the case C – 464/12 ATP Pension Services A/S which will be decided in the near future.

#### Impact

This CJEU's decision can have a direct negative impact in each EU Member State where any pension funds are suitable for defined benefit plans.

### Future German retrocession regulation under discussion

The EU is considering whether to ban completely inducements for independent advisors as part of the upcoming MiFID overhaul ('MiFID II'), although the EU seems to await the experiences that UK and the Netherlands might have with their new rules. Sweden are also considering going beyond the MiFID II rules by implementing a ban on inducements paid to client advisors and the Swiss Federal courts have ruled that inducements earned by Private Banks on discretionary mandates should be paid to investors and not retained by the Private Banks. Against this backdrop Germany has published a Draft Bill in November 2012 to introduce a client-fee based independent advisory model into the financial sector. Although commission-based advisory remains an option, the step intends to anticipate MiFID II in Germany and to path the way forward to establish more client-fee based advisory services. The Draft is based on the EU commission's draft for MiFID II that had been published in October 2011.

The Draft Bill (*Honoraranlageberatungsgesetz*) was passed through the Government to the Parliament and put for further discussions into a first public hearing on March 18, 2013. It will probably be put to the vote of the Parliament next week. Despite heavy criticism by the political opposition which appears more motivated by the forthcoming elections, the German Bundesbank welcomes the initiative, but is pointing out the need to ensure an adequate qualification of the advisors. The asset management industry association as well as big German banking networks (mainly *Sparkassen* and *Volksbanken*) see a complete ban on retrocession as a potential threat to their business model. Such fears are however not based upon the current draft as well as by any other information from BaFin or government. The timing of the draft bill appears quite early as MiFID II is still under discussion. That might imply a short term need to redraft the law in the future. Much will depend on the outcome of the final MiFID review in Brussels.

# Link'n Learn 2013

As previously announced, Deloitte has, since 2009, decided to open its knowledge resources to the professionals of the Investment Management community. We are happy to present to you the calendar of our new Link'n Learn season which, as usual, will be moderated by Deloitte's leading industry experts. These sessions are specifically designed to provide you with valuable insight on today's critical trends and the latest regulations impacting your business. An hour of your time is all you need to log on and tune in to each informative webinar. For access to the sessions do not hesitate to contact [deloittelearn@deloitte.lu](mailto:deloittelearn@deloitte.lu)

## Agenda

**02-May** Introduction to risk management (2/2): investment funds

**06-May** Evolution and latest developments on UCITS funds regulation

**16-May** Session AIFMD (1/4): introduction, general principles

**30 May** Corporate governance

**06-Jun** AIFMD (2/4): focus on direct & indirect tax aspects of the implementation of AIFMD

**13-Jun** AIFMD (3/4): focus on level II measures – ManCos, delegation, valuation ad remuneration

**20-Jun** AIFMD (4/4): custodian responsibilities – latest developments based on AIFMD and UCITS V

**24-Jun** Tips to succeed in FATCA implementation

**23-Sep** Introduction and latest updates to ETFs and Index tracker funds

**26-Sep** Impacts of Basel II – III and Solvency II for the asset management

**14-Oct** Introduction to IFRS for funds

## Africa - West and Central



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