

# Performance

A triannual topical digest for investment management professionals, issue 8, May 2012



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Growth in deteriorating markets

Data quality in asset management

Asset management  
New deal

Share class hedging  
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# Foreword



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

We would like to express our warmest welcome to the eight edition of Deloitte's worldwide Investment Management digest for professionals, *Performance*. Our Investment Management coordination team is exceptionally proud of the success this magazine has had in becoming a central exchange platform of information for our industry's key actors. Once again, we have increased the number of Deloitte participating practitioners but also and most importantly, our international readership. Thank you very much for your support, we could not achieve this without you.

For this foreword, we would like to devote some words on a key topic which we are currently facing: regulation and risk. We truly believe that pure and efficient risk management requires more than the regulatory compliance as a *de minimis*. We do not consider that it is right to use risk management as a brand to maintain our investment vehicle's attractiveness towards distribution. By this statement, we would like to say that nowadays a considerable amount of product ranges are linked to a regulatory definition (e.g. VaR funds or low SRR1 rated UCITS). We shall drive our industry towards an investor oriented mind-set and do all we can to re-build the trust between our industry and our investors. Investment management stakeholders must provide assurances that we have learnt from the past and that we want to implement a meaningful risk management framework for investment funds. Luckily, to put a positive spin on the situation, we can proudly say that our industry was not the worst in class in the financial sector.

In our humble opinion, investment management professionals must think carefully about what risk management means in today's environment, what does it protect us from and what risks are we still exposed to. We should not blindly limit ourselves to implementing regulation following regulation without questioning the essence of risk mitigation: anticipating uncertainty of market evolution.

We would like to wish you a rewarding reading of *Performance*, a magazine which would not be possible without your dedicated interest and support.

**Vincent Gouverneur**  
Partner - Tax & Consulting  
EMEA Investment Management Leader

**Francisco Celma**  
EMEA FSI Co-Leader  
Financial Services Industry

*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 & 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.*

# Editorial

Hello dear *Performance* readers,

It is time for the new and already eighth edition of our worldwide magazine about the Investment Management industry.

Without wanting to boast about our publication, we have once again managed to expand our readership and add to the number of Deloitte Investment Management practices contributing to our magazine. Who would have thought that after two years and eight editions, we would still keep increasing the success of *Performance*! I would therefore like to take this opportunity to thank you all for your support.

We are happy to provide you with interesting articles about post-crisis growth in asset management, data quality in the industry, share class hedging, financial inclusion, the IORP Directive on pensions, international distribution, fund ratings, MiFID II, depositary responsibility and the impact of AIFM Directive

for service providers. For this edition, we also managed to include external contributions from Amundi, the European Investment Bank, INVERCO and EFA.

We would be happy to hear your views and ideas on any subjects covered in *Performance*. The entire editorial team would like to wish you interesting reading.

Sincerely,



**Simon Ramos**  
Editorialist



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# Post-crisis asset management environment

## Growth in deteriorating markets

**Andreas Timpert**  
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**Profound changes in the economic environment  
will impact industry growth strategies.**

It is no secret that the financial crisis of 2008 fundamentally altered the global economic landscape. Some of the world's highest profile financial institutions filed for bankruptcy, a severe liquidity crisis ensued, equity markets collapsed and national debt levels reached new heights in both the United States and European Union.

For the asset management industry, the crisis led to the abrupt end of a long era of strong growth and expansion of international capital markets. The global value of professionally managed assets fell sharply while investor confidence in the industry and the

markets dropped to new lows. There was a shift to less risky, less expensive and less complex products. The combined impact of the economic environment, tougher regulatory climate and greater client sophistication has transformed the asset management industry.

Asset managers must revise their strategies and fundamentally change their business models to survive in today's complex climate and find a way to grow. This article highlights some opportunities for growth and explains how asset managers can access these opportunities in spite of the challenging environment.



### A passive dependency on industry growth is no longer sufficient

The asset management industry has historically benefited from ever-increasing wealth and an appetite for financial products in the western hemisphere which led to rapidly expanding financial markets.

However, there has been a high degree of volatility and instability in the markets since the 2008 crisis. 2011 was viewed by many as a turning point as confidence in the markets improved and central banks increased efforts to stabilise the economy. Over the summer months, though, global stock markets dipped again and had not fully recovered by the end of the year. This was largely a result of prolonged, unsuccessful attempts to ease the eurozone crisis, the U.S. debt ceiling crisis and stubbornly high U.S. unemployment rates. In 2012, the story does seem to have improved somewhat. The first quarter showed strong performance in most equity markets as a result of the stabilisation effects

from the easing of the crisis in Greece and the results of the recent U.S. banking stress tests. However, these positive signs are by no means an indication that a strong and stable recovery is around the corner. In the eurozone, there are still signs of stress as, for example, the Irish economy falls back into recession and sovereign bond yields in the Mediterranean countries rise again. In addition, for the first time in history, we saw a downgrade of the U.S. sovereign debt rating, and recent data on U.S. growth prospects has been disappointing.

With the halt of the dramatic expansion rate of the financial markets since the crisis, the familiar platform for growth is no longer available. The positive upswing has not yet taken root and markets will remain unpredictable. As such, it is vital that asset managers develop alternative, innovative strategies for growth to ensure that they are able to remain competitive. Relying purely on industry growth is no longer sufficient.



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For the asset management industry, the crisis led to an abrupt end to a long era of strong growth and expansion of international capital markets.

**Pursuit of typical growth strategies may not be optimal**

There are a number of standard plays that can be made when considering how to boost market share in a stagnant or shrinking industry. Acquiring assets via Mergers and Acquisitions (M&A), for example, can have an immediate impact. Buying a portfolio and eliminating a competitor in one move is appealing in terms of increasing scale and scope, and this type of activity did feature prominently in the history books of the last decade. However, the effects of the financial crisis mean that there is now less M&A activity in the asset management industry as compared to five years ago and, in general, this trend is not expected to change. Volatile markets increase the difficulty of determining the true value of a potential target and most asset managers are focused fully on client retention.



Another option to increase market share is to move into new markets. While this may be an attractive option, it is typically a slow and expensive strategy. At present, most asset managers are hesitant to take the financial risk associated with a strong move into new business areas.

Given the issues surrounding the pursuit of M&A and new markets as growth strategies, how should asset managers expand their businesses?

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## With the halt of the dramatic expansion rate of the financial markets since the crisis, the familiar platform for growth is no longer available.

### The importance of client service and efficient operations

Asset managers are typically very good at new product development and are competent at entering new markets. However, the industry tends to focus less on client service and efficiency improvements. Too few asset managers are challenging themselves to assess what else would provide a competitive advantage beyond innovative and/or high-performing products. Two areas that are typically ignored are process and service innovation and the associated client-centricity, both in terms of the sales cycle (with institutional clients and intermediaries) and the servicing of existing clients.

### Growth via outstanding service provision

Investors, particularly institutional investors, take service offering and service quality into account when making investment decisions in addition to the standard considerations around product performance and product mix. However, many asset managers underestimate the impact of delivering a high quality service and the possibility of differentiating themselves through their service offerings.

Although the story is somewhat more positive for asset managers with institutional clients, a brief foray into the consumer business industry illustrates how far behind asset managers are in general when it comes to creating an easy-to-use website offering a memorable user-experience:

- The home page of the Apple website provides an overview of all product types, making it easy for customers to find their way around
- The core features of each product type are explained in an easy to understand manner, and presented for ease of comparison
- When placing an order, the customer is able to personalise the configuration of the product, with the price adjusting immediately

Asset managers can adapt the lessons learnt from 'Apple' to suit their own businesses. Within the industry, efficient company websites are more important to distributors than to end customers. The primary concern of the financial advisor as a distributor is to quickly convert an inquiry from a client into a sale. A financial adviser is more likely to recommend a product to a customer if the interfaces between themselves and the investment manager operate smoothly and efficiently.

Anything that an investment manager can do to streamline this interface will lead to some growth. For example, instead of simply displaying pure numbers on the website, asset managers have started to consider completely transforming their website to provide risk-return graphs with the ability to compare funds. In addition, a simple simulation of the total cost of a fund is another value-adding tool that can be included on a website to expedite the interaction between a financial adviser and their client.

The focus on customer needs must be high on the agenda of senior management and it should be at the core of the asset manager's strategy if it is to become embedded in the company's 'DNA'. To become a true customer service champion, an asset manager must:

- Develop a deep understanding of what drives their distributors and customers: What motivates distributors? Why does a customer choose one product over another?
- Design and construct tools and processes that are tailored to meet the needs of customers and distributors, but that are also cost-efficient
- Implement an ongoing control process that ensures distributor and customer needs are continuously monitored and incorporated into the tools and process landscape

### **Growth via process and service innovation**

Successful companies must embed innovation into the culture of the company and must have the right processes and objectives defined to enable innovation. Truly innovative companies do not simply allow space for creative minds, they are also able to commercialise good ideas. They take a holistic approach to innovation; product, process, service and strategy are all considered and all treated similarly from an investment perspective.

Innovation in the asset management industry has focused predominantly on new product creation and is mostly confined to product development. This strategy may produce limited success in terms of growth as new products are copied quickly in financial services. As such, it is very difficult to secure competitive advantage for any length of time. The majority of asset managers have thus far neglected innovation in process and service areas, despite the fact that they are comparably easy to achieve given that they require internal changes only. This type of innovation is often the more effective way to achieve growth and true competitive advantage.

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**Asset managers are typically very good at new product development and are competent at entering new markets.**

Low-risk innovations include:

- Standardising processes for new product creation to enable quick action and reaction to changes in the investment environment
- Implementing a state-of-the-art process to manage regulators ensuring no time is lost when regulators and other government bodies require information (for example, standardising both the process to develop the Key Investor Information Document (KIID) and the document itself)
- Setting up an efficient and easy to use fund platform to satisfy distributors and influence their decision regarding which fund they promote to their clients (as in the example from the previous section)

The implementation of new regulation is an excellent example of how asset managers can obtain a competitive advantage by incorporating strategic process innovation. The implementation of the Key Investor Information Document (KIID) has been a hot topic in the industry. The typical asset manager has built a taskforce to determine the quickest and cheapest way to comply with the new regulatory requirements. This approach is not surprising given the tight timelines that need to be adhered to. However, many asset managers are not replacing these short-term solutions in favour of more automated and efficient solutions. Leading investment managers, on the other hand,



are building a process that takes an end-to-end view of the components required for KIIDs and integrates them into daily procedures. The 'Risk and Return Profile' section within the Synthetic Risk and Reward Indicator (SRRI), the 'Previous Performance' section, the 'Costs' section and the 'General Information' sections should all be integrated in the related business units. The SRRI, for example, should become standard procedure in the risk department and should, as such, be used in internal as well as external risk management procedures whenever a product is launched, rather than remaining a one-off activity whenever a new KIID is required. Another example is the marketing material which can be included in the general information section. Additionally, the marketing department should standardise the structure and feel of the marketing content for the general information section for every new product launched. Leading investment managers thus eliminate inefficiencies and ensure that regulatory requirements and client needs are met jointly.

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Asset managers can adapt the lessons learnt from 'Apple' to suit their own businesses.

## Conclusion

Due to the financial crisis and ensuing economic downturn, asset managers can no longer rely on growing in the undertow of industry expansion. The industry is expected to remain stable or even shrink over the course of the coming years. In addition, asset managers also have to deal with the implications of the stricter regulatory environment.

In spite of this, there are opportunities for asset managers to grow by gaining market share and enhance their competitiveness by developing innovative strategies that focus on optimising key processes and improving service quality. In fact, there are a number of low-risk innovations that can be implemented to deliver improvements in these areas.

The key to success with these growth strategies, and so the key to competitive advantage, will be the development of a deep understanding of what drives distributors and clients, as is often the case in the consumer business industry. Asset managers will need to commit to continuously reviewing and improving services offered and processes in line with the changing requirements of distributors and clients to maintain this competitive advantage.

### To the point:

- Asset managers can no longer rely on growing in the undertow of industry expansion
- However, asset managers can increase market share and by adopting innovative strategies based on service quality and process optimisation
- A deep understanding of what drives clients and distributors is absolutely essential for success





# Data quality in asset management

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Data are a key concern for the various actors in the asset management responsibility chain: data providers, asset managers, risk teams, reporting, asset servicers. It is reinforced by new regulations and marketplace requirements (Solvency II, Basel III, AIFMD, FATCA, etc.).



In this context, the quality of data and the implementation of connected and reliable processes are strategic elements in dealing effectively with sector expectations (management and steering of activities, compliance with regulatory constraints, client knowledge, customer care, etc.).

#### Some definitions

Definition of data: *"Data are facts and statistics that can be quantified, measured, counted, and stored"*<sup>1</sup>.

*Types of data:*

- Internal data for the management and teams (portfolio management, compliance, trading, financial reports, accounting, etc.) versus external data for clients, partners, providers, regulatory authorities (performance, performance attribution, compliance, reporting)
- Primary data from the various operating fronts, middle and back office systems (transactions, securities settlement, provisions/absorptions, fees, etc.) and secondary data calculated from primary data (positions, benchmarks, risk and performance indicators, dashboards, etc.)
- Operational/dynamic data from transactions, flows (prices, indices, rate curves, exchange rates, etc.) and referential/static data (instrument, third and referential characteristics)
- Data which may be structured (into standardised data models) and other unstructured data (spreadsheets, reports)

#### Characteristics of data quality:

1. Accuracy
2. Up-to-date
3. Availability
4. Consistency
5. Traceability
6. Security
7. Sufficiency
8. Non-redundant

#### An increasingly complex context

Three main elements are making context and data organisation increasingly complex.

#### They are related to:

1. The increase of data variety/diversity (pricing, product reference, clients, financial instruments, marketing documentation, etc.)
2. The data life cycle (systems upstream of the dissemination) with data flows and controls becoming increasingly complex, with sometimes different data life cycles
3. The acceleration of internal and external data production and booms in volumes of stored data

<sup>1</sup> Dr Donald Hawkins *Information Today*

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“Data are facts and statistics that can be quantified, measured, counted, and stored”<sup>1</sup>.

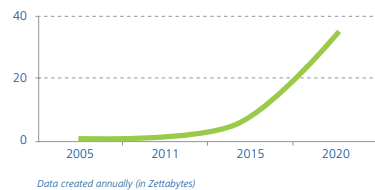
As an example, for an international French asset manager (€300 billion of assets under management), the amount of data equates to approximately:

- 60,000 instruments
- 65,000 third party
- 1,200 portfolios
- 1,300 benchmarks
- 350,000 integrated market data per day
- 80,000 positions
- 22 central accounting
- 10,000 integrated valuation per month

#### An increasing wide range of data

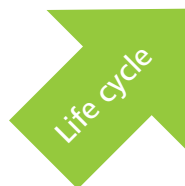


#### Acceleration of the production of internal and external data



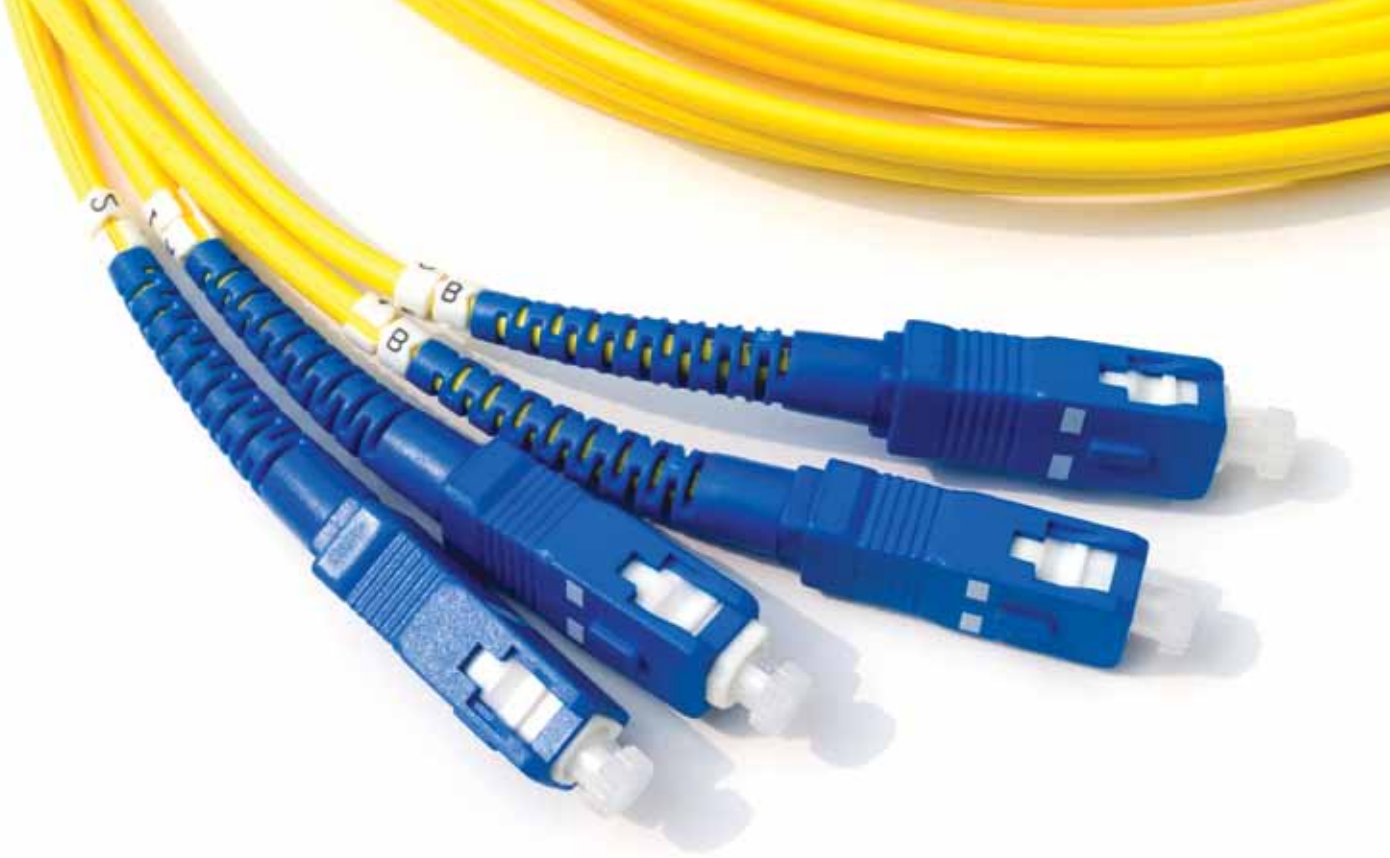
**Asset management**

#### The progression of key data and controls getting more and more complex



<sup>1</sup> Dr Donald Hawkins Information Today





### Observations in the field of asset management

Lack of control, absence of a cross-departmental approach, a low level of certification and quality impairment are often observed:

1. Lack of data knowledge and control are due to poor documentation of the data used, having a vast number of sources, external and internal flow and also incomplete data
2. The 'silo' approach, poor data consolidation, a dictionary of data which is not always shared among departments and validated by all actors and various systems, thereby preventing cross-departmental consistency within companies
3. Audit trails which are not always active during the complete data life cycle in addition to the weak automation of the traceability, all of which complicates the data certification
4. Poor data quality can lead to risk and significant costs being incurred, especially during crisis periods (risks for customers with product reports including incorrect data, risks for management, control and risk management decisions, risks for activity management, risks for partners and complexity of reconciliation works)

### Trends in the asset management value chain

#### Steering and efficiency

Activities steering and operation efficiency are two main trends which have been observed in asset management companies. Data is fundamental for these two trends.

- *Risk-steering and consolidation*: risk and issue control (counterparty risks, collateral, capital ratio, etc.), data warehouse implementation related to the different FO/MO/BO and reporting systems and customer pressure to have a detailed overview of their assets through various services
- *Business efficiency and offer differentiation*: growth of new financial products, investment strategies integrating derivatives, differentiation of the client service, 'customisation' (tailor-made reports for wealth management and institutional clients), packaged offer (industrial reports for retail clients), needs for transparency
- *Cost reduction programme*: cost analysis across the value chain, operations/IT consolidation, positioning of the data service, creation of centre of excellence, outsourcing of MO/BO/reporting functions to service providers (asset servicing providers)

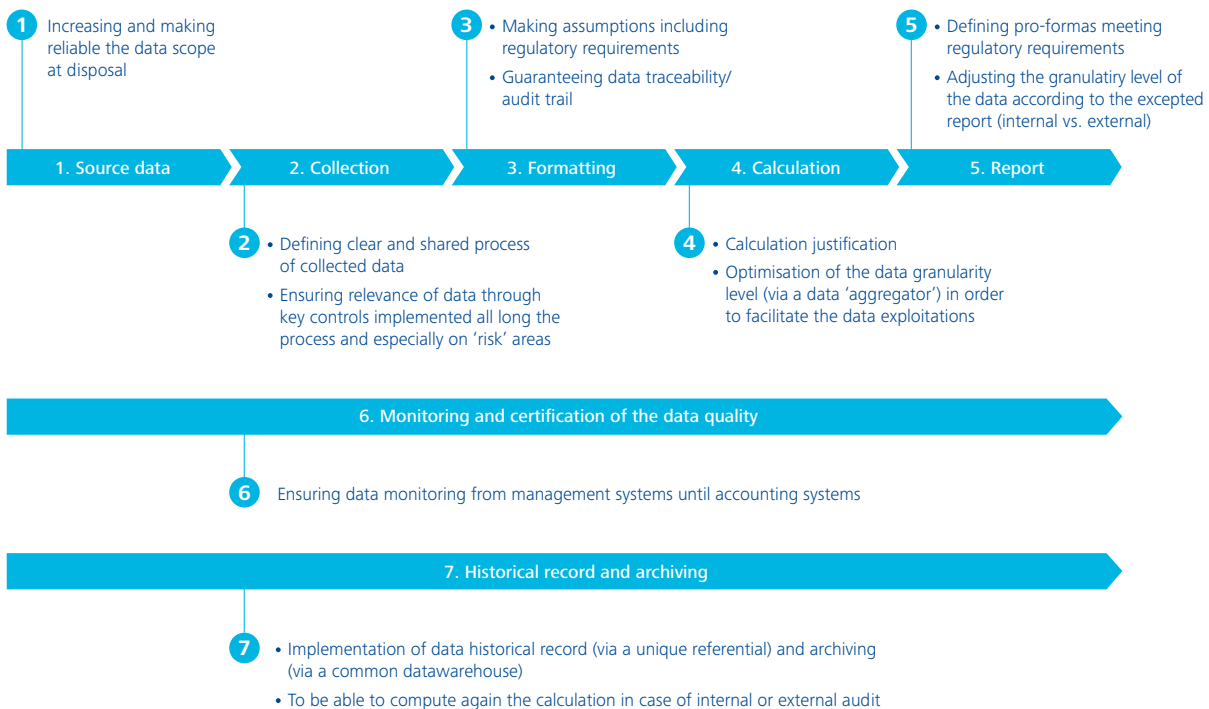
- *Operations efficiency*: setup of global and standardised processes, IT and CoE platforms, setup of solutions and technologies giving more solid data, accuracy/quality, faster order execution and smoother running processes
- *Growth and synergy*: acquisitions in order to get into new markets and geographical area (Asia), development of shared-services, system and technology integration and consolidation, compliance with regulatory obligations and requirements
- *Service customisation*: **suggesting** different risk indicators, performance, performance attribution, position, transaction and graphic , etc. according to the customer request
- *Quality, transparency and detail/consolidation of reports*: market data **quality**, portfolio data, data consolidation and details coming from different internal and external sources as quickly as possible

### Description of 'efficient data management'

In order to meet these steering, efficiency and customisation expectations, it is very important to implement data management based on the following development goals:

1. Reliability, transparency, comprehensiveness, market and portfolio data traceability and permanence
2. Speed and automation of production
3. Selectivity of data production frequencies
4. Customisation of data distribution
5. Transparency of acquisition costs and data production
6. Implementation of data quality governance covering the entire data life cycle by ensuring data quality as early in the life cycle as possible: *"Do the job only once... when possible"*<sup>2</sup>

Data management relates to the acquisition, validation, enrichment, distribution and control within the asset management company.



<sup>2</sup> Bruno Noyon Chief Operating Officer State Street France



### Virtuous circle

*"The more data consumed, the higher the quality requirement and, the higher the data quality, the more data consumed"<sup>3</sup>*

Data-specific governance, adapted to the company and its operational constraints should be implemented to ensure data quality.

Data governance establishes organisation, procedures, processes and tools with the objective of guaranteeing data quality in addition to the maintenance and retention of data definition over time.

Although it clearly covers data controls, this governance also states in detail the roles and responsibilities, the data dictionary, guidelines, validation standards, maintenance processes for the data and processes for treatment of anomalies, etc. The expected benefits of this plan lead to us to make predictions of a rationalisation of the information system, to reconsider the possibility of producing reports without data formatting, and finally, they pave the way for a more relevant and more workable data use.

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Data management relates to the acquisition, validation, enrichment, distribution and control within the asset management company.

#### To the point:

- Implement data quality governance covering the entire data life cycle by ensuring data quality as early in the life cycle as possible
- Set up data management based on the development goals to meet steering, efficiency and customisation expectations
- Rethink data management to pave the way for a more relevant and realisable data use

<sup>3</sup> Jean-François Baralon Chief Financial Officer and Chief Operating Officer Natixis AM

# Asset management

## New deal

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The combination of €70 billion in net outflows for France-domiciled funds in 2011 and an unfavourable market environment (which saw a sharp drop of nearly 35% from May to October 2011 putting paid to hopes of a renewed upward trend) has caused assets under management to fall by more than 4%, which represents the second decline in five years after 20 years of serene progress.

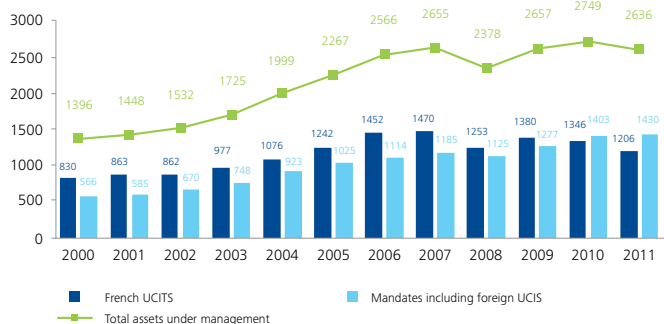
Against this backdrop, management companies are struggling to right their operating margins, which are languishing at historically low levels more than ten points below those of ten years ago.

The sector nevertheless remains particularly dynamic, especially as regards the number of management companies, which has almost doubled in the past decade to reach 600 in total, with two thirds of

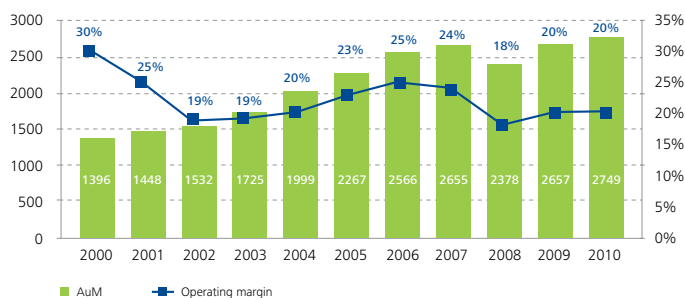
them being entrepreneurial undertakings. The level of competition in the French market can be seen in the quality of services provided, with 31 French funds ranked among the top 47 high-performing eurozone equity funds in 2011 (source: LIPPER) and five managers among European distributors' top 20 preferred brands, which are (in alphabetical order): Amundi, BNP Paribas Investment Partners, Carmignac, Comgest and LCF Rothschild (source: FT 2011). The sector's vitality



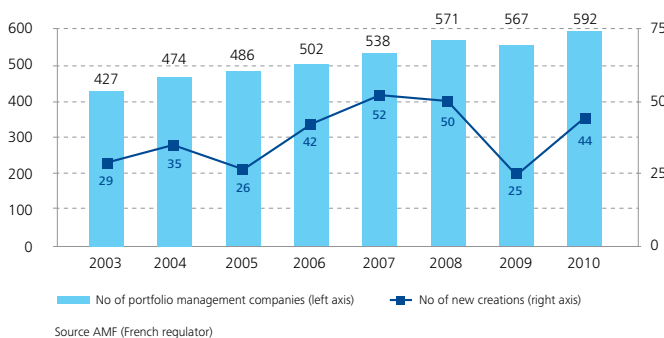
**Assets managed for third parties on the French market (in € billions)**



**Change in company profitability**



**Change in number of portfolio management companies (in units)**



is reflected in the initiatives aimed at supporting innovative structures (i.e. the role of incubators and incubation funds) and the volume of transactions, even if valuation multiples are clearly trending downwards. Further proof that times are changing for management companies is that they are being put to the test by the move from an already highly regulated fiscal and regulatory environment to a new, even more highly regulated, complex and unstable phase. In the next three years, over a dozen regulations will impact sector players directly (AIFM, MIF 2, EMIR, Dodd-Frank, Volker, IFRS, UCITS 5, FATCA, financial transactions directive, etc.) or affect investors indirectly (Solvency II, Basel III, PRIIPs, IMD, etc.), without taking into account local specificities (changes to taxation of work and/or capital and short-term bank products with single and/or multiple counterparties, the role of long-term savings in financing the economy, etc.).

**What do asset managers have to do to keep up with the changes?**

The first key theme concerns client relationships. As is the case for any mature industry, the asset management industry must switch from producing to distributing. For asset managers, the challenge no longer lies in finding clients for their products, but in finding products for their clients. Clients are in short supply: mergers between institutional investors, the considerable fall in domestic RFPs (down 55% on 2011 and for a historically low level of assets) and the participation requirements in terms of minimum size explain why management companies are finding it harder and harder to expand or even just maintain their client base. Winning a new client has become particularly costly and everything points towards re-rating clients as an asset.

**This requires:**

- Finely honed procedures for identifying clients and their profile, behaviour and expectations
- But also an ability to differentiate and adapt the characteristics of your offering (product, price, distribution and communication) to each investor
- In addition to designing and promoting a personalised message

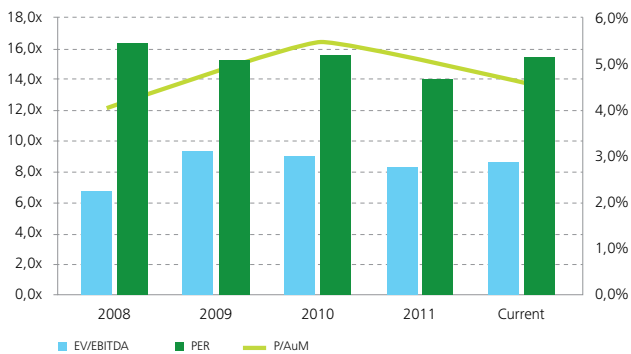
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The sector's vitality is reflected in the initiatives aimed at supporting innovative structures and the volume of transactions, even if valuation multiples are clearly trending downwards.

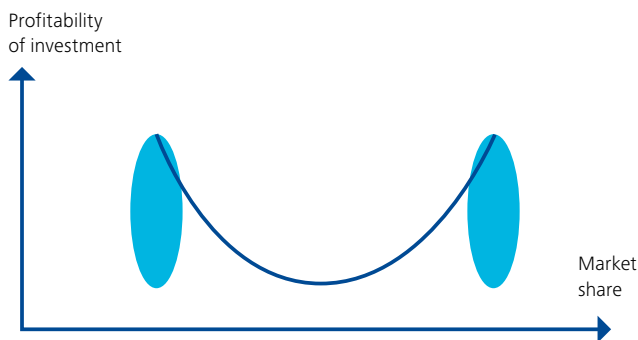
Strengthening the relationship with the client relies on tools facilitating full control of the key elements of the management company's liabilities and requires flexible resources that can be adapted to each client's individual profile in terms of reporting.

Optimising the industrial model is another important issue. Management companies must **systematically strive for agility**. Resources should be channelled into distribution activities and anticipating clients' needs as a priority. Asset managers need to streamline their structure and dispose of non-essential activities that do not offer any competitive advantage. They should also adopt an approach that will strengthen the link between distribution and production in order to boost their responsiveness. To do this, a contractual partnership must be entered into with certain asset servicers so as to capitalise on the savings that their industrial models allow.





What kind of landscape can we expect once we have come through this transitional period? This context and the impact it is having are likely to produce what we call a 'barbell' phenomenon, that is, a binomial categorisation of the winners: on one side we have the champions at creating economies of scale, while on the other we have the specialists that keep adding to their list of expertise. The number of management companies will not continue growing ad infinitum as there are only so many investors to go around, which means that reaching a critical size has become the key to expanding beyond the obvious client pool and to dealing with new requirements.



At this stage, alongside the decline in the amounts allocated by institutional investors, the retail segment is not in a position to become a growth driver. Money market vehicles which accounted for a considerable portion of assets are now competing with bank products and the amounts invested are slipping steadily. The directive on financial transactions could mark the end of the road for money market products, particularly via the spectre of double taxation, which would wipe out returns already undermined by interest rate levels. As for equities, the deep-rooted risk aversion we are currently witnessing shows no signs of abating.



Going back to the description of the winning models, the French ecosystem has a considerable number of boutique firms whose growth has stemmed from their specialisation in a small number of areas, where their brand is associated with a specific savoir faire, and which primarily target institutional investors and distributors.

**They face three major challenges:**

- Consolidating their management expertise and reaching a critical size in order to mutualise costs (development and compliance) and find a solution to the cyclicity of investment processes (without damaging their image)
- Marketing their products internationally and becoming one of the top-ten financial advisers (vertical integration and control)
- Focusing investment on key aspects of their business (production, distribution, risk, etc.) in order to enhance their agility

The French market is also home to international heavyweights that, in order to continue to grow, must amortise their production platform by participating in the market's consolidation through the acquisition of management companies belonging to groups, by finalising distribution agreements with group networks and especially by expanding their presence in growth areas. The threat of losing shareholders due to their return and/or capital requirements still hangs over these entities, however.

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**Resources should be channelled into distribution activities and anticipating clients' needs as a priority.**

This change requires the technical input of asset servicers and will only come about once they have been forced to revamp their offering, which currently offers low value-added, and increase their credibility in terms of technical capabilities and innovation. Solvency II and issues related to data quality constitute a genuine, solid catalyst in terms of the ability to be proactive in offering their clients and their clients' clients basic and/or technical solutions. This new ability must not supplant the ongoing optimisation of the production tool, i.e. the management of methods targeting industrial efficiency and continuous improvement.

The asset management industry is undergoing profound change, moving towards a new model where management companies' organisational structure is centred on client relationships and the distribution of solutions. This transition phase will be characterised by a wave of mergers in favour of pure players, a wave put into motion by the globalisation of markets, the 'untangling' of bank networks' asset management and insurance activities, and the quest for capital.

**To the point:**

- With the unfavourable market of 2011, assets under management experienced a sharp drop and management companies are struggling to right their operating margins
- With the dynamism of the sector, however, hopes are high and the level of competition in the French market is rising
- Though the future seems positive, times are changing and management companies need to adjust to increasing regulations and a complex environment



# Share class hedging

## A market overview

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Financial institutions and investors are structurally exposed to a broad range of risks. One of the most unpredictable risks is certainly the Foreign Exchange risk, as we saw in August 2011 when market volatility was combined with currency volatility.

During the course of Deloitte’s review of the performance of a broad range of funds with hedged classes, it became clear that Foreign Exchange (FX) hedging impacts can be of significant importance, sometimes the equivalent of several percentage points per year. At the same time, asset managers witnessed growing demand from investors for the drivers behind hedging impacts to be explained in detail.

*Philippe Chossonery, Chief Operating Officer of Amundi Luxembourg, outlined his view and his perspective on the subject:*

*"Recently, our customers and sales team have expressed a growing demand for hedged share-classes. Institutional and distributors are looking for the opportunity to subscribe in local currency while benefiting from the performance of our portfolios*

*strategy in another currency. For this purpose, we have developed at Amundi Luxembourg our product range of multiple currency hedged share-classes to cover the risks relative to the local currency. This commercial offer is proposed in our flagship SICAV for institutional and distributors and has met with a great success. It was the principal driver of our growth in Luxembourg during the last past year."*

This led Deloitte to undertake a survey about current share class hedging practices by interviewing 22 of the biggest European actors involved in this area, including fund administrators, asset managers, custodians and management companies. Our results are presented according to the seven main sources of hedging impacts described below:



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## It is essential to focus on a twofold perspective: the analysis and definition of an appropriate hedging policy and its daily implementation.

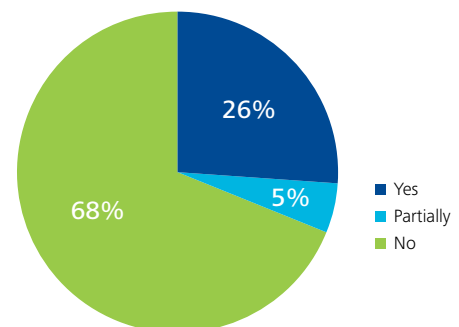
The first one is the hedge ratio which measures the percentage of the total net asset value that is left unhedged after each Net Asset Value (NAV) calculation. Once the NAV is calculated, this new NAV is compared to the notional amount of outstanding forward and spot contracts. If the hedge ratio is not within the acceptable range agreed upon by the investment manager and the person responsible for the hedge, usually the fund administrator, the appropriate corrective actions will be taken, i.e. entering into a new forward adjustment to bring the hedge ratio back into the range.

For example, if the hedge ratio of the share class is intentionally left at 95% of the NAV after the NAV valuation, and the FX rate of the fund currency falls by 8% the next day, as witnessed in August 2011 for the Swiss Franc, this will induce a negative impact on the share class investor of 40bps<sup>1</sup>.

In order to maintain control of the key elements of the hedging process, such as the hedge ratio, it is essential to focus on a twofold perspective: the analysis and definition of an appropriate hedging policy and its daily

implementation. Both are effectively addressed through a unified programme of optimisation of the share-class hedging process which aims at piloting the hedging processes and procedures under certain constraints. The rationale is to maximise a particular utility function (i.e. an objective, typically minimising a risk, or ensuring transaction costs remain within a certain range) according to specific parameters such as the volatility of the FX rate, the volatility of the underlying, the type of investment, the subscription-redemption dynamics, the NAV calculation frequency, the level of spreads, the interest rate differential and the roll-over period, etc. Using these accepted and easily-calculable parameters, an optimal hedging strategy can be defined by setting up the optimal hedging contract specifications and hedging ratio which should be applied to achieve a given objective. Over time, the hedge ratio will be changed and adapted depending on the evolution of the predefined parameters.

### Optimisation programme in place



<sup>1</sup> Hedge ratio impact = (FX variation) x (% of underhedged NAV)  
= 40bps = 8% x 5%

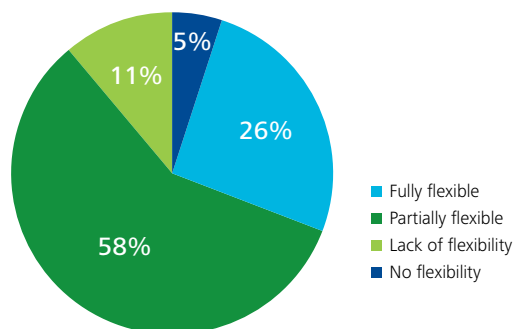


During the survey, we observed that only one quarter of respondents had put an optimisation process in place. Among the respondents were some major market players, ranging from fund administrators to asset managers. One of the reasons why some market players have difficulties implementing such a programme comes from the flexibility of the tool they use to manage their hedging process. In most cases, it prevents them from initiating an optimisation programme without first making some adjustments. For 16% of the actors interviewed, their tool would not even allow them to proceed.

*Amundi's view is that the "optimisation is a difficult process given the large number of variables to integrate in the hedging process and we have proceeded in several steps:*

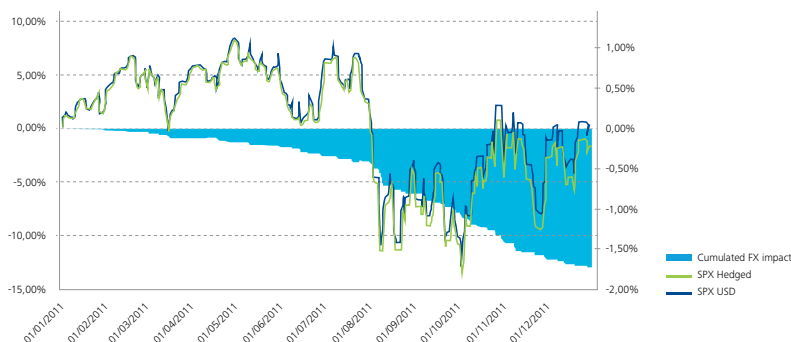
- *Firstly, identify the quick wins actions that have an immediate impact on the quality of currency hedging (transaction cost to renegotiate, Mark to market pricing model to develop, capacity to deal at the fixing rate, allocation accounting methodology to adapt...)*
- *Secondly, do a formal analysis to identify the other sources of deviation*
- *and finally passes through a questioning on how to access the foreign exchange market by choosing the most appropriate broker/dealer to get on an optimisation model"*

**Flexibility of the dedicated tool**



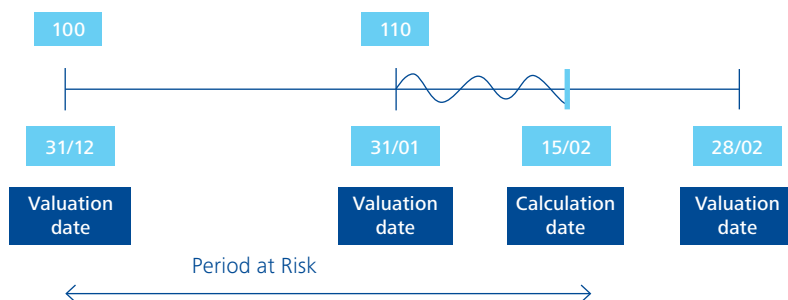
Another volume impact usually encountered is the unhedged P&L effect which is similar to the hedge ratio effect. However, the difference between them is that the hedge ratio impact measures the impact that the FX rate has on the percentage of the TNA that was left unhedged following the NAV valuation, whereas the unhedged P&L of the underlying measures the effect that the FX rate has only on the variation of the underlying portfolio between the previous NAV calculation period and the next, i.e. what could not have been hedged even with a perfect 100% hedge ratio because of portfolio fluctuation from one NAV calculation period to another.

For example, the illustration below shows what would have happened to a European investor investing in a fund replicating the S&P 500 using the common hedging procedure of adjusting the hedge each day. In the example, the hedge ratio is balanced back to 100% every day. The only impact that the fund will have is due to the fact that daily S&P fluctuations cannot be hedged. Even with a perfect hedge ratio, for 2011, the European investor would have lost 1.72% against the performance of the S&P 500 because if the hedge is performed once daily, it is not possible to adjust it to unpredictable market movements from one day to another.



For less frequent NAV calculation periods like weekly or monthly NAVs, one possibility to reduce the FX risk due to the unhedged P&L effect is to calculate intermediary estimates of the NAV. The purpose of these estimates is to reduce the delay between the NAV valuation date (on 31/12 in the example) and the hedge adjustments

(only possible after 15/02) by either speeding up the NAV calculation time (giving an estimate after 31/01 for example) or using more frequent estimates in between official NAV calculation dates (on 25/01 for example). However, not all funds are able to calculate these estimates owing to a lack of information.



When implementing a share class hedging strategy, it is important to note that there are three types of costs incurred related to the hedging process. They include transaction fees or spreads to enter into a Foreign Exchange Transaction (FET), either spot or forward, operational costs required for the day-to-day handling of the hedging process and transaction costs incurred for all asset sales and purchases, such as the FX conversions required for all subscriptions and redemptions and the asset sales linked to the settlement of the hedge, etc. However, solutions exist in order to reduce such significant sources of impact on performance. For instance, an extended roll-over period could reduce such impacts.

But given the size of the market player, transaction costs charged for hedging contracts could be reduced by a renegotiation of the SLA<sup>2</sup> agreement between the asset manager and the body responsible for FX executions, be that the FX desk, the broker or the investment banker.

One of the trends reflected in the survey is a lack of transparency from the FX provider in terms of spreads that are charged for hedging contracts. Another is the perceived complexity of the hedging costs structure, for example with globalised all-in fees. Because of these, it is sometimes difficult for some of the respondents to precisely price these impacts.

*For Amundi, "Cost of hedging is the main driver of the performance gap between the share-classes even though it is not easy to evaluate and to benchmark versus the best market practice. Our FX trading platform based in London checks systematically the dealing price and compares them to the accounting fixing valuation. In addition, we control on a regular basis that the execution margin of the FX desk is in line with the market average level. We search also other ways of cost reduction like the selection of the best counterparties via systematic RFP, the size of the FX volume traded on the market or the most appropriate financial instrument (contract, maturity...) for hedging."*



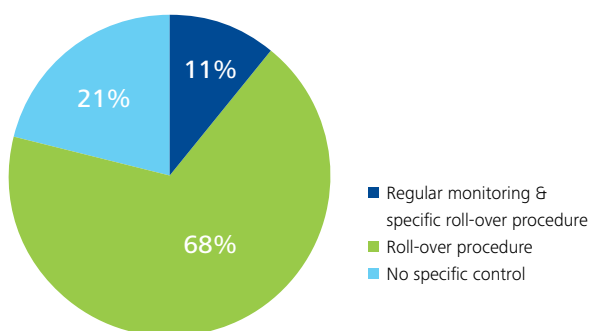
<sup>2</sup> SLA: Service-Level Agreement

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## The accounting method of NAV calculation may also produce some important deviations in the performance of the hedged class.

In accounting, FX contracts for the hedge are mainly valued with the interest rate differential over a period equal to their maturity. This relationship is derived from the Covered Interest Rate Parity<sup>3</sup> between both currencies. Thus, there will be a natural performance difference in the evaluation of the contract compared with its market valuation. We must note that there can be a significant roll-over impact at the maturity dates owing to the different valuation of the forward contracts.

Forward valuation within the NAV calculation



Especially among fund administrators, the trend is to work increasingly on the issue of forward valuation. That is why most market players have specific procedures to monitor and mitigate these impacts.

In addition to the range of possible impacts, other pricing effects can be encountered, such as the timing execution impact. Because of a timing delay, the spot and forward contracts used for hedge adjustments can be taken at a rate far different from the rate that would have been available around the NAV calculation time. This would be necessary both for variations of the value of the underlying portfolio and for subscriptions and redemptions. For example, only three out of the fifteen fund administrators that were interviewed confirmed that their FX trades were executed using the fixing rates used for the NAV calculation, but the market tendency is to include this point more frequently in the SLA.

The treatment of the unrealised P&L of the forwards used for the hedge can impact the performance of the hedged class. Indeed, if the forward has not yet reached its maturity, the potentially positive (negative) P&L of this contract cannot be reinvested (disinvested) in the portfolio and benefit from the variation of the underlying portfolio.

Apart from these impacts directly linked to the hedging process, the accounting method of NAV calculation may also produce some important deviations in the performance of the hedged class. In order to allocate the P&L generated at fund level (i.e. variation of the portfolio), an allocation ratios calculated for each class corresponding to the weight of that class in the fund. This allocation can be distorted if the unrealised hedging P&L is taken into account in this calculation.

<sup>3</sup> The Covered Interest Rate Parity defines the relationship between the spot and forward rates and the interest rate differential between two currencies



As described by Amundi, "Defining a fair allocation between all the share-classes in a portfolio is a very difficult exercise to achieve. We have put in place a specific process with our service providers which allow allocating the hedging P&L to each individual share-class. We also control the allocation ratio on a daily basis and we have a quantitative optimised model to minimize the allocation impact."

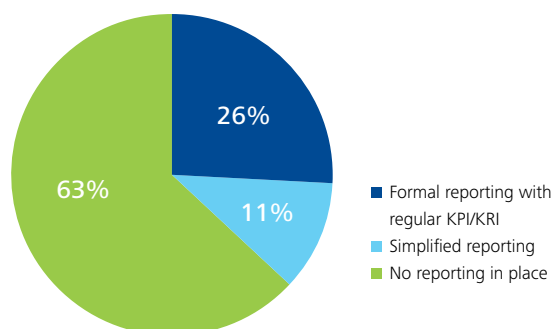
Another way to avoid problems relating to this area is to use a master-feeder structure. This method considers share classes as feeder funds which would invest in a master fund, i.e. the portfolio. The feeder funds simply hold master fund shares, as an investor would hold shares in a normal fund.

According to the survey, asset managers tend to request that their fund administrators use this structure for a hedged share class, especially for index funds which cannot deviate from the benchmark. Currently, only one third of fund administrators offer a master-feeder structure, but most of the respondents planned to implement it by the end of 2012.

To ensure that all the impacts listed above are under control, very thorough monitoring and reporting of these KPIs<sup>4</sup> is key. Yet, only 26% of the survey's respondents apply such specific monitoring of the hedging impacts. Most of the time, the management company or the asset managers do not receive sufficient information from the fund administrator regarding the reporting of the hedging impacts.

In addition to the impacts listed above, it is also interesting to take into account the level of proportional fees and the interest rate parity in order to explain all differences between the share classes' performance.

Share class hedging reporting (KPI/KRI)



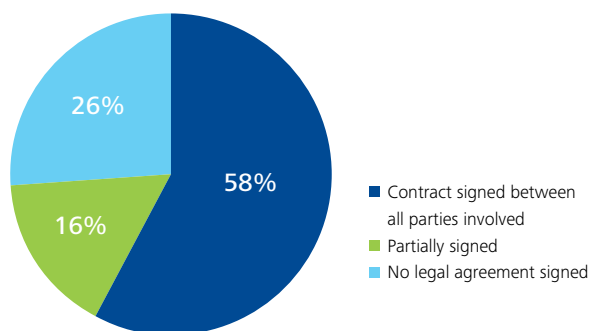
To ensure that all the impacts listed above are under control, very thorough monitoring and reporting of these KPIs<sup>4</sup> is key.

*Amundi's experience on the monitoring of these effects is the following: "We have set-up an SLA with our funds administrators to follow-up the KPI. In addition, we have also internalized the monitoring process of the currency hedging. In fact, it is essential for us to have a good follow-up and to explain any daily performance gap between the hedged share-class and its class of reference. We have conducted a thorough formal analysis of hedging model and have defined our own criteria for the daily quality follow-up. For each daily NAV, we calculate the performance gap and explain the value breakdown on each factors of our in-house model."*

Other operational errors in covering foreign subscriptions or redemptions can also occur and should be monitored closely, i.e. wrong amount, wrong settlement date, and/or fixing mismatching (time of hedging not matching with NAV FX fixing).

In order for an efficient monitoring process to be put in place, having a good contractual basis is essential, such as a well-defined SLA agreement between the asset manager or the management company and its FX hedging services provider. Indeed, the SLA agreements with regards to all hedging processes are not always clear for all parties involved. In even 26% of cases, no legal contracts are signed. For those who have these agreements, content pertaining to roles and details can vary substantially. It is essential to know how roles are distributed among all parties involved in order to have a clear picture of the process and areas for improvement.

#### SLA/operating memorandum signed



With regard to this role distribution, there can be six possible Target Operating Models (TOM). They depend on two dimensions: the parties involved, i.e. the FA, a third party dedicated team and/or the asset manager and the processes they will be responsible for, i.e. hedge ratio calculation, verification of the hedge ratio and/or the FX execution. Here is the matrix of the different models:

Process	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Hedge ratio calculation	FA <sup>5</sup>	FA	FA	AM	TP	TP
Hedge ratio verification	FA	FA	AM	AM	TP	TP
FX execution	FA	AM	AM	AM	AM	TP

A model where the operations and processes are closer to the AM, like model 4, will be qualified as an in-house model and a model with more responsibilities given to external players will be qualified as a delegated one, as in models 1 and 6. Some players use a mixed model, like models 2, 3 and 5, allowing them to delegate the hedge ratio calculation while keeping either the control of this hedge ratio or the execution of the contracts defined for hedging.

Every model has its own set of benefits and drawbacks based on a number of criteria such as flexibility, risk monitoring, the level of risk associated with the model and the level of resources allocated. For example, model 4, fully insourced, will be the predominant choice for an alternative investment fund because the investment managers interviewed believed that delegating such a fund incurs too much risk.

With regard to this role distribution, there can be six possible Target Operating Models (TOM).

<sup>5</sup> FA= Fund Administrator, AM= Asset Management, TP= Third Party

*As Mr Chossonery explained: "Our approach to this highly technical and strategic issue for Amundi Luxembourg is pragmatic. We have analysed each steps of the value chain of the currency hedging process and systematically assessed the pros and cons of internalization versus outsourcing. The outcome of this analysis has been an increase of the proportion of the insourced tasks."*

The final observation drawn from the survey is the growing trend in the industry for all market players to look for the model which is best suited to their specifications and which could offer the possibility to combine the share class hedging process and the portfolio hedging process.

**To the point:**

1. By hedging a class against FX variation, the risk exists that the hedged class does not perform in the same way than the unhedged class. That is essential to identify the different sources of impact, in order to explain it and keep the investor's confidence
2. To maintain control over these sources of impact, a regular and specific monitoring of these KPI's is necessary. However, this is currently done by only 26% of the respondents of the survey
3. Six Target Operating Models (TOM) can be found in the industry, going from a delegated approach to an in-house approach based on the players and the processes involved. The growing trend among the market players is to look at the best suited TOM to combine share-class hedging and portfolio hedging processes



# Challenges and opportunities in financial inclusion

**Plutarchos Sakellaris**  
Vice President  
European Investment Bank

## Introduction

Financial inclusion remains an important policy goal for governments and policy makers around the world. The subject is also very closely followed by the European Investment Bank (EIB), which is being increasingly called upon to contribute to financial inclusion both within the EU and beyond. In this article, I will start by analysing the need for innovative financial inclusion, in developing countries, as seen from the investor's perspective, then proceed to a short overview of the EIB's microfinance activities in the developing world and finally conclude with the challenges and opportunities in financial inclusion.

## Why is innovative financial inclusion necessary?

According to the **Symbiotics 2011 Microfinance Investment Vehicle (MIV) Survey**, the largest share of investments is allocated to microfinance institutions operating in Eastern Europe and Central Asia, as well as in Latin America. These areas received 40% and 35% of all investments made by MIVs, respectively, as at year-end 2010. Regions with the biggest needs, especially **Africa, received only a tiny share** of all allocations. For example, microfinance institutions in Sub-Saharan Africa, the Middle East and North Africa were allocated only 5% and 2% of total MIV investments, respectively.

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Although microfinance is a relatively recent activity for the EIB, it has been investing in microfinance institutions on a limited scale for over 20 years.



The investment bias towards more developed microfinance markets contrasts sharply with **the physical outreach of the financial system** in different parts of the world. For example, according to the World Bank/CGAP Financial Access 2010 Study, there were only 3 commercial bank branches per 100,000 adults in Sub-Saharan Africa, compared to 10 branches in developing countries and 32 in high-income countries. Similarly, the number of ATMs stood at a meagre 5 per 100,000 adults in Sub-Saharan Africa, compared to 29 in developing countries and 94 in high-income countries.

Another important fact is that a large number of microfinance institutions remain financially dependent on external support. According to the Microfinance Information Exchange, around one third of over 1,000 reporting microfinance institutions were not financially self-sufficient at year-end 2009. However, the real situation is likely to be worse, as many microfinance institutions opt not to disclose their results publicly.

Third, a number of important aspects of financial inclusion, above all the **provision of insurance**, remain severely underdeveloped. In the *Landscape of microinsurance in the world's 100 poorest countries*, a study carried out by MicroInsurance Centre in 2007, it was found that only 78 million people had some form of insurance in the countries surveyed. About one half of all insurance policies provided life cover, with only 6.8 million covering health and 12.6 million providing accident and disability insurance. The study estimated that **the total demand for insurance products amounted to a figure some 30 times higher**.

Lastly, access to finance still remains a major challenge in rural areas. In fact, of the estimated **1.4 billion of people living in poverty**, defined by the World Bank as having to live on less than US\$1.25 a day, the majority work and live in rural areas. Extreme poverty is most pronounced in Sub-Saharan Africa, where the number of poor has almost doubled, from 200 million in 1981 to about 380 million in 2005.

### The EIB and microfinance

Although microfinance is a relatively recent activity for the EIB, it has been investing in microfinance institutions on a limited scale for over 20 years. The first EIB microfinance investments were in the **Africa, Caribbean and Pacific (ACP) region** in the form of direct loans. The main emphasis of such operations was on the establishment of credit facilities for small businesses that did not have access to funding from commercial banking sources.

Over the years, the scope of the EIB's microfinance activities has increased substantially. Some of the increase was industry-led. As microfinance institutions matured, it became possible to scale-up EIB investments. A good example is **Banco Ademi** in the Dominican Republic, which transformed from an NGO into a fully-fledged leading commercial microfinance bank with the help of the EIB.

At year-end 2011, the EIB's commitments in the ACP region had reached around €200 million, and now cover most Sub-Saharan Africa countries, including post-conflict and the least developed countries such as Liberia, the Democratic Republic of Congo, *Côte d'Ivoire*, Mozambique and Niger.

Recognising the fact that many microfinance institutions are not financially sustainable, as noted earlier, the EIB actively encouraged the development of financially sustainable microfinance institutions, especially in Sub-Saharan Africa. The EIB was a founding shareholder of **Advans**, a Luxembourg-based microfinance holding company, and **Access Microfinance Holding**, which is dedicated to the creation of new 'greenfield' microfinance institutions.

In order to support the early-stage investment activities of its microfinance intermediaries, the EIB provided almost €30 million in **Technical Assistance (TA)** grants in ACP countries over the course of the last three years. The EIB's TA funding was mostly used to train local staff, implement management information systems, strengthen governance and internal audit and risk management procedures in new and early-stage microfinance institutions.

In addition to its equity and direct operations, the EIB has also backed a number of **debt funds**, including the Microfinance Enhancement Facility and the Regional MSME Fund for Sub-Saharan Africa (**REGMIFA**). The purpose of the EIB debt funds is to provide medium-term funding, mostly in local currency, to existing microfinance institutions.



The EIB has also supported the **Rural Impulse Fund (RIF) I**, the pioneer fund in rural microfinance, which became the first commercial microfinance fund to identify the emergence of financially sustainable microfinance institutions in rural areas. In 2010, the EIB hosted the first closing of **RIF II**, the successor fund to RIF I, targeting €120 million in total commitments by 2011. The expected economic impact of the two funds is both direct and indirect. The direct impact includes an improved capital structure of rural microfinance institutions, strengthened corporate governance and access to new business networks. The indirect impact includes improved access to financial services for micro-entrepreneurs and farmers, increased employment and business opportunities in rural areas in the investment countries.

Last year, the EIB also approved an investment of €5 million in **Fonds Européen de Financement Solidaire pour l'Afrique (FEFISOL)**, a local currency fund targeting African rural microfinance institutions and producer organisations active in fair trade and organic food production. Driven by its social mission, FEFISOL provides an alternative **impact investment model** for investors trying to support the development of sustainable community-based agriculture on the African continent.

I would also like to note that three years ago the EIB provided nearly half of the initial total commitments of the **LeapFrog Microinsurance Fund**, the first commercial investment vehicle dedicated to funding microinsurance companies in Africa and Asia. The EIB's significant initial commitment served as a catalyst in attracting additional commitments from both private and public sources, which helped the fund reach and exceed its projected fundraising targets.

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The investment bias towards more developed microfinance markets contrasts sharply with the physical outreach of the financial system in different parts of the world.





### Challenges and opportunities

Having described the main EIB initiatives targeting financial inclusion in developing countries, I would like to conclude by reflecting on challenges and opportunities from the investor's perspective.

First, **reputational issues**, as underscored by the press in recent years, remain a serious concern for public and private sponsors. As a long-term investor, the EIB has to act in a responsible manner in close cooperation with its stakeholders. In the field of microfinance, the EIB is keen to ensure that its reputation and social investment objectives are not undermined by unethical and unscrupulous practices of institutions that seek short-term profits at the expense of the poor and vulnerable clients.

**Smart regulation** has a role to play in addressing some of the reputational concerns of the industry. Regulators should encourage the development of a transparent and accountable microfinance industry. In particular, deposit collection activities should be closely monitored and supervised in order to prevent the loss of depositors' funds due to mismanagement and/or weak controls at the microfinance-institution level. However, regulations should be predictable and contribute to the establishment of a stable operational framework for the microfinance industry. Caps on interest rates, excessive statutory capital requirements and haphazard regulatory changes deter private investment and should be avoided.

Second, since a large share of microfinance funding is expected to be delivered through specialised **microfinance investment vehicles**, it is important that such vehicles are well equipped to act as trustworthy intermediaries between investors and microfinance institutions. Although tangible progress has been made in the measurement of social performance standards at the MIV level, we need to ensure that such standards are endorsed and implemented by the industry.

Third, commercial funding provided without **capacity building assistance** will not address financial inclusion challenges. Without well-trained local staff, competent managers or modern IT systems, the expansion of financial services in Sub-Saharan Africa and other developing regions of the world will remain a serious challenge. This is the main reason why the EIB is supporting its investments in REGMIFA, RIF II and FEFISOL with adequate technical assistance grants, which are provided in close cooperation with other sponsors and donors.





Finally, I would like to draw on one prominent example in order to highlight **the importance of technology** in rolling out large-scale commercially sustainable microfinance projects. What had started four years ago as a small-scale mobile banking pilot, called M-PESA, funded by the UK-based Department for International Development (DFID) and Safaricom, a leading Kenyan mobile telecommunications company, has today become a national phenomenon attracting over 12 million subscribers and well over 28,000 agents across the country as of November 2011. M-PESA is now used throughout Kenya to carry out various payment transactions and is being increasingly offered as a joint service in cooperation with commercial banks, thereby effectively providing easy and cost-efficient access to formal banking for many Kenyans who had previously had either only limited access to financial services, or none at all.

### Conclusions

The success of mobile-banking technology and inspiring stories of public-private partnerships give hope that financial inclusion will become a reality for Sub-Saharan Africa and other less developed regions in the near future. The EIB, alongside other sponsors, will continue to play an active role in promoting financial inclusion. The main emphasis will remain on promoting the financial involvement of private investors and businesses in economic development initiatives.

### To the point:

- Financial inclusion remains a major challenge in developing countries, particularly in Sub-Saharan Africa
- Public-private partnerships are key to the future success of financial inclusion
- EIB has supported the creation of specialised microfinance investment vehicles in order to promote financial inclusion in the Africa, Caribbean and Pacific (ACP) region
- More than €200 million have been invested by EIB in innovative ACP microfinance projects to date
- Capacity building and technical assistance forms an integral part of EIB microfinance operations

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As a long-term investor, the EIB has to act in a responsible manner in close cooperation with its stakeholders.

# White paper on pensions and IORP Directive review

**Angel Martínez-Aldama**

Vice Chairman

European Federation for Retirement Provision

Managing Director

Spanish Association of Investment and Pension Funds (INVERCO)

The European Commission's white paper on pensions, *An Agenda for Adequate, Safe and Sustainable Pensions*, was published on 16 February 2012.

The white paper contains 20 concrete policy initiatives from the European Commission, down from 25 in an earlier draft from October 2011. The tone of the white paper has changed and it now appears more urgent than the earlier draft leaked in October 2011.

One of the proposals mentioned in the white paper referring to the IORP Directive review suggests we should avoid treating IORPs and insurance sectors the same.

## White paper on pensions

Member states are urged to reform and improve their pension systems, and to do so now. Apart from the IORP Directive review, none of the 20 proposals particularly stand out, but it is the sense of urgency that will set the tone for the European pension debate in the coming months and years.

The new Annual Growth Survey, the European Semester and the fiscal treaty recently adopted by 25 member states have given the EU a range of instruments to guide member state policy more firmly than before.







This is visible from the language used in the white paper, which focuses mostly on economic governance and fiscal sustainability. On public pensions, the white paper recommends an end to early retirement schemes, linking the retirement age to life expectancy, the abolition of mandatory pension ages and labour policies to keep seniors in employment, for example. All this is couched in terms of keeping pensions safe, sustainable and affordable by achieving fiscal sustainability and improved public finances and through a high percentage of labour participation, including senior workers. The tone of the Commission, combined with its increased powers and its urge for member states to carry out important reforms, could provoke resistance in EU capitals or among the public.

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**Member states are urged to reform and improve their pension systems, and to do so now.**

### 1. Security of pensions:

The white paper sets out an agenda for making pensions adequate and sustainable. The major challenge to achieving this objective is an ageing population. By 2060, life expectancy at birth is projected to increase by 7.9 years for males and 6.5 years for females, compared with 2010.

A rising share of public expenditure, more than 10% of GDP on average today, is expected to increase to 12.5% in 2060, ranging from 6% of GDP in Ireland to 15% in Italy today.

Nevertheless, the Commission recognises that there has been progress in reforming pension arrangements over the last decade.

### 2. Adequacy of pensions:

The main source of income for older Europeans is their pension. The current population of persons over the age of 65 is 120 million, which represents 24% of total Europeans.

Closing the pension gap between men and women now also figures prominently in the white paper.

### 3. The role of member states and the need for pension reforms:

The white paper highlights the primary role of member states in designing their pension systems; however, many EU competences do affect national pension systems and policies.

A system which could be financially sustainable must be put in place. That implies delivering adequate retirement incomes and allowing retirees to enjoy economic independence and decent living standards. In order to achieve this objective, the Commission makes five recommendations: link retirement age to increases in life expectancy; restrict access to early retirement; support longer working lives; ensure parity between the pensionable age for men and women; and support supplementary private retirement savings.

### 4. Development of complementary private retirement savings:

On complementary pensions, the Commission now states:

*"... There is much scope for further development of complementary pension savings opportunities in many Member States. This would require, though, that funded private pension schemes become safer and more cost-effective, as well as more compatible with flexible labour markets and mobility. ... In some countries the crisis clearly demonstrated that the ability of pre-funded pension schemes to mitigate risks and absorb shocks needs to be improved. ... including mandatory private pension schemes."*

Of the 20 white paper proposals, there were 11 that concerned complementary private retirement savings.

The Commission remains convinced that there is 'untapped potential' in the single market for pensions and will pursue its internal market policies in the field, via the IORP review, portability directive and tracking of pensions and protection against employer insolvency. The focus of the white paper is on cross-border benefits and transparency and ensuring that supplementary pensions do not hinder cross-border mobility or labour market flexibility.

*Moreover, there are three new specific recommendations that did not figure in the previous draft of the white paper:*

- The Commission will request the Social Protection Committee to look into existing good practice on individual pension statements, with the aim of improving information to citizens and encouraging them to save and plan ahead
- Contract law restrictions that hinder cross-border provision of life insurance
- Stronger stance than in the previous draft on discriminatory tax treatment of cross-border pension contributions, transfers or investment returns of pension providers

## 5. Conclusions:

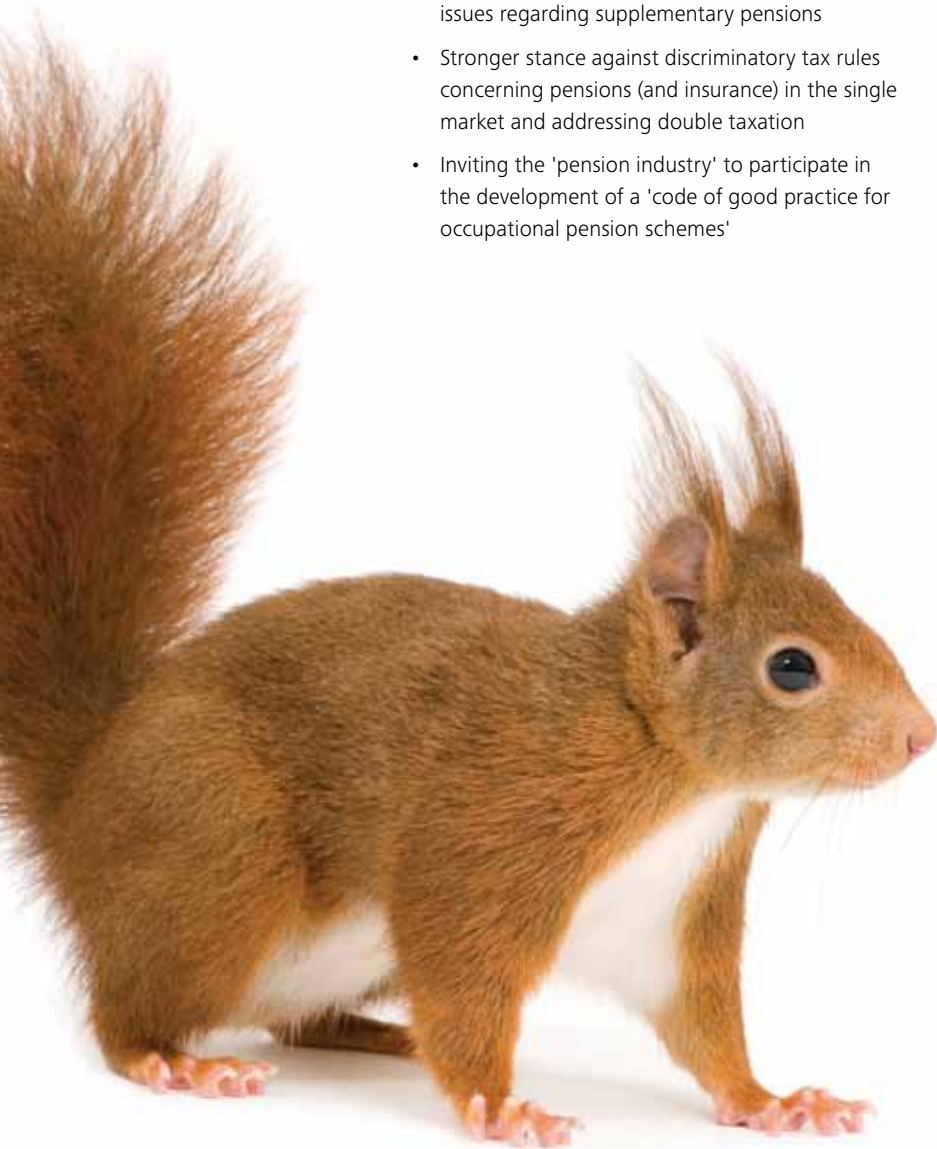
If we were to distinguish between the positive and negative points included in the white paper, in my opinion, they would be as follows:

### The positive points are:

- Clearer distinction between the second and third pillar than in the previous draft
- Better recognition of the role of social partners and collective bargaining
- More attention paid to coverage and/or access issues regarding supplementary pensions
- Stronger stance against discriminatory tax rules concerning pensions (and insurance) in the single market and addressing double taxation
- Inviting the 'pension industry' to participate in the development of a 'code of good practice for occupational pension schemes'

### The negative points are:

- There is still a determination to push the single market for IORPs and to review the IORP Directive. The sudden addition of the phrase "*the aim of the review is to maintain a level playing field with Solvency II*" is particularly unwelcome and unhelpful in this respect
- No mention of any possible involvement of the industry in policy initiatives, apart from the code of good practice mentioned above
- The Commission judges the performance of funded pensions during the crisis quite negatively, which could forebode a heavy-handed approach
- The Commission's economic and financial considerations seem to dominate the entire public pension debate. This perspective is too limited though it may not be altogether bad in terms of developing an occupational pension provision



## Review of the IORP Directive

### 1. EIOPA call for advice:

In the current European supervisory regime, workplace pensions are regulated under the IORP Directive 2003/41/EC. The IORP Directive contains several minimum requirements for IORPs on the one hand, but provides member states with the freedom to impose additional rules on a national level on the other. It is no coincidence that the current IORP Directive has been established in such a flexible manner: it is the only possible way of encompassing the various occupational pension systems existing in the EU within its scope. This diversity is due to several factors, such as the link between occupational pensions and the first pillar state pension provision, another link between occupational pensions and national social and labour law and the differences in taxation of occupational pension plans. Furthermore, the role of social partners in occupational pensions varies substantially among member states.

In April 2011, the European Commission asked the European Insurance and Occupational Pensions Authority (EIOPA) for technical advice in revising the IORP Directive, with a view to strengthening cross-border occupational pension provision, introducing further risk-based supervision of pension institutions and modernising prudential regulation for Defined Contribution (DC) pension schemes. Given the growing importance of occupational pensions in Europe, particularly DC schemes, the reasons for a review of the IORP Directive are perfectly clear: better risk-management, governance and information to members lead to better pensions. This contributes to the goal of adequate and sustainable pensions.

On 15 February 2012, EIOPA issued its Advice to the European Commission on the review of the IORP Directive.

### 2. Proportionality:

EIOPA correctly acknowledges the importance of proportionality, in particular its application to small IORPs, but also in respect of the nature and complexity of IORPs. However, EIOPA itself recalls that there are currently 140,000 IORPs operating in the European Union and that these IORPs vary greatly, so no single one-size-fits-all approach would be appropriate. Moreover, the IORPs landscape is largely differentiated following characteristics of pension systems in each member state. Against this backdrop, any regulatory change should duly take into account national diversity and leave broad margins for implementation to member states.

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The main source of income for older Europeans is their pension. The current population of persons over the age of 65 is 120 million, which represents 24% of total Europeans.



### 3. Harmonisation:

EIOPA declared its intention to adopt a consistent approach to IORPs and insurance sectors. In its Advice, EIOPA emphasises that 'consistent' does not mean 'identical' and that sometimes various differences will merit different approaches. However, in some areas EIOPA recommends approaching IORPs in a similar manner to insurance undertakings. EIOPA acknowledges differences between IORPs and insurance companies, with particular reference to the following IORP characteristics:

- Social and labour context
- Extensive commitments by capital suppliers, i.e. greater length of pension fund liabilities, protection in case of employer insolvency in some member states
- Huge difference in numbers: 140,000 IORPs vs. 4,753 insurances undertakings
- Different treatment of IORPs compared with insurance undertakings, where justified, would not represent a departure from what is already the case within insurance

However, EIOPA's position on cross-sector consistency seems very vague: the advice leaves a broad margin of manoeuvre to other institutional actors; it is unclear what expressions like 'sometimes', 'in some areas', 'similar' actually mean. This indeterminacy may pave the way for greater discretionary power in the subsequent legislative process.

Moreover, EIOPA is not taking a clear stance on the Commission's intention to introduce harmonised capital requirements for IORPs. Taking into account the large diversity in occupational pension systems in EU member states, such harmonisation will turn out to be not desirable and realisable.

### 4. Harmonisation of capital requirements:

Why is the Commission proposing a harmonisation of capital requirements? First of all, the Commission states that 'the lack of harmonisation of *prudential* regulation' is a barrier to cross-border activity of IORPs. Undoubtedly, after the introduction of the IORP Directive, there are still only a few cross-border pension schemes. However, this has not impeded the progress of cross-border pension provision and management. Benefiting from the legislative framework currently in place, many multinational companies have been able to organise their pensions in ways which ensure the core objectives regarding free movement of capitals and cross-border movement of labour. Critically, only very few EU member states would fall within the scope of the proposed changes.

A second argument for the Commission to be in favour of harmonisation is that a harmonised solvency regime for IORPs would avoid regulatory arbitrage between and within financial sectors. This argument is based on the false assumption that workplace pensions are commercial products and that pension and insurance provisions are similar.

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**In its advice, EIOPA emphasises that 'consistent' does not mean 'identical' and that sometimes various differences will merit different approaches.**



There are fundamental differences between pension funds and insurance companies, so the argument of 'same risks, same rules' does not hold true. In most member states, IORPs are fundamentally different from insurance companies and so require a different approach to their regulation:

- IORPs often have a plan sponsor, usually the employer (i.e. corporations, local authorities, universities, etc.), providing backing for the pension promise
- IORPs have flexible adjustment mechanisms. For example, in some jurisdictions, IORPs can:
  - Operate workplace pension schemes in which contributions and liabilities may be adjusted, depending on agreements negotiated by the Social Partners or at the discretion of the Board of Directors
  - Target a specific benefit level instead of guaranteeing it
- In such cases, the employer is required to ensure such scheme rules are absolutely clear in their communications to members
- IORPs usually have a governance structure involving representatives of plan members, ensuring that the pension scheme is managed in their best interests and that conflicts of interest are minimised
- IORPs tend to be not-for-profit institutions, which means there is no need to protect plan members from activities primarily undertaken in the financial interests of shareholders





## 5. Conclusions:

On 1 March 2012, the European Commission launched a process to review European pension regulation when Michel Barnier, the European Commissioner for internal market and services, opened a public hearing on the review of the IORP Directive. The European Commission aims to make important elements of the Solvency II legislation governing insurance companies applicable to IORPs across Europe. This objective is repeated in the Commission's white paper on pensions, which talks of a "*level playing field with Solvency II*".

It is dangerous to apply legislation made for insurance companies to IORPs because there are fundamental differences between them. Any effort to harmonise the regulatory regime is based on flawed logic and could have unintended consequences on pension plan members, IORPs and the economy as a whole by impeding growth and job creation.

Therefore, we should call on politicians to keep workplace pensions in Europe adequate and sustainable. This is crucial given the increasing role of occupational pensions in providing retirement benefits to European citizens now and in the future as the population grows older and particularly as state budgets suffer from the impact of the crisis.

Commissioner Barnier and the European Commission, supported in their work by EIOPA, should recognise the important issues at stake before proposing a revised IORP Directive, those being the existence and adequacy of retirement provision to millions of workers and the long-term economic growth envisaged by the Europe 2020 Strategy.

The achievement of secure, adequate and sustainable pensions will depend on our decisions in the coming months. The European Commission should reconsider its plans and create an environment that stimulates workplace pension provision. The impact of any new proposals must be measured through high-quality Quantitative Impact Studies (QIS), including assessment of the social, financial and economic effects of any proposed rule changes and their macro-economic effects. A high-level political debate is also required with involvement from all the relevant stakeholders, most notably the European social partners.

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**EIOPA declared its intention to adopt a consistent approach to IORPs and insurance sectors.**

**To the point:**

- At the European level there are two different work streams (EIOPA Call for advice and IORP Directive review) that should be coordinated
- White paper on pensions contains twenty concrete policy initiatives from the European Commission – with the aim to achieve more secure, adequate and sustainable pensions
- On complementary pensions, the white paper mentions that there is a much scope for further development in many states
- The white paper points out an untapped potential in the single market, and will pursue to achieve it through IORP Directive review, a new portability Directive and protection against employer's insolvency
- On IORP Directive review, similar approaches to Solvency II should be avoided, mainly on pillar I, because IORPs and insurance companies are completely different: IORPs have a plan sponsor, have flexible adjustment mechanisms and contributions/liabilities may be adjusted by social partners



# Achieving better international distribution

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UCITS IV has now been in force since nine months. Now would therefore be a good time to highlight any big changes it may have brought and draw attention on how the market and its players have reacted so far.

This article will be focusing on the issue of international distribution, as it was one of the legislator's main objectives as well as the potential worthwhile for fund promoters.

The directive contained two major initiatives which sought to bolster cross-border distribution and abolish domestic barriers. These initiatives were a European passport for fund management companies and a simplified notification of authorisation procedure for funds in domestic markets. With these two measures, fund managers should be in the position in which they can maintain, or even reinforce, their local presence in their home country while accelerating the distribution of their funds across Europe. In addition, the Key Investor Information Document (KIID) should enable any potential investor in Europe to have the same basis of information irrespective of the product's origin.

If we ignore the impact of fiscal issues, which should certainly not be underestimated, the directive has yet to radically change the landscape of fund distribution in Europe. Investment hubs are being increasingly used by players and, despite the passport and the simplified notification, domestic funds remain largely commercialised on a national scale. This was probably anticipated, or at least considered, by the legislator with the cross-border master-feeder possibility.

With this solution, which was at first thought to decrease funds replication costs (on top of which we can add the cross-border mergers possibility allowing managers to restructure and rationalise their fund range), fund managers can now build on their domestic flagship to create lighter products, i.e. feeder funds, either in one of the two mentioned hubs or in each targeted local market; thereby benefiting from the track record of the master fund.



Nevertheless, the necessity to use this cross-border master-feeder solution sums up the persisting barriers at the European level. In a nutshell, these barriers are operational and technical as well as psychological and marketing related.

In terms of marketing barriers, national fund managers, and particularly those small- and medium-sized players with only domestic-market products, continue to experience the 'local ISIN syndrome', which consists in an aversion from the foreign investors towards a local labelled product, even though since July 2011 the fund managers have been in a position to register and commercialise their funds without any domestic obstacles.

Second, some local fund managers willing to distribute their domestic funds outside their home country will experience a number of operational and technical issues as the distribution of funds in some countries mainly involves banking structures and foreign investors may not have, or may not want, to appoint a local correspondent bank.

Also, there tends to be very limited know-how in terms of foreign markets, while familiarity with foreign clients, local legal reporting, fee structure and investor appetite remains non-existent outside the aforementioned distribution hubs.

Therefore, the cross-border master-feeder structure would appear to offer the only alternative to commercialisation. Each fund manager who does not yet have a European fund or is not willing to replicate one should then build local feeders in each domestic market targeted. The down-side is that even if limited, this is a costly exercise and at the end of the day you are just adding a layer on the product that you really want to sell and that encounter the subsisting barriers mentioned above. A feeder fund is a receptacle with a local flavour to collect subscriptions outside your domestic market. It allows you to access the operational solution required to support your international distribution and gives some cross-border colour to your domestic flagship. This is probably a necessary step in the history of the European integration and the harmonisation of the markets, especially the financial one.

Considering the barriers and the solution offered by the directive (mainly the cross-border master-feeder), the players and especially fund administrators have developed an operational solution which may answer these marketing and technical issues.

These players are capitalising on their transfer agent and registrar platforms which for years have been the backbone of the international distribution of funds.

These solutions aim to support local funds, i.e. any European-domiciled UCITS and AIF in the near future, in their distribution outside their domestic market by playing the role of a sub-transfer agent and fronting all of the foreign distribution and globalising the flows and positions for the official local transfer agent of the domestic fund. By using these so-called 'global transfer agent' services, the fund manager will gain access to administrative tools and international know-how, as well as the existing interfaces and connections of the players, with the principal distribution markets worldwide. With this unique solution, the promoter is able to solve his or her marketing and operational problems without creating a new product and will be in a position to concentrate on selling what should be the key issue for investors: added value.

The final outlook would be as follows: the fund promoter commercialises an existing product with a track record, built in a European country 'A', with a partner in a hub for investors located in all European countries and further afield in Asia, America or anywhere else.

The promoter will be assisted in the registration of his or her products in the targeted foreign countries, have a unique access point and interface between the distributor and its official local transfer agent (including order gateway services, nominee positions, 'routage' or mirroring), outsource the management of his or her distribution network (management of positions, commissions and retro-cessions) and benefit from very comprehensive reporting.

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The necessity to use the cross-border master-feeder solution sums up the persisting barriers at the European level.

To the point:

- While UCITS IV aimed at abolishing domestic barriers on offshore funds distribution, operational, technical and marketing barriers have remained
- Cross-border master-feeder schemes could represent a good solution to penetrate pan-European and other international markets but might be a costly exercise
- Asset servicing stakeholders have strengthened their distribution support capabilities through their 'global transfer agent' solutions facilitating fund promoter's product and sales processes

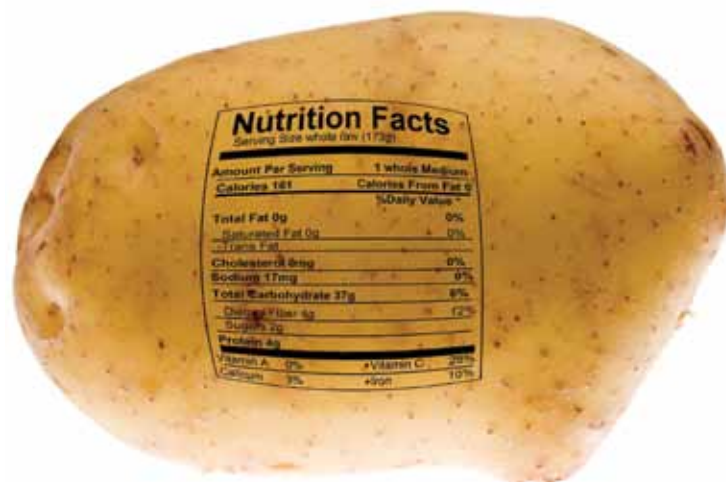


# Qualitative fund ratings

## A cross-border perspective

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With cross-border fund distribution growing, there is a clear need for more public information, on top of prospectuses, KIIDs, annual reports and performance databases. Research of qualitative fund ratings is filling the information gap by profiling funds in an independent and standardised manner.





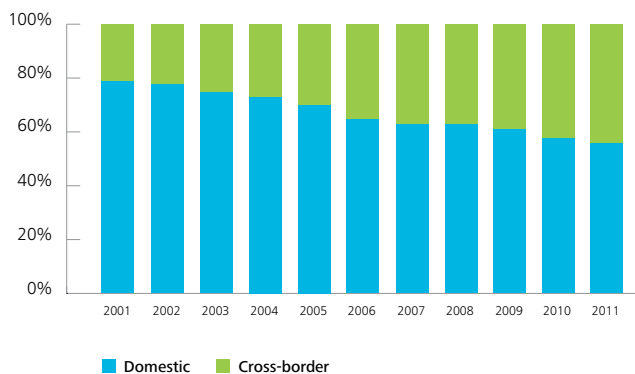
### A broader market

The last decade has seen a rapid growth in the cross-border market. According to Lipper data, cross-border activity now accounts for 43% of the industry's assets (see graph). Another example of this trend is that a third of the top 100 underlyings in French funds of funds are cross-border funds (up from zero ten years ago). With the advent of UCITS IV, we do not expect this trend to slow. Cross-border flows are not only pan-European but also transcontinental, as evidenced by the distribution of UCITS funds among Latin American pension funds and Asian private bankers.

Cross-border does not necessarily mean rationalisation and a focused product offering. On the contrary, **there is currently a proliferation of investment options available**, with over 35,000 funds available in the EU alone. The cross-border phenomenon also goes hand in hand with a multiplication of fund distribution channels, as illustrated by defined contribution schemes replacing defined benefit retirement plans and the development of open architecture in bank branches.

### European funds industry shift to cross-border

Asset breakdown in %



Cross-border: funds sourcing more than 20% of assets from a second market  
Source: Lipper

### Qualitative analysis: the missing piece

A common market not only calls for harmonised regulation (the purpose of UCITS) or a seamless and secure transactional setup, but also clear and trustworthy information. While data providers (like Lipper or Morningstar) now offer good coverage, qualitative information is still the missing piece to the puzzle. Legal documentation alone, such as prospectuses and KIIDs, is not sufficient. Indeed, **regulatory initiatives**, while important, **do not provide investors with enough information**, particularly with respect to a fund's sources of performance or the qualitative aspects of investment processes. This is especially true of newer, less mainstream investment strategies.

Currently, qualitative information comes mainly from fund managers, intermediaries and domestic research houses. The information is not standardised, independently assessed or public. Yet, one can argue that fund investors are no different from other investors and should be able to access the **standardised, independent and public opinions** that exist in other financial market segments.

This is the purpose of qualitative fund ratings, which are now becoming increasingly common. Generally, qualitative ratings provide a **forward-looking assessment** of a fund's key attributes and determine whether these attributes support the manager's ability to deliver good, consistent performance relative to peers and benchmarks.

Without overlapping with quantitative ratings, qualitative ratings cannot ignore the fund's track-record, its regularity, good and bad periods and ultimately consistency with the investment strategy. As such, qualitative ratings often incorporate **some quantitative inputs**, whose importance tends to vary among providers. It can be a filter, a lightly or heavily weighted factor, or an overlay.



### Ten questions investors need answers to

Fund investors need to have a number of questions answered at the very beginning of their search, or due diligence process, and good quality research should seek to address these issues.

#### The ten key questions are:

- Is there a gap in the operational set up?
- What is the fund manager's investment philosophy and competitive edge?
- What is the fund's investment scope?
- Where do the ideas come from?
- How do the ideas become decisions?
- How are decisions implemented and the portfolio constructed?
- How is risk calibrated and monitored?
- What is the profile and stability of human resources involved?
- How adequate is the supporting infrastructure?
- What is the profile and stability of the fund management organisation?

By its qualitative nature, this information must be the outcome of a **disciplined assessment process**, otherwise the research serves only as a subjective judgment of the portfolio manager. To address this point, qualitative ratings generally rely on clearly defined criteria that allow a benchmarking against global best practices.

**There is one last key point to make:** investors already have access to fund factsheets, quantitative analysis and fund manager communication, so there is little need to add to this information flow, which provides a continuous picture of the fund. This is why rating research generally focuses on the **structural features, strengths and weaknesses** of a fund and the underlying process, rather than on the recent performance of the fund. As a corollary, investors should expect qualitative ratings to be **less volatile** than their quantitative counterparts.

### The analytical process

Unlike quantitative ratings which rely solely on statistics, qualitative ratings require **interaction** with the fund manager. Professional qualitative ratings systematically include **on-site visits**, including desk visits, which are critical for gaining an informed perspective.

Qualitative ratings are generally **monitored and periodically updated**.

### Unlike quantitative ranking, qualitative ratings can cover newly launched funds

There is approximately 10% of turnover in the European fund universe, which is over 30,000 strong. In other words, around 3,000 funds are created and another 3,000 merged or closed every year. Unfortunately, without at least three years of track record, funds do not generally benefit from quantitative ratings.

By contrast, qualitative ratings can provide coverage on such funds. For example, in cases with a short track record or none at all, the track records of comparable funds managed by the same team or prior track records of the team can be considered, if they strictly adhere to the same investment strategy. **For funds without any track record (direct or proxy), ratings based solely on the qualitative assessment** of the investment process and operational setup, and generally marked as 'new' or 'qualifying' can also benefit investors.

### Research availability: different models

While quantitative ratings are generally public, there are different distribution models for qualitative ratings, either public or subscription-based. A **public-rating framework** allows the research to be **widely available**. Ratings and research are mass-distributed, sent to newswires and easily accessible on dedicated websites. They can also be distributed on third-party fund platforms. Conversely, a subscription-based model restricts access to the research and is more of an advisory service than an information provider. With its open distribution architecture, the public-rating model seems more adapted to a large market such as the one that emerged in Europe with UCITS.

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As a corollary, investors should expect qualitative ratings to be less volatile than their quantitative counterparts.

### To the point:

- Fund proliferation calls for more informed investors
- Legal documentation and performance databases are not sufficient
- Qualitative ratings provide insight into the investment process, risk practices and operational setup
- Unlike quantitative rankings, qualitative ratings require interaction with the fund manager
- Qualitative ratings focus on the structural features of a fund
- A public-rating framework allows the research to be widely available





# MiFID II

## Key challenges for asset managers

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The proposed amendments to the Markets in Financial Instruments Directive (MiFID) were released in October 2011 and encompass an amended directive and a new regulation, collectively referred to as MiFID II in this article.

The changes to MiFID present a number of challenges for managers in terms of evolving their current business practices and coordinating their efforts to implement the full range of proposed regulatory changes. However they also present an opportunity for firms that are able to adapt swiftly and utilise the impacts of MiFID II to drive strategic business decisions.

We have grouped the impacts into three topics: driving strategy, jumping the hurdle, closing the gap. These subjects are discussed below.

### Driving strategy

There are a number of key proposals that are likely to impact current business practices. The proposals could still change and the full extent of the proposals is not yet clear, as much of the detail will be included in the technical standards that will be drafted by the European Securities and Markets Authority (ESMA).

*The key areas of strategic impact include:*

#### Markets

One of the most significant impacts for asset managers is likely to be the market changes driven by MiFID II which may require a significant alteration of current trading strategies and execution methods.

Certain OTC derivatives will need to be traded on eligible platforms. However, these are still to be defined by ESMA. Eligible platforms will include a new category of trading venue. Organised Trading Facilities (OTFs). The impact of moving OTC trading onto eligible platforms will depend on how OTFs are defined.

While pre- and post-trade transparency requirements already exist for equities, the proposals extend the scope of pre- and post-trade transparency requirements to other instruments, such as bonds. The introduction of mandatory pre-trade requirements to these instruments will impact transparency and liquidity in the market and, ultimately, could affect transaction costs for asset managers. In the United Kingdom, for example, fixed income instruments account for 36.1%<sup>1</sup> of assets under management and therefore any impact on the fixed income market could be significant for asset managers.

Asset managers may use High Frequency Trading (HFT) as an execution method. It is estimated that in 2010, HFT accounted for approximately 38% of equity trading activities<sup>2</sup> on the market as a whole and ESMA figures indicate that in HFT firms accounted for between 40% and 70% of the total equity trading volumes in Q4 2010 on individual trading platforms<sup>3</sup>.

The proposals include additional requirements for algorithmic trading. The imposition of more robust controls, including circuit breakers, should enhance market stability. The proposals to require algorithmic trading strategies to provide continuous liquidity on a regular and ongoing basis to trading venues could lead to operators of these strategies adopting alternative execution strategies. Asset managers that employ these strategies could be required to make a market and any arising costs could squeeze revenue margins. In addition, conflicts of interest in respect of client funds will need to be managed. This could lead to fewer buy side firms employing this execution strategy, which has the scope to impact execution quality.

<sup>1</sup> 'Asset Management in the UK 2010-2011. The IMA Annual Survey.' IMA, July 2011

<sup>2</sup> 'Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency.' Consultation report issued by IOSCO July 2011

<sup>3</sup> 'Guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities.' Final report issued by ESMA December 2011



### Inducements

The proposals set out a potential ban on the receipt of monetary inducements for the provision of portfolio management services and providers of independent advice.

The level of overall impact for the asset management sector will vary depending on the type of management activity undertaken as the proportion of assets under management which constitute discretionary mandates varies across Europe. The European Fund and Asset Management Association placed Greece at the bottom end of the scale, with discretionary mandates only accounting for 18% of assets under management, while 81% of assets under management were under discretionary mandates in the Netherlands in 2009<sup>4</sup>.

The degree of impact will also vary depending on current revenue models and existing practices in each jurisdiction. Concerns have been raised that commission sharing arrangements, which currently enable asset managers in the United Kingdom to purchase research using execution fees, could be impacted<sup>5</sup>. While UCITS managers and distributors are considering the impact on distribution models with some considering building 'business-to-consumer' business models, 'independent' advisers will no longer be allowed to receive retrocession fees from UCITS and other fund managers.

<sup>4</sup> 2011 Asset Management in Europe: 'Facts and figures', 4th annual review issued by EFAMA, May 2011

<sup>5</sup> AIMA Position Paper – 'Markets in Financial Instruments Directive', AIMA, January 2012

*This may lead to:*

- A greater number of non-independent investment advisers link to a small number of fund managers, thereby reducing choice for end investors and a reversal of the last ten-year trend in open architecture
- The emergence of 'business-to-consumer' fund platforms for the large asset managers who can afford the infrastructural costs
- Leakage of investor assets out of investment funds towards less transparent investments like insurance

There could be a number of changes made to the current proposals as regulators, trade associations and firms propose amendments. Indeed, the draft Ferber report proposes amendments to the proposals, which would only require that clients be informed about the expected scale of inducements and provided with periodic reports to disclose all inducements paid or received<sup>6</sup> when receiving portfolio management services, instead of banning them outright.

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**We have grouped the impacts into three topics: driving strategy, jumping the hurdle, closing the gap.**

### **Third country firms**

The proposals include changes to the treatment of third country firms, which include the introduction of an equivalence test by the European Commission (EC) in respect of third countries before firms from these jurisdictions can request to provide services. There will also be additional requirements for firms, depending on the classification of their client base. There are carve-outs for firms of the European Economic Area (EEA) seeking the services of third country firms. According to the United Kingdom's Investment Management Association (IMA), the value of assets managed worldwide on behalf of UK institutional clients is £2.2 trillion<sup>7</sup>. Although this figure includes assets managed across the EEA and globally, this still demonstrates the potential significance that changes to requirements for third country firms could have for both investors and managers.

There are a number of other proposed changes that could impact processes and procedures, such as defining structured UCITS as complex products. As the proposals remain in flux, the impacts can be difficult to assess. However, the key strategic changes should be reviewed and firms should start to incorporate the impact of these proposed changes into their business plans.



<sup>6</sup> 'Draft report on MiFID,' Ferber March 2012

<sup>7</sup> 'Asset Management in the UK 2010-2011 – The IMA Annual Survey,' IMA July 2011

### Jumping the hurdle

Firms are facing a wide range of regulatory changes that they will need to adopt over the next few years. While the isolated cost of implementation for MiFID II has been estimated between €512 and €732 million for one-off costs and between €312 and €586 million<sup>8</sup> for ongoing costs, this does not take into account the full cost of regulatory change. For example, changes to the current market abuse requirements are expected to lead to estimated administrative one-off costs of €320 million and ongoing costs of €297 million (there are additional costs estimated for member states)<sup>9</sup>.

Assessing the full scope of regulatory change may enable firms to leverage overlaps among the different regulations. Firms should start to link operational and business impacts among different legislations (such as Dodd-Frank, AIFMD and PRIPS) and identify where requirements overlap. One example of this is the governance proposals in MiFID II, which should be considered in conjunction with changes proposed by the Capital Requirements Directive IV (CRD IV).

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The imposition of more robust controls, including circuit breakers, should enhance market stability.

It may not always be possible to implement different regulatory changes simultaneously, particularly where the expected implementation deadlines vary significantly (e.g. EMIR is expected to be implemented in 2013, while the MiFID amendments, will not be implemented until 2014/or 2015 at the earliest). Firms are also unable to assess the full impact of the changes as additional details are likely to be issued through ESMA technical standards. However, when establishing new processes and tools to comply with one piece of regulation, these processes and tools should have sufficient flexibility to incorporate the anticipated regulatory changes.

### Closing the gap

The level of change introduced by MiFID II is likely to be significant. However, there is evidence that the level of change is likely to differ across the EEA as national regulators introduce local changes which link to aspects of the MiFID II proposals.

In the United Kingdom, there is some linkage between the Retail Distribution Review (RDR), which is due to be implemented from 1 January 2013. RDR will amend the definition of independent advice and ban the receipt of inducements by independent advisers in relation to personal recommendations. However, there are key differences. The RDR includes the introduction of 'restricted advice', which is not included in MiFID II, and also bans the receipt of inducements by restricted advisers in relation to personal recommendations.

<sup>8</sup> Based on estimates provided in the MiFID and MiFIR proposals issues by the European Commission, October 2011

<sup>9</sup> 'Commission Staff Working Paper. Impact Assessment' EC, October 2011





In the Netherlands a complete ban on inducements on a wide array of complex financial products, including some insurance contracts, is foreseen to be implemented on 1 January 2013. The Dutch Finance Minister is mindful of the jeopardy of introducing strict rules on a limited range of financial products and has sought to create a level playing field with anti-avoidance rules, the so-called 'waterbed effect'.

These examples demonstrate that the domestic measures introduced by some EU regulators, outside of the MiFID II changes, may impact the level of change required by MiFID II and how much work firms will ultimately have to do to close the gap.

#### To the point:

- Firms should assess the strategic changes that MiFID II is likely to make to their business models and an early assessment of these is likely to allow firms to better utilise the business opportunities that MiFID II presents
- MiFID II should be considered within the context of proposed changes to the wider regulatory landscape in order to leverage opportunities and benefit from cost reduction in the implementation of regulatory change
- Firms should be vigilant to domestic, EU and third country regulatory changes and understand the impact on corporate, business and product structures

# Custodian responsibilities

## The evolving role of the fund depositary

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The latest European directive regulating the Undertakings for Collective Investments in Transferable Securities (UCITS IV) is not yet fully implemented and players are already starting their planning for the next directive, UCITS V, which should mainly cover the role and responsibilities of a fund depositary, in addition to remuneration and the alignment of sanction regimes.



UCITS V aims at reviewing the current framework applicable to UCITS depositaries in line with the Alternative Investment Fund Managers Directive (AIFMD) and introducing new provisions for the remuneration of UCITS managers. A proposal is expected for 2Q 2012.

### The regulatory context

The current applicable framework for European fund depositaries has not substantially evolved since the first European UCITS Directive in 1985. Starting in 2008, the regulation has begun to show its limits in terms of suitability, as compared to the new business reality for the depositary function.

First, the industry has drastically evolved with the increasing complexity of eligible products, the rising level of services and systems required to run the activity, the expanded number of stakeholders and geographical footprint.

Second, the Madoff fraud and Lehman default have revealed weaknesses and new forms of risk associated with the depositary function. In addition, divergence of interpretations of the UCITS directive by the different EU member states has certainly contributed in creating an uneven playing field in the protection of investors.

As a matter of fact, the European Commission (EC) has launched two wide-ranging public consultations on the UCITS depositary function since 2009. These consultations aimed at identifying the divergence between member states in the interpretation of the role and responsibilities of the depositary, with a view to reinforcing the level of protection for UCITS investors.

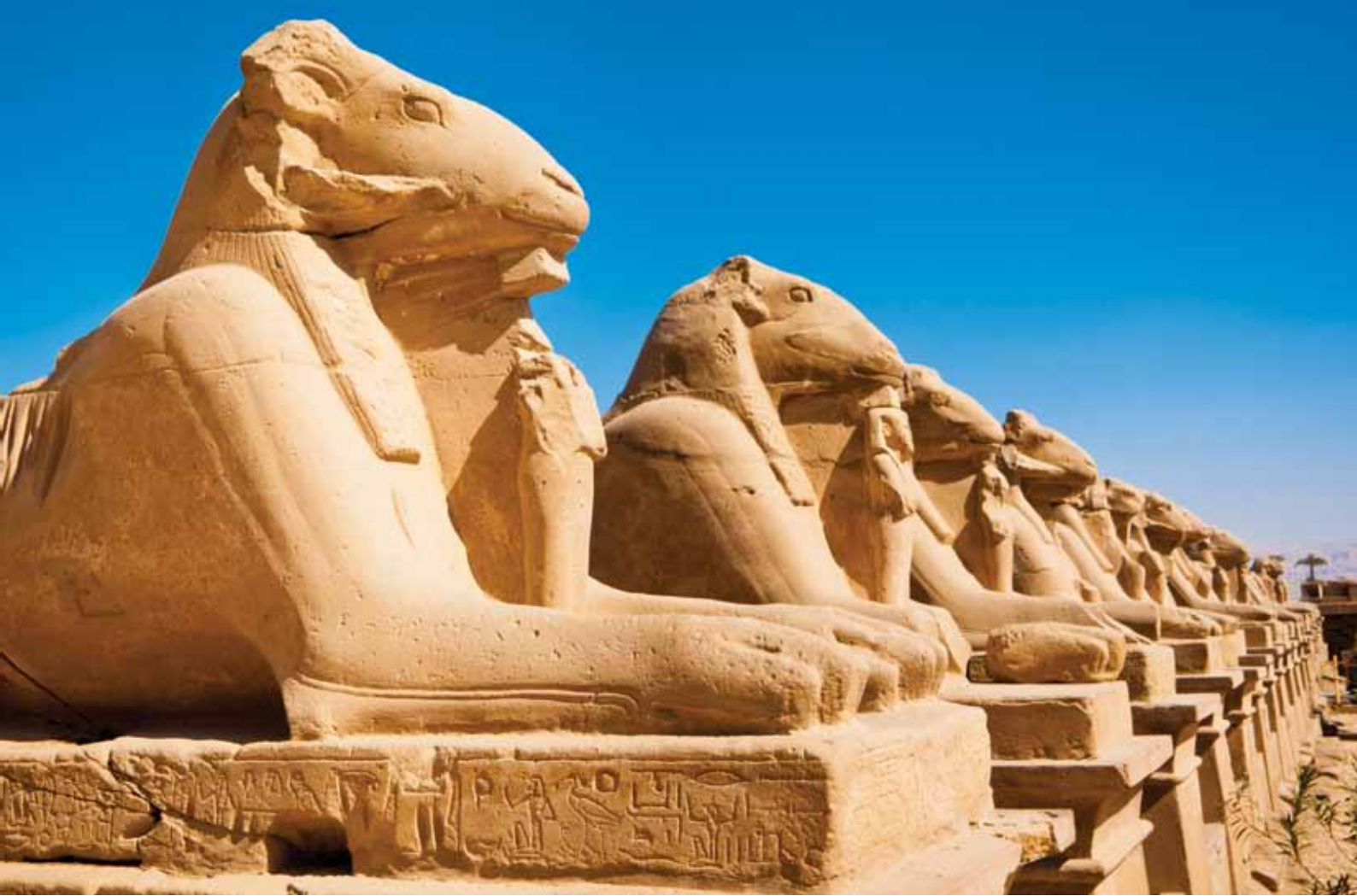
At the same time, the EC published a proposal to regulate alternative fund managers, the AIFM Directive, which also introduced some provisions applicable to the depositary function in order to offer a more transparent and robust regulatory framework, as well as an appropriate level of investor protection.

In the UCITS framework, the depositary to which the assets of a UCITS fund are entrusted and that has to perform certain oversight functions of the fund is an entity independent from the fund manager. In other words, the depositary, by rendering 'independent' services, ensures one of the key pillars of the fund industry: fund protection and therefore investor protection. With the AIFMD, such independence between fund manager and depositary will also be required.

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**As a matter of fact, since 2009, the European Commission has launched two wide-ranging public consultations on the UCITS depositary function.**

While the custodian has a general role of safekeeping of assets, the depositary needs to ensure a global supervision of the assets in custody. However, a depositary may delegate part of its activities, except for supervision, to one or more sub-custodians, depending on their presence and expertise on specific markets.



### What will change for the depositary?

#### Eligibility and country of domicile

Parallel to the AIFMD, UCITS V should extend the eligibility to act as a depositary to MiFID investment firms. This extension of eligibility could create opportunities by opening the market to new entities. On the other hand, those entities will need to be subject to similar rules in terms of capital requirements, investor protection, etc. in order to ensure a proper level playing field in the industry without undermining the protection of investors.

The AIFMD permits the depositary of a non-EU Alternative Investment Fund (AIF) to be established in the same third country, provided that the local regulatory regime satisfies certain requirements, one of which being an effective and prudential regulation and supervision equivalent to that of the EU. It will be the responsibility of the EC to clarify which countries meet these criteria, but a level of uncertainty remains as of today.

### Assets held under custody vs. other assets

The AIFMD makes a distinction between financial assets than can be held under custody and other assets. Regarding the safekeeping function, an asset-class approach has been introduced: on the one hand, custody duties relating to financial instruments that can be **held in custody** through a sound depositary chain (instruments that can be registered in an account opened in the depositary books or can be physically delivered to the depositary); and on the other hand, asset monitoring duties relating to the financial instruments that **cannot be held in custody** because of their nature (not dematerialised, derivative contracts, etc.).

Financial instruments that can be held in custody can only be held by the depositary itself or by its delegates (sub-custodian) in segregated accounts opened in the name of the AIF. Thus, financial instruments that are directly registered in the name of the AIF should not be held in custody unless they can be physically delivered to the depositary or the instrument is registered or held in an account directly or indirectly in the name of depositary.

As for UCITS, in addition to the safekeeping and cash monitoring duties, the depositary of an AIF will have to ensure that the sale, issue, repurchase, redemption and cancellation of units or shares are carried out in accordance with the law and prospectus and that the valuations of units or shares are calculated in accordance with the law and prospectus. They will also carry out the instructions received by the AIF manager, unless they conflict with the law, prospectus or articles of incorporation.

### Liability regime

As one of the most important features of the AIFMD and future UCITS V, the liability regime will be clarified, harmonised and extended. Under the AIFMD, in case of loss of financial instruments, depositaries would be obliged to return 'without undue delay' the identical financial instruments or a corresponding amount of assets, where fungible, to the AIF. Under the UCITS V proposal, the obligation to return identical assets is also required but in a more stringent manner: 'with no delay'.

As a consequence, this concept of full and immediate restitution of financial assets may place a heavy financial burden on the fund depositary. For instance, there may be a long time delay for restoring the assets to the investor in case of a failure of a sub-custodian or when receiving assets that have been frozen under an administration process. Moreover, requesting the fund depositary to return the securities 'with no delay' may require the depositary to buy identical securities on the market, which may create an additional market risk on the value of such securities between the purchase date and the time when securities are released from bankruptcy proceedings.

In this context of a higher liability regime, depositaries might refuse to take responsibility for investments in countries where the law requires that certain financial instruments are held in custody by a correspondent local entity. This could impact the investors by limiting their choices of investments in some emerging markets.

Alternatively, some players may consider extending their own network into specific markets rather than relying on a third party sub-custodian. In any case, there are likely to be significant changes to the selection procedures of the sub-custodian network, for assets that cannot be held directly, and to the economic conditions for carrying on with the business. The depositaries will need to review their network and all the current contractual arrangements.

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While the custodian has a general role of safekeeping of assets, the depositary needs to ensure a global supervision of the assets in custody.

### Discharge of liability

If the AIFMD provides for the possibility of contractual discharge of the obligation to return financial instruments without undue delay, then it is important to note that according to the current UCITS V proposal, there should be no such possibility of contractual discharge or transfer of liability except in the case of a 'force majeure'. If the definition of 'force majeure' needs to be clarified by the directive so as not to leave the risk of a divergence of interpretation among member states, then we can also outline the risk of legal uncertainty and confusion created by such a discrepancy between the AIFMD and UCITS V.

### Practical aspects

Having depicted in detail the regulatory landscape for depositaries in a pan-European context, we will now look into a more practical aspect of the topic: what is changing in the day-to-day life of a fund depositary?

Upcoming stringent regulations will foster a corresponding need for depositaries to adapt with them.

First, they will have to adapt their operating model while remaining the sole entity responsible for safekeeping and supervision. Service providers are striving to maintain a flexible and pragmatic custody operating model but are aware that they will need to broaden their supervisory functions. Supervision is a core responsibility of a fund depositary and, as opposed to safekeeping, this function cannot be delegated.





This being said, we believe it is crucial for fund custodians and depositaries to continue their on-going efforts in reviewing their functional organisation, legal framework, control environment and due diligence activities. Operating models of depositaries can be clustered into legacy-driven pools. Basically, we can distinguish between integrated and segregated asset servicing models. Financial groups operating global custody and asset management business units will have the tendency to insource fund custody and depositary functions. Independent asset management brands will instead focus on their core activity and delegate fund custody and depositary functions to third party vendors. As a result, third party asset servicing is an important market, but brings with it further challenges than a group referred activity.

Opening fund custody platforms to third party asset managers requires agility in terms of operating model adaptation. As a result, on-boarding and day-to-day servicing of non-group entities requires the setup of dedicated processes which are not always in line with the business functionalities of the historic group activities.

A first challenge resides in the initial due diligence, basically consisting in auditing a client's financial and organisational soundness. There is no need to explain the potential commercial risk in cases where the depositary's due diligence on its target client is not purely positive.

- *Do I, as a depositary, increase my risk appetite to facilitate a business relationship?*

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Service providers are striving to maintain a flexible and pragmatic custody operating model but are aware that they will need to broaden their supervisory functions.



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## As one of the most important features of the AIFMD and future UCITS V directive, the liability regime will be clarified, harmonised and extended.

A further example, if we consider that the depositary is in charge of organising the relationship between the fund, non-traditional agents (e.g. prime brokers, derivatives brokers, transfer agents on target funds not eligible on traditional platforms, etc.) and the depositary itself, how is this managed in practical terms. The commonly observed market practice shows that, in most cases, these agents are selected by the client without notifying the depositary.

- *Do I take the risk to supervise assets from a client-directed actor or do I impose my own selection criteria and a potential veto right on the collaboration with the agent in case of a low-rated due diligence result?*

On a daily operating level, non-group clients will have specific technological, servicing and operational requirements which often require the custodian and depositary to set up new processes or, in the best case scenario, amend the historic business model to accommodate third party clients.

- *Is my operating model scalable enough to support multiple information flows (potentially, one per third party client)?*
- *Can I live with a potential increase in manual trade-processing activity?*
- *Do I have sufficient support from my group hubs and centres of excellence to help me support my ad-hoc operating flow for third party clients?*

We have so far focused on the main observed challenges for third party client servicing in terms of the custody business.

Returning to general principles, though, the law requires the depositary to know how the fund's assets are invested and how they are held at any time. A stricto sensu interpretation of the current European depositary function may raise further questions:

- *What do I do as a depositary, for example, in terms of initial and on-going monitoring of Microfinance Institutions (MFI) appointed by my client to manage the assets of microfinance funds?*
- *Do I rely on my client's due diligence (assuming that it is documented and available) without adapting my day-to-day controls of, at least, payments made out of the fund's assets to the MFI?*

Another challenge facing depositaries is the reconciliation process on most non-traditional agents. In this practice, fund depositaries rely on the process being handled by the fund administration, which is not forbidden by regulation, as such.



- If the fund administration is a group entity, do I need to perform an extended due diligence on its reconciliation activity?
- *In case of a third party group fund administration, will I require the formal permission from the fund's board of directors to perform a due diligence on the reconciliation process?*
- *In order to have the full comfort of a depositary and in anticipation of the AIFMD, do I decide to systematically mirror all transactions, knowing that this process will be very resource intensive?*

We believe and hope that the AIFMD and UCITS V will clarify many of these questions. In any case, the role of the depositary will be adapted to the new business reality briefly described above. A lot of fund custodians and depositaries are already performing custody health-checks to anticipate the changes required in their organisation. Deloitte's approach to the matter is very pragmatic. A risk-based and pragmatic-control framework is the key to avoiding any inefficient supervision by depositaries. Controls shall be focused towards the real responsibility of the depositary. The depth and breadth of controls shall be appropriately adapted versus the risks of the controlled business area (e.g. no recalculation of the Net Asset Value per share (NAV) will be required by custodians, instead they will closely monitor the indirect reconciliation process).

## Conclusion

The current European regulatory framework and the new role of the depository are not fully aligned. Consistency between the UCITS V directive and the AIFM Directive is of utmost importance regarding the duties of depositaries and the liability regime. Undoubtedly, inconsistencies in the definition of the tasks and a different standard in the liability regime of depositaries between UCITS and AIFs may have significant negative consequences for depositaries in terms of choices of investments, processes, operations, systems and risks. This situation could create regulatory confusion and higher costs for depositaries.

From a timing perspective, considering that AIFMD will come into force in July 2013 while UCITS V should not be implemented before Q2 2014, we potentially will face a situation where professional investors will have a higher degree of security than retail holders. It can be questioned if this is the right message to give to the market. Will this unusual situation be handled actively or passively, we have no clear sign yet on the way forward.

The aim is now to find the right balance between good investor protection and placing an undue burden on the depository, which would inevitably lead to a sharp reduction in the range of actors willing to continue to service this market and higher costs towards the investors. It is highly probable that the operating model of depositaries will be strongly restructured. So to summarise, depositaries will have to take action in order to appropriately face challenges in terms of risk assessment, procedures, systems, processes and organisation. We believe it is the right time for depositaries to start reviewing the appropriateness of their control framework in order to setup a pragmatic and risk based approach.

### To the point:

- The current European regulatory framework and the new role of the depository are not fully aligned
- Inconsistencies in the definition of the tasks and a different standard in the liability regime of depositaries between UCITS and AIFs may have impacts on investments, processes, operations, systems and risks
- We will potentially face a situation where professional investors will have a higher degree of security than retail holders
- The operating model of depositaries should change in terms of risk assessment, procedures, systems, processes and organisation
- It is the right time for depositaries to start reviewing the appropriateness of their control framework in order to setup a pragmatic and risk based approach

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A first challenge resides in the initial due diligence, basically consisting in auditing a client's financial and organisational soundness.

# The AIFMD for fund service providers

## Taking a strategic approach

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The Alternative Investment Fund Managers Directive (AIFMD) continues to generate controversy as the detailed implementing measures take shape under the stewardship of the European Commission. Certain aspects of the implementation remain subject to debate but much of the framework for the new regime has now been clarified.





Fund service providers that proactively respond to the directive and develop tailored AIFMD solutions will stand the best chance of gaining from the new regime. In this article we take a look at some of the key challenges and potential opportunities the AIFMD presents for depositaries and fund administrators.

At this stage in the process we await the Commission's final implementing measures which are expected by the summer of 2012. EU member states will then have until July 2013 to implement the new regime at national level. Existing managers falling within the scope of the AIFMD will have a further year to comply with the directive, but this timeframe remains extremely challenging given the significant amount of operational change required.

As behind the scenes discussions on the Commission's draft regulation continue, areas concerning fund service providers and depositaries are subject to change. The Commission's position on delegation could have significant impacts for current management company models and outsourcing arrangements. The treatment of collateral under the new depositary liability regime may also be subject to change. In any event, service providers will have a key role to play in facilitating the new regime from an operational and risk perspective. Service providers therefore need to ensure they are prepared for AIFMD as early as possible, not only to meet the requirements of both European and non-European fund managers but also to best position themselves to take advantage of the opportunities presented by AIFMD.

### The AIFMD for depositaries

#### Liability

The depositary provisions are among the most controversial elements of the directive due to the new liability regime and its associated costs. The AIFMD imposes a form of strict liability on depositaries for the financial instruments they hold in custody, which must be replaced by the depositary without undue delay in the event of loss. The exact scope of assets held in custody and therefore under strict liability remains a contentious area as the implementing measures evolve. At a minimum, assets under strict liability will include transferable securities (including embedded derivatives), money market instruments and units of some undertakings for collective investment.

In its advice to the Commission, the European Securities and Markets Authority (ESMA) ruled out the inclusion of OTC derivatives within custody due to the numerous impracticalities surrounding this concept. Cash deposits, private equity shares and financial instruments (including units of collective investment schemes) that are not registered or held in the name of the depositary are also out of scope. However, funds of funds and life settlement funds will be subject to custody and depositaries will need to develop new market practices to maintain accurate valuations and records for holding these types of assets in custody.

The treatment of collateral is perhaps the most contentious point in relation to the scope of the depositary liability. ESMA's advice was to generally exclude from strict liability assets provided as collateral, thereby acknowledging current market practice and the prime broker's role as a counterparty rather than a sub-custodian. However, the status of collateral is currently far less clear and could lead to differing treatment depending on whether there is a transfer of title. The inclusion of collateral within the depositary liability regime would have significant implications for interaction between the depositary and prime brokers with resulting changes in market practice.

#### **External event and discharge of liability**

Only if an event is 'external' and 'beyond reasonable control' where the consequences would have been 'unavoidable', can the depositary discharge its liability. These criteria and their interpretation by ESMA make it more challenging for a depositary to discharge its liability, as the depositary will be liable for the actions of both affiliated and non-affiliated sub-custodians. For example, the depositary retains liability for instances of fraud or insolvency within the sub-custody network. Accounting errors, operational failures and failure to apply the asset segregation requirements properly at sub-custodian level also constitute 'internal events' for which the depositary is liable. External events under which the depositary could discharge its liability are limited by ESMA's advice to extraordinary occurrences such as natural events beyond human control, acts of state (e.g. nationalisation), war, riots or major upheavals. ESMA has also clarified objective reasons under which the depositary may contract a discharge of liability with the sub-custodian and the Alternative Investment Fund (AIF) and/or Alternative Investment Fund Manager (AIFM) but these are also very limited in scope. The depositary must have no other option but to delegate custody duties to a third party (e.g. as a result of legal constraints) or because the AIFM considers that it is in the best interests of the AIF and its investors for the depositary to discharge its liability.

#### **Due diligence**

Depositaries will look to exercise a greater level of due diligence over their sub-custody networks, not only due to the increased level of risk, but also because the AIFMD lays down detailed requirements in this regard. Depositaries will need to review sub-custody contractual arrangements, strengthen their policies and procedures for appointing and monitoring sub-custodians and ensure that assets are properly segregated at sub-custody level. Even if, for reasons of local law, the segregation measures are insufficient, the depositary must assess what additional arrangements it can deploy to make the assets as insolvency-proof as possible. In the event of loss, the burden of proof will lie with the depositary to demonstrate that the loss could not have been prevented and the level of due diligence required must be rigorous and comprehensive rather than reasonable. This new level of due diligence and compliance burden will come at a cost and will likely require further investment in resources and technology.

#### **Additional duties**

In addition to the new liability regime, the AIFMD also clarifies the duties and functions of a depositary, which include safekeeping, oversight, cash monitoring, due diligence and segregation of assets. Cash monitoring in particular will be a new requirement for most depositaries, involving oversight of subscription and redemption flows. Depositaries will have to take a view on how much risk-weighted oversight should be performed on these transactions and a standard market practice may take time to emerge. Depositaries can also expect increased oversight from other depositaries in applying these rules. Cash monitoring duties are similar to the services currently provided by fund administrators and therefore depositaries that do not have a strong fund accounting function may be at a disadvantage.

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**The depositary provisions are among the most controversial elements of the directive due to the new liability regime and its associated costs.**

### Pricing risk

The new liability regime will require depositaries to price appropriately for the risk of losing assets in the custody network under the new liability regime and the cost of holding additional capital to cover that risk. Depositaries will need to assess their existing custody arrangements to determine how the risk profiles are likely to change for each asset type and jurisdiction. One key challenge is that the risk associated with any given sub-custodian may be difficult to measure and any failure or credit event could result in catastrophic losses for the depositary. Depositaries that respond by applying blanket fee increases to existing clients are likely to face significant resistance from clients, but more importantly, will have significant mis-pricings across their book of business. Over time, this is likely to result in riskier clients gravitating towards the depositary and in lower risk clients migrating to service providers that are better equipped to measure and price risk.

The challenge for depositaries is therefore to develop capabilities to measure and price risk effectively while also pricing in the additional due diligence and compliance responsibilities. This will require the development of an effective risk model using powerful data analytics to accurately assess and price risk, based on a comprehensive set of risk factors and scenarios. Depositaries that can develop effective risk and pricing models will be in a sounder financial position under AIFMD and can use this advantage to achieve true market differentiation.

### Market impact

The landscape of the European depositary market is likely to change radically post AIFMD. The increased risk and the associated increase in the level of capital that depositaries will be required to hold, may reduce the attractiveness of the fund depositary business. On the demand side, clients may gravitate towards those depositaries with the largest and safest balance sheets, contributing to a smaller number of players operating in the market. We expect to see a greater level of members and acquisitions activity within the market as certain players seek an exit strategy while others seek to grow market share. The winners will be those depositaries that are well positioned in terms of scale, capital, risk pricing and global custody networks.

Depositaries should perform a cost benefit analysis of the markets in which they operate and of their existing sub-custody arrangements. Certain markets may be identified where it is no longer viable to provide custody services, while in other cases depositaries will seek to revise fees upwards to reflect the new risk levels. Consequently, investing in emerging and frontier markets could become considerably more expensive at a time when appetite for such markets is increasing rapidly. Depositaries that have, or can develop, an extensive sub-custody network within their group will be able to use their branch network to mitigate risk. For that reason we may see depositaries establishing new branches to perform custody activities in jurisdictions where previously they relied on external sub-custodians. Other depositaries may seek to establish strategic relationships across certain jurisdictions or develop certain specialisations.

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Only if an event is ‘external’, ‘beyond reasonable control’ and the consequences would have been ‘unavoidable’ can the depositary discharge its liability.





For depositaries that develop the right model, there will be real opportunities for growth. The overall size of the market is set to grow as various entities that currently do not appoint a depositary will now be required to do so. This is particularly the case for segments such as private equity and real estate. As private equity shares and real estate will not fall under the strict liability regime, acting as depositary for these entities might be particularly attractive to non-EU credit institutions. An EU AIFM marketing a non-EU fund into the EU under private placement must appoint one or more entities to carry out the duties of a depositary under AIFMD. Managers may require additional support from service providers to carry out these functions, which cannot be performed internally. The third country passport, due to come into effect from 2015, will require compliance with the full depositary regime for non-EU funds managed by non-EU managers, creating a new market for depositary services.

#### **UCITS V and beyond**

The draft UCITS V Directive will follow AIFMD in seeking to harmonise depositary duties and liability across the EU, in an attempt to eliminate the inconsistencies in depositary rules that were brought to the fore

during the recent financial crisis. Both directives will clearly increase the workload, level of liability and costs for depositaries. However, both directives lay the foundations for an EU depositary passport and a common EU depositary market that will enable greater operational efficiencies and facilitate economies of scale. Depositaries will be able to develop common standards, policies and procedures and centralise controls and oversight across EU markets. All of these developments point towards large, well-capitalised, highly efficient and highly specialised depositary service providers.

#### **The AIFMD for fund administrators**

The term 'fund administrator' is never specifically mentioned in the directive. Nonetheless, investment managers will undoubtedly look to their fund administrator for assistance on various operational aspects of the directive, particularly with regard to regulatory, investor and risk reporting, liquidity profiling and complex valuations. The AIFMD can offer fund administrators the opportunity to provide value added services and enhance profitability at a time when intense fee pressure and market volatility have reduced margins.



### Reporting

One of the objectives of the AIFMD is to monitor systemic risk and this is to be achieved through reporting to the AIFM's regulator. Reporting will be required for each fund either on a quarterly, bi-annual or annual basis, depending on the level of assets managed by the AIFM. ESMA has prescribed a 16 page template requiring detailed reporting on investment profile, risk, liquidity and leverage. The time and resources required to complete the form for each fund under management on a quarterly basis will be significant, with costs conceivably running to several hundred thousand euro for medium to large scale managers. In many cases fund managers will look to

outsource this complex, operationally intensive process in order to minimise costs and maintain their focus on core activities. Non-EU managers selling into the EU will also be required to undertake this reporting and will almost certainly need assistance from local fund administrators in fulfilling these requirements.

Fund administrators already have access to much of the underlying data required for regulatory reporting purposes and are therefore ideally placed to provide this as an additional service. Success will depend on the administrator's ability to deliver a competitively priced automated solution which minimises manual inputs and operational risks. New investor disclosure requirements combined with market demand for increased transparency provide scope to develop tailored investor reporting solutions. Operational synergies with other reporting and transparency initiatives such as the Form PF in the United States and EMIR<sup>1</sup> should also be identified in order to maximise efficiencies and future-proof systems insofar as possible.

### Risk reporting and liquidity profiling

Much of the UCITS risk-management framework has been imported into the AIFMD, requiring the application of new, uniform risk-management standards on the diverse alternatives sector. This creates a further opportunity for fund administrators to provide additional risk reporting and enhance their middle office and compliance capabilities. The AIFMD also requires managers to monitor the liquidity profile of the underlying assets against the redemption policy to ensure they are consistent. Administrators are well positioned to perform this liquidity profiling and to provide analysis for liquidity stress testing.

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Depositaries will look to exercise a greater level of due diligence over their sub custody networks not only due to the increased level of risk but also because AIFMD lays down detailed requirements in this regard.

<sup>1</sup> The pending regulation regulation of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories, commonly referred to as the European Market Infrastructure Regulation (EMIR)

### Valuations

The directive clarified that the AIFM is ultimately responsible for the valuation of the fund's assets but may delegate to an 'external valuer' who is liable in turn to the AIFM. ESMA's final advice has clarified that a third party administrator incorporating values obtained from the AIFM or other sources is not the 'external valuer' by virtue of this activity alone. Contractual arrangements between the various parties regarding valuations will need careful consideration as a result of the AIFMD. There may be demand for third party administrators to perform the role of external valuer. While this would come with additional liability that some administrators may not wish to take on, others may see an opportunity to provide new valuation services such as esoteric asset valuation.

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For depositaries that develop the right model, there will be real opportunities for growth.

### On the 'front foot'

The AIFMD will have far-reaching compliance, operational and distribution implications stretching beyond Europe. Both EU-based and non-EU managers will require increased operational support in navigating this new regime. Service providers will be forced to consider their market positioning and operating model in this new and evolving environment. EU depositaries face a range of new requirements and increased operational risks but this new regime also presents opportunities to gain market share in a growing market. For fund administrators, the AIFMD can provide a route to enhancing profitability and creating deeper strategic partnerships with clients as they address the operational challenges of the AIFMD. Service providers that react quickly to market requirements by developing bespoke AIFMD solutions can secure a genuine competitive advantage through these advanced capabilities.

### To the point:

- AIFMD's new liability regime will increase risks and therefore operating costs for depositaries. The challenge will be to measure and price for these new levels of risk appropriately
- Depositaries that can develop effective risk and pricing models will be in a sounder financial position under AIFMD and can use this advantage to achieve true market differentiation
- AIFMD is likely to lead to a smaller number of players in the depositary market. The winners are likely to be large, well-capitalised depositaries that have extensive group sub custody networks or form strategic alliances
- The overall size of the market is set to grow as various entities that currently do not appoint a depositary will now be required to under AIFMD
- Both AIFMD and UCITS V lay the foundations for an EU depositary passport and a common EU depositary market that will enable greater operational streamlining and economies of scale
- Fund managers will seek assistance from fund administrators with regard to regulatory, investor and risk reporting, liquidity profiling and complex valuations
- Success will depend on the administrator's ability to deliver a competitively priced automated solution which minimises manual inputs and operational risks

### European Market Infrastructure Regulation (EMIR)

On March 29, 2012, the European Parliament adopted the final text of the Regulation for the EMIR. EMIR aims to ensure efficient, safe and sound derivatives markets, reducing counterparty and operational risks, increasing transparency and enhancing market integrity.

**The regulation which is anticipated to be finalised and expected to be applicable as of January 1, 2013, will introduce:**

- A clearing obligation for eligible 'Over The Counter' (OTC) derivatives with measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives
- Common rules for Central Counterparties (CCPs)
- A reporting obligation for OTC derivatives
- Rules on the establishment of interoperability between CCPs
- The concept of data trade repositories

For those who are subject to the mandatory clearing obligations and deal in eligible derivatives, they will be obliged to clear them either by becoming a clearing member of a relevant CCP or becoming a client of an entity which is a clearing member. The implications of the regulation will include considering establishing necessary clearing relationships in advance before the regulation comes into force.

### EFAMA presents six new fund classification categories

On April 23, 2012, the European Fund and Asset Management Association has published a report presenting a complete set of categories to facilitate the use of the European Fund Classification (EFC) by all industry stakeholders. The classification system was developed to allow all interested stakeholders, particularly the fund distributors, to group both cross-border funds and domestic funds with comparable investment strategies.

**Under this system, the investment funds are split into six categories namely:**

1. Equity funds
2. Bond funds
3. Multi-asset funds
4. Money market funds
5. Absolute return innovative strategies
6. Other funds

The classification of funds according to the EFC criteria is done by a neutral classification administrator on the basis of the funds' portfolio of holdings. The EFC categories will enable fund groups to identify the specific EFC category to which each of their funds belong to.

The publication of the EFC categories report is accompanied by a publicly available EFAMA spreadsheet showing which EFC categories the 3,296 cross border funds (13,048 share classes) belong to. These funds are promoted by 125 fund managers, including those belonging to the largest European fund management groups.

### Aberdeen/Santander Tax Reclaim

**ECJ issues ruling on the French regulation on withholding tax applicable to dividends paid to funds**

The European Court of Justice (ECJ) has decided on May 10, 2012 that the French rules on the application of withholding tax on dividends paid to non-resident investment funds whilst exempting from taxation dividends paid to resident investment funds is contrary to EU law. The ECJ has also indicated that the tax treatment of the investors does not need to be taken into account to compare the treatment of French and non-French investment funds.

Following such ruling, the French government asked the ECJ to limit the effects of its judgement to claims filed before the judgement date so that only claims filed with the French tax authorities before May 10, 2012 are valid. The ECJ has refused to apply such restriction. Accordingly, reclaims can still be filed in France by EU and non EU investment funds within the legal statute of limitation.

This case follows a ruling by the ECJ back on June 18, 2009 on the Aberdeen Property Fininvest Alpha Oy case.

# Link'n Learn 2012

Since 2009, Deloitte has 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 webinar training 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 into each informative webinar. For access to the sessions do not hesitate to contact [deloittelearn@deloitte.lu](mailto:deloittelearn@deloitte.lu)

## Agenda

- |  |   |
|--|---|
| <b>03-May</b> Transfer pricing <b>NEW!</b>   | <b>27-Sep</b> Solvency II – The challenges of Pillar II and the ORSA <b>NEW!</b>                            |
| <b>10-May</b> AIFMD: what does your business need to know  | <b>04-Oct</b> Introduction to private equity funds  |
| <b>24-May</b> MiFID II <b>NEW!</b>   | <b>18-Oct</b> Introduction to Islamic funds   |
| <b>07-Jun</b> Risk & capital: from Basel II to Basel III   | <b>25-Oct</b> Introduction to derivatives instruments (part 1)  |
| <b>21-Jun</b> Custodian responsibilities<br>Latest developments based on AIFMD and UCITS V <b>NEW!</b> | <b>08-Nov</b> Introduction to derivatives instruments (part 2)  |
| <b>28-Jun</b> Introduction to tax and real estate funds  | <b>15-Nov</b> Evolution of the custody framework:<br>a focus on Target 2 Securities and UCITS V <b>NEW!</b> |
| <b>05-Jul</b> Transaction cycles and net asset value calculations                                      | <b>22-Nov</b> Investment restrictions of investment funds   |
| <b>12-Jul</b> Treatment of errors and anti-dilution techniques   | <b>29-Nov</b> Introduction to IFRS for funds  |
| <b>20-Sep</b> Introduction and latest updates to ETFs and index tracker funds                          | <b>13-Dec</b> Performance fee calculation and multi-class of shares principles                              |



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