

# Performance

A triannual topical digest for investment management professionals, issue 19, January 2016



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Interview— Investing in the “Real Assets” market— Perspectives

The Art & Science of Smart Beta

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Back (office) to the future— The four digital trends altering the status quo for custodians

Regulating the asset management industry proportionally will help create growth and jobs

German custodians on the New Silk Road—Guiding investors into faster growing markets

European depositary regulation— Striking the right balance?

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# Foreword



Welcome to this new edition of Performance. Welcome or perhaps ‘Willkommen’ for there is a distinct German flavor to this edition that brings with it a fascinating combination of insight, information, challenge and vision.

To a certain extent, it is amazing that Germany—its citizens and concerns, its riches and its contradiction—manages to be so discreet. Certainly, its leaders are constantly on the European and World stage, their influence and importance acknowledged and needing no introduction or explanation. Others, who would accompany them hand in hand, have a habit of fading into anonymity in their shadow. But Germany itself, the building blocks that are the bedrock of its success and essence, the behavior of those investors that are a draw to investment managers, the accumulation of wealth that makes them attractive, so many of the facets of what Germany is remain a well-guarded secret for the rest of Europe, not to mention the wider world.

For this reason, we are especially gratified to see in this edition so much in-depth analysis of investments and investing from a German perspective.

With thoughts about distribution in German-speaking countries, we get a glimpse of what makes up this fascinating paradigm, and we see it also through the lens of regulation as seen from a German perspective. We are also fortunate to have the benefit of the thoughts of Dr Klinz, long at the heart of the formative process of regulation. Perhaps more unusually we are also afforded an insight into the world of German depositaries and this in one case linked to the evocative subject of the Silk Road project, a whole subject on its own.

Reflections on infrastructure carry over into on one hand reflections on real assets within the investment sphere, and more precisely, the thinking of the BVI on ELTIFs. If ELTIFs are a possible hope for sustained growth and the way of the future within the European Union, we are also brought back to the harsh realities of that European context by a thought-provoking and slightly uncomfortable piece examining the specter of the ongoing euro crisis that many would wish us to believe behind us, and here examined in the cold and rational light of objective reasoning.

In summary and in brief, this edition of Performance breaks new ground in bringing you insights that inform as well as provoke reflection. It challenges stereotypes as it challenges pre-conceived or accepted ideas, and it updates our understanding of what is new and what is topical in the wide world of investing.

We should like to extend our special thanks to the distinguished list of contributors to have brought together this expertise. And as ever, we should like to thank you our readers for your support and loyalty, and once again encourage you to make your thoughts and reactions known. The world, especially the investment world, grows richer as a function of the interaction of diverse views and experience.

We wish you informative and challenging reading.

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The financial services sector in Europe is presently facing a number of challenges. On the one hand, current ECB policies are causing a flood of liquidity on the market, as well as historically low interest rates, combined with the associated downward pressure on asset managers' margins. Moreover, regulatory demands on the asset management industry are increasing.

On the other hand, the asset management industry is facing the immense challenge of digitalization, with its twin consequences of information overload in terms of speed and volume, and vastly increased numbers of market participants.

Furthermore, the technology itself, the new market participants and the general financial services framework all call existing organizational structures into question; this even applies to the current business models themselves. This has knock-on effects, e.g., for product development and the sales and distribution process. It is also important not to overlook the progressive automation of the retail customer relationship, which allegedly leads to increased transparency and radically different—and increasingly volatile—patterns of consumer demand.

A quote from Klaus Schwab, *Founder and Executive Chairman of the World Economic Forum*, provides a particularly apt description of the times. He defines the pace of technological changes as follows: *"In the new world, it is not the big fish which eats the small fish, it's the fast fish which eats the slow fish."* This appears to be highly appropriate and gives an excellent perspective on the future of the financial services sector.

The asset management industry has profited from the current economic situation and financial system framework. The low interest rate environment has led to an increase in demand for professional asset management, both active and even more so, for passive asset management. For example, when we consider Germany, asset managers added almost €141 billion of net capital inflows in the first nine months of 2015. This is more than double the amount achieved in the first nine months of 2014, which was already a record-breaking year in history. Asset managers find themselves under pressure to optimize their processes and increase their levels of innovation because of the ever-increasing amount of regulation. This is also mandatory, because the pressure from "FinTechs" is here to stay and is more than likely to increase as digitalization progresses. With respect to product development and sales, one could say that advances in future technology will be the deciding factor in the competition between market participants, at least in respect of the retail market.

The many complex aspects of the financial services sector and especially those in the asset management industry, which in our opinion cannot be solved by the individual domestic markets, will lead to a Europe-wide duty and responsibility to meet these challenges. This not only refers to the financial services sector, but also refers especially to other topics that currently affect us, from the stream of migrants to other general terror threats.

This edition of the *Performance* magazine addresses many financial services topics, in which the outlook and solutions for the asset management industry are portrayed. We hope that you will enjoy reading it.



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# ZOOMING IN ON THE FEATURES AND EFFECTS OF THE ELTIF FRAMEWORK

Interview with Dr. Julia Backmann, LL.M. Vice President (legal) at BVI



Dr. Julia Backmann, LL.M. Vice President (legal) at BVI, the German Fund and Asset Management Association. In this capacity, she deals with all kinds of relevant legislation on EU and national level in particular relating to corporate law and corporate governance issues as well as closed-ended funds and fund distribution rules. Before joining BVI in 2012, Dr. Backmann worked at an international law firm. She is attorney at law (Frankfurt bar) and is regularly invited to speak at international conferences.

In April 2015, the European legislators adopted a new investment fund framework designed for investors who want to put money into companies and projects for the long term. The regulation on these private “European Long-Term Investment Funds” (ELTIFs) aims at increasing the pool of capital available for long-term investment, such as infrastructure and small and medium-sized businesses in the EU economy by creating a new form of fund vehicle.

We conducted an interview with Dr. Julia Backmann—Vice President of the legal department at the German Investment Funds Association BVI—on the current status of the ELTIF regulation. The ELTIF regulation has entered into force on 9 December 2015. The European Supervisory Authority ESMA consulted implementing measures (known as Regulatory Technical Standards—RTS) in early autumn 2015. These RTS will determine some of the final circumstances under which the new funds will operate.



### **1. What do you believe are the drivers for setting up the ELTIF framework?**

*Julia Backmann:*

The main driver behind the ELTIF regulation is to create a win-win situation for both the European governments and the market participants. While reliable sources of long-term financing, such as infrastructure, are needed throughout Europe, and public budgets are tight, institutional investors are striving for stable returns. In times of low interest rates, pension providers and insurance companies as well as private investors have a growing appetite for long-term investments in infrastructure or other tangible assets such as real estate.

### **2. What are the main features of the ELTIF framework compared with other products?**

*Julia Backmann:*

Although the ELTIF is often understood as an infrastructure fund, ELTIF-eligible assets comprise much more. An ELTIF may also invest directly or indirectly in real assets as well as so-called Qualified Portfolio Undertakings (QPU), in particular companies (unlisted or small and medium-sized listed companies with a market capitalization of up to €500 million). In addition, ELTIFs may also grant loans to such QPUs.

The rules on portfolio composition, investment limits, lifetime of the ELTIF and redemption rights, as well as the requirements for distribution are quite detailed. Throughout the legislative process, BVI has continuously raised its concerns that the rules might not allow for enough flexibility to create a product that the market will accept. For instance, it is unclear whether an ELTIF manager will be able to find the minimum required five typical ELTIF assets with more or less the same lifetime to cover at least 70 percent of the ELTIF capital.

Whether ELTIFs are going to be feasible in practice remains to be seen and with the regulatory discussions still ongoing, it is far too early to say at the moment. This is particularly true when comparing ELTIFs with existing products; the introduction of an EU passport for retail distribution of ELTIFs could, to a certain extent, close the gap between UCITS offering retail investment opportunities in securities markets and alternative investment funds (AIFs), which provide for an EU passport for professional investors. To become a market success, the framework therefore needs to address the interests and needs of retail and professional investors.

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The European Supervisory Authority ESMA consulted implementing measures (known as Regulatory Technical Standards—RTS) in early autumn 2015

**3. What are the characteristics of an ELTIF fund (Open/closed or something in between)? If ELTIFs are to be opened to retail investors, how is it possible to align the liquidity of the vehicle and its assets with the liquidity expectations of the retail investor?**

*Julia Backmann:*

ELTIFs are designed to be closed-ended funds; however, in the event that certain preconditions are met, redemption rights are allowed. The ELTIF must invest a minimum of 70 percent in typical ELTIF assets (real assets and QPUs) including loans granted to QPUs but may invest up to 30 percent in typical UCITS assets. The redemption rights have to be limited to the amount equaling these liquid assets. Redemptions are only allowed after half of the ELTIF's life has passed, at the latest after five years. The redemption rights have to be defined by the ELTIF's fund rules. Furthermore, the ELTIF manager has to provide for an appropriate liquidity management system as well as a redemption policy. I believe that these rules allow ELTIF managers to be able to align the liquidity with the redemption rights provided for investors.

Even with limited redemption rights, ELTIFs can enhance investors' portfolios. Germany has a long history of closed-ended funds marketed to retail investors. Until the AIFMD implementation, such funds often provided for special termination rights for retail investors, e.g., in the case of unemployment. Such special termination rights would address retail investors' needs to disinvest in case of unexpected events. The liquid assets should generally be sufficient to allow for such redemption rights.

**4. Do you believe that there are significant concerns as to potential "mis-buying" on the part of retail investors? What are the additional safeguards if ELTIFs are marketed to retail investors? How will the MiFID II requirements affect the marketing of ELTIFs to retail investors?**

*Julia Backmann:*

No, I do not think there are significant concerns regarding "mis-buying". Generally, regulation has increased investor protection since the financial crisis. In addition, the ELTIF regulation provides for a number of additional safeguards for retail investors. The ELTIF regulation requires disclosure, in the form of a PRIIPs KID e.g., and specific cost disclosure within the prospectus. Furthermore, the ELTIF manager has to set up an internal procedure to assess whether the ELTIF is suitable for marketing to retail investors (similar to the product governance requirements according to MiFID II). Moreover, retail investors who have accumulated a portfolio (composed of cash deposits and financial instruments) that does not exceed €500,000 may only invest up to 10 percent of their portfolio but need to invest a minimum of €10,000 in the new product.

Furthermore, the ELTIF regulation allows ELTIFs to only be sold to retail investors if the investor receives investment advice and therefore the suitability of the ELTIF has been tested, even in the case of direct distribution. In this regard, the MiFID requirements regarding investment advice apply and ELTIF interests cannot be distributed by execution only or advice-free. Furthermore, ELTIFs are likely to be considered as complex. Regardless of whether all AIFs will be considered complex products, as suggested by ESMA under MiFID implementing rules, all products that have a fixed investment term of a number of years with exit barriers are considered complex. This will apply also to ELTIFs unless a liquid secondary market can be established.





**5. Is the ELTIF a nice-to-have or a must-have regulatory framework? What support can be given to ELTIFs to encourage their take up?**

*Julia Backmann:*

To be a “must-have”, a product has to give the specific type of investor and the relevant manager an advantage over the use of other products. Professional investors already benefit from an AIF EU passport without any regulation of the product on a European level. Depending on the national requirements for the AIF as a professional product, they can therefore generally set up the equivalent of an ELTIF. In many cases, they would not have to comply with the restrictions on investment limits, duration requirements, etc.

ELTIFs currently offer two advantages as a product for professional investors compared with the common AIF:

- An AIF may grant loans to unlisted companies as well as to listed companies with a market capitalization of up to €500 million. Depending on national restrictions for AIFs to grant loans, this might be an advantage also compared with AIFs for professional investors.
- For retail AIFs, no EU passport regime (except for EuVECAs and EuSEFs) exists. The ELTIF framework provides a passport for retail AIFs, which invest in real assets for example. However, there are many additional safeguards for distribution of an ELTIF to retail investors. Some of these safeguards are open to interpretation and might hence impose an increased liability risk to the manager.

In addition, the European Commission proposed some amendments to the Solvency II regime to enable insurance companies to benefit from lower capital charges for ELTIF investments. However, institutional investors already have access to invest in infrastructure today.

Therefore, some see the ELTIF regulation as being more legally restrictive for the institutions than alternative infrastructure products. I believe that the advantages provided by the current regime are more likely to create a “nice-to-have” rather than a “must-have” product.

**6. We have noticed that there is a lot of interest outside Europe for ELTIFs, reflecting an interest in viable, unitized vehicles for investing in infrastructure by facilitating cross-border fundraising in the EU. Why do you think this is the case?**

*Julia Backmann:*

This is true, there seems to be an interest in ELTIFs outside Europe, for example in the Asian market. This might be based on specific national requirements. Another explanation is the general success of UCITS outside Europe. Like UCITS and unlike AIFs, the ELTIF is a product regulated on a European level and could be considered to be comparable with UCITS in terms of supervision and product regulation, which allows investment in real assets.

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“I believe that the advantages provided by the current regime are more likely to create a “nice-to-have” rather than a “must-have” product.”

**7. What support can be given to ELTIFs to encourage their take-up? Does the ELTIF regulation require changes to prevent it from going down a similar path to the EuSEF regulation, which seems to have really failed in its objective to promote the creation of social funds?**

*Julia Backmann:*

We believe that some adaption of the ELTIF regulation would facilitate the success of the product. For instance, the additional safeguard for investors whose portfolio does not exceed the €500,000 mentioned before does impose legal uncertainty and civil liability issues from the viewpoint of the ELTIF manager or the distributor. From a civil law perspective, the ELTIF manager or the distributor may be required to verify and scrutinize any information that the investor provides in this respect. Since any consequences under civil law are hard to predict, I think this is a significant obstacle for taking up the ELTIF as real retail product. It is therefore unclear whether this risk would outweigh the advantages of a cross-border product.

Furthermore, I believe that the ELTIF regulation should provide for some flexibility for institutional investors that do not qualify as professional investors according to MiFID II. This applies in particular to investors considered as semi-professional, such as certain pension providers or foundations.

Finally, for professional investors, the ELTIF adds unnecessary complexity. Nevertheless, for some institutional investors, investments might be easier if the product itself is regulated. This might lighten a due diligence burden if recognized by the regulator of such institutional investors. Whether the proposed amendments to the Solvency II regime will increase the success of the product for insurance undertakings remains to be seen.

**8. Investments in real assets require a minimum investment of 10 million. Do you believe that a lower “entry ticket” to a portfolio of infrastructure investments via an ELTIF is a decisive factor in ensuring the success of ELTIFs in the future?**

*Julia Backmann:*

No, I do not believe that market participants consider the “entry ticket” an obstacle. Obstacles for infrastructure investments are the lack of respective projects rather than potential vehicles that could be used for such investments. For instance, open-ended institutional funds in Germany may today purchase loans that finance infrastructure projects. Closed-ended funds may invest in all types of real assets.

**9. Can the proposed RTS encourage or discourage the take-up of the ELTIF?**

*Julia Backmann:*

Generally, ESMA’s approach shows an interest in finding practicable solutions to facilitate the framework’s success. However, according to the ELTIF regulation, the rules delegated to the Commission, which are to be suggested by ESMA, are limited. This limits the additional flexibility ESMA could provide for accordingly. For instance, ESMA has to propose rules regarding lifetime, hedging investments, disinvestment schedule, and facilitations for retail investors. The rules are quite technical and put limits on what ESMA can allow.

**10. Do you believe that the current regulation supporting ELTIFs is too multi-purpose? Is the design under a “catch-all” approach covering infrastructure and other purposes too unspecific to answer specific investors’ (e.g., pension funds) needs to invest in a specific infrastructure label? Do you think it might be beneficial to leverage the experience of both the EIF and similar entities, and of regulators who have already considered infrastructure funds, to determine if it would be appropriate to define a specific category or status of AIFM to manage infrastructure ELTIFs?**

*Julia Backmann:*

No, I do not believe that the multi-purpose approach is an obstacle for the ELTIF’s success. The fact that an ELTIF could be structured in a totally different way, with underlying assets with a varying degree of liquidity, investments in equity and debt instruments and loans as well as real assets, should support the ELTIF’s acceptance.

Since the understanding of infrastructure differs, I think it is an advantage that the ELTIF regulation does not try to define infrastructure, thereby narrowing the possible investments. The long-term nature of the fund is rightly not only focused on infrastructure but generally real assets as well as instruments that may be used to finance real assets.

**11. In Conclusion: what do you think about the ELTIF regulation?**

*Julia Backmann:*

Overall it’s a good idea. It seems to be positive for the market. However, it remains to be seen whether it really is workable or will be in the future.



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“I believe that the ELTIF regulation should provide for some flexibility for institutional investors that do not qualify as professional investors according to MiFID II.”



# INVESTING IN THE “REAL ASSETS” MARKET— PERSPECTIVES

Interview with Francis Louvard and Gregory Ingram, principals of Thunderbolt Partners and shareholders of KGAL, conducted by Christof Stadter, FSI Investment Management Partner at Deloitte and Stephan Mühlbauer, Director at Deloitte, at EXPO REAL (the real estate trade fair in Munich).

Investment opportunities in the area of real assets are developing rapidly, especially in Europe. Asset managers are now looking much more towards the opportunities available in real asset investments, not only because of the continuing low returns on the standard securities/fixed income markets, but also because regulatory developments in the area of socially responsible investing are becoming ever more supportive of the business development opportunities for real asset investment projects.

Many real asset investments have their origins in the leasing business. Today, however, these investments are not just to be found in the traditional areas of property, shipping, aircraft, and containers, but are

rather more present in other socially responsible infrastructure projects, which are often either linked to renewable energy sources (e.g. solar or wind power) or to infrastructure projects benefiting the general population (e.g. transport, housing).

We asked the new owners of an established asset management company in Germany (KGAL) that specializes in real assets for their evaluation of the current and future market perspectives for investing in real assets both in Europe and on a global scale, to find out their reasons for choosing to invest in the German market.



**1. What were the main reasons for your decision to purchase an asset manager that specializes in real assets rather than securities or other financial instruments?**

Asset managers investing in real assets rather than securities are, in our opinion, the future of the investment industry for several reasons:

Firstly, people are generally fed up with finance-driven investment products with complicated structures, which are ultimately disconnected from the real economy, have no social benefit, and are simply there to justify the fee structure and food chain of various agents.

Secondly, people want to invest in what they can understand, what they can touch: real assets, where the ownership structure is clearly established and there is a simple, transparent fee structure.

Thirdly, people are seeking returns in the current environment of historically low interest rates. Today, neither standard equity nor fixed income investments are able to ensure preservation of capital or secure long-term recurring income.

Real assets can contribute to solving the present problem of both institutional and retail investors, namely that of investing in projects with a longer-term view towards generating returns, combined with the intention of promoting economic development as well as capital preservation.

Accordingly, we were looking to acquire a real asset management company that embodies all these values and investment practices. The company also needed to be well established with an extremely good reputation in Germany, stretching back over a longer period

of time. In addition, the company must have built successful business models across different real assets (such as real estate, aviation, and renewable energy assets).

In essence, our motivation to acquire KGAL was love at first sight. The relationship of trust and confidence that KGAL has built up with its institutional investors was a strong factor in our decision, as was the impressive and very detailed knowledge of its employees about the specific real asset markets in which their investments are concentrated.

We believe that with KGAL, we have found a company that is based on values and principles that we support - something that unfortunately cannot be taken for granted nowadays.

**2. Why did you chose the German market for your acquisition of a real asset manager rather than Luxembourg, Switzerland or somewhere else in the EMEA, or alternatively the USA or APAC region?**

We made our purchase in Germany, because we believe in Germany and its future. Furthermore, we respect German corporate values. "Made in Germany" still enjoys an excellent reputation. The German corporate culture is known for being serious and effective. German employees are capable of developing long-term strategies, as well as ensuring that the job is done right. Also, Germany is a real economy, within the true meaning of the word. Relationships with and commitments made to clients, investors and service providers are based on trust and a long-term perspective. We prefer this way of doing business.

**3. Did you consider any of the following factors when making your decision?**

**a. Is the regulatory environment in Germany more conducive to investing in real assets than in other countries?**

No. Regulations abound everywhere, with the same level of reporting.

**b. Is the support of the government in Germany for real asset investment projects more advanced than the support in other European countries?**

This is indeed the case—notably in the area of renewable energy. In this sector, Germany has done a very good job. We do hope that a similar approach will be applied and extended to infrastructure in general (grid, district heating, power storage, etc.).

**c. The position of KGAL in terms of established market success in the area of real assets and especially its future development perspectives?**

Yes. KGAL is a stellar company, and its performance as well as its people speak for themselves.

**d. Your view on the future desire of institutional investors to make real asset investments in Germany rather than in other countries?**

Again, our view is that Germany is a safe haven, where people work hand-in-hand with a long-term view. Not to mention that Germany is the engine of the European economy. Germany is attractive for institutional investors for these reasons, in addition to the security of its legal system, infrastructure, etc.

**4. How do you view the market for the sale of real asset funds to institutional investors generally?**

It is an emerging market, which is gathering momentum worldwide. Institutional investors do need to match their long-term liabilities with appropriate assets (to pay for our pensions for example). No other asset class provides the elements of capital preservation, direct ownership, and recurring yield, while being able to outperform other asset classes. However, the implementation of Solvency II requires insurance companies as well as asset managers to implement monitoring and risk reporting functions to efficiently manage their real asset investments.

**5. Do you see real asset opportunities as being further developed in Germany than in other EMEA countries?**

We believe that German institutional investors are always at the forefront of practical and good common-sense investments. Their conservative approach supports real asset investment growth. We would not say the same of French institutional investors, despite the fact that we are French.

**6. Do you see a move towards real asset investments by retail investors, either now or in the future? And how do you see such developments in Germany, especially in relation to other Euro-pean countries?**

Somehow, the debacle of the closed-end fund industry in Germany during the last financial crisis has been impeding real asset investments reaching retail investors. We do feel that as an element of diversification, yield generation, and capital preservation, real asset investments would be a perfect match for retail investors. In this respect, other European countries are more advanced (UK, France, Nordic countries, etc.).



**7. How do you perceive the international sales market for real asset products using a German asset manager? Do you believe international sales will be possible via the use of an EU passport, or will the asset manager require the acquisition of other licenses to sell its real asset products internationally?**

The EU passport for asset managers is a recent development, and national implementations still lag a little behind: we experience roadblocks from time to time, perhaps with the intent to protect local asset managers. We do think that within the next two years, this will become a much more versatile and effective market.

The “Made in Germany” brand does hold strong appeal, and the stellar track record of KGAL is an undeniable advantage. Also, as a competitive advantage, KGAL provides a full-service offering for a single fee. In real estate, for example, KGAL has leasing agents, architects, engineers, etc., and therefore offers a full in-house added value service.

We feel very confident about KGAL’s prospects for success on a global scale.

**8. How do you see the regulatory environment for real asset investments in Germany compared to other countries? Is it more advanced? Better regulated in all areas e.g. sales, investor protection? Or do you believe it is more strictly regulated?**

Here, there is no doubt: German professionalism works at its best, especially these days, with the regulators. We feel that in general the implementation of AIFMD and other regulations is done very well and very effectively in Germany. We personally support a stringent and extensive regulatory framework for the investment industry: in the end, as an asset manager, we are the fiduciary agent for investors (whether institutional or retail), and we must be fully accountable for their invested funds. The regulator is there to ensure best practices for asset managers and to protect the investors. This is totally normal. We know that some people in the investment industry complain about increased regulation, but frankly, this is overdue after the last financial crisis and the excesses committed. Our experience with the German regulatory authority has always been very fair, constructive, and actually we enjoy this very German approach of collaborative work at all levels.

**9. Lastly, how do you see growth perspectives for real asset investments in Germany and other countries evolving over the next five to ten years?**

We expect this industry (real assets) to triple in volume in the next five to ten years. And real assets serve basic human needs (for example housing, offices, transportation and energy). This is a long-term trend. Why not invest in what you use every day and what you will use for a long time?



# The art & science of Smart Beta

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Global Head of Smart Beta  
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**Alexander Mertz**  
CIO  
BlackRock Asset Management  
Deutschland AG

The rise of data and technology is transforming the investment industry, just as it is transforming our everyday lives. Look no farther than your own pocket for proof: 30 years ago, the 7.5 kg Apple Macintosh revolutionized the home computer industry with its mouse capability, a paint feature and the ability to connect to a printer.







Today, the computer that you carry in your pocket can give you the shortest route to a destination by crowdsourcing traffic data in real time, control your TV and give you a satellite image of anywhere on the planet, all while firing off as many e-mails as your fingers can type. The investment industry has experienced a similar transformation: 30 years ago, it took a sea of analysts and a room full of super computers to gather and analyze basic fundamental data like dividend yield or price-to-book. That information is now freely available from the very same 5-inch computer that woke you up this morning.

Our lives are changing, and so is the way we can build portfolios. The availability of computing power and the sheer breadth of data now available has shifted the balance of power in the investment world. Insights on valuation and sentiment were once only available to investment insiders, providing a meaningful informational advantage that could be exploited as alpha. But technology and regulatory reforms have levelled the playing field and shifted the balance of power. Today we can build portfolios in ways that simply were not possible in the past: the widespread availability of reliable data and the insights on how to apply it have redefined the notion of passive investing. We can now deliver a wider range of outcomes – not just cap-weighted index portfolios, but index-like portfolios that capture proven drivers of returns that

have historically out-performed cap weighted indices – otherwise known as Smart Beta.

Indeed, Smart Beta strategies seem to have taken the investment industry by storm in the last few years. Smart Beta AuM has grown at an annualized growth rate of 36% since the beginning of 2012 – about twice the rate of the broader exchange-traded product (ETP) industry. Smart Beta is an increasingly global phenomenon, with adoption increasing across all regions, particularly in Europe. Dividend-focused funds represent close to half of global Smart Beta assets, but growth is fastest in minimum volatility and multi-factor funds.

The growth in Smart Beta has led to a proliferation of different investment strategies – at the last count there are more than 700 Smart Beta ETPs in existence, and this number is growing! How do investors choose among the plethora of offerings? While data and technology have powered the Smart Beta revolution, there are many human choices that are required in strategy development and implementation to ensure the end result is actually a smart investment. So when evaluating Smart Beta strategies, here are three things that matter:

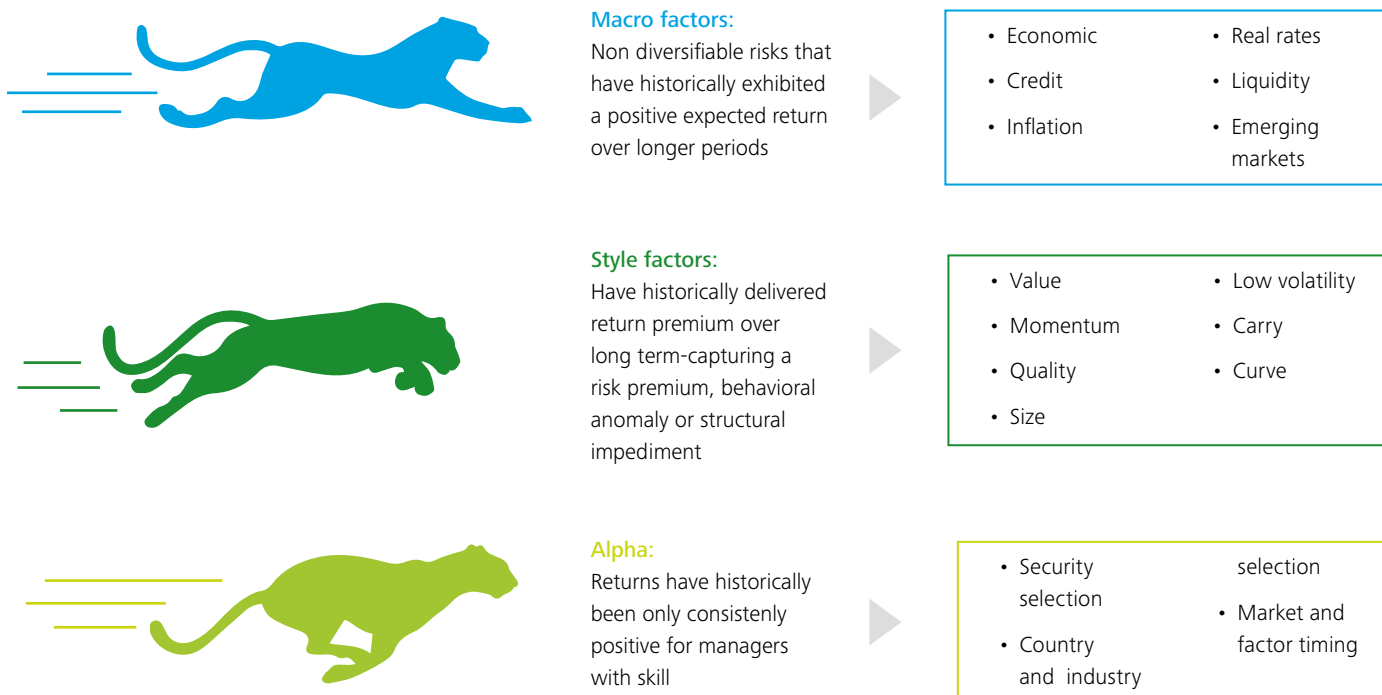
- factor exposures
- portfolio construction rules
- implementation

First and foremost, factor exposures matter. Factors are nothing more than broad, persistent drivers of returns – the true economic building blocks of all portfolios. You might compare factors in asset classes to the nutrients that are in food – both milk and steak contain fat and protein, just as economic risk is present in public equities, private equities, high yield bonds and most hedge funds. Healthy eaters look at the foods they consume to analyse the nutrients they contain, just as factors allow us to cut across asset classes and identify the true sources of risk and return in any portfolio. Of course, the nutrients – or factors – you want will differ depending on your goals – if you are training for a marathon, you can eat a lot more cake and chips than someone trying to lose weight on a low-carb diet.

Finding the right mix of assets is impossible without understanding the economics of these underlying factors. Armed with a better comprehension of these return drivers, we can build more robust, better diversified portfolios.

If factors are important, which factors matter? Figure 1 describes a set of factors that are based on strong economic rationale, backed by a wide body of academic and empirical evidence. Each of these factors has historically outperformed the market over long periods, and has been implemented by the best investment managers for decades. They are so pervasive that these patterns of outperformance are seen in domestic and overseas equities markets, as well as across fixed income, commodities, and other asset classes. They are so persistent that we have known about them for decades. And yet, they persist because they represent a reward for bearing risk. These investment styles also continue to generate enhanced returns compared with the market, because they result from an economic structural impediment or go against behavioral biases of the average investor.

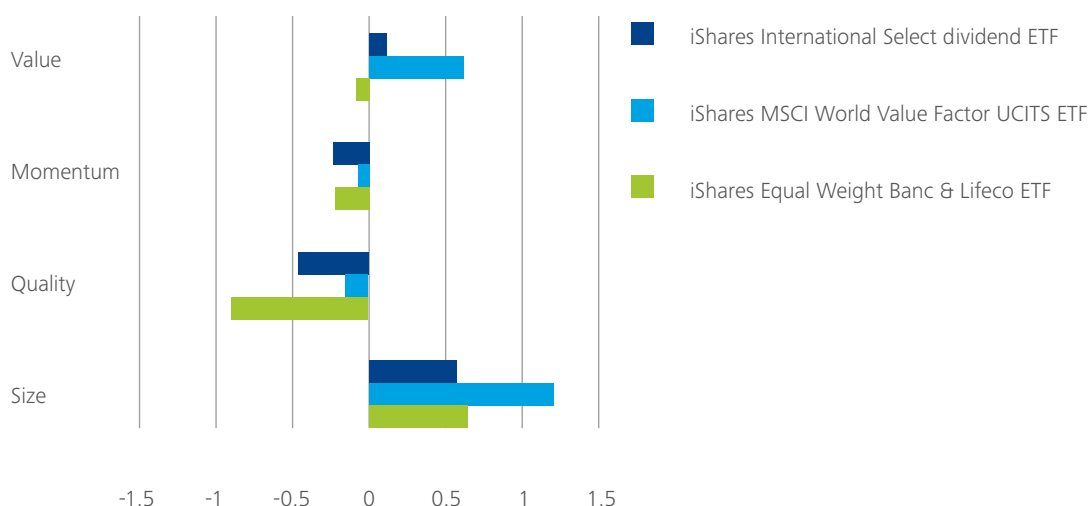
**Figure 1: Summary of macro and style factors**



For example, we can apply this lens to three very different sounding ETFs: a dividend fund, a value factor fund and an equal-weighted portfolio of Canadian banks. Figure 2 plots the Z scores for each of the ETFs to four style factors: Value, Momentum, Volatility, and Size (a score of zero would indicate style exposures similar to the broad global equity market). These three seemingly different ETFs turn out to have similar factor

exposures – they are all biased towards large cap stocks, less volatile names and less momentum oriented names. These style exposures will drive a large portion of excess returns. Understanding these exposures becomes even more important in multi-manager portfolios where it is critical to determine how the pieces add up: are your selected strategies diversifying in relation to one another, or simply compounding unintended risks?

**Figure 2: Z-score for style exposures**



Secondly, portfolio construction rules matter – because it is these choices in portfolio construction that give rise to the factor exposures that are ultimately delivered. Many strategies may sound similar, but subtle differences in portfolio construction choices may lead to large differences in performance. Of the many portfolio construction choices to consider, the rules governing security selection (screening) and weighting scheme have the largest impact on portfolio characteristics and performance.

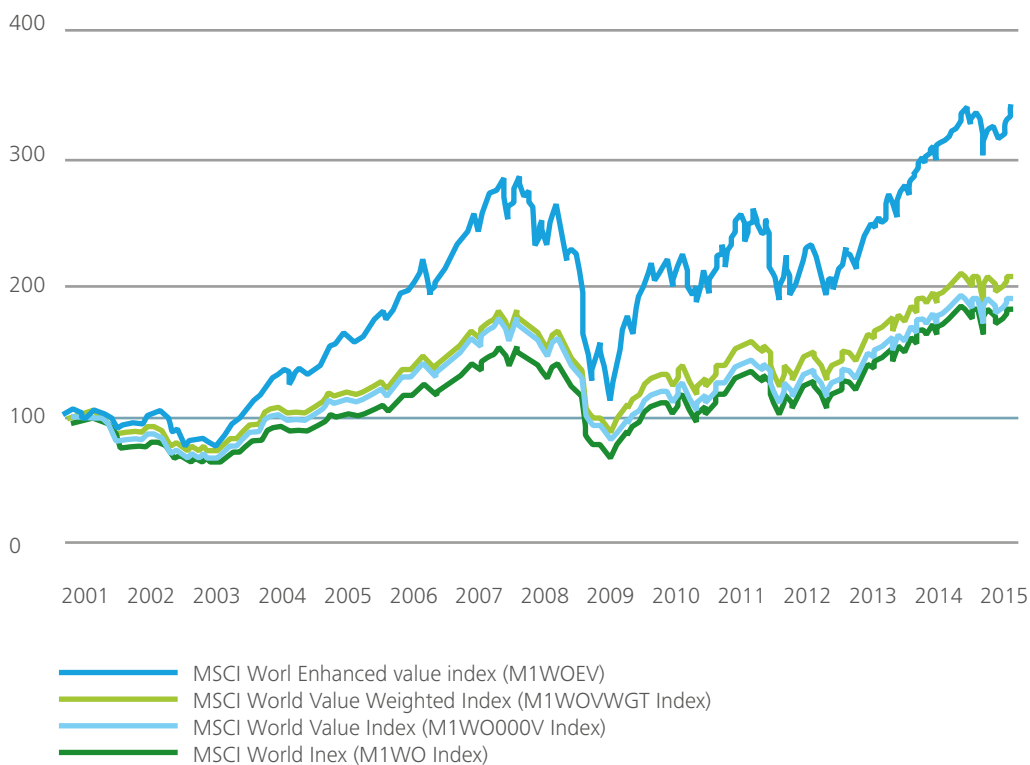
To illustrate this, Figure 3 plots the cumulative historical return for three value-oriented strategies: a traditional (cap-weighted) value index, a fundamentally weighted index and a value factor index. Each provides a tilt towards value-oriented securities – but with a very different total performance experiences:

- A traditional value index like MSCI World Value Index includes only a subset of the universe with the lowest valuation ratios, but remains cap weighted
- A fundamental index like MSCI Value Weighted includes all securities in the universe, reweighted in proportion to a value score to emphasize the most value-oriented names
- Finally, the MSCI Enhanced Value Index, a value factor fund, is both screened and reweighted, including only the names with the highest value scores, then reweighted in proportion to those scores

While all three strategies deliver an exposure to “value” in varying degrees, the rules governing stock selection and weighting criteria have a profound impact on the strength of the nature of the exposure that is delivered and therefore on the performance of the strategy.



**Figure 3: Cumulative performance comparison for value strategies**

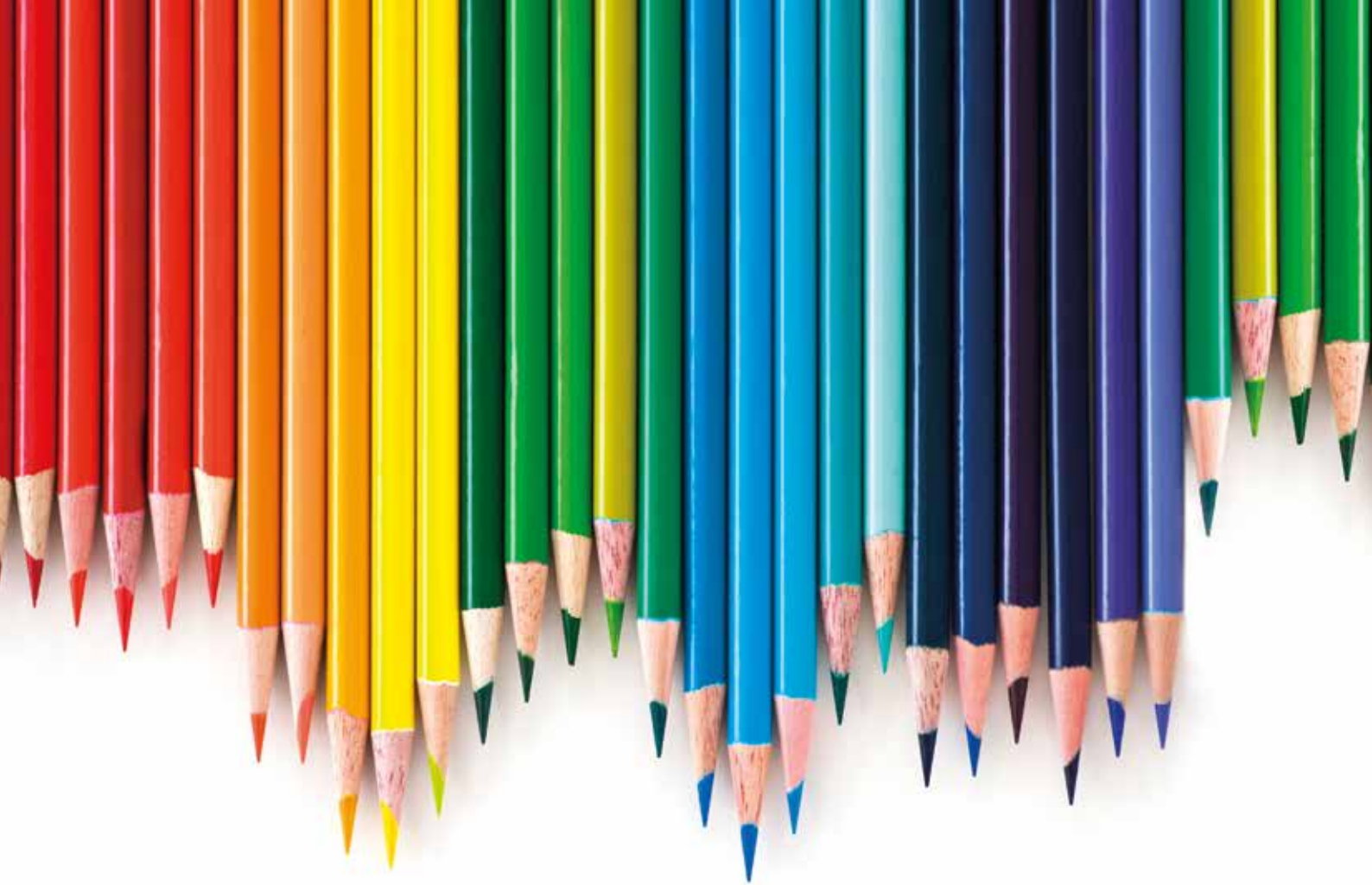


Lastly, implementation matters. The best-laid designs can be quickly eroded without skilled implementation. Smart Beta strategies tend to have a higher level of turnover and a less advantageous liquidity profile compared to standard cap-weighted strategies: most Smart Beta indices have annual turnover rates in the range of 20-60%, for example, compared to 3-5% for a standard cap-weighted index of large and mid-cap securities. Without skilled implementation, transaction costs and illiquidity can quickly erode the benefits that Smart Beta strategies aim to provide. The best managers utilize thoughtful evaluation of potential returns alongside risk and costs – a skill that requires an understanding of benchmark methodology and global capital markets. Of course, implementation matters for even the most straightforward and liquid index strategies. For example, comparing the annual returns for flagship S&P 500 Index funds across the four largest index managers

reveals differences of 12 bps in a single year<sup>1</sup>. The S&P 500 is arguably one of the most liquid and replicable indices on the planet, and the potential differences are only magnified for strategies that are more complex and challenging to trade. Choosing a skilled manager for Smart Beta implementation becomes a critical final component for success in the strategy.

At their best, Smart Beta strategies empower investors, providing efficient and affordable access to time-tested investment strategies. The rise of data and technology make data mining easier than ever, and has powered the surge in Smart Beta strategies. Before you pack your skis and head to the mountains for the winter, be sure you have vetted the underlying factor exposures, portfolio construction rules and implementation skills of any Smart Beta strategy you consider.

<sup>1</sup> Source: eVestment Alliance, June 2015



# Why the Eurocrisis is here to stay and what it means for investors

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## What the five presidents propose is nothing more than a long-term implementation of a transfer union

### **No recovery without exchange rate realignment**

Postponing the inevitable is not a solution. This simple truth seems to be having a hard time in the sphere of European economics and especially politics. Constant calls for transfers of power to Brussels and a fiscal union, most recently voiced in the “Five Presidents” report by Jean-Claude Juncker, Donald Tusk, Mario Draghi, Jeroen Dijsselbloem, and Martin Schulz, are a misleading solution to the eurozone crisis. What the five presidents propose is nothing more than a long-term implementation of a transfer union. From an economic perspective it is quite obvious that fiscal transfers can do very little to solve the underlying problem of a lack of competitiveness. Nor can the proposed national and European Competitiveness Authorities solve this problem. The paper of the “Five Presidents” aims firstly at the implementation of a joint European deposit guarantee scheme, which would pool the risk of existing national schemes. Countries with already comprehensive depositor protection would see their liabilities increase, as risk is transferred from the periphery to the core of the eurozone.

The approach advocated by the Troika and the Eurogroup, namely internal devaluation, is also a self-defeating option if the need for devaluation is significantly high. According to a study by the Ifo-institute, a well-known German economic think tank, by spring 2015 Greece had managed to internally devalue about 8 of a necessary 21 percent it would need to restore competitiveness.<sup>1</sup>

The first and foremost problem of the eurozone is the reluctance to recognize what is at its heart: the misalignment of exchange rates within the eurozone. Until this central problem is resolved, the eurozone will struggle to emulate the recoveries seen in the United States and the United Kingdom. The consequences will be slower growth and higher unemployment, lost business opportunities, and below potential returns for investors.

<sup>1</sup> See CES IFO Forum “The Greek Tragedy”, June 2015.

### Making business in times of crisis

Would Southern Europe be the place you look for exciting investment opportunities? To be fair, there could be some bargains because of a strong privatization agenda, but the most important ingredient of a good investment, namely a healthy growth perspective for the economy, is missing. The European Commission estimates growth in Italy and Greece to be between 0 and 1 percent for this year. However, the Commission has gained notoriety for its overly optimistic forecasts in recent years.

From the perspective of the management of a hypothetical Southern European company, the situation and outlook are depressing. Low growth rates in the region, stagnation or even severe recession in recent years suggest internal demand has been crushed by deflationary policy. At the same time, external demand has also been undermined due to a still overvalued currency. Spain, often highlighted as the model pupil, has a 7.5 percent share of the EU28 economy, but only 5 percent of the group's external trade.<sup>2</sup> Its consumer base has been harshly diminished. The chief beneficiary of the eurozone seems to be Germany, for which the undervalued currency is working like a subsidy. It represents 21 percent of the EU28 GDP and 28 percent of external trade.

It is challenging for firms in the periphery of the eurozone to get credit because their local banks are suffering from non-performing loans due to high unemployment levels and capital flight. According to information by the European Central Bank (ECB), the capitalization of Southern European banks remains dire. More than 20 percent of core bank capital consists of deferred tax credits in Italy and Portugal; in Spain the amount is 18 percent, while in Greece it reaches 46 percent.<sup>3</sup>

The last financial statement could drive firms to cut labor costs significantly, but this will be met with strong resistance from employees. Additionally, policymakers appear to have conflicting aims: the need to come to a balanced budget in times of crisis; governments are forced by the so-called institutions—the former Troika—to increase tax levies on businesses, while at the same time talking about improving the business environment.

The recent problems of companies are the concerns of future investors. The dysfunctional European Monetary Union creates a very fragile and crisis-prone environment with high political uncertainty, demonstrated by the frequent government crises in Greece and Italy. Many companies in which you consider investing would have difficulty realizing projected revenue streams in such a weak growth environment. In every economy there are winners and losers, but the abnormally high level of losers in Southern Europe stems from the aforementioned reasons. The rapid acceleration of deindustrialization in Greece, Italy, Spain and France is a consequence of the loss of international competitiveness. According to Confindustria, since 2007 Italy has lost about 15 percent of its industrial capacity.<sup>4</sup>

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The success of Northern Europe's export industries is underpinned by a strongly undervalued currency and not by an increase in productivity

<sup>2</sup> Data from Eurostat, own calculations.

<sup>3</sup> This data was obtained by the authors in a Parliamentary Question to Daniele Nouy, President of the Supervisory Council at the European Central Bank.

<sup>4</sup> See <http://www.spiegel.de/international/europe/economic-crisis-in-italy-continues-to-worsen-a-912716.html>

### Quantitative easing cannot cure the eurozone crisis

The European Central Bank was called to the rescue. After having exploited the scenario of cutting interest rates, the ECB turned to quantitative easing. This has not helped the real economy as banks have been reluctant to lend to businesses, but has greatly inflated asset prices and depressed interest rates to historical lows. Conservative investors are now having a difficult time because traditional low-risk bonds deliver hardly any attractive return.

Investors with a bigger appetite for risk could be happy about inflated asset prices because the ECB will improve their returns this year and maybe next year. But short-term happiness can come with a bitter long-term price. Identifying the right moment to realize profits is difficult, as by definition not everyone can beat the market. Maybe last time you did, but can you be sure that you will beat it again? A look at The Economist's house price index reveals strong value growth of property in Germany and the United Kingdom, among others. A more dynamic market is thus not necessarily a bad thing. However, one should be aware that the recent indicator spike is caused by a few big cities. Excessive house price developments in some regions are a prime example of asset bubbles in the making, especially if the underlying economic fundamentals have not changed. Cheap money policy after the dotcom crisis delighted investors in the run-up to the Great Recession, but was undoubtedly itself one of the main causes of the meltdown, as it led to excessive risk-taking by investors.

Additionally, it remains highly disputed among economists whether quantitative easing has any effect on the real economy. Whereas data from the United States and the United Kingdom suggest there is, unconventional monetary policy has not helped Japan to overcome its long-term crisis. As John Maynard Keynes correctly observed, you can lead a horse to water, but you can't make it drink. From the perspective of creating a healthy economic recovery in the eurozone, quantitative easing is disappointing, as it cannot resolve the issue at the heart of the eurozone crisis, namely the misalignment of the exchange rates within the monetary union.



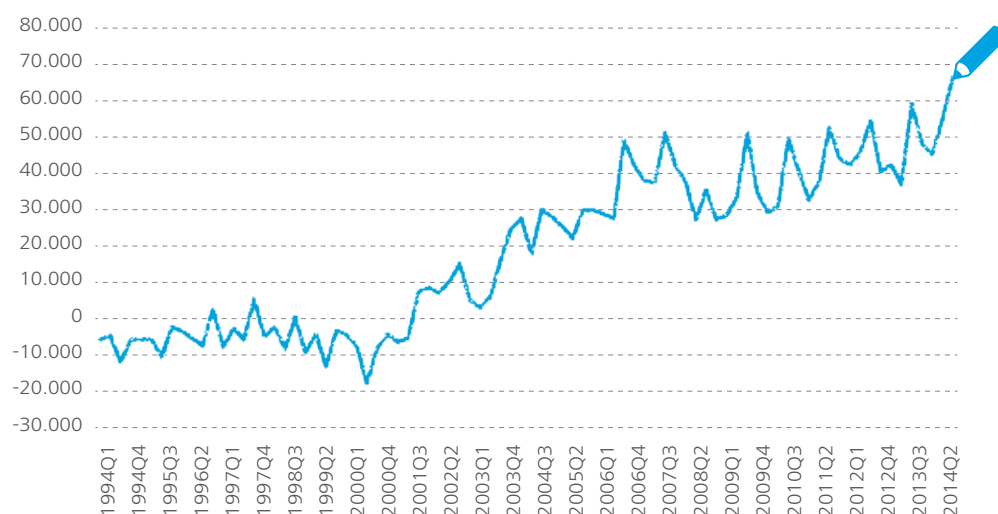
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The first and foremost problem of the eurozone is the reluctance to recognize what is at its heart: the misalignment of exchange rates within the eurozone

### Conclusion

Economic recovery prospects in the eurozone remain bleak. The success of Northern Europe's export industries is underpinned by a strongly undervalued currency and not by an increase in productivity.

Figure 1: The Swelling of the German current account



At the same time, Southern Europe's industrial sectors are suffering from an overvalued currency. The approach to restore international competitiveness by internal devaluation means undermining demand, which makes the life of companies in non-export-oriented industries extremely challenging. In Italy alone the number of bankruptcies has more than doubled from 6,000 in 2007 to more than 14,000 in 2014. The wave of bankruptcies and disappointing revenue streams across Europe is understandably deterring investors from engaging in the region.

The costs of not addressing the real cause of the eurozone crisis are rising every day for businesses and investors. Any manager knows if a company is struggling and its business model is not working, you need to make tough decisions to come to reverse your fortunes and save the company. Without a realignment of exchange rates within Europe, as an essential component for a real recovery, there is virtually no chance that European businesses will be able to realize their full potential. Faith in the ECB's QE is misplaced. Additionally, the by-product

of ECB's unconventional monetary policy was weakening the euro vis-à-vis the U.S. dollar. As a result, the dollar appreciated and this hit the earnings of U.S. companies. The beggar-thy-neighbor-policy is no solution to the eurozone's woes, but rather increases the number of those negatively affected by the eurozone crisis. Because of the crisis, not only have investment opportunities in Europe been significantly reduced for U.S.-based investors, but they also suffer from the damage done to the U.S. firms by the euro-rescue policy.

A reform-oriented agenda following the realignment of exchange rates must be part of the U-turn in order to secure a return to a sustainable economic health of European economies. And the investment community will once again be pleased with the scale of business opportunities flourishing across the continent.



**To the point:**

- A misalignment of exchange rates is at the heart of eurozone stagnation
- Businesses will struggle to thrive under the economic conditions in Southern Europe
- The ECB's loose monetary policy will not help firms, but will risk asset bubbles
- The longer this misalignment prevails, the higher the potential costs for businesses and investors will be
- U.S. companies are also suffering because of the euro's devaluation and lost business opportunities



An aerial night view of a city with illuminated buildings and streets. A flying car is visible in the upper left corner. The text 'BACK (office) TO THE FUTURE' is overlaid on the image.

# BACK (office) TO THE FUTURE

## The four digital trends altering the status quo for custodians

Philippe Denis  
Chief Digital Officer  
BNP Paribas Securities Services

In the 1985 film *Back to the Future*, Michael J. Fox is whisked into a Hollywood vision of 2015, featuring technological marvels like hover boards and flying cars. The marvels of the real 2015 are smartphones, connectivity and technological disruption—advances that have not just disrupted business processes but even converted brands into common verbs. “Let’s Google it” or “I’m Ubering over” show just how deeply technology is now embedded in everyday life. For custodians, four distinct types of digital transformation are converging in 2015 to cause significant changes to business practice as we know it.





### Changing client conversations

If you are of the generation before mobile phones, you probably have trouble remembering how two people ever managed to meet in a public place without the ability to call their counterpart to say, “I’m here—where are you—I see you.” The way that we communicate with our clients has evolved in much the same way. The jump from fax and Excel-based back office processing to email and web-based portals significantly increased the speed of our operations. In addition to face-to-face and phone interactions with clients, we have multiplied the types of communications we send by providing thought leadership online and easy access to the latest market insight and research, as well as by disseminating that information through regular web-based newsletters. Now, the key conduit for communication with our clients is the digital world. Our publications, whitepapers and industry commentaries are broadcast via LinkedIn and Twitter. Our website offers a number of resources for our clients to access at any time and also links to our client-based interactive portal.

In addition, by streamlining data output to clients, a new kind of expertise has naturally developed on both the side of the custodian and that of the client: data interpretation and optimal visual packaging. Added emphasis on data visualization has not only changed the kind of daily conversations our operations teams are having with clients, but we have noticed a striking increase in demand for expertise to convert this data to present it in visually compelling ways.

### The evolution of client applications

A defining moment in the evolution of back office connectivity was marked by the introduction of mobile phone technology. Prior to this, clients of custodians would receive stacks of spreadsheets for teams of operations employees to interpret and report on. The onset of web-based applications fundamentally changed the way clients were able to view data: as the custodian was able to present data in increasingly visual ways, the client could more quickly interpret and act on that data. Interactive solutions have always been delivered interactively on the web, and even earlier via RTC (telephone network with modem). The evolution began with the creation of dedicated applications and continued towards the integration of these applications on web-based portals, enabling clients to navigate through them.

BNP Paribas Securities Services has seen first-hand how beneficial the development of interactive applications can be for clients. For example, data navigation tools have completely changed the way clients receive and interpret data for their own clients. Since this data is commonly presented via apps for mobile devices, they are able to communicate the information in a more transparent and dynamic way.

### The evolution of product and process

The core of a custodian's business is processing, and this function is also going through a digital transformation. A lot has been achieved in this space, including workflow management of the operations themselves. Custodians continue to support industry-wide initiatives to improve trade processing times and have invested considerably to support the implementation of T2S and other industry developments.

Aside from the improvement of operational processing capabilities, we are also looking to optimize our time-to-market for new products and services. BNP Paribas Securities Services is the first financial services provider to apply Product Lifecycle Management to such processes. This approach, which has been successfully applied within other industries like fashion and aerospace, is ensuring progress for our product teams by streamlining digital processes across global operational, IT, legal and compliance departments. By creating a single method for product teams to follow around the world, the common language and consistent project documentation give full visibility of all our product-related updates and initiatives to teams. PLM will enable us to ensure that investment is aligned with pre-defined strategies, to secure multi-disciplinary collaboration for developments and to identify opportunities and threats with greater ease.

### Digital transformation technologies

While custodians have long been tinkering with technologies from various parts of the techno sphere, they have been quite guarded about how they will adapt these technologies to their businesses. Two of the key transformational trends for custodians today are:

#### 1. Shifting data usage

Custodians have long been responsible for guarding the data of their clients, so the concept of "big data" is hardly revolutionary. The novelty lies rather in the shift in how clients are using data for analysis and development of products and services. The sheer amount of data being produced is higher than ever before and the insights offered by this

data are invaluable. Custodians need to continue to provide more sophisticated tools and applications in order to enable clients to use their data. Data analytics tools, as previously mentioned, are a good example of how data analytics via interactive tools are enabling our clients to explore their data in the way they want—with strong drill-down capabilities.

#### 2. The blockchain

The term "blockchain" is used to describe the technology of decentralized ledgers with two components: a transaction and a record (or "block"). The sequential records of these transactions are publicly available for anyone to view on the internet, and the sequence of records is known as the "blockchain". A new block is added to the blockchain approximately every ten minutes documenting the last ten minutes' transactions, and each transaction is irreversible. In a traditional world, the register is centralized. On the internet, every participant has a copy of the ledger; everyone can see the balance of all accounts through their public key, but no one can tamper with the results.

Today, anyone can create their own blockchain-based network. Dozens of them now exist and some have value while others are completely worthless. They are used to record current cryptocurrency ownership (e.g., in the case of Bitcoin) as well as at all points in the past. The real innovation of blockchain and cryptocurrencies is the unique ledger and methodology used. The network is designed as a decentralized peer-to-peer network to ensure resilience against any shutdown attempt, very much like the internet.

Custodians have been working with this technology since 2011 to analyze the market opportunities and technical possibilities for the industry. The most ambitious players believe that file storage, the execution of code and even business administration will use this infrastructure. Custodians that embrace it will be very well placed in the future.





## Conclusion

A huge amount of investment is pouring into financial technology (fintech) start-up firms, estimated by Accenture to have reached US\$12.21 billion globally in 2014, up from US\$4.05 billion in 2013. The astonishing jump in investment levels can be attributed in part to technological maturity, and in part to investor appetite. The level of excitement surrounding technology initiatives today in finance should also be tempered by reality.

It is the combined power of all these digital trends together at the same time that will have the most impact for custodians and their clients. So in another ten years, we may well be Ubering over to see clients on hover boards or in flying cars, but you can be sure that smart phone and digital transformation will be fully integrated with them.

## Cyber security remains a priority

Cyber security has always been a top priority for custodians. The challenge now is to be even more secure in an open world where more and more applications and platforms will interact.

An increasingly popular cyber-attack route is through a firm's own cybersecurity providers—the path hackers used to attack three South Korean banks in 2013. A common third-party attack route uses certification protocols, the two-factor identification system for customers and staff in which handheld devices such as security fobs generate a temporary numerical code in response to a user pin. Cryptographically generated, these have a short lifetime, but they can be cloned or reprogrammed.

The financial services industry has adopted extremely sophisticated countermeasures to evaluate the level of security of their infrastructure and mitigate the risks: in 2013, all major UK banks took part in an extensive exercise to test their ability to survive a sustained online attack on payment and market systems. It is clear that data security is one of the most pressing issues for financial services companies.

Cybersecurity can no longer be left to the IT department alone. It is time for the executive board to work closer with IT and engage more on the issue. As the threat to individual financial services entities becomes inextricably linked to a systemic threat to market stability, firms will also come under more pressure from national governments to put their houses in order—or face the consequences.



# Regulating the asset management industry proportionally will help create growth and jobs

**Dr. Wolf Klinz**

Former Member of the European Parliament (MEP) and Chairman of the Parliament's Special Committee on the Financial, Economic and Social Crisis



Seven years after the financial crisis of 2007-08, the economic situation in Europe is still unsatisfactory: stagnation, high unemployment, deteriorating infrastructure and insufficient investment in R&D and education. Last but not least, inflation has hit rock bottom, with recent quarters even showing signs of deflation. These economic conditions have seen the European Central Bank (ECB) launch an unprecedented quantitative easing program worth €1,44 billion, which may even be expanded to twice this amount in the near future should conditions not improve.

Under these circumstances, it is no surprise that the European Commission (EC) and national economic and finance ministers have started to think hard about how economic growth could be reignited within Europe. On a macroeconomic level, Europe is in tremendous need of investment, in particular in the fields of energy infrastructure, transportation, and R&D in digitalization. This growth is essential for EU member states, not just to make their economies more competitive, but to stabilize their own worsening financial situations. In reality, however, most of these actions simply fall short of what is needed to rectify the situation.

One of the main reasons for this problem is a mixture of inability and unwillingness on the part of banks and insurance companies to lend to the real economy. To a large extent, this is the result of the many new regulatory requirements European lawmakers introduced following the financial crisis in order to stabilize the financial system and better protect investors. Banks are now required to hold much more capital than before and have thus embarked on a massive deleveraging process that has seen their balance sheets be substantially reduced in order to improve their capital ratios and satisfy the new regulatory requirements. At the same time, (life) insurance companies are also being compelled to retain a much higher percentage of capital against any long-term investment (e.g. such as investment in infrastructure projects).

The substantial amount of newly introduced legislation may have created unintended consequences. It is therefore not surprising that the European Commission

recently launched a “call for evidence” to evaluate the overall impact of the “Barnier era” (the former European commissioner for internal markets and services). However, this is clearly not meant as an initiative to deregulate the financial sector, as not too many concrete changes to the existing level 1 legislation are expected. Rather, it is the intention of the European Commission to focus on the more technical, so-called level 2 measures. Amidst all these challenges, it is encouraging to see that the new Commission under Lord Hill has identified the asset management industry as a key player for change.

The first spark for this massive undertaking is to be provided by the so-called “Juncker plan”, which foresees investments of around €315 billion, the first tranche of €21 billion being bankrolled by the EU budget and the European Investment Bank, the rest being bankrolled by the private sector. In a low-interest environment such as the current one, private and institutional investors share the same interest in ensuring a reasonable yield on their investments; thus, they could find it very attractive to participate in long-term projects promoted by the EC, but only if the conditions are right.

By this we mean:

First and foremost, the EU needs a single European code of regulation. The fragmentation of the European market is bigger today than before the crisis. Member States have become used to gold-plating (i.e. adding their own national requirements on top of EU legislation); therefore, from a pan-European perspective, regulatory details have introduced another layer of costly and burdensome bureaucracy.



Secondly, the principle of proportionality has not been respected as promised, and especially tedious and overlapping reporting requirements to supervisors have become an immense operational burden on many industry participants. In addition, many legislative files have been introduced as directives, not as regulations, leaving a lot of room for national specificities that are inconsistent with each other.

One issue, in particular, that the asset management industry is constantly being faced with is that it is confused with the banking sector and not perceived for what it is: an agency business. As such, its business model is different from other financial services firms and its business proposition is to help clients reach their investment objectives. The responsibility of these agents is fiduciary by nature. As agents for their clients, they must place their clients' interests ahead of their own. In contrast to banks and insurance companies, an asset manager's clients are the asset owners. As such, the risk stays with the clients, not the asset managers. The performance of the asset portfolio is attributed to the client; thus, he or she takes the profit or loss.

This clearly demonstrates that the current trend towards regulating all financial services companies in the same way is questionable. Asset management is a business *sui generis* and should be addressed as such. What is important is that asset managers can work in a true single European market without national barriers. Only then will the huge differences that still exist within the investment fund sectors of the various Member States gradually disappear. Currently, funds face a number of impediments when attempting to do business across borders: the UCITS passport does not work as well as intended, registration fees differ, some countries require local paying agents, and prospectuses for shares, bonds and funds are still far from a maximum level of harmonization.

There are, of course, also new business developments to take note of: so far, asset managers have not provided credit to individuals or corporations. They do not tend to work with borrowed money either. Hence, there is no risk of an asset-liability mismatch on an asset manager's balance sheet. However, many market segments where asset managers have been active show an alarmingly low level of liquidity. There have been instances of funds lending to businesses in Ireland and Germany. Some national supervisors have introduced regulatory standards to deal with this situation. It seems obvious that an asset management company will have to respect the same regulatory demands as other financial services companies, if it offers the same service. It will be very interesting to monitor these future developments closely.

When taking a closer look at the important regulatory initiatives, four directives will have to be recalibrated in particular:

- Shareholder Rights Directive II (SRD II)
- Banking Structural Reform (BSR)
- MiFID II
- Capital Requirements Directive IV (CRD IV)

The objective of SRD II is to strengthen the commitment of shareholders and create incentives for institutional investors and asset managers to invest long term. Today, shareholders still do not have the possibility to vote easily across borders. SRD II attempts to alleviate this situation. However, fund companies may be forced to publish their investment strategy. This would make the acquisition of institutional clients much more difficult, since they want the asset manager to design and follow a client-specific strategy that is not widely known. Putting resources and know-how to work would no longer give the asset manager "the first mover advantage". The best-in-class principle would be worthless—a major disadvantage for the asset management company, particularly in view of the very thin operational margins.

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## On a macroeconomic level, Europe is in tremendous need of investment, in particular in the fields of energy infrastructure, transportation, and R&D in digitalization

One aspect of the banking structural reform currently being discussed is to decouple it completely, splitting the deposit taking and investment activities of the largest European banks. One suggestion that is being proposed by the Commission is to also prohibit the institutions from involvement with any type of alternative investment funds (AIFs). However, the AIF category comprises many different funds and the one-size-fits-all approach is not useful. Hedge funds can be risky, particularly if they are heavily leveraged. In contrast, special funds (Spezialfonds in Germany) try to avoid or at least diversify risks, are not leveraged, and try to ensure a certain level of liquidity. Therefore, instead of banning all trading activities in AIFs, a more differentiated approach based on leverage should be followed. MiFID II is at risk of increasing the patchwork situation in the EU. The inducement regime under MiFID II will generate very different approaches across Europe. The planned ban of using dealing commissions to pay for research activities will turn out to be a major disadvantage. This ban does not exist outside the EU. For example, IOSCO does not intend to introduce such a ban either.

The EU risks introducing unilateral changes that are neither in the interest of the asset management industry nor the investors.

Finally, the remuneration laws, as laid down in CRD IV, should be based on the principle of mitigating risk. It at least looks as if the supervisory authorities EBA and ESMA are showing willingness to consider this aspect when detailing the implementing measures.

If an asset management company is part of a bank or insurance company, their remuneration rules should not apply without proper identification of the risk takers when constructing the remuneration policy. Since the

asset management company has quite a different risk profile to the mother company, blanket rules should not be applied to the identified risk-taker positions, but nuances of country specifics and product specifics should be taken into account.

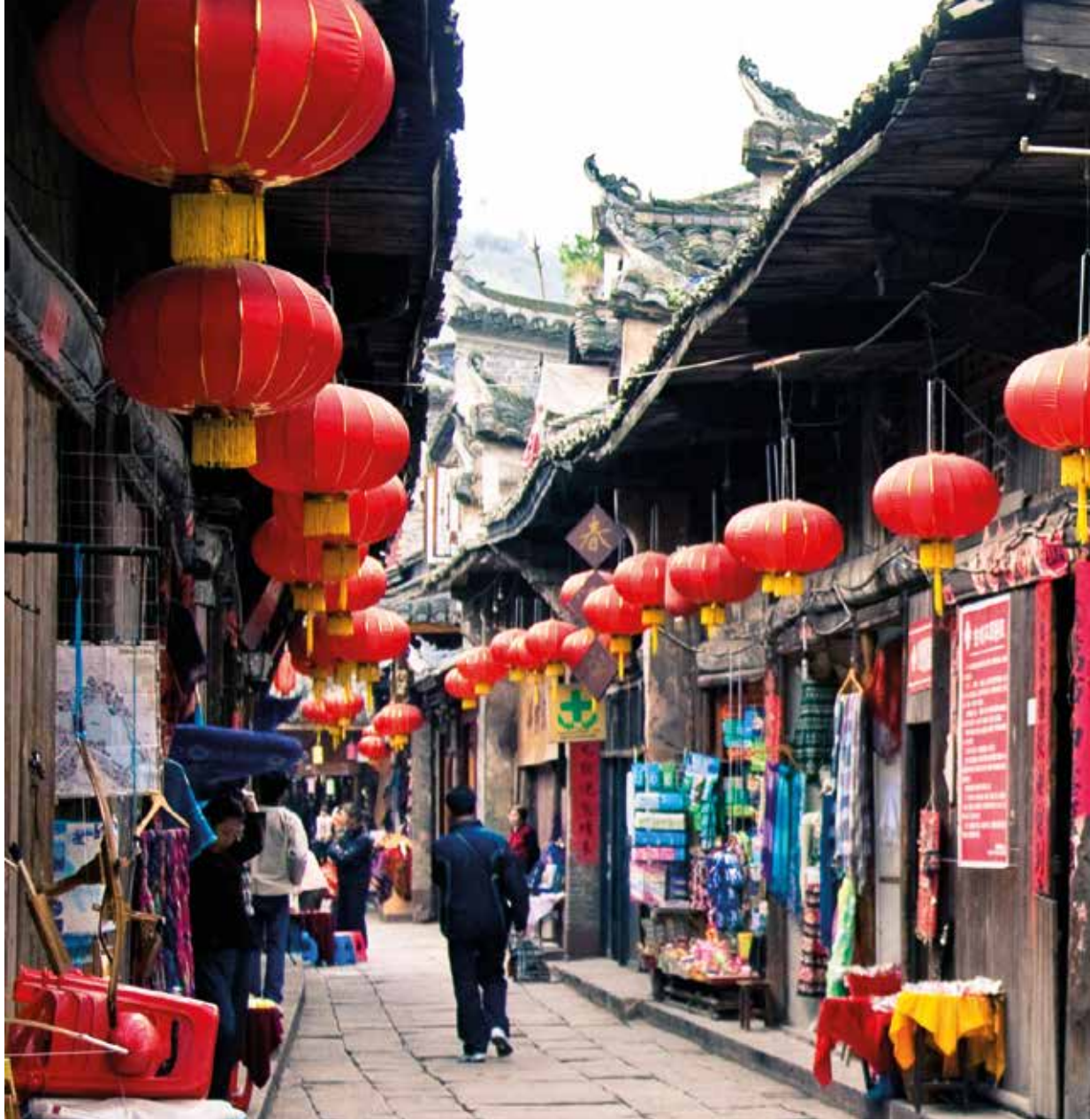
A group policy should serve as a code of conduct that creates a standard across the group for the various categories of risk taker or risky person (sales, asset managers, management board) identified, as well as those that come into contact with customers (customer service advisors, relationship managers, etc.).

### Conclusion:

The asset management industry is well-suited to fill the financing gap for important European projects. New vehicles like ELTIFs, designed and proposed by the European Commission, could turn out to be ideal in helping the asset management industry make a much-needed, important contribution to the European economy and at the same time offer its clients a financial yield which is satisfactory and much more stable than could be found elsewhere.

Hopefully, in this regard, the regulators will thoroughly consult the industry and design the products and respective regulations correctly, so as to make them work properly and achieve the best results; this does not seem to have always been the case with products and regulations in the past.





# German custodians on the New Silk Road Guiding investors into faster growing markets

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The German custody and depositary bank industry has seen transformational change, with the market massively consolidating and service providers focusing on regulatory change, improving cost efficiencies, and streamlining their organization. Service providers with a long-term strategy must now focus on innovation and become providers of knowledge and solutions. The key macroeconomic trend will be the increasing importance of Asia generally and China specifically: custodians have to set out for the New Silk Road.

The German custody and depository banking market is seeing transformational change. More than 70 percent of the market's €1.72 trillion in assets under custody<sup>1</sup> is now consolidated with the five largest providers: BNP Paribas, J.P. Morgan, State Street, BNY Mellon, and HSBC. A considerable number of local providers have exited the market over the past 24 months. This development towards consolidation is largely the result of three key factors:

#### **The regulatory paradigm change**

Not only have the laws changed, but the world in which the custody market operates has also seen a fundamental shift. The regulatory tsunami that the market has seen and continues to see is merely the result of a new financial world order, which has been triggered by the global financial crisis. Regulatory change comes at a massive cost, and this cost imposes a significant burden on service providers. EMIR, AIFMD, UCITS V, MiFID II, and FATCA, to name but a few, may serve as examples that affect essentially all providers. Where providers lack critical scale, the cost of regulatory change is forcing many to exit the business.

#### **Margin compression**

There is continued margin compression both in core custody and ancillary revenue, putting a significant strain on custodians.

Core custody revenue in itself has come under pressure as institutional investors and their asset managers are passing on their own margin pressure to their service providers. The expectation is frequently that market initiatives around infrastructure harmonization (such as Target-2-Securities) or moves to self-clearing and self-custody via proprietary agents should be reflected in improved rate cards.

Margin compression also extends to ancillary revenue. Years of an almost unprecedented low interest—and even negative interest—environment put an additional burden on market participants. FX revenue, traditionally a significant source of ancillary revenue for global custodians, has also been under pressure for years. Where providers lack sufficient revenue, they opt to leave the market.

#### **Rationalization**

A significant number of banks have pursued exercises to improve efficiency, increase profitability, and streamline their organization. This tends to come with a focus on core competencies and in some instances with a disposal of business activities which may, for one reason or another, be considered as non-core. Such considerations are likely to have led smaller providers to exit the custody business, particularly in cases where they lack scale, where they work on an outdated IT infrastructure and where they would have to approve substantial IT investment to merely retain their market position in the medium term.

These three factors have considerably changed the shape of the German custody market and continue to truly represent what one commentator has recently referred to as *"a crackling market environment"*<sup>2</sup>.

In such a challenging market environment largely dominated by regulatory and cost challenges, custodians that do play in the big leagues and have a long-term growth agenda need to be able to demonstrate that they have a relentless focus on future growth and innovation. They need to be able to differentiate themselves and determine which overarching trends are most fundamental to their clients and their business, and invest to provide comprehensive solutions.

Typically, industry discussions focus on the following key issues:

Firstly, there is the issue that could be summarized as the digital agenda. This discussion is about automation, connectivity and data provision. This type of innovation is largely related to systems and processes with the objective of achieving greater efficiency, helping clients and service providers to bring down costs. In essence, this is innovation to achieve optimization.

<sup>1</sup> *BVI Verwahrstellenstatistik (investment statistics of the German Federal Association for Investment and Asset Management), as per 30/06/2015*

<sup>2</sup> *Clemens Schuerhoff, "Ein knisterndes Spannungsfeld", dpn Dossier / Special Report "Custody / Administration", August/September 2015, p. 7*





Secondly, there is the issue of demographic change and an ageing society, largely discussed in-country although it applies to most of the Western world more generally. The assumption is typically that this inevitably leads to substantial growth in both the life insurance business as well as in fully-funded pension schemes, whether they are corporate, occupational or private. Innovation within this area of discussion aims at developing bespoke solutions for this particular industry, e.g., the servicing of new investment vehicles (in Germany for example the so-called Investment-KG), solutions for unit-linked life products, overlay management or master record-keeping solutions. This type of innovation is undoubtedly demand-oriented. The demand, however, stems from a delta in asset growth that is largely meant for future consumption. Hence, at least from a purely domestic perspective, this is innovation that helps to secure short and medium term strategic objectives but is unlikely to secure a long-term strategic position.

Thirdly, there is a significant discussion around innovation to support so-called new asset classes (depending on the perspective of the investor). There is indeed increased client demand for the launch of credit or loan funds, for volatility as an asset class, for investments in infrastructure (toll roads, airports, pipelines, etc.), real estate, and a variety of alternative investments (e.g., airplanes, ships, wine, forests, etc.). Largely, this growing demand is not the result of a voluntary change in risk appetite among investors. Rather, many investors, particularly insurance companies and pension funds—which in Germany

constitute the two largest groups of institutional investors—are forced to increase risk. This is because they must meet obligations which typically result from contracts that were concluded at a time when an environment of near-nil or negative interest rates over a prolonged period of time were inconceivable. Again, while innovation in the area of new asset classes is clearly demand-oriented, it is essentially innovation addressing risk-driven behavior.

There is one overarching phenomenon, which from its macroeconomic importance outshines the three other issues by far. That dominant macro development is the transformation of the global economy. HSBC research shows that by 2050, 19 of the world's 30 largest economies will be countries that we consider as emerging markets today<sup>3</sup>. The market is already observing a massive re-allocation of wealth and of investments—from West to East, and, to a lesser degree, from North to South.

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### Faster growing economies

Rather than merely constituting an additional, fourth discussion area, this transformational change of the global economy should be the key focus of all strategic discussions in the global custody arena: innovation that helps clients to invest in the world's faster growing economies is the only type of innovation that is purely based upon growth.

Figures from HSBC Germany may serve to illustrate that claim: while overall assets under custody have grown by 45 percent since 2011, emerging market assets held by clients have grown at a relative average of 78 percent (Asia Pacific 76 percent, Middle East 80 percent, Latin America 103 percent). It is the fastest growing business.

While Western markets require the highest possible degree of automation and a continuous improvement to STP rates, servicing investors in emerging markets first and foremost requires expertise, both in the target country as well as in the country where the investor is domiciled.

There are simple reasons why many of these economies require specialized expertise. Countries that are in the process of liberalization and market opening typically operate with stricter investor monitoring regimes. Commonly, individual investor licenses need to be obtained (and often require substantial documentation), frequently there are a variety of restrictions on foreign exchange, specific rules on account segregation, transaction reporting, pre-funding, shareholder limits, requirements on officially notarized translations, and highly complex tax rules, to name but a few.

There is of course no simple explanation for what generates economic growth in emerging markets and individual success stories tend to all have their own characteristics. However, improving productivity, better education, and strengthening of the rule of law are key factors that contribute to economic growth in the world's faster growing economies, apart from a demographic dividend that many emerging markets are enjoying.

India, the Philippines, and Malaysia will be among the world's fastest growing economies. However, the single most important market is China—and China is a market which requires highly complex and innovative custody solutions.

### Why China?

China is by far the largest emerging economy. By 2050, China is likely to have overtaken the United States as the world's largest economy<sup>4</sup>. The role of the renminbi both as a trade and investment settlement currency is continuously increasing and is likely to expand until it matches China's economic power. China's resources and commitment to grow, and specifically to invest in large-scale infrastructure projects, are significant. Of the many major investments, the "One Belt – One Road" project is the most important one. This project, commonly referred to as the New Silk Road, will connect 29 percent of the world's GDP and is based on an estimated ongoing infrastructure investment of more than RMB1 trillion (approximately US\$160 billion)<sup>5</sup>.

<sup>4</sup> *ibid.*, p. 4. HSBC estimate based on UN, World Bank and proprietary HSBC estimates.

<sup>5</sup> HSBC Global Research, Qu Hongbin, "Will China Hold Up?", *The Hong Kong and Shanghai Banking Corporation Ltd.*, Q4 2015



China A Shares are increasingly likely to be included in some of the industry's leading emerging market indices. The China Interbank Bond Market has a total outstanding amount of RMB37.93 trillion<sup>6</sup> (approximately US\$6 trillion) and continues to grow at double-digit rates. Moreover, the Chinese government has demonstrated that it is liberalizing its capital markets carefully, rigorously, and step by step, following Deng Xiaping's motto of "crossing the river by feeling the stones".

Traditionally, it used to be difficult for investors from outside of China to access its emerging capital market. Many market participants still have a perception that China involves a significant amount of bureaucracy and investments are potentially difficult to repatriate.

However, with the July 2014 extension of the Renminbi Qualified Foreign Institutional Investor (RQFII) program to asset managers from Germany, the situation has changed significantly.

Up until recently, German asset managers only had the QFII scheme (QFII as opposed to RQFII) available to invest in China, which required them to hold a minimum of 50 percent of their investments in equities. With German institutional money largely managed via so-called Spezialfonds, and these funds being formally represented by their management company (the KVG), the management company needs to apply for investor status and then have their underlying institutional clients inject money into the Spezialfonds. However, the 50 percent in equities criterion made investments in China somewhat unattractive for most of Germany's largest investors (particularly from the insurance industry), since their asset allocation is largely fixed income based.

With the 2014 introduction of RQFII to Germany, the 50 percent equities requirement was dropped. There are no longer any restrictions on asset allocation. Specific fixed income funds can now invest in the China Interbank Bond Market. Moreover, the former waiting period for additional quota applications and the six month injection period no longer apply under RQFII. Importantly, provided the fund is set up as an open-ended fund, daily liquidity is now permitted.

The RQFII scheme is open to institutional investors from a selected number of countries only. Currently, as the entire quota allocated to investors from Hong Kong is already utilized, Germany has more unallocated quota available than any other eligible jurisdiction, giving asset managers and institutional investors based in Germany an opportunity to seize the moment.

Where the German custody and depository bank and the Chinese custodian work closely together, they are able to provide highly innovative solutions to their clients. The New Silk Road—literally and figuratively symbolizing and representing new markets and new opportunities in Asia—is a unique opportunity. As with all new roads, those who explore them first will know the road best. And those who are able to travel them with an experienced local partner can do so at a lower risk.

#### Future outlook

To be a provider of choice for the future, expertise, guidance, and knowledge will become an ever more important business feature. In the future, in addition to providing a highly automated technical infrastructure, global custodians must become providers of knowledge or vanish—in a digitized and commoditized business such as the securities services industry, they will differentiate themselves by the level of specialized expertise that they can provide to their clients. In particular, they must be able to show that they have expertise in Asia and specifically in China, as this will be the region with the strongest growth globally.

To do that, custodians will need to have three features:

1. an extensive proprietary network of local agents that help them to globally and rapidly channel local market developments
2. the ability to lead and guide investors into emerging markets rather than merely react to their technical needs
3. innovative product solutions that help clients implement their investment plans in this changing global environment.

The vision is that in the future, the custody industry will no longer speak of emerging markets. It will only speak of faster growing markets.



# European depository regulation Striking the right balance?

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In response to the financial crisis, the G20 countries made strengthening the stability of the financial system a primary focus of their regulatory reform regime. Policymakers in both the US and the EU quickly realized that improving market conduct and strengthening investor confidence were also key to restoring public trust in the industry and in financial markets in general. As a result, the financial services industry has been confronted with—and has to adapt to—the persistent flow of regulatory change within their new “business as usual” environment.

As part of the effort to strengthen investor protection for investment fund investors in the EU, the AIFMD (Alternative Fund Managers Directive), which also covers previously unregulated fund structures, and the review of the UCITS Directive (UCITS V) were initiated. Both initiatives, amongst others, introduce increased requirements for depositaries, in particular, a strict liability regime for financial instruments held in custody by the depositary on behalf of the AIF/AIFM or UCITS. While the AIFMD has been fully implemented, the revised UCITS framework will become applicable on 18 March 2016, with the implementing measures currently being finalized.

In light of the discussions around the details of the depositary liability and the depositary obligations, in the context of the UCITS V implementing measures, two questions arise:

1. Will the implementing measures achieve the regulatory objective of investor protection?
2. Are the costs of implementing the measures proportionate to the achievable revenues in this sector?

#### **Harmonization to achieve investor protection**

With UCITS V becoming applicable on 18 March 2016, at the time of writing, the Level 2 implementing measures are being finalized by the European Commission (EC). These implementing measures will contain important details on the depositary’s duties and obligations set out in the Directive as well as more details regarding the liability regime and the elements that are required to be included in the depositary contract. When drafting the implementing measures, a fundamental decision the EC has to make is whether to use a directive or a regulation. In general, and as part of its efforts to achieve a higher degree of harmonization across the EU, the EC increasingly uses regulations (i.e., directly applicable EU law) instead of directives, which require implementation into national law.

Greater harmonization is a basis for a consistently applied investor protection scheme and also helps to avoid regulatory arbitrage between EU member states. The downside, however, is that regulations are more rigid and provide less flexibility to accommodate different national market standards and practices that have evolved in the various EU member states.



Such differences can be observed in the tasks performed by European depositaries in the various member states as well as with regards to specific functions, such as the Transfer Agency function.

#### **Different processes and functional responsibilities**

The responsibility of the Transfer Agency function in the asset management business is a good example to demonstrate the difference in responsibilities across EU member states. For example, in Germany there is no owner register for regulated securities investment funds to record beneficiary information. The fund shares (issuance) are reflected in a global note, which is deposited with the German CSD (Clearstream Banking Frankfurt). Normally, the depositary receives the orders (buy or sell orders) from investors via their respective custodian bank and provides for the mark up/down of the global note, accordingly. The administration of fund shares is, therefore, an activity performed by depositaries in Germany. By contrast, in Ireland or Luxembourg the fund or its manager appoints a Transfer Agent to maintain a register of fund shares.

In Germany, the issuance practice and the mechanics described above (via securitization) ensures that fund shares are fungible and eligible for safekeeping. This is not the case in other member states. The difference in approach causes significant challenges when implementing the AIFMD or UCITS V. It is unclear if fund shares issued under either of these models need to be treated equally or if the depositary's liability for the loss of assets should be determined by the particular kind of registration. A clear understanding about the different processes in all member states is therefore a pre-condition to ultimately achieving effective and fair harmonization.

#### **National gold-plating is counterproductive to achieving objectives**

Going beyond these functional differences, another challenge for harmonization is the inconsistent approach of national regulators to implementing directives into national law. For full harmonization to be achieved, it is necessary not only to harmonize certain functional differences at a European level, but also to encourage consistent national implementation of European legal acts. While such differences in implementation to some extent accommodate for certain national specificities, there is a risk that the landscape will become more fragmented overall, making it more difficult to have harmonized processes and procedures across the EU.





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## For full harmonization to be achieved, it is necessary not only to harmonize certain functional differences at a European level, but also to encourage consistent national implementation of European legal acts

The absence of such harmonization also makes the introduction of a depositary passport unachievable. The latter would represent the completion of the single market for depositaries, as it would introduce the possibility for depositaries to offer their depositary services on a cross-border basis in the EU. Currently, a fund's depositary must be located in the country where the fund is established.

### **Change of liability in the interest of investor protection**

With the AIFMD, the liability for a loss of financial instruments held in custody has fully shifted towards depositaries. This shift has now been replicated in UCITS V. However, this new regime should not be viewed as eliminating the responsibilities of all parties in the investment process. Strict depositary liability only applies to financial instruments that can be held in custody following trading decisions of funds and their managers. It is therefore important for funds to ensure that appropriate due diligence and responsibilities are considered at the beginning of the process. However, it is unlikely that these considerations will change the already fixed perspective of regulators on the depositary.

More important to consider is the impact that the significant change in depositary responsibilities and the related implementation costs and risks will have. How will depositaries address the challenges resulting from the stricter liability regime and the increased administrative burden following the extended duties and obligations, including with regards to the markets they offer and their fees? This question is surely becoming more critical, as the economics of this business are being reviewed by organizations where the depositary business is not core to their operations in light of the increased liability and a general consideration within banks as to the most efficient allocation and use of their capital.

At this stage, it is too early to draw a conclusion as to whether the right balance has been struck. Much will depend on the details of the final level 2 measures and even more on how the individual EU member states will implement the European rules and the extent to which they create additional requirements.

All market participants surely have an interest in ensuring the right balance is struck between regulatory objectives and the ability for service providers to deliver cost-effective services; room for improvement is warranted, especially at the current early stages of implementation. The overall importance of the final outcome should not, however, be underestimated, as it will be a contributor to the future success of the UCITS brand, both within and outside the EU.

# Impacts of Solvency II on the investment policy of insurers

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With the final translation, in September 2015, of the second set of implementing technical standards and guidelines from EIOPA into all European languages, as well as the new draft of the amended delegated acts published at the end of September 2015, the Solvency II project is beginning to take shape.

From 1 January 2016, the new supervisory regime for insurers comes into effect. It delivers an impact far beyond the originally planned scope of its application, especially where investment management companies (KVGs in Germany) provide investment services to insurers, who will also be affected by the impact of Solvency II.

For the affected KVGs, Solvency II firstly results in a necessity to identify the own capital requirements of the insurer at the individual investment level. At the portfolio level, diversification effects must also be generated as far as possible, optimizing the investment allocation. Over and above this, the regulatory reporting requirements for the insurers in the context of the supervisory reporting process must be taken into

account. However, the main focus of this article clearly lies in the discussion: "How far will Solvency II influence the investment policy of insurers that strive for optimal investment allocation and thus influence the products that will be offered by the KVG?"

The starting point for the analysis lies in a few essential considerations for the investment policy of insurance companies. These will be especially determined in the area of personal insurance, through the requirements and the performance profile of the insurance products themselves. Above all the actuarial interest rate assumptions (guaranteed interest rate) have to be achieved. Over and above this, it should be possible to achieve a surplus participation for the insured person, as well as adequate interest on equity capital for the company.





In the context of the investment policy of the insurer, an optimization takes place by means of risk calculations on rates of return, taking account of the minimum rate of return that must be achieved, and targets which can only be missed within a predefined probability range. With Solvency II comes the transition from direct investment regulations with qualitative and quantitative requirements regarding the allowed investment classes of investments, to a preferably risk based calculation of the insurer's own solvency capital requirements as an additional limiting factor.

The solvency capital requirements can be found in the optimization calculation. e.g., in the form of cost of capital for the required solvency capital requirement, or as an input to the risk adjusted amount of "expected rate of return/solvency capital required" in the calculation. The additional condition that must also be taken into account is that the solvency capital requirements which must always be available may not exceed the as-is equity capital. This is made more difficult by the fact that the allowable as-is equity capital is derived from the solvency balance sheet and thus because of present value fluctuations is subject to a certain pro-cyclical volatility.

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## For KVGs in this environment, the task remains above all to be innovative in the development of the individual instruments and to develop products that require less equity capital, but which are nevertheless in the position to be able to generate a significant contribution towards the predefined target rate of return

Besides the limiting factor of the solvency capital requirements, the qualitative regulations for all of the investment classes remain as an additional restriction and must also be taken into account in the form of the so called prudent person principles. Simply put, an insurer can only hold investments that can be properly handled by its own risk management team. This means—as the supervisory authority (BaFin) officially communicated during the Solvency II regulatory preparation phase—that an insurance company must develop its own performance and risk management ratios for monitoring its own investments (this is very similar to the CRA-Ordinance on rating agencies, which states that the insurer may not only simply rely on the rating from the rating agency but must perform their own rating). Here BaFin states that the insurer may not only simply rely on the knowledge of its asset manager, but must prove that it has considered all relevant material for managing the risk of the investments and manages this on an ongoing basis.

Alongside is the discussion about the effects of Solvency II on the investment policy of the insurance company and to differentiate between, on the one hand, the level of the individual investments and the corresponding Solvency capital requirements and, on the other, the portfolio level and the ongoing accompanying diversification effects. One consideration on the level of the individual investments that makes sense is derived from the look through approach, by which the individual investment classes are assigned to the respective sub-risk module. This also applies to investment funds.

At the level of the individual instrument, not only is a longer-term return expected from the respective investments for achieving the predefined minimum rate of return for the insurance companies, but also the rate of return as defined in the Solvency II solvency capital requirements is of vital importance. However, not only are the respective sub-risk modules resulting from the solvency capital requirements to be respected, but the circumstances of the risk sub-modules—such as interest rate risk, concentration risk or currency risk—must also be taken into account.

Bonds form the basis of the core investments for insurers. Above all and as far as possible, they should have a similar duration, to enable the reproduction of the actuarial obligations and to match the resulting promised rate of return requirements in the current low interest environment. In addition, the achievable rate of return across all asset classes is moderate, irrespective of the credit worthiness or rating of the issuer, and is associated with a corresponding large setback potential most notably connected with long-term instruments. By application of the standard formula stipulated for corporate bonds in the spread risk sub-module, the Solvency capital requirements in principle are dependent upon the rating and time to maturity of the security. Reduced capital requirements have been established for covered bonds and most recently also for infrastructure loans.

As a concept of organizing intrinsic value incentives for state financing, bonds of EU Member States are in principle to be considered as having a zero solvency capital requirements in the context of spread risk. However, it should be noted that bonds in the context of the interest rate risk module will still be subject to the interest rates' upward and downward stress, via which the duration gap on both the active and passive sides (the asset liability mismatch) is increasingly reflected in the solvency capital requirements.

For equity investments, empirical data for Germany over the last 50 years suggest that an expected rate of return of 7 to 8 percent per annum is justified. For the purposes of Solvency II it is necessary to distinguish between shares that are registered in OECD or EEA Member States and those registered in emerging markets. The first group are subject to the principle of an own funds stress factor of 39 percent and the second group are subject to 49 percent. In addition, those assets under 49 percent stress are more likely to be classed as alternative investments, because of the higher expected rate of return and because they carry a risk of total loss. Such assets are especially suitable for grouping under the subgroup of alternative investments similar to private equity, hedge funds or commodity commitments (see the table on next page: "Overview of Stress Factors Standard Model").

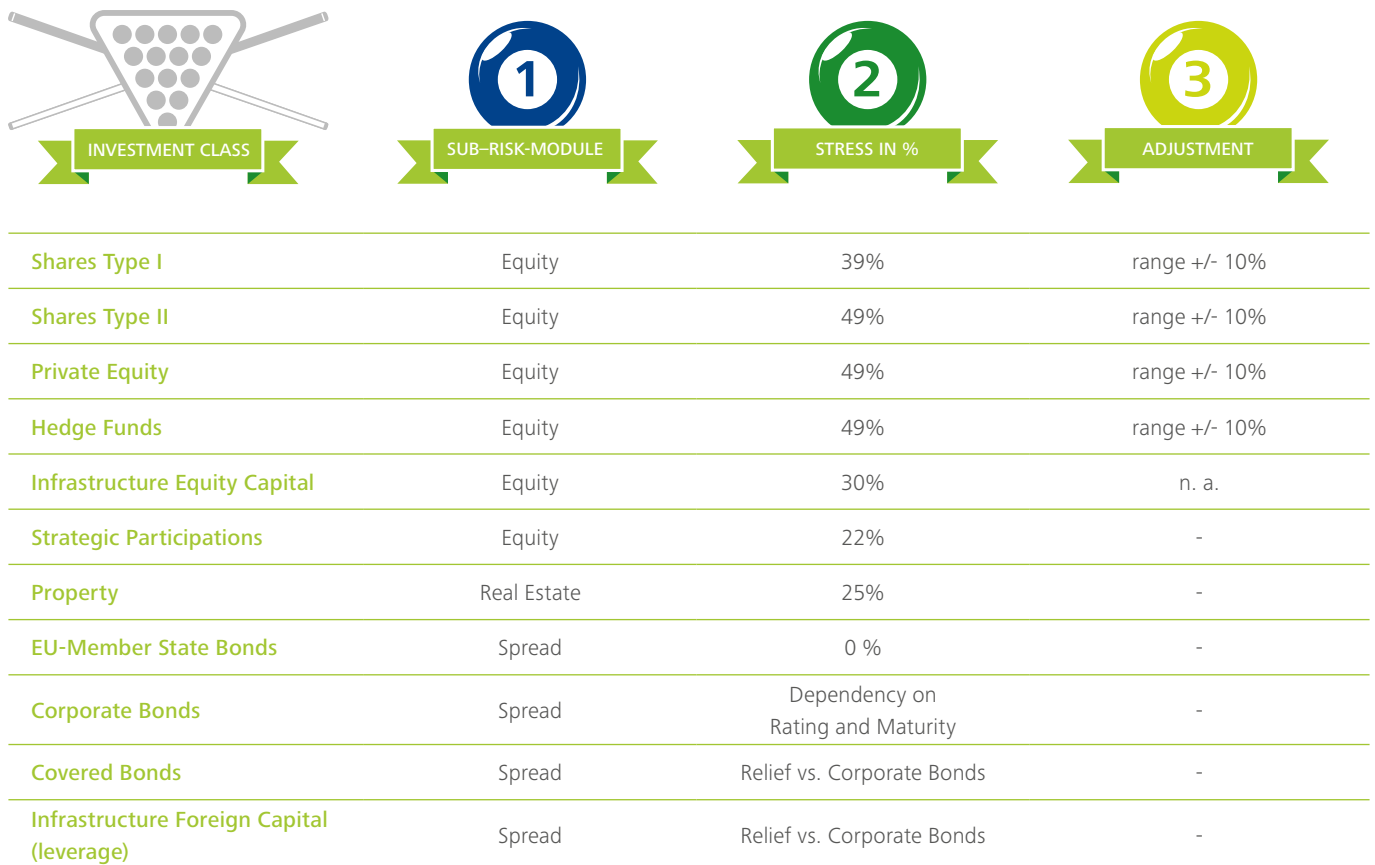
To avoid pro-cyclical effects, both stress factors use a symmetrical adjustment mechanism that can, depending on the position in the market cycle, lead to an increase or reduction of the basic stress factor by up to 10 percent. This gave the result that, as of 31 December 2013, an additional increase in the stress factors occurred, amounting to 7.5 percent to 46.5 percent up to 56.5 percent. For share engagements, the transitional rules are still to be observed. Recently, this has applied to both types of shares. It can then be assumed from a 22 percent stress factor with a linear increase within the seven-year transitional period until the final stress factor applies accordingly that these transitional measures can be used in the form of a right to choose.

Furthermore, it is worth pointing out that infrastructure investments with their own special equity capital characteristics should from now on be subject to a 30 percent stress factor. A special case exists for strategic participations, which are expected to see a major reduction in market value volatility over the next 12 months and which, because of the strategic characteristics of such investments, justifies the application of a 22 percent stress factor. Nevertheless, it should be noted that the necessary requirements to satisfy the characteristics for justifying a strategic investment are relatively restricted in their development. For insurance companies, property provides hope of long-term value increases as part of the mixed deposit investments, because of the low volatility compared with other own funds investments. Property investments are still subject to a 25 percent stress factor despite huge criticism, and the fact that the stress factor is calibrated based on the development of prices in the commercial property market in London. It must also be noted that the uptake of credit from outside the insurance group to finance property requires the same stress factor as for the second group of equity engagements. This means that leverage financing can definitively lead to an even higher stress factor on the unstressed investment than the 49 percent figure.










Figure 1: Overview of Stress Factors Standard Model



At the portfolio level, the optimization of investment allocation and above all the diversification effects must be taken into account. This can be done using standard formulas in the supervisory authority standardized correlation matrices (see illustration below), both within the risk module for market price risks as well as at the level of the risk modules. Although it must be noted that apart from concentration risk and currency risk, above all between equities and property on the one hand and interest instruments on the other, compensation effects regarding the solvency capital requirements can occur. In such cases, it depends primarily on the extent of the supervisory regulation standardized diversification effects as to whether the downward interest rate or increasing interest shock of the adverse scenarios is represented. In the first case, the correlation factor of 0.50 will be used and in the second, independence would be assumed.

The solvency capital requirements can be found in the optimization calculation. e.g., in the form of cost of capital for the required solvency capital requirement, or as an input to the risk adjusted amount of “expected rate of return/solvency capital required” in the calculation

Figure 2: Correlation Matrix Market Risk Module

CorrMkt	Interest Rate	Shares	Property	Spread	Exchange Rate	Concentration
 Interest Rate	1					
 Shares	A*	1				
 Property	A*	0.75	1			
 Spread	A*	0.75	0.5	1		
 Exchange rate	0.25	0.25	0.25	0.25	1	
 Concentration	0	0	0	0	0	1

A\* the correlation amounts to 0 as far as the interest rate rise scenario in the interest rate risk module represents the adverse scenario, otherwise 0.5

In summary, it can be stated that with the standardized supervisory regulation and Solvency capital requirements that a unique feature of the risk dimension is to be found in the input to the optimization calculation for the investment allocation of the insurer. Against the backdrop of the current investment environment, this hinders the already difficult task of generating the predefined minimum rate of return prescribed by the insurance companies in that alternative high interest bearing forms of investment are afflicted with the equivalent high solvency capital requirements. This means the capitalization of the insurer will finally determine how far the targets for its required rate of return goals can be achieved.

For KVGs in this environment, the task remains above all to be innovative in the development of the individual instruments and to develop products that require less solvency capital, but which are nevertheless in the position to be able to generate a significant contribution towards the predefined target rate of return.

At the portfolio level, it is the optimization of the investment capital allocation that makes the best use of the potential diversification effects. This could correspond to the perception of clients acting on the assumption of a widely diversified bond portfolio, but in fact realized in short maturity investments with a mix of property and equity instruments and by entering into alternative investment engagements, especially in infrastructure investments but also private equity and hedge funds, etc.

To the point:

- The impact of Solvency II goes far beyond the scope of insurers and reinsurers. Investment companies, for example, will also be affected
- With Solvency II, direct investment regulation is replaced by risk-based calculation of the solvency capital requirement as an additional limiting factor
- Solvency capital requirements find their way into portfolio optimization e.g., in form of cost of capital or as an expected return adjusted for required solvency capital and as a limiting constraint
- Solvency capital requirements (e.g., stress factors) have to be identified at the level of each individual investment or asset group
- Diversification effects determined by standardized correlation matrices should be taken into account when performing portfolio optimization
- The capitalization of the insurer will determine to what extent the required rate of return specified by the insurer would be reached
- For investment companies, the final goal is to develop products needing less solvency capital, and at the portfolio level, to generate an investment allocation making maximum use of diversification effects



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“How far will Solvency II influence the investment policy of insurers that strive for optimal investment allocation and thus influence the products that will be offered by the KVG?”







# A common language is not enough

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Sharing a mother tongue is very helpful when it comes to distribution—after all, we feel most comfortable when discussing business in our own language. This creates a sense of belonging in a market where competition is truly international and industry leaders in many segments from “abroad” (in particular the UK and the US) enter the market.

From our experience, language seems to be a key driver when establishing sales teams, in particular in the German-speaking region that covers Germany, Austria, Switzerland, and Liechtenstein. Unfortunately, a shared language does not mean shared laws and regulations. That is particularly relevant when it comes to Switzerland, so far continuing to resist the temptation of joining the European Union (EU) or the European Economic Area (EEA), at least for the near future. From a business perspective, the temptation would certainly be great in many regards. Asset management serves as a particularly striking example. With the introduction of the UCITS and AIFM directives, a single

market with mostly harmonized, but at least similar standards has been established, which facilitates cross-border distribution activities. Germany and Austria as EU member states, and Liechtenstein as an EEA member state, are able to benefit in many ways from the potential that the aforementioned directives offer.

We would like to give you a practitioner’s overview of product registration in German-speaking countries—an important element when it comes to cross-border distribution. Despite one common language, there are four different regulatory set-ups to be considered. For these purposes, we have made the distinction between public distribution (covering essentially the UCITS world) and non-public distribution (covering the rest, in particular the AIFM directive). This has proven to be a helpful approach for navigating the different sets of rules applicable in German-speaking countries. We have tried to group countries to which a homogenous set of rules applies.



## Public Distribution



### Austria ↔ Germany ↔ Liechtenstein

The benefits of the UCITS directive are available to Austria, Germany and Liechtenstein. This means that all authorized UCITS domiciled in these countries are eligible for the regulator-to-regulator notification procedure between these countries under UCITS IV. However, it is highly relevant from a practical perspective that not all aspects regarding the cross-border distribution are harmonized and member states have a certain degree of freedom to maintain a limited set of national rules. These specific characteristics are certainly manageable, but may prove time-consuming and hence frustrating if time to market is a relevant factor (as it often is). In table 1, we have compiled a non-exhaustive list of differences in the application of UCITS notifications for the markets under discussion. The requirement to appoint local agents—e.g., an information or paying agent—is relevant when determining a timeline for the market entry as the selection and negotiation processes take time and have to be taken into consideration.



### Germany ↔ Switzerland

As a third country, Switzerland closely monitors the development of EU laws and regulations. Compliance of Swiss law with European counterparts is a necessary requirement for the entitlement of Swiss asset managers to manage European collective investment schemes. However, there has always been hope in Switzerland that transposing EU law into Swiss laws and regulations might even do a little bit more than just that, namely granting Switzerland broader access to the European market. Consequently, Switzerland has introduced a fund type equivalent to the European UCITS. The Swiss security fund (Effektenfonds) adheres to essentially the same rules as UCITS—and in some aspects even stricter rules apply.

For the first time, following EU law seems to pay off for Switzerland and its European counterpart in terms of enlarged market access. On 1 January 2014, an agreement between BaFin and FINMA entered into force, introducing a notification procedure for UCITS that intend to market their units in Switzerland and vice versa. The notification procedure is the same as for UCITS and the same rules apply when it comes to the appointment of agents (e.g., paying agents), required documentation, and specific language, just as they would apply between EU member states. This regulator-to-regulator notification procedure is highly beneficial for the asset management industry in both Germany and Switzerland, as it ensures:

1. Minimum delays for entering a market with new or existing products
2. A truly plannable market entry

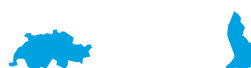
These points are relevant for roadshows and imperative for strengthening the relationship with key clients (i.e., seed investors). Delays in a complicated approval process—which relies on many involved stakeholders and is therefore subject to many potential sources of error—bear the potential to challenge clients' trust in their asset managers and in turn the trust of asset managers in their service providers. Delays in defined timelines for a product launch in a given country for reasons that are beyond one's control are not easy to communicate to clients and they may regard such delays with suspicion.

With the introduction of the notification procedure between Germany and Switzerland, there is a compelling case for asset managers targeting retail investors in all German-speaking markets from a pure distribution perspective: launching a UCITS under German law and reaching out to all German-speaking countries by using the simplified notification procedure.



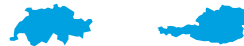
#### **Austria/Liechtenstein → Switzerland**

The aforementioned simplifications of the notification procedure are currently limited to German UCITS. Austrian and Liechtenstein UCITS need to follow the standard procedure of obtaining FINMA approval before starting public distribution activities in Switzerland. In most cases, approval may be obtained in reasonable time, i.e., within one month, provided that all required documents are filed in the required manner (please see table 1 for certain requirements to consider). In exceptional cases, the approval process may take longer—namely if the organizational set-up of a UCITS indicates that an investment advisor does in effect act as investment manager of the UCITS, thus circumventing licensing requirements.



#### **Switzerland → Liechtenstein**

As the procedure and requirements for registering Swiss collective investment schemes in Liechtenstein is quite similar to the way this functions the opposite way round, we will refrain from elaborating on this further.



#### **Switzerland → Austria**

Switzerland is regarded as a third country as Swiss collective investment schemes are neither eligible for the UCITS notification procedure nor is an agreement in place, as is the case with Germany. Consequently, there is no standardized procedure for registering a Swiss collective investment scheme for public distribution in Austria.





## Non-public Distribution



### Austria ↔ Germany ↔ Liechtenstein

With the introduction of the AIFMD and the associated EU passport, there are no more standalone requirements on a product level when an AIFM intends to cross borders and distribute to a restricted, qualifying target audience. The notification of the AIFM regarding the provision of cross-border services includes all relevant AIFs that it intends to distribute. While the notification procedure is not yet strictly harmonized, it should not pose significant challenges for asset managers based in EU member states (as opposed to the reporting requirements under AIFMD).

However, Liechtenstein as an EEA member state is a special case. The AIFMD has not yet been incorporated by all EEA member states; thus Liechtenstein is currently treated as a third country and national, non-harmonized regimes apply for inbound and outbound AIFs. As it is expected that this situation will change in the coming months (i.e., the application of the AIFMD extending to all EEA member states), we refer to the following deliberations concerning the relationship with Switzerland in this respect:



### Austria/Germany/Liechtenstein → Switzerland

There are two possibilities to consider for asset managers from Austria, Germany, or Liechtenstein when intending to target a restricted Swiss clientele that excludes retail investors. This path has to be followed for all products that do not qualify as UCITS, as otherwise the equivalence of the applicable rules to Swiss laws and regulations would need to be demonstrated to FINMA. In most cases this is very difficult as applicable rules are often simply not equivalent. Consequently, the options for an EEA asset manager are:

1. Remaining entirely out of scope of Swiss legislation by directing activities exclusively to (i) regulated financial intermediaries i.e., banks, securities traders, fund management companies, and asset managers of CIS or (ii) regulated insurance institutions (Art. 3(1) and 10(3)(a) and (b) CISA). Other exemptions available always necessitate that the initiative for the distribution activities is with the investor (i.e., reverse solicitation one way or another);
2. Exclusively targeting qualified investors according to Swiss law. These include the aforementioned entities and certain additional target investors (e.g., corporations or pension funds, each with professional treasury). In these cases, there is no need to obtain FINMA approval for the relevant investment schemes. A Swiss representative and paying agent need to be appointed and a limited set of additional rules observed.



### Switzerland → Austria/Germany

As long as the applicability of the AIFMD passport to third countries is not clarified—ESMA has issued an advice on this matter and suggested that the EU Commission postpone further deliberations on those issues until March 2016—the private placement regime as outlined by the Austrian FMA must be followed. The Austrian private placement regime explicitly refers to UCITS or comparable collective investment schemes. The main criteria of the Austrian regime are (i) the number (up to 149), (ii) nature (need for protection) and anonymity (from the perspective of the asset manager) of targeted individuals. However, these criteria need to be assessed on a case-by-case basis.





**Switzerland → Germany**

Swiss asset managers can register investment funds for distribution to professional or semi-professional investors in Germany in the event that the notification procedure described above does not apply. The approval process is quite extensive (even more so if targeting semi-professional investors) and essentially covers the demonstration of equivalence of local laws and regulations with EU rules (i.e., AIFMD). Following receipt of a complete file, BaFin will make a decision within

two months in the case of distribution to professional investors or four months in the case of distribution to semi-professional investors.



**Switzerland → Liechtenstein**

The formal rules and procedural steps are identical to those already laid down above for public distribution.

**Table 1: Overview of important requirements in relation to public distribution**

	AUSTRIA	GERMANY	LIECHTENSTEIN	SWITZERLAND
<b>Paying agent</b>		Required only if units of UCITS are/were issued as printed individual certificates		
<b>Information agent</b>				
<b>Umbrella</b>	Statement listing notified compartments	Prominent statement listing <b>non-notified</b> compartments in relevant sales documentation	No special requirements	Every reference to non-notified/ non-approved compartments is to be removed from sales documentation
<b>Other major specific features</b>		Information for investors in Germany needs to be explicitly <ol style="list-style-type: none"> <li>page-numbered and</li> <li>listed in the table of contents</li> </ol>		Mandatory wording of information for investors in Switzerland  Publication of total expense ratio  Mention of representative, paying agent and location where relevant documents may be obtained in every publication
<b>Specific tax requirements</b>	Tax reporting  Appointment of tax representative	Tax reporting		Tax reporting



Yes



No





# A view on the future landscape of European Regulatory Reporting

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A view on the future landscape of European regulatory reporting requires an understanding of the current state of financial services regulations. As a next step, one should ask oneself how the markets will react to the new regulatory constraints and what the future goals of regulators might be. A market infrastructure provider with global reach will not only need to adapt to changing circumstances, but should also endeavor to support the progress towards more stable and well-functioning markets. In this, both challenges and opportunities will abound. Regulation forms one of the three central pillars of tomorrow's markets, together with technological advances and new global markets.

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## Market infrastructure operators must be ready to fulfil the strong regulatory reporting role assigned to them by European governments, parliaments and regulators

MIFID II, MiFIR, REMIT, CSDR, SFTR, MAD/R—the volume of new regulation due in the near future will have a large impact on the infrastructure, resources and budgets of market infrastructure providers and their subsidiaries. The ubiquity of acronyms adds complexity and difficulty to seeing the synergies between regulations and any potential savings. From the regulators' perspective, the task at hand, namely that of policing all financial markets to fulfil the G20 mandate of preventing the world from sliding into a new financial crisis, appears even more herculean.

Current regulation can be viewed from various perspectives, encompassing compliance with the rules and the design of new markets, challenges and opportunities. A market infrastructure provider needs to look at market regulation from all angles and adjust to new regulation itself, carrying the burden of changing systems, interfaces and workflows like every other participant in the market. Some regulations are squarely directed at exchanges. In particular, the role of high-frequency and algorithmic trading has come under the spotlight of regulators. The fear is that “flash crashes”, which have been observed several times and whose origins are not well understood, might foreshadow the emergence of systemic problems. Although preventing such problems on the trading platforms is quite challenging, the motives behind current regulatory drive are highly respected.

Regulatory efforts have focused on two interrelated topics for quite some time now, namely the opaque OTC business and the credit risk lying dormant under the veil of derivatives. For more than twenty years, OTC markets have been a breeding ground of new products and innovation in the financial markets. On the other hand, LIBOR-fixing and other scandals have amply demonstrated that left to their own devices, the markets are not able to keep risks from spinning out of control or create a level playing field for all participants. It was mostly investment banks that profited from this in the beginning, but many of these were then swallowed up by the financial crisis that their own actions had helped to instigate.

For now and the foreseeable future, it is time to clean up and restore the confidence of citizens and states in the workings of the financial markets. Authorities want to know, through regulatory reporting, which risks reside in the financial system. They expect publication mechanisms to provide investors with real-time information on market transactions across all execution venues, covering all asset classes. For this purpose, regulators have invented new entities, such as the “Trade Repository” (TR), “Authorized Reporting Mechanism” (ARM) and “Approved Publication Mechanism” (APM). Lastly, (at least) one “Consolidated Tape Provider” (CTP) is to be created, whose purpose is to provide the markets with one tape of all transactions, whatever the execution channel.

Market infrastructure operators must focus on the strong regulatory reporting role assigned to them by European governments, parliaments and regulators.



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## Three trends driving financial market changes are intertwined: continuing digitalization and automation, globalization, and all-encompassing regulation

Taking a long view, one might be tempted to interpret the current regulatory focus on the financial markets as a flash in the pan. However, we believe that there will be no turning back, as the focus on regulating the financial markets will not recede for many years to come.

First of all, regulation is going to shape the new markets. It is expected that in time, most old-style (OTC) derivative trading will be transformed or even vanish. Standard derivatives must be settled via a Central Counterparty (CCP) based on the clearing obligation declared by the regulator ESMA. If liquidity is sufficient, these must not be traded OTC anymore, due to ESMA's declaration of a "Trading Obligation". Instead, trading will take place at a new type of venue, the Organized Trading Facility (OTF). Traditional roles are shifting in the bond markets as well, with the banks squeezed by capital requirements and the buy-side necessarily playing a larger role.

Furthermore, new regulations mean that investment firms dealing in securities or derivatives and holding sizable positions for their own account must register as "Systematic Internalizers" (SI). SIs are obliged to comply with comparable pre-trade and post-trade requirements as the trading venues. Established trading venues need to help new partners like emerging OTFs and SIs fulfil their regulatory reporting obligations.

Furthermore, new-style regulations aim to be forward-looking and risk-reducing. In order to mitigate credit risk, all-encompassing trade collateralization is the regulatory answer to the financial crisis of 2007-08. The next wave of regulation covers security financing transactions (SFTR) to make sure that collateralization works in practice. The European parliament is about to confirm the existing drafts of the MIFIR RTA and ITS by ESMA. Clearstream serves its customers via a Global Liquidity Hub to deal with the regulatory constraints on collateral management and optimization. Customers should expect market infrastructure operators to help them with the forthcoming regulatory reporting obligations for SFTR as well.

Of course, market observers have commented with glee that much of the derivative data collected as part of existing EMIR regulation are contradictory. There are several reasons for this, such as lack of standardization, gaps in rules or conflicting rules and so on, which will take years to resolve, but none of these will be a permanent road block. Interestingly, regulatory initiatives drive standardization, which is a rather important condition for the digitalization of trades; examples include the unique transaction identifier (UTI), legal entity identifier (LEI), and unique product identifier (UPI).





The financial markets and globalization are natural partners. Some friction has emerged, because (supra-) national sovereignty over regional rule-setting collides with the realities of global trading: one party in one block, the counterparty in another. However, US regulations (Dodd-Frank), European regulations (MiFID II, etc.), and emerging regulations in the other countries seem sufficiently aligned, so that no fragmentation along national borders should be feared. Some intermediate hiccups notwithstanding, there are and will be opportunities for regulatory arbitrage, but these will

disappear in time, like all real arbitrage opportunities. Technology is a game changer. Adding it to regulation has given rise to the breath-taking process of digitalization and automation which is still in its adolescent stages. Just a few years ago, it would have seemed impossible to master the sheer amount of data that millions of daily transactions create. But now in the era of Big Data, computers and data storages comfortably handle terabytes of data. Despite problems created by the current regulatory waves, real progress is to be made on the path to the oversight of markets by regulators and investors—even in real time. One can assume that for every trade in the market, there will be a shadow trade in the books of the regulators. Market infrastructure providers must strive to offer a complete service to their clients. Important information, such as liquidity in benchmark products of key markets, should be provided on trading platforms. Trading, clearing, settlement—offering every step of the value chain for financial security transactions as part of a single service has been maligned in the past. However, reliability and robustness, speed and connectivity are of paramount importance to clients so that they can focus on their own core business. Integrating regulatory services is a logical consequence of a business model aimed at providing a complete service offering to customers.

A regulated market is required to comply with transparency and reporting obligations for transactions executed on its trading platforms. With the regulator having obligations aligned between different execution venues, Deutsche Börse, like other market infrastructure operators, must open its regulatory platform to other market participants. One advantage for infrastructure providers when they make their products more widely available is that the build costs are spread over a customer base that is potentially much larger. For clients, this means they can outsource the challenges and share the expenditures related to building and operating the regulatory reporting hub.

Clients expect to be supported in meeting their MiFID II related requirements. Market infrastructure operators are uniquely positioned to serve their customers by providing a central European regulatory reporting hub and to act as trusted partners in helping clients meet their regulatory obligations in an efficient and cost-effective manner, whether this involves providing a MiFID II transaction reporting or OTC trade reporting service. A MiFID II transaction reporting service enables clients to submit the relevant data to the national competent authorities via an ARM.

A MiFID II OTC trade reporting service is an efficient and straightforward option for clients to meet the transparency requirements for OTC transactions under the new regulations via an APA.

A central regulatory reporting hub offers a strategic answer to the multitude of required reporting dimensions.

Data, data, and data—we are in the middle of the regulatory data collection stage. Every day, customers send seven million derivative trades to Regis-TR. Much has been written about the difficulties of regulators sifting through this data and making sense of it. Admirably, regulators frankly admit when data quality is too poor to draw conclusions from, e.g. FX derivative parametrizations in recent regulatory technical specifications for MiFIR implementation of the European regulator ESMA have been left out for this reason. Data consolidation is very much of the moment; thus, regulators envision a regime of regulatory data service providers acting as an intermediate layer of consolidation between market participants and trade repositories, or respectively regulators' databases.

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## The creation of a central regulatory reporting hub by market operators will enable their customers to alleviate their regulatory burden

The regulators need high-quality data not just for keeping an eye on risk positions. At the center of market regulation is the idea that transparency levels need to be balanced against the legitimate interests of trading parties not to reveal trading interests in thin, illiquid markets or to be caught with positions that are too large in size before being able to close them. An elaborate scheme of parametrizations at sub-asset, sub-class or even instrument level has been designed. It requires constant re-tuning based on checking its effects on market liquidity. A regulatory reporting hub familiar with market practices, but otherwise neutral, may deliver sound data and help regulators and market participants to get unbiased views on the trade-off between transparency and liquidity.

Post-trade data from trading venues and APAs (for OTC) are to be made available to the "European Consolidated Tape" (ECT) in real time and provided free of charge after 15 minutes. This is the most important tenet to achieve post-trade transparency in the European markets as requested mainly by the buy-side. A regulatory reporting hub carries the onus of translating all client data into a normalized format. As an APA, it will be regulated to provide high-quality OTC data.







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## A regulated market is required to comply with transparency and reporting obligations for transactions executed on its trading platforms

The success of current market regulation is not ensured in itself, but the creation of strong regulatory reporting hubs may help to alleviate many challenges, in particular during the first couple of years, i.e. the transition period between old and new regulatory reporting regimes. Liquidity may even dry up if regulatory burdens overwhelm too many market participants. Sky-rocketing regulatory costs may even force market participants to retreat from some markets.

While the costs of regulatory obligations are a major concern for clients, there are qualitative aspects to be considered as well. Unfortunately, regulators fail to provide a “golden source” of covered instruments. Correct reference data provisioning has been an area of client concern for a long time. OTC trade reporting of derivatives is not free of ambiguities concerning the instrument scope either. Ambiguities in interpreting legally binding texts should not exist, but they frequently do. They may lead to interpretation and consequently legal risks. After a long history of bad data-quality delivery by banks, regulators tend not to look kindly on misreporting, over-reporting, or underreporting.

Another area in which a central regulatory reporting hub offers help to clients is delegated reporting. Transaction reporting identifies those persons (or algorithms) responsible for each side of a transaction. This may run counter the interests of buy-side clients who have taken some bank into service, but would like to protect confidential information on their client. In such cases, a bank can publish transaction reports generated on the regulatory reporting platform. Separately, their clients can fill out confidential information through direct access on the platform.

The hub service architecture provides clients with more than a tactical solution to solve their MIFID II related reporting obligations. The hub supports the capture of data for multiple regulations, with the relevant data being routed to the correct end point per regulation, be that an ARM, RRM or trade repository. In this way, the hub can cater for current regulations, while laying the ground work for future regulations, such as SFTR, and regulation in other geographical domains.





# Fund distribution under MiFID II

## Strategic considerations for investment managers distributing funds across the EU

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MiFID II<sup>1</sup> will have a significant impact on the distribution of investment funds, and this impact will vary across distribution channels. Firms managing funds which are sold across the EU will need to consider how this will affect their business.

Under MiFID II, distribution will be reshaped by new rules on product governance, the appropriateness test, inducements and disclosures to investors<sup>2</sup>. In October, Deloitte<sup>3</sup> published a paper looking at the strategic impacts of MiFID II on investment managers across different parts of their business<sup>4</sup>. On distribution we concluded that MiFID II may further drive an increase

in direct-to-client (D2C) offerings and digital services. However, the impact will vary across the EU depending on local distribution models. This article looks at these differences in more detail and considers how firms could position themselves in light of the impact of MiFID II on each distribution channel<sup>5</sup>.

<sup>1</sup> *The revised Markets in Financial Instruments Directive and a new Regulation.*

<sup>2</sup> *As this article was going to print, the EU institutions were discussing a potential delay of the MiFID II implementation deadline, which was originally set at 3 January 2017.*

<sup>3</sup> *Deloitte LLP*

<sup>4</sup> *Navigating MiFID II: Strategic decisions for investment managers, Deloitte, Oct 2015*

<sup>5</sup> *For this article, we have spoken to Deloitte client teams in Belgium, France, Germany, Italy, the Netherlands, Spain and the UK. In addition, we gathered views from Deloitte practitioners in Ireland and Luxembourg, jurisdictions with largest numbers of funds domiciled (in the EU).*

### What are the main changes to the investor protection rules under MiFID II?

- **Product governance:** Product providers will be required to ensure that products and distribution strategies are consistent with the needs of identified target markets and that distributors have the information needed to understand and sell the product properly. Distributors are expected to be required to pass sales information back to product providers. There will be increased costs due to the need to renegotiate agreements between providers and distributors and the ongoing exchange of information required.
- **Appropriateness test:** A wider range of products, including structured UCITS<sup>6</sup> and AIFs<sup>7</sup>, will be deemed complex and subject to the appropriateness test. This requires an assessment of an investor's knowledge and experience before a sale is made.
- **Inducements:** Independent advisers and portfolio managers will be prohibited from receiving third-party inducements<sup>8</sup>. Other firms can continue to receive inducements if they are designed to enhance the quality of service to the client and do not impair the firm's ability to act honestly, fairly, professionally and in the best interests of its clients. The rules on what constitutes enhancing the quality of service are expected to be stricter than under MiFID I.
- **Disclosures to investors:** MiFID II introduces an EU-wide definition of independent investment advice and requires firms to disclose to clients whether they provide such advice. MiFID II will also require more detailed disclosure of costs and charges.

### Current distribution landscape in the EU

Fund distribution models differ across EU countries. This results from a range of factors, including different supervisory regimes, historic distribution structures and consumer preferences.

In many EU countries, **banks are the biggest distributors of retail funds**, offering in some cases predominantly in-house funds (e.g. Belgium, France and Spain), and in other cases a wider range of funds (e.g. Germany and the Netherlands). By contrast, in the UK most distribution of funds to the retail market is done via platforms (89%), independent financial advisers, or a combination of the two<sup>9</sup>. The UK has seen a significant

increase in the use of platforms over the past few years and is now seeing some interest from wealth managers in setting up platforms for their clients. In the Netherlands, the local regulator, the Authority for the Financial Markets, banned third-party inducements in January 2014 and the share of distribution via platforms has grown since then. Dutch consumers now have a wide range of options to invest via online platforms; all offer execution-only sales and some also offer automated advice. In other EU countries, platforms are slowly taking off but the market share of retail clients buying directly is still relatively low (see the chart).

<sup>6</sup> UCITS are undertakings for collective investment in transferable securities. In Article 36(1) of the UCITS IV Directive, structured UCITS are defined as UCITS which provide investors, at certain pre-determined dates, with algorithm-based payoffs that are linked to the performance, or to the realisation of price changes or other conditions, of financial assets, indices or reference portfolios of UCITS with similar features.

<sup>7</sup> Alternative investment funds as defined in the Alternative Investment Managers Directive.

<sup>8</sup> Independent advisers and portfolio managers will still be able to receive minor non-monetary benefits subject to certain conditions.

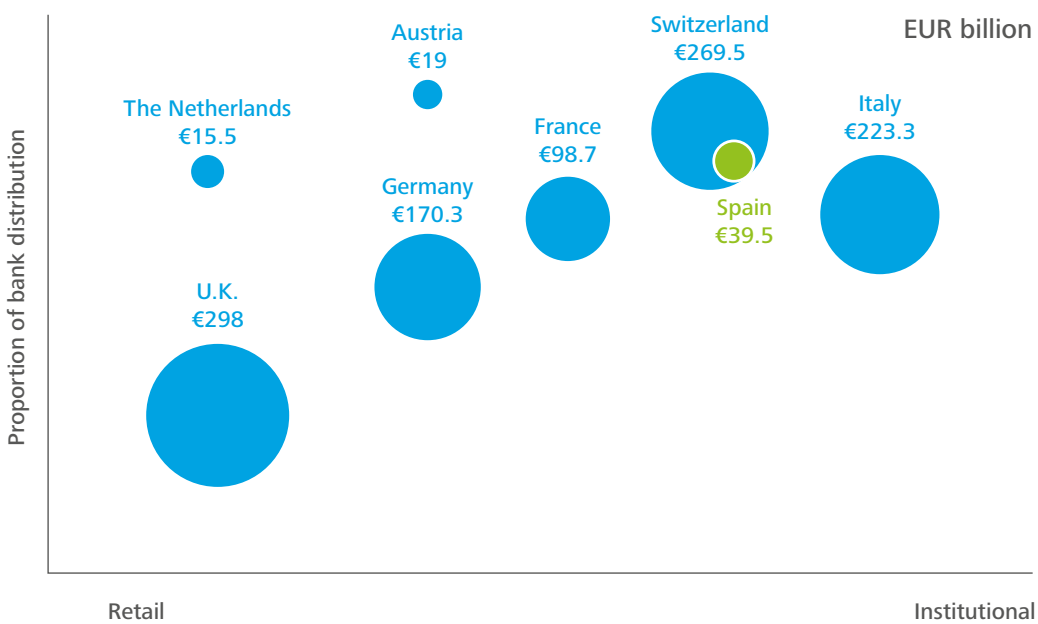
<sup>9</sup> Asset Management in the UK 2014-2015, The Investment Association Annual Survey, Sep 2015.





The chart below provides an overview of fund distribution via platforms in the EU and indicates the amount of platform-distributed funds (in € bn) in each country<sup>10</sup>. While there is demand for platforms across all the countries included in the chart, many of these focus on institutional clients (e.g. Italy and Spain). Platforms in the UK and the Netherlands mainly cater for retail customers.

Figure 1: Fund platforms - Market positioning



Source: The Platform "European platforms and open architecture 2014: A traveller's guide to the galaxy", March 2014

<sup>10</sup> MiFID II, What will be its impact on the investment fund distribution landscape? Deloitte, Jun 2015

Some countries have also seen investment managers setting up their own D2C platforms. For example, in Spain a few private and universal banks have set up online platforms as personalised advice is less cost-effective for retail clients. These platforms offer execution-only services and in some cases also generic advice; investors pay a subscription fee. In Germany a small number of investment managers have platforms selling their own funds.

**Independent advice** makes up only a small proportion of retail distribution in many EU countries but is more common for high net worth clients. A small but growing number of platforms offer “robo-advice”<sup>11</sup>. In its Green Paper on retail financial services, the European Commission looks at how digitisation can improve competition and choice for consumers<sup>12</sup>. In its Discussion Paper on automation in financial advice, the Joint Committee of the European Supervisory Authorities seeks input from stakeholders on what, if any, action is required to harness the potential benefits of automated advice and mitigate its risks<sup>13</sup>. In the UK, Her Majesty’s Treasury and the Financial Conduct Authority are also examining whether firms face any barriers to providing advice to those with less complex financial needs as part of their Financial Advice Market Review<sup>14</sup>.

In many EU countries, **retail investors** are sold AIFs as well as UCITS. The types of AIF sold to retail investors include funds compliant with local retail fund regimes (such as UK Non-UCITS Retail Schemes) and closed-ended funds. For example, AIFs sold to retail investors include German real estate funds, French capital investment funds and Belgian capital protection funds. In some countries, such as France, the majority of retail investment is via life insurance products. The Insurance Distribution Directive will regulate the distribution of insurance-based investment products and aims to achieve a similar level of investor protection to MiFID II.

In some countries, local supervisors have already taken action to reduce the sales of **complex products** to retail clients. For example, in Belgium, a moratorium on the distribution of particularly complex structured products<sup>15</sup> has resulted in a substantial reduction in the complexity of structured products. In Italy, a regulatory communication on the distribution of complex financial products to retail investors<sup>16</sup> has led to many firms reducing the complexity of some of their products.

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## Under MiFID II, distribution will be reshaped by new rules on product governance, the appropriateness test, inducements and disclosures to investors

<sup>11</sup> “Robo advice” is an online service that provides automated, algorithm-based portfolio management with minimal human intervention.

<sup>12</sup> Green Paper on Retail Financial Services, European Commission, Dec 2015.

<sup>13</sup> Discussion Paper on automation in financial advice, Joint Committee of the European Supervisory Authorities, Dec 2015

<sup>14</sup> Financial Advice Market Review, Call for input, Her Majesty’s Treasury and Financial Conduct Authority, Oct 2015.

<sup>15</sup> Moratorium on the distribution of particularly complex structured products, FSMA, 2011.

<sup>16</sup> Comunicazione sulla distribuzione di prodotti finanziari complessi ai clienti retail, Consob regulation n.0097996/14, Dec 2014.

### How will MiFID II affect different distribution channels?

**Banks** receiving commissions for distributing funds will be affected by the new inducements rules, which are expected to require them to do more to demonstrate an enhanced quality of service to the client. In many cases banks do not provide independent advice so will be less affected by the outright prohibition on inducements to independent advisers. Banks distributing funds from a wide range of providers may face significantly increased costs under the product governance rules and may look to reduce the number of providers whose funds they distribute. This could advantage in-house funds over external funds. Where banks are selling AIFs or structured UCITS on an execution-only basis they will need to incorporate the appropriateness test into their sales process.

**Financial advisers** which are not part of banks or insurance companies may currently label their services as “independent advice” even where no local regulatory definition exists. These firms will be affected by the MiFID II ban on inducements for independent advice and many are likely to re-label their advice as non-independent. However, in the UK and the Netherlands, both independent and non-independent advisers are already prohibited from receiving inducements under local rules. Advisers which are deemed non-independent under MiFID II but distribute funds from a wide range of providers may look to reduce the number of providers whose funds they distribute due to increased costs per provider under the product governance rules.

In the UK, the major **platforms** provide funds from a large number of investment managers and may become more selective about the providers whose funds they include on their platform as a result of increased costs

under the product governance rules. In many other EU countries, platforms often host a single investment manager’s funds or a smaller range of providers so the product governance rules may be less costly. Where platforms sell complex products on an execution-only basis they will need to introduce the appropriateness test, which will increase their costs and change the user experience. Investment managers distributing via platforms may consider moving towards non-complex product structures where this can be achieved without significantly altering investment strategies. Platforms receiving inducements will have to demonstrate that these enhance the quality of service to their clients if they wish to continue receiving them. UK and Dutch platforms will be less affected by the inducements rules as they are already subject to domestic inducements rules.

**Wealth managers** carrying out portfolio management will be prohibited from receiving commissions from product providers. As with other channels, the product governance rules may lead some wealth managers to reduce the number of providers they deal with in order to reduce costs. In countries where independent advice is not currently defined, MiFID II may create new opportunities for them to provide this as a premium service to high net worth clients.

Where investment managers **sell funds directly to clients** they will need to comply with the product governance rules but the absence of a separate distributor will reduce the complexity of the process. They will also need to introduce the appropriateness test for complex products.

Sales to **institutional investors** are less likely to be affected by the MiFID II rules on investor protection since in many cases no inducements are paid to distributors, mandates are agreed with individual clients and investment managers can generally assume that professional clients have the level of knowledge and experience required under the appropriateness test<sup>17</sup>.

Across all these channels, the **increased disclosure of costs and charges** required in MiFID II and PRIIPS<sup>18</sup> may increase competition in the market as it becomes easier to compare different products side by side. These may work in tandem with existing market trends towards low-cost, less complex and passive funds. Firms may continue to rationalise their product range as the new product governance rules increase the costs to firms per fund<sup>19</sup>.

**To the point:**

- Distributors selling funds from a wide range of investment managers may look to reduce the number of investment managers whose funds they sell as costs increase under the product governance rules. This is likely to particularly affect the large UK platforms but may also affect other distributors such as banks and financial advisers across the EU. Investment managers which may be affected by this could look to build D2C solutions.
- Banks receiving inducements to distribute funds will need to ensure that the inducements they receive sufficiently enhance the quality of service to the client. This may involve providing more ongoing services, such as market insight or personalised reporting.
- In view of the MiFID II appropriateness requirements, investment managers of AIFs and structured UCITS which are sold on an execution-only basis may consider moving towards products which are deemed “non-complex” where this can be achieved without significantly altering the fund’s investment strategy.
- In many EU countries where independent advice is not currently defined, MiFID II may provide a new opportunity for some firms to provide this service to high net worth clients.
- As MiFID II will increase distribution costs, increase the transparency of costs and charges, and require the appropriateness test for a wider range of products, investment managers will need to make strategic decisions about their offering. This may include moving to lower cost, less complex and passive funds and/or developing robo-advice solutions.

<sup>17</sup> Article 36 of the MiFID Implementing Directive.

<sup>18</sup> Packaged Retail and Insurance-based Investment Products Regulation.

<sup>19</sup> Data from Lipper shows that the number of funds merged or liquidated by European fund managers has exceeded the number of funds they launched every year since 2011.





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