

Performance

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In focus

The GPIF and the future of the Japanese equity market

The GPIF and its reform

Hot topic—The generation game: savings for the new millennial

Preparing for Solvency II—Time for asset managers and asset servicers to act

Investment management, mobility, and managing investor security concerns

No time for KIDding around—PRIIPs is on the way

New tax regulations impacting investment funds

Loan funds—Europe’s alternative source of business funding

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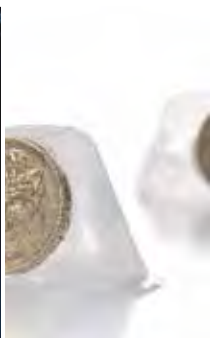
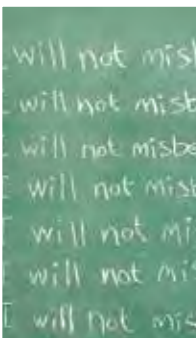
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Foreword



Dear friends and readers,

It is with great pleasure that we send you our very best wishes for 2015 along with this issue of *Performance Magazine* - THE forum for the well-informed finance professional.

It is a sobering thought that had we attempted to set out at the beginning of 2014 some of the challenges that we would end up facing during the course of the year, whether financial, regulatory or geopolitical, we would have been hard pressed to identify all of them - especially the geopolitical ones. It is a tribute to the collective resilience of markets that despite these upheavals, the year closed at levels both of valuation and activity that belied the often repeated doomsday warnings of the sector's 'soothsayers'!

We shall see what 2015 brings. One thing we can be sure of it will only be partly what we expect, and there will once again be surprises along the way.

As you will have noticed, with each new issue of *Performance*, we aim to break new ground in the scope or technical detail of the articles that we bring you, or through the wealth of contributors willing to share their insights and thoughts with us all. This issue is truly our 'follow the sun' offering - a trend we trust will be recurrent as successive issues come off the press.

In this edition of *Performance Magazine*, we are delighted to set the scene by looking at Japan, with an editorial and a thought leader interview, as well as an in-depth look at that most topical of issues - pensions. Clearly, as many 'developed' areas of the globe struggle to come to terms with ageing populations and underfunded retirement benefits, they do so at different rates. Not all populations age uniformly and some countries are further down this particular curve than others. There is much to be learnt from the Japanese experience. We would hope that this will give rise to future thoughts, especially from those countries in what is sometimes termed the 'developing world', who in turn will be confronted with similar issues but to some extent also have the advantage of working from a blank sheet of paper - there are no structures already in place that require reform. Where schemes are being put in place they could prove the envy of supposedly richer cousins. This is your magazine, so your contributions are invited, especially on this key and crucial issue.

As we 'follow the sun' westwards, through time zones and subjects, there is a certain inevitability as night follows day. When we consider the inevitable, at some point our thoughts turn to tax. The ongoing raft of tax legislation and initiatives lead us to consider the dichotomy between the legislative process and practical questions of implementation.

Finally our journey draws to a close in the Western Hemisphere, with a rich variety of contributions both external and our own, looking at matters as diverse as mobility in investment management, mobility and addressing investor concerns, plus 'the Generation Game', where we return to the key theme of savings.

So, once again, we hope there will be something for everyone, with cutting-edge articles combining information and insight; and once again, we hope that the knowledge exchange that is our contribution to you will allow us all to meet the challenges of 2015 and beyond.

Happy and fruitful reading.

Vincent Gouverneur
EMEA Investment
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Editorial

Dear readers,

Asymmetry is a word that is becoming increasingly popular, or at least one that one hears to a greater extent in debate, or reads in magazine and newspaper articles. Furthermore, at a time when geopolitical tensions are once again beginning to figure large in projections as to the direction and health of the global economy, the term, asymmetry, appears in many contexts. It is found in theatres of conflict, with the current situation in Iraq and Syria, or Ukraine, to quote two very disparate examples; there it refers to apparent disproportionate strengths and how they may at times yield unexpected results.

It appears in comparative economies, where one bloc may be teetering on the edge of deflation, whilst other areas may be facing currency imbalance induced inflation. Demographically, it perfectly describes the different growth dynamics fuelling supply side economics. Basically, although not necessarily the first point of reference, asymmetry is a constant in world affairs and everyday life. What is less appreciated is that asymmetry in itself is neither good nor bad, but a driver like many others. As each set of problems arise, there is a natural tendency to consider them to be common, and unique; yet the world is constantly confronted with concomitant and opposite problems at the same time.

There is, despite what logic and experience may suggest, a temptation at each new challenge to set out in search of the 'philosopher's stone', to seek a panacea for all evils; some would find this in planned economies, some would seek it in ultra-liberalism, some would turn to specific authors such as Keynes or Hayek. It is perhaps Keynes and Hayek who, with a sad shake of the head, would point in the true direction in which to focus. That is the experience and interaction of the present context. And that means asymmetry.

This latest issue of *Performance* takes us on that journey. The spectre of deflation is new to Europe, - it is familiar in Japan. The issues surrounding an aging population, that Europe is proving remarkably unwilling to face, are already demanding, and finding solutions in Japan and elsewhere in the Far East. With this background at the macro level, regulation, as can be seen in Europe and the United States, seeks to achieve economic stability and growth. The intent is that if these objectives can be achieved, some of the complexities that have been highlighted will be alleviated. However, with an increasing reliance on a detailed rule based approach, regulation itself throws up new challenges, unforeseen consequences and sometimes unintended results.

One thing, however, is certain, symmetric or asymmetric, shared experience is richer than individual enlightenment.

We wish you enlightening and asymmetric reading.



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In focus



The GPIF and the future of the Japanese equity market



Interview with Dr. Konari Uchida

Dr. Uchida is a professor specialising in corporate finance and corporate governance at Kyushu University Economics Department. His approach involves the application of data analysis to corporate governance, and his papers and remarks are quoted frequently. He advises the Japanese government on economic and business-related matters.



It is important that companies go beyond simply increasing profitability and reach profitability levels that exceed capital costs, which are normally shouldered by shareholders

Deloitte: It was announced that the policy asset mix for GPIF will be changed from the 2015 financial year. As a result, the proportion of Japanese equities will increase from the current 12%, to 25%. How do you evaluate this change?

Dr. Konari Uchida

I think that this is a welcome change. The public pension system is a system that is supposed to continue indefinitely. I think that it is preferable to manage public pension assets over the long term with equities that have the potential to create profit over the long term. However, the use of equities means that there are certain issues that need to be resolved.

Deloitte: What issues need to be resolved?

Dr. Konari Uchida

There are two. The first is companies having the ability to increase profits. The second is companies placing importance on shareholder returns. Let me start by explaining the first issue. The ability to increase profits is the ability to maintain and improve Earnings Per Share (EPS). Japanese

companies should be more mindful of profitability indicators such as EPS than they have been in the past. It is important that companies go beyond simply increasing profitability and reach profitability levels that exceed capital costs, which are normally shouldered by shareholders.

Deloitte: Are you suggesting that current market profitability is insufficient?

Dr. Konari Uchida

I made simple calculations, so my answer won't be precise, but please consider the following analysis. The Price to Earnings Ratio (PER) in the current market is 17-18. Assuming that the current level of profitability were to persist indefinitely, back-calculating from this PER would give us an expected return on equity (capital cost) of 5.7%. The yield on Japanese government bonds, which serves as an alternative to the risk-free rate, is approximately 0.47%. As such, the risk premium of equity is approximately 5%, which is a reasonable level considering the past risk premium.

Japanese companies should be more mindful of profitability indicators such as EPS than they have been in the past

Deloitte: That is indeed a reasonable level if you consider current share prices. In that case, there really is no major problem, correct?

Dr. Konari Uchida

The current level of share prices is supported by this expected return of 5.7%, or rather this low risk-free rate of 0.47%. In other words, if profitability remains at its current level, then it is not unreasonable to expect an increase in share prices beyond current prices. It is therefore critical to accelerate business growth and improve profitability moving forward. Several policies have been enacted under Abenomics. Share prices went up as a result of these policies, but profitability also needs to be increased. The government will likely take more action on the economic front from this point forward, but it remains to be seen if such action will produce positive results.

Deloitte: Do you think that the Japanese version of the stewardship code will help to raise profitability?

Dr. Konari Uchida

I think that the Japanese stewardship code will play a major role. The GPIF complies with this code. I believe that this is absolutely the correct action to take.

Share prices are not decided by profitability alone. Remember the second issue that I said needs to be resolved: companies placing importance on the shareholder returns. To do this, companies should effectively use non-core assets on their balance sheets. If companies have extra cash and investment securities, they can then conduct share buybacks to boost shareholder returns, as is done in Europe and the United States.

Compared to other countries, Japan has a relatively low PBR. It was around 1.1 the last time I checked. This could be indicative of too many assets being held in proportion to profitability. In that case, it would be reasonable for companies to pass on surplus cash through share buybacks or other means and reduce assets for the benefit of shareholders. The GPIF is pre-empting other pension funds by complying with the Japanese stewardship code, and by linking the pursuit of shareholder returns to the revitalisation of the Japanese stock market.

Deloitte: These changes to the policy asset mix allow the GPIF to invest up to 5% in alternative assets (real estate, private equity, etc.). What is your view on this?

Dr. Konari Uchida

Diversification of investment assets generally serves to improve the risk-return profile. From this perspective, we should welcome the opportunity to diversify using new assets. However, it is necessary to put in place a system for monitoring new assets. We will do this in the case of the GPIF while moving forward with alternative assets. In this respect, I think that it is reasonable to set an initial limit of 5% for alternative assets.



Deloitte: Given its large size, what effects will the GPIF have on the Japanese market in the future?

Dr. Konari Uchida

Since the GPIF is a ¥130 trillion fund, it goes without saying that its effects are significant. I believe that raising the proportion of Japanese and overseas stocks, as we have done this time, will have a positive effect on returns over the long term. However, it is somewhat unfortunate that we couldn't raise the proportion of Japanese stocks earlier, as doing so would have produced a higher

return. Moving forward, the GPIF expects, as an asset owner, to ask companies to improve their ability to increase profits and place importance on shareholder returns. I believe that doing so will further shift the emphasis of the Japanese stock market towards investors and create greater returns. The Japanese stewardship code and corporate governance code are also moving forward. We expect that these measures will provide strong support for the GPIF reforms and result in a virtuous cycle.





The GPIF and its reform

Mitoshi Yamamoto
Partner
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Japan's Government Pension Investment Fund (GPIF) is one of the largest investment funds in the world, with assets of ¥130,884.6 billion (as of end-September 2014).

It has been announced that the GPIF will change its policy asset mix, governance and other key aspects this year. This reform will impact the market and asset management industry. In this article, the details of changes in the asset mix and the governance system will be described.

The GPIF and policy asset mix

The GPIF is an independent administrative institution with the objective of managing and investing the Reserve Funds of the Employees' Pension Insurance and the National Pension. The GPIF also manages and invests the Reserve Funds of the Government Pension Plans entrusted by the Minister of Health, Labour and Welfare, in accordance with the provisions of the Employees' Pension Insurance Act (Law No. 115 of 1954) and the National Pension Act (Law No. 141 of 1959). It is responsible for contributing to the financial stability of both plans by remitting investment profits to the Special Accounts for the Government Pension Plans.

The policy asset mix of GPIF has been changed (see Matrix 1). The new policy asset mix will be applied from 1 April 2015. Meanwhile, the proportion of equities held under the GPIF will increase at the expense of bonds—a shift that is likely to impact the market. Japanese equity indices such as the Nikkei 225 and TOPIX have gradually been moving upward.

In the new asset mix, the GPIF's exposure to equities will rise from 24% to 50% (both Japanese and foreign equities will increase from 12% to 25%). Exposure to foreign currencies will also rise, from 23% to 40% (foreign bonds will increase from 11% to 15%, and foreign equities from 15% to 25%). Exposure to safer assets such as Japanese bonds will therefore decrease, from 60% to 35%.

Matrix 1: Policy asset mix

	Japanese bonds	Foreign bonds	Japanese equities	Foreign equities	Cash etc.
Old asset mix	60%	11%	12%	12%	5%
New asset mix	35%	15%	25%	25%	-

So far, so good. The return from the portfolio has been almost ¥3 billion since the third quarter of the 2012 financial year, when Shinzo Abe became Prime Minister of Japan. The GPIF enjoys returns that make up for the risks that the GPIF has been taking during the period of 'Abenomics'.

Some professionals point out that the GPIF needs to be careful with respect to risks in view of these exposures to the equity and foreign exchange markets. The largest U.S. pension fund, known as CalPERS (California Public Employees' Retirement System), allocates 61% of its assets to equities and has an advanced risk management system and organisation. There may be many points that GPIF can learn from CalPERS or other leading institutional investors in risk management of equity in its asset portfolio.

On the other hand, market participants have welcomed this change in view of the strong impact of the GPIF, particularly on the Japanese equity market. It is said that a 1% increase by the GPIF in its allocation of the Japanese equity market will bring ¥1 trillion into the market.

Some may wonder whether the GPIF will have any exposure to alternative assets. It was announced that the GPIF will allocate a maximum of 5% of its assets to alternatives such as real estate, infrastructure and private equity. These alternatives will be recognised as equity or bonds according to their characteristics.

Some professionals point out that the GPIF needs to be careful with respect to risks in view of these exposures to the equity and foreign exchange markets

Governance

The GPIF reform strengthens three areas, with the aim of improving governance: (1) internal control, (2) risk management capabilities and (3) human resource management.

Regarding internal control, GPIF managers will appoint a compliance officer, bolster the internal audit system by expanding the role of the internal auditor, review and develop its disclosure policy to enable effective investment management and upgrade its IT security management system.

With regard to risk management, the GPIF's macroeconomic and market analysis capabilities will be strengthened. It has hired external consultants and installed an IT system to analyse both investment assets and expected payouts in 2014, and is in the process of developing a sophisticated risk management system.

In order to strengthen internal control and risk management, the human resources function also needs reform. The remuneration system has been changed so that external experts can be hired, and the GPIF has already announced that, in January 2015, it will appoint Hiromichi Mizuno, a partner from Collier Capital, as executive managing director and Chief Investment Officer (CIO).

Before these changes, the policy asset mix of the GPIF had been decided under its internal rules by its president, without requiring the agreement of other GPIF members. This past summer, GPIF changed that system and set up an investment committee to establish pre-clearance of essential decisions made by the president. The reform of the GPIF's governance is still in progress.

Japan's Stewardship Code

The Principles for Responsible Institutional Investors, referred to as 'Japan's Stewardship Code' were published by the Japanese FSA in 2014. So far, 160 institutional investors, including the GPIF, have complied with these principles.



The seven principles of Japanese 'stewardship' are reproduced below:

1

Institutional investors should have a clear policy on how they fulfil their stewardship responsibilities, and publicly disclose it.

2

Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities, and publicly disclose it.

3

Institutional investors should monitor investee companies so that they can appropriately fulfil their stewardship responsibilities with an orientation towards the sustainable growth of the companies.

4

Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.

5

Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist; it should be designed to contribute to the sustainable growth of investee companies.

6

Institutional investors in principle should report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries.

7

To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.

The main purpose of the principles is to promote the sustainable growth of companies through the 'engagement' of asset managers (investment companies) or asset owners (pension funds, etc.). Engagement is defined as a dialogue between investors and companies, and such engagement is supposed to promote mutual understanding between investors and companies.

The Japanese FSA will soon publish a code for a higher level of corporate governance for Japanese companies. These two codes are seen as essential for achieving sustainable growth of the Japanese equity market. The GPIF must, in this context, have better governance.

Secure Japanese pension system

It is not appropriate to classify the GPIF as a Sovereign Wealth Fund (SWF), as it has the liability of pension payments. When we look at the size of the GPIF, it is clear that it needs to have the same or even a higher level of governance through a clear decision-making system, strong internal auditing, a sophisticated risk management system and a secure IT system. The GPIF is on the path toward being a better organisation, and this progress will affect not only the Japanese market but other markets too.

Hot topic
question

The generation game

Savings for the new millennial

Paul Traynor
Head of Insurance International
BNY Mellon

Financial services providers such as life insurers, asset managers and banks are failing to connect with millennials (people born after 1980) at a time when young people need the industry more than ever. Increased longevity and reduced state and employer pension provision mean millennials will have to save more of their earnings than their parents, and do so over a longer period.



Yet, as the findings of new research from BNY Mellon and a team of undergraduates from Saïd Business School at the University of Oxford demonstrate, the techniques used by financial services providers to engage with baby boomers do not always work with millennials.

The study, entitled *“The Generation Game: Savings for the New Millennial”*, looks at the saving priorities, attitudes to retirement planning and expectations around different types of financial institutions of millennials across seven key markets—Australia, Brazil, China, Japan, the Netherlands, the United Kingdom and the United States.

This geographical spread allowed the researchers to engage with a broad range of millennial populations: emerged and emerging; large and small; those with a collective approach to pensions and those with a unit-linked system; and compulsory and voluntary pension systems. The members of the research team that produced this report are all aged between 19 and 21, so it is a study of millennials by millennials. More than 1,100 millennials were surveyed.

Connecting the future to the present

Persuading people to put away money today to fund a retirement several decades away is arguably the biggest challenge faced by both pension providers and those shaping pensions policy. Research in the field of behavioural finance has demonstrated that human beings are hard-wired to prioritise a benefit they will enjoy in the near future to one in the distant future—a phenomenon known as hyperbolic discounting.

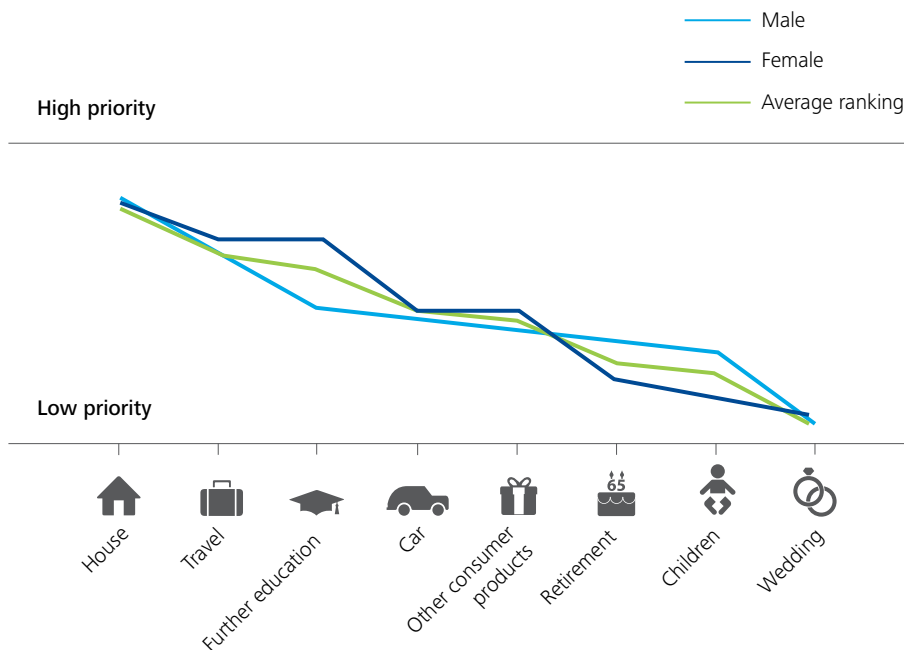
Pension policy and marketing need to find new ways to overcome this tendency.

- 73% of millennials would save more if they were rewarded in some way
- 51% of millennials would be more inclined to save for the future if their retirement money was not completely locked away
- 59% of millennials believe they have not seen products targeted at people like them

Our research demonstrates just how susceptible millennials are to prioritising spending today over saving for tomorrow, even when they are offered powerful incentives to tie their money up for longer. As part of our research, millennials were asked whether they preferred to receive US\$50 today, US\$80 in one year's time or US\$200 in ten years' time in order to determine whether they were short-term thinkers or long-term planners. Just 22% of millennials would take the US\$200 after ten years, rather than US\$50 today (42%) or US\$80 a year later (36%).

A new generation of pension products is needed, operating in conjunction with existing products, that can enable millennials to connect the present to the future. We recommend that financial services providers and policymakers investigate ways pension products can be structured to deliver limited early access to at least part of the funds held within them. For example, access could be linked to funding specific items of expenditure such as clearing student debt or a deposit for a home.

Saving for retirement is a low priority for millennials



Global challenges, local differences

Millennials in different countries approach retirement saving very differently. The extent to which millennials trust the system to deliver the sort of retirement enjoyed by their parents varies considerably from country to country, with demographic, political and economic factors likely to be key influencers of attitudes.

Millennials demonstrated significant distrust of pension schemes where investments are pooled rather than ring fenced. This suggests an opportunity for financial services providers marketing pure, unit-linked defined contribution plans to reinforce trust by emphasising the fact that savers' money is ring fenced in their plans.

Australian millennials are by far the most optimistic about being able to access the same sources of retirement income as their parents (84%), compared to only 16% in Japan. The low figure in Japan is probably because the country's retirement system is collective rather than individual. Japanese millennials contribute to a 'pay as you go' system and everyone draws their pension out of the same central pot. Unfortunately, Japanese millennials appear to doubt that the benefits they are paying for now will actually be available to them when they retire. The comparatively high figure for Australia is also driven by its retirement system, in which individuals contribute to their own pension pots, choose who manages their investments and can look at their pension statement online.

On the whole, millennials are trusting of financial services companies' ability to keep their money safe. In most countries, around a fifth to a quarter of respondents do not trust financial services providers with their money. Chinese and Dutch millennials showed a deep-rooted distrust of financial services providers. Among Chinese respondents, 44% agreed with the statement *"I don't trust financial services providers with my money"*, while 39% of Dutch respondents agreed. This may reflect the impact of fraudulent activities experienced in those countries, such as Dutch savers' losses following the collapse of Icelandic banks and a series of banking scandals in China.

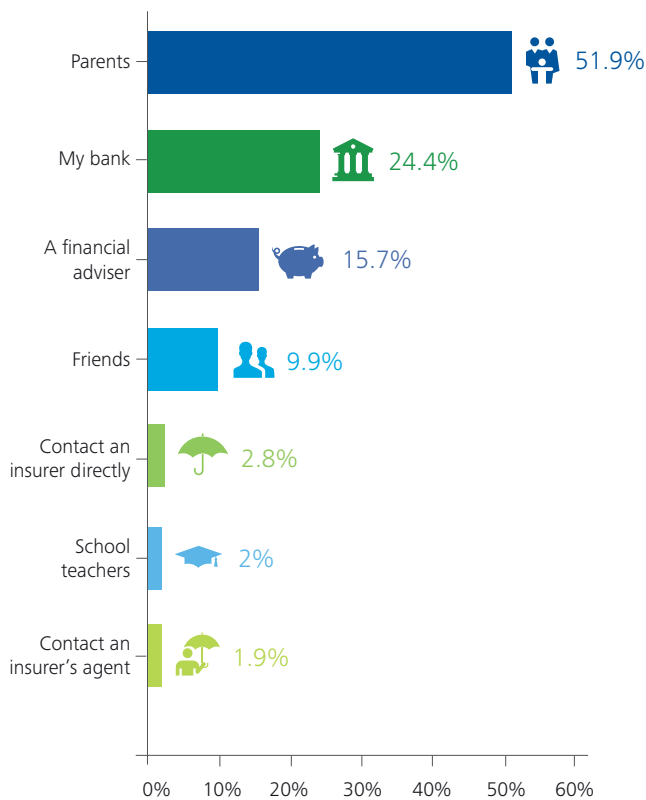
Financial services providers should leverage the strong connection millennials have with their parents in relation to financial products

Parent power

Millennials are likely to draw on more than one source of advice before making a purchasing decision. We therefore asked them to rank seven sources of advice in order of preference so that average rankings could be calculated. Average rankings nearer to one mean sources are more popular, while rankings nearer to seven mean sources are less popular. Parents achieve the highest average ranking, with a score of 2.36, followed by banks (2.55), financial advisers (3.05) and friends (3.64). Insurers (4.75) and insurance agents (4.87) were in fifth and sixth places respectively, beating only schoolteachers, who achieve an average ranking of 6.03.

The quantitative research findings that parents are the principal influencers of millennials' financial decision-making and that financial services providers' roles are less significant are backed up by the qualitative research.

Rank these sources of financial advice, in order of which you would approach first



Telephone interviews conducted with millennials from seven countries around the world indicate that young adults turn to their parents because they perceive them as trustworthy, independent and experienced, in that they have had to make similar financial planning decisions to those faced by their children. However, interviewees from emerging markets indicated that where parents have not themselves had access to retirement products, for example where these products have not been widely available, they are perceived as a less useful source of advice.

Both the qualitative research and quantitative research indicate that millennials' engagement with financial services providers is low. Yet at the same time, millennials understand they will have to do more to provide for their retirement than their parents' generation. To enable them to achieve this, the financial services industry needs to do more to educate them on how pensions and other forms of long-term savings work, connect with them as consumers and rebuild trust following the financial crisis.

Millennials overwhelmingly turn to their parents for advice and guidance on financial planning. We cannot say, and do not know, whether their parents are equipped to advise them correctly, however, we know that half of our respondents do not understand how a pension works.

Financial services providers should leverage the strong connection millennials have with their parents in relation to financial products. Financial services providers' marketing efforts should focus on the parent/millennial dynamic and target both millennials and their parents with products created specifically to appeal to millennials.

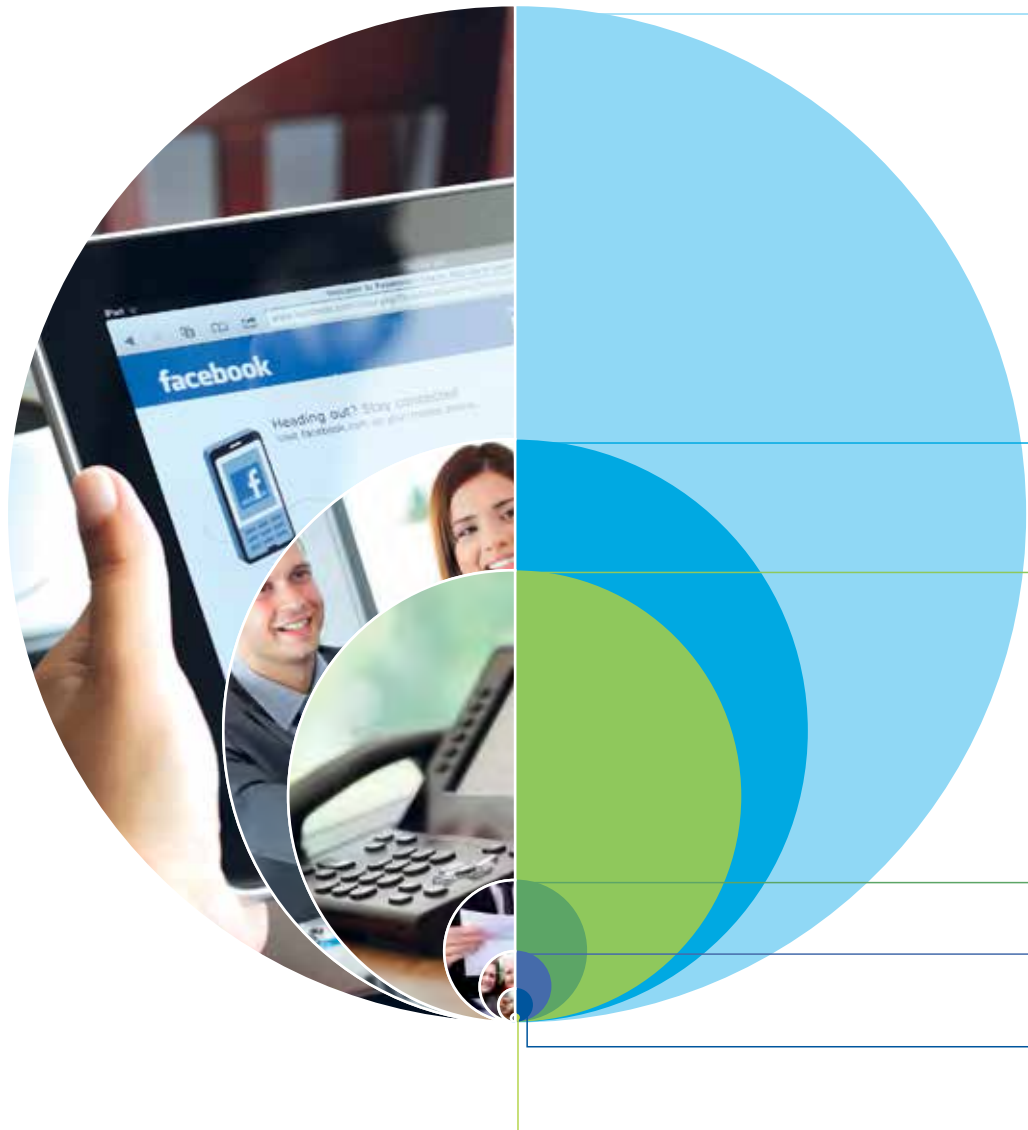
Social media scepticism

While they are generally comfortable being targeted by consumer brands through social media, millennials do not want financial services providers using these channels to contact them. The survey data shows the proportion of millennials who want contact with financial services providers through social media is miniscule. Asked how their contact with financial services providers could be improved, less than 1% of millennials actively expressed a desire to connect through social media.

This very low appetite for communications from financial services providers through social media was also evident in the qualitative research. Quantitative data from the survey indicates millennials want to interact with providers through a range of channels, with website and email the most popular choice (40%), followed by face-to-face contact (23%) and telephone (18%). Demand among millennials for social media interaction with financial services providers on the other hand is virtually non-existent. Of 664 respondents who expressed a view, just two said they wanted to be contacted by their financial services providers through social media.



What form of contact do you want with financial services providers?



The qualitative research echoes millennials' low appetite for social media interaction with financial services providers, indicating that they largely see it as a space for interacting with peers and friends. Some explicitly stated that social media undermines the credibility of financial services institutions, and referred to their use of these channels as 'silly', 'creepy' and 'pally'. These findings suggest there is a line of familiarity that millennials do not want financial institutions to cross in their interactions with them.

Millennials interviewed in the qualitative research indicated that use of social media made financial services institutions look as though they were trying too hard, and that after the global financial crisis, they mainly want 'boring', safe and stable providers.

Millennials are also not comfortable with the idea of their personal information being used in a financial context through social media, viewing personal finance as a private matter that should stay private. While the research shows financial services providers should not regard social media as a solution to their challenge of connecting with millennials, it does not mean that providers should abandon social media altogether. Not having a social media presence at all, or having an inadequate one, can be as much of a problem for

Website/email

40%

Face to face/in branch

23%

Telephone

18%

Letter

5.4%

Parents

3%

Smartphone app

1.4%

Social media

0.03%

Policy makers need to move towards a tax-incentivised savings pot that allows for a certain number of lifetime drawdowns

a financial services provider as having too aggressive a social media presence.

On several occasions financial institutions have been criticised for an inadequate or non-existent social media response to problems experienced by customers. Done in a proportionate and sensitive manner, groups of potential and existing customers can be engaged with, as long as it is understood that social media should not be expected to lead to widespread engagement with millennials. The key for financial services providers is to signpost on Facebook and other social media sites how millennials can engage with them, as opposed to popping up uninvited in their social media living room.

An urgent need for education

Our research found that around half of millennials do not believe they know how pensions work. This number increases to 61% among those under the age of 23. Millennials in Brazil, China and the United States stand out as being most uncertain about how pensions work, while Australian millennials are the most informed.

If millennials do not understand how pensions work, financial institutions—which were clearly not prioritised as a source of advice in the research—have to embrace the role of creating a culture for financial education. We think that this initiative can and should start early. High school and college students, young workers joining the job market and many other audiences must be informed and educated about the importance of and options for saving for retirement.

Marketing messages need more impact

The findings from the qualitative research suggest millennials think current marketing strategies adopted by financial services providers fail to hit the mark. The research indicates that millennials want marketing to deliver the information they need in order to understand how they should be saving for their retirement. But they also say advertising campaigns need to be more impactful if they are to succeed. However, while millennials do not want financial institutions to connect with them through social media, they may be open to web-based solutions such as apps and games. Interviewees suggested one way financial institutions could connect with millennials is by creating apps that would be useful to them, in the same way banks create budgeting apps for students. Gaming may be another way of engaging with millennials in some countries.

When marketing themselves to millennials, financial services providers have to walk a fine line between being perceived as boring and appearing credible, reliable and solid. At the same time, they need to deliver marketing messages that are sufficiently hard-hitting to break through the media noise surrounding young adults.

Millennials interviewed as part of this survey said they thought advertising campaigns from financial services providers were bland, unchallenging and targeted at a middle-aged audience. In several of the interviews, millennials volunteered unprompted that they would engage more with marketing that gave a more frightening picture of poverty in retirement, referring specifically to government anti-smoking campaigns as an example of effective shock tactics. Without hard-hitting messages, millennials believe financial services providers' campaigns to get them to save for the long term are destined to fail.

While we understand that financial services providers may be wary of associating their brand with negative images of poverty in old age, we believe there remains scope to connect with millennials in a more impactful way, engaging them in a mature dialogue about the very real challenges they face.

The views expressed herein are those of the author only and may not reflect the views of BNY Mellon. This does not constitute insurance advice, or any other business or legal advice, and it should not be relied upon as such.

To the point:

- Financial services providers such as life insurers, asset managers and banks are failing to connect with millennials at a time when young people need the industry more than ever
- The low level of understanding of pension systems by millennials highlights the growing need for financial education
- Insurers, asset managers and other financial services companies should identify millennials as a distinct target market. Connecting through parents was a constant theme throughout the research findings. Where financial services providers already have a relationship with parents, this could be made to trickle down to the next generation
- Financial institutions need to handle social media campaigns with care and should avoid crossing a line of familiarity that millennials will find 'creepy'
- While the shift towards short-term rewards is endemic, financial institutions need to emphasise the long-term benefits of saving and the power of compound returns. The value of commencing pension contributions early, while recognising the existence of other financial strains such as student debt, should be stressed
- In the long term, policy makers need to move towards a tax-incentivised savings pot that allows for a certain number of lifetime drawdowns

While millennials do not want financial institutions to connect with them through social media, they may be open to web-based solutions such as apps and games





Preparing for Solvency II Time for asset managers and asset servicers to act

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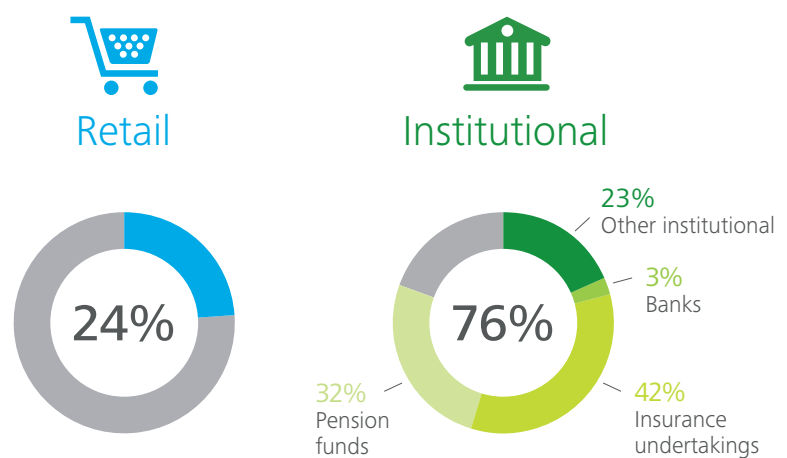
Michael Cravatte
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The insurance industry is a significant player in the overall fund sector, accounting for an estimated 42% of the European asset management market. This represents approximately €7 trillion¹ of assets held by an estimated 4,325 insurance and reinsurance undertakings across Europe. Although the incoming Solvency II regulations are not directly applicable to the fund sector, they will impact on Asset Managers and asset servicers (AMs) with insurance sector mandates in two ways. Firstly, considerable efforts will need to be undertaken by the asset management sector to become compliant with insurance-specific portfolio requirements.

Secondly, sound levels of preparation in this regard offer a competitive advantage to those AMs seeking to increase mandate wins from insurance clients. We outline the key areas of focus below.

European asset management industry Total AuM



¹ EFAMA, *Asset Management in Europe, Facts and Figures, June 2014*, based on total AuM of €16.8 trillion



Market risk is the largest component or module (more than 50%) of the standard Solvency Capital Requirement (SCR) formula

Solvency II—time is running out

Solvency II rules enter into force on 1 January 2016, with the objective of implementing common solvency requirements that better reflect the risks that insurers face, while at the same time delivering a consistent supervisory system across all EU member states. The new system is intended to offer insurance undertakings a greater incentive to measure and manage their risk situation more effectively, for example through lower capital requirements and lower pricing. It is the most important regulatory change impacting the insurance industry for a number of decades.

In order to ensure market readiness, the European Insurance and Occupational Pensions Authority (EIOPA) issued guidelines for National Competent Authorities (NCAs) on how to proceed in the period leading up to the application of the directive. Most EU NCAs have made a commitment to apply those guidelines. The guidelines require insurance undertakings to perform calculations and submit quantitative information relating to the 2014 financial year.

Solvency II is built on three pillars that govern the solvency requirement and approach:

- **Pillar 1** considers the quantitative requirements of the system, including the calculation of technical provisions, the rules relating to the calculation of solvency capital requirements and investment management. Market risk is the largest component or module (more than 50%) of the standard Solvency Capital Requirement (SCR) formula. The main elements of this module are equity, spread and interest rate risk, although the relative importance of the sub-modules varies widely according to the type of insurance undertaking
- **Pillar 2** deals with the qualitative aspects of an insurer's internal controls, risk management process and defines its risk appetite framework
- **Pillar 3** is concerned with enhancing disclosure requirements in order to increase market transparency and ease comparability

New product development

Investment funds currently represent around 29% of the total financial assets on the insurance balance sheet, and the capital requirements imposed by Solvency II will change the insurer's asset allocation. The insurance industry is now in the market for new asset management products that better reflect their incoming obligations and match their specific risk management framework.

To offer the products required by the insurance sector, AMs will have to consider the cost of capital of each type of investment and whether the cash flow matches the insurer's cash flow obligations. The investment strategy must take account of the fact that the SCR calculation is based on the Delta NAV approach, which requires modelling techniques to capture the interaction between the insurer's assets and liabilities. The SCR ratio calculated by the AM will not reflect the liability impact, and can therefore only be used by insurers as a risk/performance indicator.

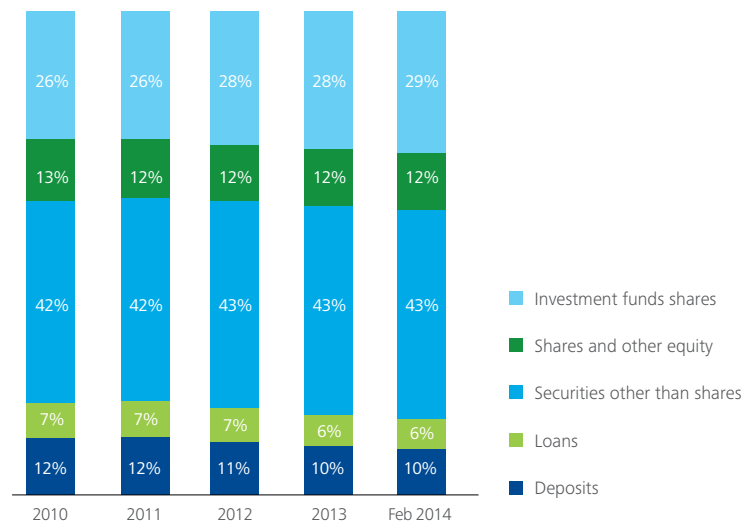
With this new regulation, AMs will have the opportunity to design tailored products that will secure and potentially increase the share of insurance undertakings in their institutional client portfolios.

Reporting

In order to properly assess the market risk inherent in collective investment undertakings and other investments packaged as funds, more granular information will be necessary. Insurance sector clients will be expecting a look-through approach to the underlying assets, since this is required for the Quantitative Reporting Template (QRT), as well as the SCR calculation.

Structure life insurer's investment portfolio

Euro area



Where the look-through approach cannot be applied to collective investment undertakings or investments packaged as funds, the SCR may be calculated on the basis of the target underlying asset allocation. However, this is dependent on the target allocation being available to the undertaking at the level of granularity necessary for calculating the Solvency Capital Requirement, and on the underlying assets being managed strictly according to this target allocation.

Where this approach is not possible, and for all collective investments to which the look-through approach cannot be applied, the type 2 equity charge (largest impact) should be applied. In this situation, however, insurance undertakings must provide an explanation to the regulator as to why the other approaches were not taken.

Insurance sector clients will be expecting a look-through approach to the underlying assets, since this is required for the Quantitative Reporting Template (QRT), as well as the SCR calculation

AMs must also align their agendas with those of their insurance client's risk management closing calendars (generally between three to six weeks after the closing date for quarterly evaluations). Some insurance undertakings are already in contact with their AM in order to define the content and format of the new reporting, while some initiatives at a national market level are currently defining a standard data request or a target reporting platform.

AMs should also be aware that these data requests have a number of implications for confidentiality (for example, the AM's investment strategy), fair treatment of different categories of investor (institutional and retail) and the transmission of data purchased under agreement from financial data providers.

Governance

Three particular areas of governance should be considered by AMs: data governance, mandates and the prudent person principle.

Data governance

Under Solvency II, AMs will become data providers. Data provided by AMs will be used by insurance undertakings to calculate the SCR and for disclosure purposes. Insurance undertakings are likely to implement data quality control procedures to identify deficiencies and to measure, monitor, manage and document their data quality. Deficiencies in data quality could affect business relationships with AMs.

Asset management mandate

Insurers must perform a detailed review of the service provider's ability to deliver the required functions. A written agreement (such as a Service Level Agreement) with the service provider that clearly allocates the respective rights and obligations of each party, including data governance aspects, will be expected. The service provider will also need to have an adequate risk management and internal control system in place.

Prudent person principle

While Solvency II does not implement any investment restrictions, it does not mean that undertakings can take investment decisions without considering whether they are prudent and in the interest of policyholders. AMs should only invest in assets for which the risks can properly be identified, measured, monitored, managed, controlled and reported.





The requirements of Solvency II extensively cover the main aspects of the prudent person principle, such as asset-liability management, investment in derivatives, liquidity risk management and concentration risk management. The more familiar AMs are with these requirements, the more flexibility they will be able to bring to their portfolio management.

Conclusion

Readiness in the asset management market for Solvency II varies widely. While France, Germany and the United Kingdom have adopted a common approach, many other countries are some way behind. A thorough knowledge of Solvency II requirements stands to become the defining feature of AMs seeking to retain or expand their portfolio of insurance clients in the future. Given the short time left prior to the new regime entering into force, insurers are likely to begin challenging their AM to provide comprehensive details. AMs will have to work hard to introduce and test new business processes well in advance of the January 2016 deadline to ensure a smooth transition. However, investments made now by willing firms can position them favourably for future growth opportunities in the insurance sector.

To the point:

- The new regulatory regime for the European insurance/reinsurance industry, Solvency II, will enter into force on 1 January 2016
- This regime provides a risk-based framework for supervision, in addition to strengthening governance
- Market risk is the largest component of the standard Solvency Capital Requirement formula
- A key issue related to market risk is the application of the look-through approach, particularly for unit-linked business and structured products
- The look-through approach is a real challenge for the insurance industry in terms of calculation and reporting
- The prudent person principle requires insurers to show that their investment strategy matches the interests of policyholders, thereby modifying the relationship between (re)insurers and their AMs



Investment management, mobility, and managing investor security concerns

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The investment management industry is developing mobile offerings for both clients and advisors. In many ways, the current state of the mobile channel harks back to the early days of the internet.

Investment managers had vociferous debates about the value of the internet, the return on investment of websites, what types of information and functionality to offer, and of course, on the safety and security of the internet channel. These very same questions are now being asked about the mobile channel.

To provide some data to better inform this latest debate, the Deloitte Center for Financial Services commissioned a survey by Andrews Research Associates, conducted in January 2014. The 2,193 respondents (of whom 1,488 were investment management account holders) were asked about their awareness, usage, preferences, and concerns when it came to interacting with financial services firms via mobile devices. Many operational and technical issues raised by the survey are covered in greater detail in a companion paper published by Deloitte University Press.¹ In this article, we focus specifically on the issues that impact the investment management industry.

Just how important is the mobile channel to investment managers?

At first glance, our survey data seem to indicate that mobile offerings may not be all that important to investment management account holders: only 27% of IM account holders said that mobile offerings are extremely important or important, with 36% stating that mobile is unimportant or not at all important.

When asked how useful mobile services are, the survey respondents tell a similar story: only 27% of IM account holders find the mobile services of investment managers extremely useful or very useful, while a majority, 53%, find the services not very useful, not useful at all, or are undecided as to how useful the mobile channel is.

These results might lead some investment managers to question whether it is worth investing in mobile at all. If clients don't find the service important or useful, why not invest those dollars elsewhere?

¹ Val Srinivas, Sam Friedman, Jim Eckenrode, 'Raising the bar on customer engagement through mobile financial services', Deloitte University Press, May 19, 2014

However, the story is more interesting when you dig a little deeper into the data. It turns out that the typical IM account holder who is a mobile user—as represented by respondents to the Deloitte survey—is potentially a very attractive customer to many investment managers.

For example:

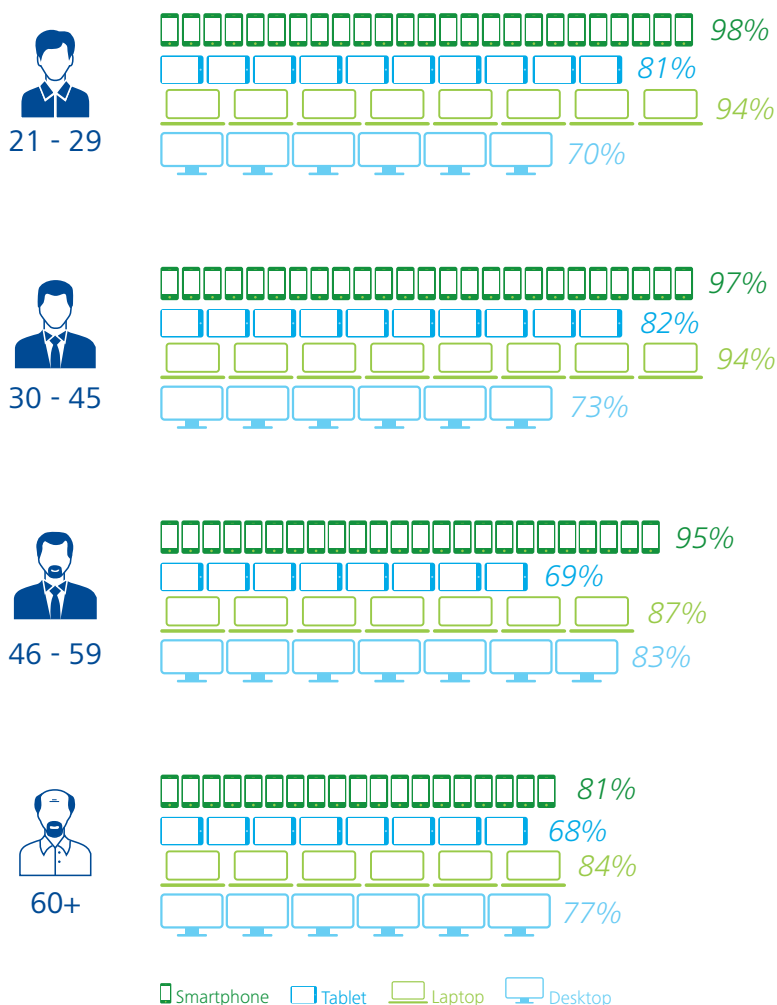
- 83% are homeowners
- 63% have a college or post-graduate degree
- 23% report income in excess of US\$100,000
- 55% report investable assets in excess of US\$100,000

These respondents seem to fall squarely within the “emerging affluent” and “affluent” segments that many investment managers are targeting. Another factor in favour of investing in mobile is that nearly all respondents aged 21-59 use a smartphone to interact with financial institutions (Figure 1).

It is also interesting that more than 80% of IM account holders aged 21-45 use a tablet to interact with financial institutions, and that IM account holders use multiple devices to interact with investment managers.

The survey data also indicate that a slight majority of IM account holders, despite an apparent lack of enthusiasm, do in fact interact with a financial institution (not only an investment manager) via mobile devices. It is noteworthy that IM account holders are using their mobile devices for some financial services activities, despite saying that those same mobile services are less important for investment management.

Figure 1: Which of the following devices, if any, do you use to interact with your financial institution?



Variable N=1,110 to 1,391 investment management account holders
Source: Deloitte Center for Financial Services, 2014

The biggest challenge to widespread mobile adoption in the financial services industry, by far, is concern about security

How is the mobile channel being used in investment management?

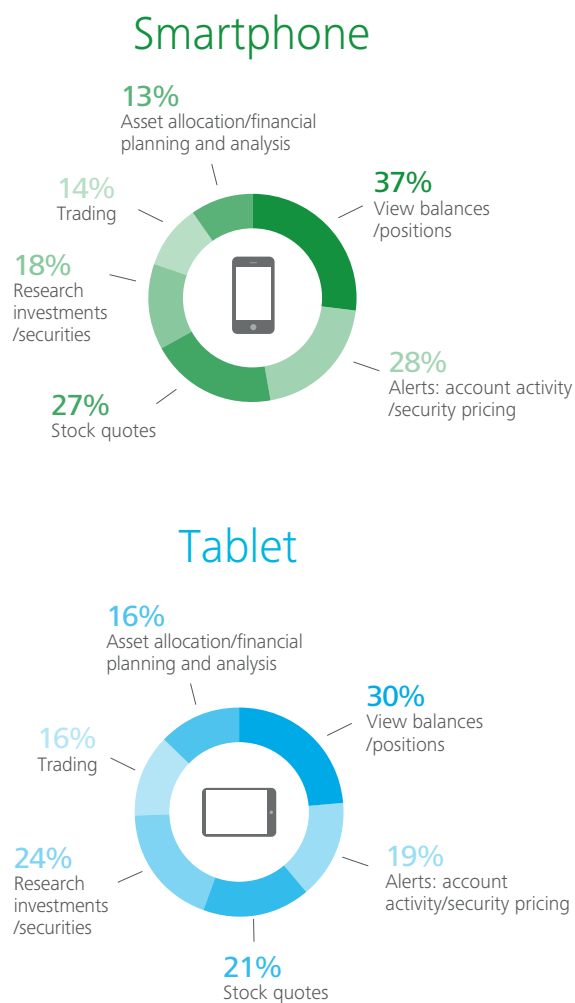
According to our survey, IM account holders primarily use their mobile devices for the consumption of information. As shown in Figure 2, the top four options chosen are all information-based activities. Mobile use for an actual transaction, i.e. trading, is one of the least popular offerings, at about 15% of those surveyed.

The importance of the size of the device also came through when we asked IM account holders about the major limitations impacting the use of mobile for financial services. The two leading responses were: “difficulty in seeing on a smartphone screen”, at 31%, and “difficulty in typing on a smartphone screen”, at 23%. When asked the same question about tablets, only 3% had those issues.

Our survey data show that the biggest challenge to widespread mobile adoption in the financial services industry, by far, is concern about security (Figure 3).

The fact that 78% of respondents were at least “fairly concerned” about mobile security for investment purposes goes a long way to explain the less extensive use of mobile services for investment management. The real impact on investor behaviour is also shown in Figure 3, with 75% of respondents stating that their security concerns had at least ‘moderately’ restricted their use of mobile for all financial services. The concerns about mobile security are palpable in some of the survey’s open-ended responses.

Figure 2: How do you currently use your smartphone or tablet for investments?





Investment managers should next consider what they want to get out of their mobile offering and build accordingly

These include:

- *"Hackers are becoming more and more active in the world and are able to access and steal identities."*
- *"I am afraid that my account information could be captured by an outside group. Also I am not convinced that mobile security programs are effective. Therefore I prefer to do as little financial business as possible on mobile devices."*
- *"I am not even going to take the chance."*

These security concerns are impacting which mobile services, if any, investors are willing to use. The Deloitte survey data suggest that respondents have several levels of concern regarding mobile security. According to our open-ended answers in the survey, IM account holders were least concerned about viewing general information, and more concerned with any activity

that required entering their own information. This argument is also consistent with the data in Figure 2, which indicate that mobile use is low for transactions. This tiered level of concern should be considered when investment managers are designing their mobile offerings.

What about the advisor?

One intriguing finding from our survey is that all respondents were more likely to find mobile banking services extremely or very important (39%) than investment services (23%) or insurance services (19%). One possible reason for this is that for many, banking tends to involve more routine transactions. Another factor is that both insurance and investments are more likely to be intermediated than banking, meaning that the investment manager does not always have a direct relationship with the end client because an advisor is often in the middle.

The fact that many advisors serve clients outside of their office provides a real opportunity to harness the power of mobile offerings. For example, an advisor could use a tablet to present a client with a quarterly review, or wirelessly print an account application, and complete it electronically with e-signature capability. Another useful finding from the study is that 53% of investment management account holders said that immediate access to a video call with their investment advisor would be fairly or very valuable. This type of virtual face-to-face interaction could have any number of service applications for investment managers in the future.

What does it all mean and what should investment managers do?

Is mobile a worthy pursuit?

The first task is to decide whether and how much to invest in a mobile strategy. Our data show that it is by no means clear that investors are ready to widely accept mobile services and that presents a challenging decision for investment managers. However, because of the growth of smartphones and tablets overall, and the fact that a significant percentage of account holders do interact with investment firms via mobile devices, we expect the majority of investment managers to continue to invest in mobile.

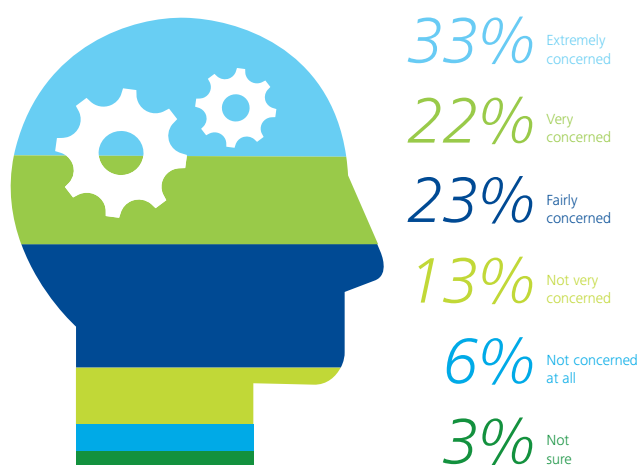
Assess priorities

Investment managers should next consider what they want to get out of their mobile offering and build accordingly.

Is the primary goal marketing and branding, is it serving advisors, is it enhancing customer service, or is it to make all web functionality, such as transactions, accessible via mobile devices? This setting of priorities will have far-reaching implications for the design and delivery of mobile offerings and should be carefully considered.

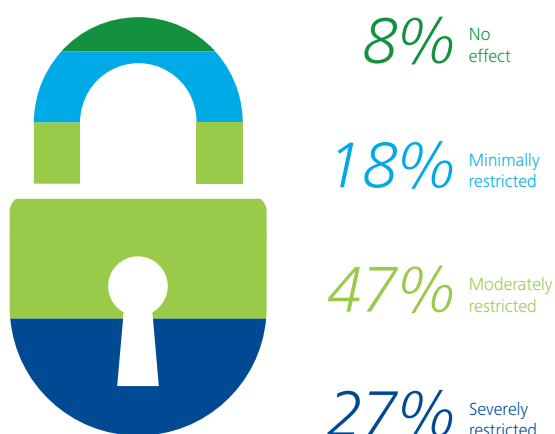
Figure 3: Investor security concerns versus actual mobile use

How concerned are you in general about the security of your mobile devices for investment purposes?



*N=1,488 investment management account holders
Source: Deloitte Center for Financial Services, 2014*

To what extent has your concern about security restricted the way you use your mobile devices to access financial services?



*N=1,283 investment management account holders
Source: Deloitte Center for Financial Services, 2014*

Integrate customer touchpoints

Our survey also shows that investment management account holders interact via multiple devices. This means investment managers cannot think of mobile as a discrete channel. Rather, it is part of a customer service ecosystem that must be integrated with other customer touchpoints.

It is customers who will determine how, when, and on what devices they will interact with investment managers. For example, a customer on the train to work might use a tablet to check the status of a fund purchase, then, seeing an issue, might stop by a branch office to inquire, and then check again later that day from their laptop to ensure the trade was executed.

Address security concerns

An important part of the prioritisation process for investment managers is the security concerns of their clients. Our data indicate that accessing general or educational information is less of a concern to many investors. However, the real power of mobile can be harnessed when clients log into their accounts, can view the performance of their individual accounts, and are able to make transactions. By making the mobile experience personal, it becomes more valuable, has the potential to reduce service costs, and can provide valuable analytics.

For example, when investors are logged in, investment managers can gain precious demographic information on the use of mobile services and build accordingly in the future. The focus on security requires effort in both technology and marketing. Investment managers should strive to ensure the security of their mobile offerings and they must convince their clients of that security if they want full investor engagement. This is a challenging, long-term and ongoing effort, but a necessary step in the evolution of mobile investment offerings.



To the point:

- IM account holders who use mobile devices are potentially very attractive customers to many investment managers, as according to the survey 83% are homeowners, 63% have a college or post-graduate degree, 23% report income in excess of US\$100,000, 55% report investable assets in excess of US\$100,000
- IM account holders primarily use their mobile devices for the consumption of information including viewing balances and positions, alerts, quotes and research
- The two major limitations impacting the use of mobile devices were *"difficulty in seeing on a smartphone screen"* at 31%, and *"difficulty in typing on a smartphone screen"* at 23%, while only 3% of tablet users had these challenges
- 78% of survey respondents were at least fairly concerned about mobile security. They were least concerned about viewing general information, and more concerned with any activity that required entering their own information
- 53% of respondents felt that that immediate access to a video call with their investment advisor would be fairly or very valuable

Mobile is part of a customer service ecosystem that must be integrated with other customer touchpoints

No time for KIDding around PRIIPs is on the way

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At the start of this year, the EU regulation that will introduce Key Information Documents (KIDs) for Packaged Retail and Insurance-based Investment Products (PRIIPs) entered into force, marking a significant milestone in a process that has already been seven years in the making.

From the end of 2016, all persons in the EU advising on or selling PRIIPs will be required to provide the KID to retail investors. KIDs will be highly standardised documents, no longer than three sides of A4-sized paper. They will be drawn up by the PRIIP 'manufacturer' and include information such as the PRIIP's risk-reward profile and the total aggregate costs.

The KID regulation is a key pillar of the EU's consumer protection agenda, intended to improve the ability of retail investors to understand and compare investment products across sectors. Hence the term 'PRIIP' covers a range of products including investment funds, life insurance policies with an investment element, structured products and structured deposits. Importantly, as UCITS already have their own Key Investor Information Document (KIID), they will be exempt from the regulation for at least five years, after

which the transitional period could be extended, the UCITS KIID could be replaced with the PRIIPs KID, or the two documents could be deemed to be equivalent. The same transitional rules will also apply where Member States have already extended UCITS KIID rules to non-UCITS funds sold to retail investors.

The investment management sector will already be well aware of the operational challenges that were involved in implementing the UCITS KIID. Firms that manufacture UCITS will be able to draw on these experiences to some extent, while firms that focus on non-UCITS PRIIPs (e.g. retail Alternative Investment Funds (AIFs)) will have a higher mountain to climb. When set alongside other regulatory initiatives addressing investor protection, such as MiFID II, PRIIPs may also have wider strategic implications for firms by enhancing competition across products, sectors, and ultimately, countries.

The Regulation is a key pillar of the EU's consumer protection agenda, intended to improve the ability of retail investors to understand and compare investment products across sectors



Manufacturing on an industrial scale

A key challenge for PRIIP manufacturers will be the sheer volume of KIDs that will need to be produced. As of 2009, the total PRIIP market in the EU was estimated at €9 trillion, although UCITS accounted for 58% of this figure¹. Manufacturers will need to establish an inventory of all their PRIIPs, identifying all non-UCITS that meet the PRIIP definition and are sold to retail investors. They will need to source and collect accurate and up-to-date information and data about each PRIIP, from the right department in the firm, to populate the KID. This may prove particularly challenging with respect to the calculations of risk and costs, where the information may differ from that required for the UCITS KIID or may not be readily produced by existing systems. The KID will need to be written in clear and understandable language that avoids financial jargon, while remaining accurate and not misleading. Experience from the implementation of the UCITS KIID suggests that this could prove particularly challenging in a document intended to be concise. Manufacturers will need to ensure that KIDs are kept up to date and made easily available on their website, and that distributors, who are responsible for providing the KIDs to retail investors, receive sufficient training with respect to the KID.

The manufacturer will not be able view the KID in isolation, as it will need to be consistent with any binding contractual documents, with the relevant parts of the offer documents, and with the terms and conditions of the PRIIP. Moreover, the manufacturer will need to consider any overlaps with other EU disclosure documents. As outlined above, the future of the UCITS KIID is currently unclear, but for the next five years at least, UCITS will be exempt from PRIIPs. There could also be some relief in relation to MiFID II disclosure. According to a discussion paper issued by the Joint Committee of the three European Supervisory Authorities (ESAs)² in November 2014, the ESAs are seeking coordination between MiFID II and PRIIPs, "so that information in the KID on costs might be considered complete and sufficient for the purposes of disclosures required by MiFID II"³.

It will be important to get the KID right, as manufacturers will be liable where damage is suffered by the retail investor as a result of reliance on a KID that is misleading and/or inaccurate, or inconsistent with pre-contractual or contractual documentation. Firms will struggle to do this on a manual or ad hoc basis. Instead, they will need a streamlined process, with robust governance arrangements. Firms will

1 *Impact assessment of the proposal for a regulation on key information documents for investment products*, European Commission, July 2012

2 *The European System of Financial Supervision (ESFS) consists of the three ESAs, the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA), and the European Systemic Risk Board (ESRB)*

3 *Discussion paper: Key information documents for Packaged Retail And Insurance-based Investment Products (PRIIPs)*, Joint Committee of the ESAs, November 2014



need to ensure a team is responsible for overseeing and documenting the lifecycle of the KID, to compile, verify and maintain the KID. Firms that manufacture UCITS may to some extent be able to leverage existing experience, processes and systems used for the UCITS KIID. One option for firms could be to outsource their KID production, as many firms have done with respect to the UCITS KIID. However, they would still retain liability under the PRIIPs Regulation.

Staying ahead of the competition

While there is no doubt that PRIIPs will bring significant operational challenges, particularly for firms that focus on non-UCITS PRIIPs, firms should regard PRIIPs implementation as more than a compliance exercise. The ESAs are seeking to ensure that the KID does not become yet another disclosure document that investors skim read or ignore. Drawing on behavioural economics, the content and design of the KID will be informed by consumer testing organised by the European Commission and completed by a contractor which will assess the relative effectiveness of different KID 'mock-ups'. The testing will be completed in August 2015 and will include assessing how well visual summary indicators of risks and costs associated with the product (e.g. 'traffic light' symbols or charts) are understood by customers.

If the KID works as the ESAs intend, retail investors, as well as independent advisers, should be able to easily and quickly compare the relative value of products between different manufacturers, and across sectors and countries, enhancing competition. Behavioural economics suggests that people are less likely to choose products that have extreme results in the summary risk and cost indicators. The KIDs products that may be difficult for retail investors to understand will also contain a 'comprehension alert' flagged by the manufacturer, which could prompt investors and advisers to consider whether a less complex product could be more appropriate.

And PRIIPs is not the only initiative seeking to strengthen investor protection. Among a number of other requirements, MiFID II will introduce extensive product governance rules and a definition of independent investment advice. There will also be stronger inducements rules and enhanced disclosure on products and services. Against this backdrop, now might be a good time for firms to consider their product offerings to ensure that their products meet the needs of a defined target market, are not unnecessarily complex, and offer good value for money.

Next steps

While the text of the KID Regulation has been finalised, in some ways this is only the beginning of the story. Work is now under way by the ESAs to develop the level two measures that will underpin the regulation. They have a lot to get through if they are to leave firms with sufficient time to implement the regulation before the rules 'bite' on 31 December 2016.

The discussion paper issued by the ESAs in November 2014 outlined preliminary options and possible approaches for the KID Regulation. A further discussion paper is expected in the spring on more complex aspects of the Regulatory Technical Standards (RTS). The ESAs will publish further consultation papers prior to the summer covering specific parts of the KID Regulation, and a consultation on the draft RTS in autumn 2015. The RTS will be submitted to the European Commission between December 2015 and February 2016, where they will need to go through a further EU approval process before entering into force. These rules will apply directly in member states, without the need for transposition.

It may therefore be some time before we know the final content and format of the KID. Given the narrow implementation window for firms, implementation plans should consider how much can be done in advance of the finalised requirements. Firms should follow the level two discussion closely and be aware of the implications for their business. This should leave them in a relatively strong position to make any necessary investments in systems and resources to meet the implementation deadline.

To the point:

- The PRIIPs regulation will bring significant operational challenges for manufacturers to compile, verify and maintain a large volume of KIDs, particularly for firms that focus on non-UCITS PRIIPs
- If the KID works as the ESAs intend, retail investors, as well as independent advisers, should be able to easily and quickly compare the relative value of products between different manufacturers, and also across sectors and countries, thus enhancing competition. Other initiatives, such as MiFID II, will seek to further strengthen investor protection. Against this backdrop, now might be a good time for firms to consider their product offerings
- The Regulation will apply on 31 December 2016. The ESAs are to consult on the draft RTS in autumn 2015. Given the narrow implementation window for firms, implementation plans should consider how much can be done in advance of the finalised requirements
- Manufacturers will need to consider overlaps with other EU disclosure documents, although it is unclear if the UCITS KIID could be replaced by the PRIIPs KID, or the two documents could be deemed equivalent. UCITS will be exempt from the Regulation for at least five years. There could be some relief in relation to MiFID II disclosure, since the ESAs are seeking coordination between MiFID II and PRIIPs





New tax regulations impacting investment funds

Germany **India** Ireland Netherlands
Switzerland



Germany

New tax regulations under AIFM-StAnpG—guidance from the German fiscal authorities

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Till Westermeier
Manager
Financial Services Tax
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At the second attempt, the AIFM Tax Adjustment Act (AIFM-StAnpG) came into force on 24 December 2013. The Federal Ministry of Finance (BMF) has issued a set of guidelines regarding, *inter alia*, the treatment of share classes, investment restrictions, allocation of expenses, distribution order, transitional arrangements and eligible assets.

Background—scope of application and changes

Modified scope of application

In general, the German Investment Tax Act (InvStG) is applicable for all UCITS and AIFs. Holding companies, institutions for occupational pension schemes, securitisation special purpose entities, venture capital companies and public sector capital investment companies are not subject to the InvStG.

The taxation of mutual funds in its current form remains generally unchanged; however changes will be made in subareas. From a tax perspective, UCITS and AIFs only qualify as funds when the requirements of section 1, paragraph 1b of the InvStG are fulfilled. In other cases, funds are considered to be investment companies, for which the taxation for business partnerships or corporations applies, depending on the legal form of the entity concerned.

Changes

Domestic pension pooling/investment limited partnership

The open-ended investment limited partnership was introduced as a third form of an open-ended domestic investment fund. As an investment fund, it is exempt from trade tax and does not establish a domestic business premise for its investors.

The main objective of introducing an open-ended investment limited partnership was to create a transparent investment tool for DBA purposes that offers domestic pension scheme institutions the opportunity of a full or partial reduction or refund of foreign source taxes. German pension and retirement institutions should compare the advantages of this structure with schemes currently used.

Distributions

Distributions made after 23 August 2014 are to be primarily taken from earnings from the current and past fund financial years for tax reasons. A substance distribution, meaning repayment of capital, can only be made if all income and gains for the current year and prior years have already been distributed.

The taxation of mutual funds in its current form remains generally unchanged; however changes will be made in subareas

General transitional rules

The AIFM-StAnpG regulations are generally to be applied after 23 December 2013. The transition regulations state that investment funds which were launched before 24 December 2013 will be considered as investment funds until the end of the financial year that ends after 22 July 2016, as far as they continue to fulfil the previous requirements of an investment fund according to the old InvStG. The InvStG regulations in the version applicable on 21 July 2013 will continue to apply for the period from 22 July 2013 to 23 December 2013.

Cost allocation

Direct costs must be set off against the corresponding income if a direct economic link can be established. Subsequently the remaining expenses are considered to be 'general expenses' (*Allgemeinkosten*) and have to be deducted in three distinctive steps (Level 1 to 3), increasing the complexity factor.

- **Level 1:** 100% of the general expenses have to be allocated to their corresponding source of income based on the previous fiscal year, i.e.
(1) DTT-sourced (tax-exempt real estate proceeds),
(2) equity-sourced and (3) other assets
- **Level 2:** expenses have to be split within their 'category' between current income (e.g. rent, interest, dividends, manufactured dividends, gains/losses reclassified as DDI "*Finanzinnovationen*") and realised gains/losses from disposal of investments (i.e. disposal of real estate after ten years, equity and other investments) on a pro rata basis
- **Level 3:** another allocation of general expenses to certain further sub-categories within their specific income category applies. The details are set out in BMF Circular dated 22 September 2014 and amended on 10 November 2014

Remaining expenses have to be deducted in three distinctive steps (Level 1 to 3), increasing the complexity factor



Share classes and income equalisation

The procedure for general expense allocation has to take into account income equalisation. Generally, the fiscal authority prefers a single expense allocation ratio for all share classes; newly issued share classes adopt the previous year's values of the existing entire sub-fund. Expense allocation ratios that differ at the share class level are only accepted by the fiscal authority if the difference is immaterial. So far, the only official statement is that a difference between classes deriving from currency hedging would be considered immaterial. As a simplification rule, the income equalisation values may be taken into account only for share classes for which the German tax reporting data is calculated and published according to section 5 of the InvStG (paragraph 1, sentence 1, points 1-3).

Start of calculation at fund launch

The launch of a new sub-fund also requires the determination of three types of assets—real estate, equity and other. Due to the lack of a prior year, the ratio of the average assets has to be based on the current fiscal year, as in previous legislation. At Level 2, the costs are divided equally between current income and realised gains/losses from the disposal of investments.

Level 3 cannot be applied for newly launched funds. The fiscal authority would therefore accept any appropriate and coherent allocation criteria.

The fiscal authority prefers a single expense allocation ratio for all share classes

Funds of funds

A simplification rule for funds of funds is already in place. At Level 1, the asset source of target funds is classified according to the fund categories set out in the BMF Circular on the Investment Tax Act (text no. 66) dated 18 August 2009.

At Level 2, funds of funds can make use of another simplification rule for the allocation between current income and other realised gains/losses from the disposal of investments.

Transitional rules for cost allocation

There are transitional rules in place to allow for a less than strict interpretation. The BMF will accept a different general expense allocation for fiscal years beginning before 1 April 2015 and will not request retroactive corrections.

Investment restrictions (*Anlagebestimmungen*) and asset classification

Requirements within investment restrictions

The InvStG establishes its own scope of application, apart from the investment law (KAGB). UCITS and AIFs are considered to be investment funds if they fulfil the requirements of e.g. supervision, right of redemption, risk diversification and no active commercial management of the assets.

- A temporary suspension of fund unit redemption for up to 60 months is accepted, e.g. for the winding up of portfolios
- The fiscal authority will consider foreign UCITS as being risk diversified without assessment. A temporary mismatch at launch/winding up is accepted

Inadequate asset classification by a data vendor

If a data vendor (e.g. WM Datenservice) provides an inadequate asset classification for a German tax reporting calculation, a correction has to be made when this is brought to light. Future publications under section 5 of the InvStG must also reflect the correction.

A temporary suspension of fund unit redemption for up to 60 months is accepted, e.g. for the winding up of portfolios

Lump-sum taxation under section 6 of the InvStG

German lump-sum taxation rules breach the EU principle of free movement of capital, according to the 'Van Caster' decision of the European Court of Justice (C-326/12).

In general, funds have to fulfil German tax reporting requirements (calculation and publication) for German investors within four months after the end of the fiscal year or, if applicable, after a formal distribution resolution. If such tax-relevant information has not been made available or the related publication requirements have not been met, the taxable income attributed to German investors through investments in "non-transparent investment funds" has to be determined on a lump-sum basis (a minimum of 6% of NAV at the end of the calendar year).

The ECJ decision

In its decision C-326/12 dated 9 October 2014, the ECJ ruled that lump-sum taxation under the German investment fund tax reporting regime breaches the EU concept of free movement of capital, as investors are not allowed to provide tax authorities with proof of actual income generated using appropriate documents or information.

Following this ECJ decision, the BMF issued a draft circular dated 31 October 2014 giving guidance on how to provide the tax authorities with proof of actual income generated through appropriate reporting. The level of detail and depth has to be the same as in the relevant fiscal year-end publication in the Federal Gazette (*Bundesanzeiger*). Only the strict timeline (four months after the fiscal year-end or formal distribution resolution within four months) can be omitted.

Future approach: non-transparency?

There are current discussions about a completely new approach with respect to the taxation of mutual funds. This future approach might include a tax regime for mutual funds without any reporting requirements. The specific outcome is still unknown.

In general, funds have to fulfil German tax reporting requirements for German investors





India

The regulatory and tax framework for offshore funds investing in India

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India opened its capital markets to Foreign Institutional Investors in 1992 as a part of wider economic reforms. Foreign Institutional Investors or FIIs (as they are popularly known in India) have played a very important role in the growth of the country's economy as well as its capital markets. FII investments have grown (on a net basis) from US\$826 million in 1993 to US\$39 billion in 2014 (January to November 2014). Cumulative net investment by FIIs since 1992 has totalled over US\$200 billion (www.sebi.gov.in).

Prior to investing in India, the first step is to seek a licence or registration from the capital market regulator, the Securities and Exchange Board of India (SEBI). Since January 2014, the SEBI has overhauled the regulations applicable to FIIs and replaced the earlier FII regulations with the new foreign portfolio investor (FPI) regulations.

Prior to investing in India, the first step is to seek a licence or registration from the capital market regulator, the Securities and Exchange Board of India (SEBI)

Under the new regulations, any foreign investor (subject to meeting entry conditions) can invest in the Indian capital markets. This is a significant relaxation from earlier norms, where only specific types of investor (such as sovereign funds, pension funds, mutual funds, etc.) were eligible to register as FIIs or sub-accounts. For instance, non-broad based funds, family offices, foreign corporates or individuals who could not get registration under the earlier regime can now register as Category III FPIs. Furthermore, in the new regulations, there is no requirement for non-fund investors such as banks or insurance companies to introduce a broad based sub-account (with 20 or more investors) as in the earlier regime.

The other significant change made by the new regulations is that the SEBI has now delegated the process of granting registrations to the sub-custodians, which are called Designated Depository Participants (DDPs). Also, an outer timeline of 30 days has been set by the SEBI for custodians to grant registrations to FPIs. On the flip side, the Participatory Note (P-Note) regime has been made very strict and only regulated funds eligible to invest as FPIs will now be allowed to subscribe to P-Notes of FPIs. Moreover, investments under the P-Note route and FPI route will be pooled for the purposes of monitoring the investment ceiling. This will require FPIs issuing P-Notes to have a more robust KYC and investment monitoring framework. In addition, FPIs are no longer allowed to invest in unlisted shares.

An overview of the regulatory and tax framework applicable to FPIs is provided on the following pages.



FPI regulations

Definition of FPI

The regulations define a Foreign Portfolio Investor (FPI) as a person who satisfies the eligibility criteria prescribed under the regulations and has been registered as an FPI. Existing FIIs, sub-accounts and Qualified Foreign Investors (QFIs) have been grandfathered as FPIs.

Conditions to be met by an investor to register as FPI:

- The investor is not resident in India and is not a non-resident Indian
- The investor is a resident of a country whose securities market regulator is a signatory to the IOSCO (International Organization of Securities Commissions) Multilateral Memorandum of Understanding (Appendix A Signatories) or a signatory to a bilateral memorandum of understanding with the SEBI
- If the investor is a bank, it should be resident in a country whose central bank is a member of the Bank for International Settlements
- The investor is not resident in a country identified in the Public Statement of the Financial Action Task Force

- The investor entity should not be an opaque structure such as a protected cell company, segregated cell company or equivalent, where the details of the ultimate beneficial owners are not accessible/ring fenced, etc.
- The investor is legally permitted to invest in securities outside its own country and is authorised by its memorandum of association or articles of association or equivalent document to invest on its own behalf or on behalf of clients
- The investor has sufficient experience, a good track record, is professionally competent, financially sound and has a good reputation of fairness and integrity

For its part, the Indian government has tried to contribute by easing the regulatory framework for FPIs

FPI categories

The following three categories have been prescribed in the regulations under which FPIs would be registered. The categories are based on the risk profile of investors, with Category I being the lowest risk category. The KYC documents required from an investor have been rationalised on the basis of the category to which it belongs.

Category I	Category II	Category III
Government and government agencies	*Broad based funds including mutual funds, investment trusts, insurance/reinsurance companies	Non-broad based funds, unregulated funds
Central banks	*Banks, asset management companies, investment managers/ advisors, portfolio managers	Corporate bodies, trusts, individuals, family offices
Sovereign wealth funds	University funds, pension funds	Endowments, charitable associations/trusts/foundations
International or multilateral organisations/agencies	University-related endowments registered with the SEBI as FIIs/ sub-accounts	Other foreign investors not covered in Category I & II

*The entity needs to be regulated by the securities market regulator or banking regulator. In the case of an unregulated broad based fund, its investment manager should be appropriately regulated and registered as an FPI, and remain accountable for the fund's compliance.



Key investment conditions and restrictions

The key investment conditions and restrictions are listed below:

- Investments are permitted in equity shares, preference shares, government bonds, corporate bonds, mutual fund units, warrants, exchange traded derivatives, commercial papers, Indian depository receipts, security receipts of asset reconstruction companies
- Investment in shares, bonds (other than in the infrastructure sector), warrants restricted to “listed” or “to be listed” securities
- Investments in equity shares by a single FPI or an investor group (i.e. multiple FPIs with common beneficial owners) must amount to less than 10% of the issued capital of the company
- Investment in bonds is subject to the availability of debt limits
- Investments in exchange traded derivatives are subject to the position limits and margins stipulated by stock exchanges
- Investment in equity shares subject to margins stipulated by stock exchanges
- Securities can be purchased either from the issuer in the primary market or through a registered broker in the secondary market
- Category I & II FPIs (except for unregulated broad based funds) can issue offshore derivative instruments (such as participatory notes) on the basis of underlying Indian securities to regulated entities eligible for FPI registration in India
- Investment in the equities of an Indian company by all FPIs taken together is restricted to 24% of the paid-up capital or the limit approved by the company by special resolution (subject to a sector cap/statutory limit)
- Investments are not permitted in companies engaged in the defence industry (subject to licensing requirements), chit funds, Nidhi companies, agricultural or plantation activities, real estate or the construction of farm houses or trading in Transferable Development Rights (TDRs)

- The currency risk on the market value of investment in equities and debt securities can be hedged by executing forward instruments and options contracts. IPO-related flows can be hedged using FCY-INR swaps
- Investment in the equity shares of private sector banks by FPIs is restricted to 5% of the paid-up capital
- Sale proceeds or any other income can be remitted out of India only after payment of taxes

Tax framework

Tax rates

Typically, income earned by FPIs in India includes gains from the sale/transfer of securities, dividends and interest. The domestic tax rates applicable to FPIs are discussed below.

Capital gains: capital gains are divided into long-term and short-term capital gains. In the case of listed securities and units of equity-oriented mutual funds, if the security is held for more than one year, it results in long-term capital gains, and if sold within a year, it results in short-term capital gains. For other securities (including unlisted securities), this threshold period is three years. Long-term capital gains earned from the sale of equities on the stock markets and from the sale/redemption of units of equity-oriented mutual funds are exempt from tax, whereas short-term capital gains from such transactions are taxed at 15%. The capital gains earned from other transactions (including bonds, derivatives or the off-market sale of equity shares) are taxed at 10% for long-term gains and 30% for short-term gains.

Under the new regulations, any foreign investor (subject to meeting entry conditions) can invest in the Indian capital markets



Dividends: dividends received by FPIs from Indian companies are exempt from tax, as the Indian company is required to pay a dividend distribution tax of 15% on them. Dividends paid by foreign companies in India on Indian depository receipts are taxable at 20%.

Interest: until May 2015, interest income earned from government securities and most corporate bonds is taxable at 5%. If the current concessional tax rate is not continued, interest income will be taxable at 20% after May 2015.

The tax rates mentioned above are as per the domestic tax law and required to be increased by a surcharge and education cess (rate), which depends on the quantum of income and legal status of the taxpayer. If the FPI is a tax resident of a country with which India has entered into a tax treaty, the treaty provisions would be applicable to the extent that they are more beneficial to the FPI. For instance, in case of funds based in Mauritius, Singapore or even certain European countries such as Belgium, Denmark, France etc., capital gains earned in India are not taxable provided the treaty conditions are met.

FPIs that route their investments through tax-efficient countries such as Mauritius are concerned about the proposed implementation of General Anti-Avoidance Rules (GAAR)

Recent developments

Clarification of the treatment of income from the transfer of securities: in the 2014 Budget, the Indian government clarified that the income earned by FPIs from the transfer of securities would be classified as capital gains. This clarification has put to rest the controversy on whether to treat such income as capital gains or business income. Moreover, it was also mentioned that this clarification should encourage FPIs to locate their fund managers in India, as there should be no concerns regarding the location of the fund manager in India being taxed as a permanent establishment of the FPI.

GAAR: FPIs that route their investments through tax-efficient countries such as Mauritius are concerned about the proposed implementation of General Anti-Avoidance Rules (GAAR) likely to be enacted from April 2015. Under the GAAR, the tax authority will have the power to tax any arrangement that lacks commercial substance or where the main purpose of the arrangement is to avoid tax or to misuse/abuse the provisions of the law.

Taxpayers are concerned that various structures could be challenged on the argument that they are abusive. This concern emanates from the fact that there are no objective tests provided in the law to test the various triggers mentioned in the GAAR, such as the lack of commercial substance or misuse/abuse of the law, and therefore the ground level tax officer may take an aggressive stance—especially in the case of investments through tax-efficient countries such as Mauritius. There is an expectation that the government will issue certain clarifications or may even defer the enactment of the GAAR, but any official announcement in this respect is expected only in February 2014 when the Finance Minister presents the Budget for 2015. Fortunately, GAAR will not apply to FPIs where the annual tax benefit does not exceed approximately US\$500,000.

Indian tax implications for the transfer of shares of entities located outside India: in 2012, the Indian government amended the income tax law with retrospective effect from 1962 to clarify that the transfer of shares or interests in a foreign entity would be taxable in India if such entity derives substantial value from assets located in India.

The Indian government clarified that the income earned by FPIs from the transfer of securities would be classified as capital gains

While these provisions have not been enforced on investments under the FPI route, technically, the transfer of shares/interests by the beneficiaries of the funds as well as the restructuring of the funds could be subject to tax in India, especially in the case of India-focused funds.

There have been multiple representations on this aspect by investor forums to the Indian government to keep stock market investments outside the scope of indirect transfer tax, but there has been no clarification from the government on this issue as yet.

India is now on the world stage in relation to fund investments, and the Indian stock market has been one of the best performers globally this year. For its part, the Indian government has tried to contribute by easing the regulatory framework for FPIs. While FPIs enjoy a simplified tax regime, recent changes such as the GAAR and indirect share transfers are being watched carefully by foreign investors. Any clarifications on these aspects for FPIs will certainly be welcome.



Ireland

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ICAV

The Irish Collective Investment-management Vehicle (ICAV) will be Ireland's newest corporate fund vehicle. The ICAV offers enhanced distribution and a simplified compliance model. The ICAV is being introduced under new legislation which is tailor-made for investment funds resulting in a more efficient and effective fund structure.

The ICAV has many benefits over the existing fund structures available in Ireland. The aim of the ICAV is to combine the advantages of each of the existing fund vehicles into one, offering many benefits to investors and promoters.

The ICAV offers an attractive alternative fund structure, both for existing funds who may opt to convert to an ICAV and also for new funds being established

The main advantages of the ICAV include:

- Future proofing against company law changes in Ireland and in Europe
- U.S. "check the box" election is possible (the existing Variable Capital Company (VCC) structure is not eligible for "check the box")
- Can hold a single asset
- The ability to prepare financial statements on a sub-fund basis
- Easier to amend constitutional documents
- The ability to elect to dispense with an AGM

The ICAV is optional, so existing structures are not obliged to change, but have the option to do so if they wish. We would expect that funds may decide to change to the ICAV where the cost-benefit of changing is favourable.

Existing VCCs will be in a position to convert to an ICAV through a simplified conversion process. Overseas investment companies will be able to convert to an ICAV under the streamlined re-domiciliation migration one-step process introduced in 2009, rather than being required to migrate and then convert.

Conversion and migration will be available to both UCITS and AIFs structured as corporate entities.

Under the current draft of the legislation, UCITS can merge to form ICAVs, but it remains to be seen whether AIFs will be permitted the same flexibility. It is envisaged that mergers of existing overseas funds will be through a streamlined one-step approach process.



When considering if you should convert your existing VCC into an ICAV, the tax matters to be addressed include:

- Have your US tax advisors reviewed your proposed ICAV structure to ensure that any sub-funds are suitable for “*check the box*” election and meet your US tax objectives?
- Will “*checking the box*” trigger any adverse tax consequences for US investors who currently treat the investment as opaque?
- Liaise with your tax advisors on foreign tax reporting to understand if any considerations need to be addressed (e.g. German, UK, Swiss tax reporting).
- Is the same Investment Undertaking Tax (IUT) number still appropriate?
- Will the non-residency fund tax declarations remain intact for the new ICAV (as the forms are in the name of the VCC)?
- Will the nature of the changes give rise to any unintended disposal or other tax implications for existing investors?
- Is the service provider able to perform the required reporting for US investors if the “*check the box*” option is utilised?

From an Irish tax perspective, the ICAV falls within the normal funds tax regime, i.e. gross roll up fund, which pays no direct tax in Ireland when all investors are non-Irish resident.

The ICAV offers an attractive alternative fund structure, both for existing funds who may opt to convert to an ICAV and also for new funds being established.

AIFM

Irish tax legislation has been updated to confirm that an Alternative Investment Fund (AIF) managed by an Irish Alternative Investment Fund Manager (AIFM) will not fall within the Irish tax net, purely by virtue of its being managed by an Irish AIFM. This confirmation is very welcome for the Irish funds industry, given that many global investment managers have chosen Ireland as the location for their AIFM. This Finance Act change gives comfort that the AIFs managed by such AIFMs will not automatically fall within the Irish tax net.



Change to employment taxes that benefit the funds industry

A number of changes to the personal tax system in Ireland may encourage more senior executives with industry expertise to relocate to Ireland.

The higher rate of personal income tax in Ireland has dropped by 1% to 40%.

Ireland has put in place a Special Assignee Relief Programme (SARP) which has been enhanced in the recent Finance Act. The SARP programme has been extended to continue for another number of years, the upper salary limit has been removed, the residency requirement has been amended and the exclusion from working abroad has been removed. In addition, an assignee is only required to have been employed abroad by the employer for a reduced period of 6 months going forward in order to be in a position to obtain the relief.

Another relief, which is the foreign earnings deduction, has also been enhanced with the potential to benefit employees who work abroad on a regular basis. The maximum deduction per annum is €35,000, the number of days working abroad has been reduced to 40 (previously 60), the number of consecutive days abroad per trip has been reduced to 3 (previously 4), time travelling between countries is now included in calculating days abroad and the number of qualifying states has been extended. All in all, this could benefit employees of the funds industry who undertake work abroad on a regular basis.

Exchange of information

The Finance Act has introduced provisions for the collection and reporting of information with regard to financial accounts held by a person who is tax resident in another country.

This is in anticipation of the introduction of the Common Reporting Standard following the Multilateral Competent Authority Agreement recently signed by more than 50 jurisdictions (including Ireland), which will allow for the implementation of the OECD Automatic Exchange of Information Standard.

Additional regulations may be introduced outlining further detail on the reporting obligations. Any common reporting standards introduced in Ireland (and indeed globally) are likely to impact the funds industry.

New tax treaties

Ireland continues to expand its network of double taxation treaties, 72 of which have now been signed. The legal procedures to bring our most recent treaties into force—treaties with Ukraine, Thailand, Botswana and Ethiopia – are now being followed. In addition, negotiations for new agreements with other jurisdictions are ongoing.

The ever-increasing number of Irish treaties serves to improve returns for investors in Irish funds, with Irish funds recognising the benefit of reduced rates of foreign tax in treaty countries in many cases.

Common Contractual Fund (CCF)

The Common Contractual fund (CCF) is an Irish regulated asset pooling fund structure. Asset pooling enables institutional investors to pool assets into a single vehicle fund with the aim of achieving cost savings, enhanced returns and operational efficiency through economies of scale. Experience of existing CCFs shows a saving of 10-20 basis points.

A CCF is an unincorporated body established under a deed whereby investors are 'co-owners' of underlying assets that are held pro rata to their investment. A CCF is usually established by a management company and investors must not be individuals, i.e. only institutional investors are permitted. CCFs are authorised and regulated by the Central Bank of Ireland and can be structured as a UCITS or a non-UCITS fund. A CCF is not a separate legal entity and is transparent for Irish legal and tax purposes.

As the CCF is fiscally transparent, it is therefore exempt from Irish tax on its income and gains. Investors in a CCF are treated as if they directly own a proportionate share of the underlying investments of the CCF.

Key benefits of the CCF are:

- Well established with a proven track record
- More than 70 CCFs in operation, both UCITS and non-UCITS
- Wide investor base – institutional investors, pension funds, insurance companies, corporates, life assurance companies, asset managers and MNCs
- Purpose built for the funds industry
- Tax transparency in at least 20 countries
- Transparency enshrined in many of our double taxation agreements
- Can lead to tax savings of approximately 20bps, depending on the investor/investment mix
- Experienced services providers in the industry

Real Estate Investment Trusts (REIT)

Since its launch in 2013, the Irish REIT offers investors a way to invest in the Irish property market in an efficient tax manner. The key benefits of the REIT include:

- Tax exemption in respect of the income and chargeable gains of a property rental business held within a company
- Access to Ireland's extensive treaty network (see above)
- Capital gains made by non-Irish resident investors on their disposal of shares in a REIT are not taxable in Ireland

To date three REITs (Green REIT Plc, Hibernia REIT plc and IRES REIT) have been established and have managed to raise circa €1.27 billion. We expect to see further REITs in 2015 with expansion beyond Irish investments to include foreign property.

2015 promises to be an interesting year for the Irish funds industry, particularly with the positive developments like the ICAV coming into play



Netherlands

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The debate over the levying of Dutch dividend withholding taxes has continued over the last year, and there are a number of cases pending. Below, we cover some of the cases of interest to the asset management industry.

Withholding tax reclaim opportunities

Investment companies and investment funds

Just before the end of 2013, the Dutch Supreme Court issued its judgement in the Finnish Investment Fund case.

The court judged that the Netherlands is not obliged to follow the tax rules (i.e. tax exemptions in this case) of another member state. Instead, the test should be how the entity would be taxed in the Netherlands. Therefore, despite being tax exempt in Finland, the Finnish open-ended investment fund would be subject to tax if resident in the Netherlands. As such, the company could not benefit from the reimbursement of Dutch dividend withholding tax.

The investment fund argued that it should be seen to be the Finnish equivalent of a Dutch Fiscal Investment Institution (FII) and would therefore be subject to a 0% tax rate in the Netherlands. However, as the Finnish investment fund did not actually distribute its income as dividends to its shareholders, the Dutch Supreme Court did not consider the entity to be comparable to a Dutch FII. It did not, however, discuss the application of this condition in more detail, and did not explain any of the other conditions that need to be fulfilled by foreign investment companies and investment funds in order to be considered comparable to an FII (comparability test) and be entitled to a refund of Dutch dividend withholding tax. As a result, several cases are pending before the Dutch courts in order to clarify the conditions for the comparability test.

Finally, it remains somewhat disappointing that the Dutch Supreme Court did not put any preliminary questions to the European Court of Justice, even while similar cases were pending, such as the Emerging Market Series case and an infringement procedure against Denmark.



Life insurance companies

Last year, the European Commission started an infringement procedure against the Netherlands, because of the discriminatory taxation of dividends received on shares held by insurance companies established in another member state or in an EEA country (Norway, Lichtenstein and Iceland).

Under Dutch law, Dutch insurance companies are not taxed on dividends received on shares held in accordance with the unit-linked insurance framework. For such companies, the dividend withholding tax is an advance payment in respect of corporate income tax, which is levied on a net basis. As a result, Dutch insurance companies are able to deduct the increase of the obligation to pass the dividends on to their policyholders against the dividends received. Therefore, the corporate income tax base is effectively reduced to (close to) zero, while any Dutch dividend withholding tax may be credited against the corporate income tax liability, or refunded if it exceeds the corporate income tax liability.

The Dutch dividend withholding tax is a final taxation for insurance companies established in the EU or the EEA receiving Dutch dividends on shares held in the framework of unit-linked insurance. Unlike Dutch insurance companies, they are taxed on gross dividends, and cannot obtain a corresponding tax credit. The European Commission considers the higher taxation of insurance companies established elsewhere in the EU/EEA to be incompatible with the freedom of capital movement within the meaning of the Treaty on the Functioning of the European Union and the European Economic Area (EEA) Agreement.

Other (non-life insurance) companies

The debate over the levying of dividend withholding tax is not limited to investment companies, investment funds and life insurance companies. In another Dutch case (*Société Générale*), the CJEU was asked by the Dutch Supreme Court to clarify the standard of comparability when assessing a dividend withholding tax violation. The specific question is whether a settlement of dividend withholding tax as an advance payment in respect of the corporate income tax due in domestic situations by the entity receiving a dividend—while such settlement is not possible for a foreign entity receiving a dividend—constitutes a breach of EU law.

The uncertainty over the levying of Dutch dividend withholding tax is expected to continue in 2015



Switzerland

New tax opportunity for investment funds

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Aberdeen withholding tax claims

Dividend payments received by Swiss investment funds on stocks from companies domiciled in a European Union (EU) member state could be subject to domestic withholding tax levied on outbound dividends. Under an applicable double tax treaty, such withholding tax may typically be reduced to 15% for portfolio investments. However, the tax treatment of dividends paid to resident investment funds and comparable non-resident investment funds may differ, and may therefore result in discriminatory treatment.

In 2009, the European Court of Justice (ECJ) reached a decision in the Aberdeen case (C-303/07), ruling for the first time that levying withholding tax on dividends paid to non-resident investment funds is discriminatory if the same dividends paid to resident investment funds are exempt from withholding tax. In the Aberdeen case, a Finnish resident real estate company, Aberdeen Property Fininvest Alpha Oy (Aberdeen), which was owned by a real estate fund incorporated as a Luxembourg SICAV, asked the Finnish tax authority whether dividends distributed to the Luxembourg SICAV could be exempt from Finnish withholding tax. Aberdeen considered such taxation to be discriminatory under EU law, because the same dividend payments to a Finnish corporation or investment fund would have been exempt from withholding tax.

As the Finnish tax authority rejected the exemption, Aberdeen submitted the issue to the Finnish courts, which referred the matter to the ECJ. The ECJ resolved that the different tax treatment of non-resident and resident investment funds represents a restriction to the freedom of establishment and the free movement of capital principles.

Since then, the ECJ has confirmed in new court cases that discriminatory tax regimes contravene EU law. In particular, the ECJ explicitly stated in the Santander case (C-338/11 to C347/11) in May 2012 that the French tax treatment of dividend payments to non-resident investment funds was contrary to the free movement of capital principle and is not compatible with EU law. As the free movement of capital principle is also applicable to non-EU countries, this decision is applicable to both EU and non-EU resident investment vehicles, including mutual investment funds. Furthermore, the ECJ stated that the decision has retroactive effect, thereby allowing investment funds to claim back discriminatory withholding tax for past years.

Lastly, in April 2014, the ECJ decided in the EMS DFA Case (C-190/12) that Poland's tax treatment of outbound dividends to a U.S. investment fund was contrary to the free movement of capital principle and allowed the U.S. investment fund to recover withholding tax incurred in Poland.



The Polish authorities claimed that the withholding tax treatment should not be assessed under the free movement of capital principle, but under the principles of freedom of establishment or freedom to provide services instead. As the freedom of establishment and the freedom to provide services principles are only applicable to countries that are a member of the EU or the European Economic Area (EEA), this would have excluded investment funds in third countries such as Switzerland from recovering discriminatory withholding tax.

However, the ECJ decided that for portfolio investments, the Polish tax treatment was contrary to the free movement of capital principle, which finally opened the door for third country investment funds (such as Swiss investment funds) to claim back discriminatory withholding tax levied in EU member states.

Based on these ECJ decisions, and in view of the tax laws of EU member states, there might be opportunities for Swiss investment funds to reclaim discriminatory withholding tax incurred in Austria, Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Poland, Spain and Sweden.

We therefore recommend that Swiss investment funds and investment foundations review their past withholding tax positions, and consider whether it would be beneficial to reclaim discriminatory withholding tax.

Loan funds

Europe's alternative source of business funding

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The financial crisis caused liquidity problems for banks globally, with a knock-on reduction in access to capital for businesses. To address this challenge, regulators in Europe are introducing alternative sources of financing, and in particular, are implementing measures to allow investment funds to issue loans to businesses.

At a European level, the 'European Long-Term Investment Fund' (ELTIF) is being established, while Ireland has recently launched its own 'Loan Originating Qualified Investor Alternative Investment Fund' (referred to below as Irish Loan Fund (ILF)). Both measures offer a regulated fund that originates loans to business, and in this article we compare the key features of each.

Note that the ELTIF is not required to be a loan fund—it must invest at least 70% of its assets in eligible assets. These eligible assets can constitute several forms of long-term investment, including loans. In this article, we focus on the ELTIF structured as a loan fund.



Background and current status

The ELTIF originated in 2012 as part of a proposed package of reforms to UCITS funds, dubbed 'UCITS VI'. One proposed reform was the introduction of a long-term investment product for Europe's retail market. Following industry feedback, the European Commission instead issued its proposal for a Regulation on ELTIF in June 2013 as a stand-alone fund product regulated by the Alternative Investment Fund Managers Directive (AIFMD).

Discussing the ELTIF Regulation, the Internal Market and Services Commissioner Michel Barnier explained: *"We need to secure long-term financing for Europe's real economy. Currently, financing is often scarce and where it exists, too focused on short-term goals. The European Long-Term Investment Fund is an investment vehicle that will allow professional investors and individuals to invest long-term in European non-listed companies and in long-term assets such as real estate and infrastructure projects.*

Making ELTIFs available to all types of investors across the European Union is vital to maximise the pool of capital available to European companies. I hope that creating a new EU investment brand will gain the confidence of investors and companies alike."

The European Commission adopted a green paper on the long-term financing of the European economy in March 2013. It examined the supply of long-term financing in Europe and confirmed the need for investment funds to aid the improvement and diversification of Europe's long-term investment measures.

On 10 December 2014, the Permanent Representative's Committee on behalf of the Council of the European Union approved the final compromise text of the ELTIF Regulation following provisional agreement reached through trialogue discussion. To achieve a similar purpose, i.e. non-bank financing for businesses, Ireland launched the Irish Loan Fund (ILF) in October 2014.

Structure

The funds have similar structuring requirements—both must be authorised in their home member state, can form part of an umbrella fund, must be closed-ended, and must have an AIFMD authorised investment manager. The rationale for prohibiting open-ended structures is to avoid situations where a loss in investor confidence could lead to investor runs, which in turn could lead to loans being recalled or sold onwards. Under exceptional circumstances specified within the rules of incorporation, the ELTIF can be structured to allow redemption if this fits the fund's investment strategy and its life cycle can be extended or reduced to allow for more flexibility.

Although ILFs must be closed-ended, they are permitted at authorisation to specify interim redemption dates within the fund's life cycle. Distributions and redemptions are permitted if liquid assets are available and there is no risk of jeopardising the ILF's regulatory compliance or liquidity obligations. The rules allow the ILF to make redemptions subject to investor approval, while distributions may be made throughout the ILF's lifecycle.

The ILF can be structured as any form of Irish investment vehicle, including a unit trust, an investment limited partnership, an Irish Collective Asset-management Vehicle or a variable capital company.



ELTIFs have an equally broad range of available structures. However, if being marketed to investors, ELTIFs cannot be structured as partnerships. This feature drew criticism as it could create obstacles in jurisdictions where partnerships are the only viable legal structure for funds.

Eligible investments

The defining feature of any fund is its investment strategy, particularly its permitted investments. The key characteristics of a loan fund are the type and balance of loans it can hold in its portfolio, particularly the profile of the permitted loan recipient. The funds have different balancing criteria for their portfolios: the ELTIF has a narrower category of permitted loan recipient than the ILF, while the ILF is required to be a single strategy fund.

Permitted loans—eligible investments

The ELTIF has significant flexibility regarding its portfolio—at least 70% of its capital must be invested in eligible assets, which include loans to ‘qualifying portfolio undertakings’, with the balance in diversified assets. Qualifying portfolio undertakings are portfolio undertakings (excluding funds, financial undertakings, organised trading facilities and listed entities) and listed Small and Medium Enterprises (SMEs).

Ireland’s ILF is obliged to be a single-strategy fund, focusing solely on lending. However, it can exist as a sub-fund within an umbrella fund that follows a wider investment strategy including securities. The Central Bank of Ireland (CBI) has confirmed that in addition to originating loans, the ILF can also participate in loans, acquire loans in the secondary market, and seek exposure to loans by way of sub-participations. It is also permitted to engage in operations resulting directly from activities such as handling any collateral used as security for the loans, and to engage in treasury management and the use of derivatives for hedging purposes.

ILFs are permitted to buy loans from a credit institution where the sale is on an arm’s length basis following an offering to multiple parties. Where the sale is on a bilateral basis, the ILF may purchase the loan if the credit institution retains a net economic interest of 5% of the nominal value of the loan as measured at origination.

The funds have similar structuring requirements—both must be authorised in their home member state, can form part of an umbrella fund, must be closed-ended, and must have an AIFMD authorised investment manager





Permitted loan recipient

The goal of the ELTIF is to drive growth in long-term projects across Europe and to contribute to financing the Union's real economy. This is reflected in the permitted recipient of a loan from an ELTIF: non-financial unlisted entities that were established to invest in infrastructure, property, ships, aircraft rolling stock or listed small and medium-sized enterprises; European Social Entrepreneurship Funds; and European Venture Capital Funds. They are also permitted to channel the European Investment Bank Group's European infrastructure or SME financing.

The ILF has a wider goal of providing financing to businesses generally, and so can issue loans to non-financial businesses. It cannot issue loans to financial companies or natural persons.

Marketing—eligible investors

As AIFMD-regulated entities, both funds can be passported across the EU under the AIFMD passport. Given its origins as a proposed reform to the UCITS regime, it is unsurprising that the ELTIF is available to retail investors. Note that even an ELTIF being marketed to retail investors can be passported under AIFMD—this is an interesting development, since under AIFMD only funds marketed to professional investors can generally be passported.

The ELTIF's minimum investment of €10,000 has attracted criticism (including from the UK Government) that this relatively high threshold would remove the ELTIF from the reach of most retail investors. Perhaps the European Commission set this threshold to protect the lower end of the retail spectrum from the perceived higher level of inherent risk in a loan fund?

The ILF is widely available for investment by professional investors for a minimum investment of €100,000.

Leverage

The retail versus professional nature of the funds is illustrated by their respective leverage limits: as a product tailored for retail investors, the ELTIF's profile is more risk averse than the ILF, for example, the ELTIF permits leverage of only 30% while the ILF permits 200%. In addition, to protect against shadow banking, ELTIFs cannot use borrowed cash when issuing loans. Given the relatively low leverage limits of both funds and the ban on ELTIFs using borrowed funds as loan funding, it is likely that unregulated loan funds will continue to be established where more highly geared structures are required.

Transparency requirements

As AIFs regulated by AIFMD, both funds are already subject to detailed levels of disclosure. The CBI acknowledges this, yet explains that the unique nature of the ILF requires supplementary disclosures, both pre-investment and periodically at each net asset value calculation point.



It considers that ILFs should apply the same criteria as banks to distressed loans so that investors can have some assurance that appropriate categorisation is applied. Information to be disclosed to unitholders includes details of the fund's loan book, while the ILF must also submit a list of any undrawn committed credit lines to the CBI to allow it to monitor systemic risk.

An ELTIF marketed to retail investors must publish a KID in accordance with the Regulation on key information documents (or KIDs) for investment products, which introduces a new pan-European pre-contractual product disclosure document for packaged retail investment products.

As AIFMD-regulated entities, both funds can be passported across the EU under the AIFMD passport

Conclusion

The CBI anticipates that managers of ILFs and banks are likely to form mutually beneficial partnerships, where the ILF will leverage the bank's expertise in credit analysis, risk management and the structuring and servicing of loans, and gain access to the bank's client base. It also anticipates that banks, on the other hand, could potentially issue loans jointly with ILFs for risk-sharing purposes, or refer clients that the bank is not in a position to take onto its own balance sheet to the ILF. It will be interesting to see the impact of these funds across Europe: will the increased pool of funding and credit lines to SMEs reduce the loan interest rates on offer to companies?

Will ELTIFs actually issue loans, or will they focus instead on the other assets in which they are permitted to invest, for example real estate or infrastructure projects? Will different countries consider loan funds to be a form of shadow banking, and will they allow them to be marketed to their investors? Following the launch of the ILF, the draft of ELTIF was amended fundamentally to permit redemption in certain circumstances and investment in listed small and medium enterprises – will future amendments to the funds cause them to become polarised or to converge?

Finally, it will also be interesting to see whether the introduction of loan funds and an extra pool of business funding achieves its primary goal of driving growth in the EU economy.

Comparison between the ELTIF and the ILF

	ELTIF	ILF
UCITS or AIF?	AIF only	AIF only
Minimum investment	€10,000	€100,000
Marketing passport	Yes	Yes
Authorised or registered AIFM	Authorised only	Authorised only
Regulated?	Yes	Yes
Retail/professional investors	Retail and professional	Professional only
Open-/closed-ended	Closed-ended, has the option to include redemption rights	Closed-ended, with pre-determined redemption dates throughout the life of the fund
Diversity requirements	Max. 10% of capital in assets of a single issuer or single asset	Max. 25% in a single issuer during a specific timeframe
Eligible assets	70% may be invested in equity/debt/loans or infrastructure projects. This limit does not apply for the first five years during construction of the portfolio, or during the end of the life of the fund when positions are being closed. Up to 30% can be invested in diversified assets	Loans only The rules require that a loan fund cannot engage in other businesses. However, the loan fund can be structured as a sub-fund within an umbrella fund, where the other sub-funds invest in loan assets, e.g. equities, etc.
Loans available to?	<ul style="list-style-type: none"> • Non-financial unlisted entities established to invest in infrastructure, property, ships, aircraft, rolling stock, listed small and medium enterprises • European Social • Entrepreneurship Fund • European Venture Capital Fund 	Businesses (non-financial)
Leverage?	Up to 30% of the capital of the ELTIF, non-recourse and used only to acquire eligible assets	Gross assets must not exceed 200% of the net asset value
Legal structure	Cannot be a partnership	Any
Can investors transfer their interest?	Yes, they can sell their interest in the secondary market	No restrictions on transfer
Transparency requirements	<ul style="list-style-type: none"> • Details of how the ELTIF's investment objectives and strategy mean the fund qualifies as 'long term' • Prospectus Directive disclosure requirements • AIFMD disclosure requirements • Prominent description of eligible assets • Prominent warning of the illiquid nature of the fund • All costs attached to the fund • KID disclosure requirements (if marketed to retail investors) 	<ul style="list-style-type: none"> • A prominent risk warning highlighting the particular risks inherent in loan origination, i.e. how an investment in a loan originating fund is not guaranteed and is subject to the possibility of investment losses and illiquidity • Information on the fund's risk/reward profile • Anticipated concentration levels • Credit monitoring process • Confirmation of whether the manager will allow access to records and staff for due diligence • A risk warning that the central bank may tighten lending standards and leverage limits • Information that a reasonable investor would deem important when considering an investment in the fund • The implications of the central bank's Code of Conduct for Business Lending to Small and Medium Enterprises where loans are made to SMEs • Details of the fund's loan book must be disclosed periodically

To the point:

- The financial crisis caused liquidity problems for banks globally, with a knock-on reduction in access to capital for businesses. To address this challenge, regulators in Europe are introducing alternative sources of financing, and in particular, are implementing measures to allow investment funds to issue loans to businesses. At a European level, the 'European Long-Term Investment Fund' (ELTIF) is being established, while Ireland has recently launched its own 'Loan Originating Qualified Investor Alternative Investment Fund'. Both measures offer a regulated fund that will originate loans to business, and in this article we compare the key features of each
- The CBI anticipates that managers of ILFs and banks are likely to form mutually beneficial partnerships, where the ILF will leverage the bank's expertise in credit analysis, risk management and the structuring and servicing of loans, and gain access to the bank's client base

It also anticipates that banks, on the other hand, could potentially jointly issue loans with the ILFs for risk-sharing purposes, or refer clients that the bank is not in a position to take onto its own balance sheet to the ILF

- It will be interesting to see the impact of these funds across Europe: will the increased pool of funding and credit lines to SMEs reduce the loan interest rates on offer to companies?
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It will also be interesting to see whether the introduction of loan funds and an extra pool of business funding achieves its primary goal of driving growth in the EU economy

Investment opportunities


Locking the potential of future benefits

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The last couple of years have seen an increase in pension funds and corporate pension schemes being transferred to insurance companies. These transfer deals, known as buy-outs or buy-ins, offer companies the opportunity to reduce their exposure to pension liabilities. Evolving accounting regulations, volatile equity markets and a transfer of risk from corporates to individual participants have increased the speed of this process.

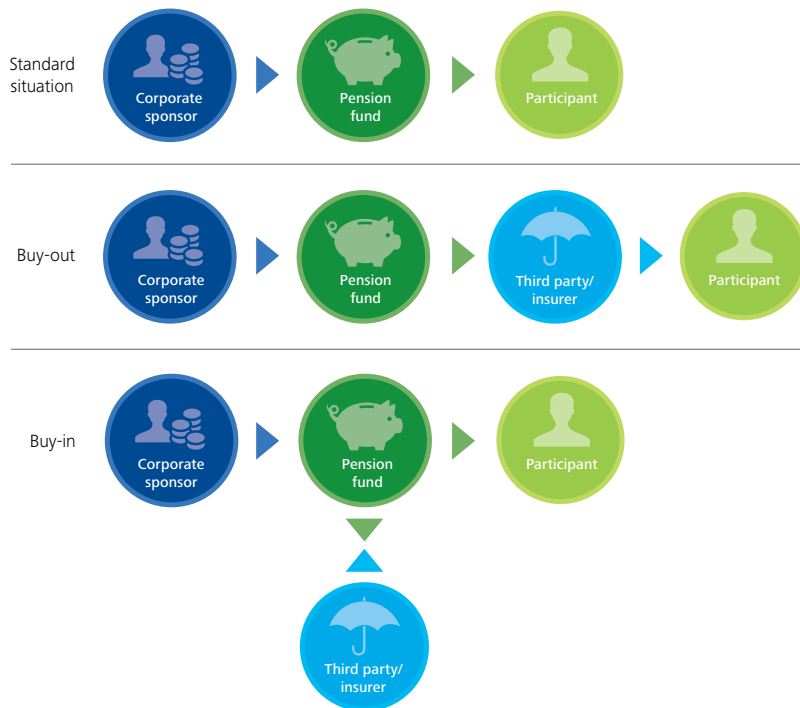


Employee benefits have turned into a financial liability for corporates, with limited upside. Depending on their risk appetite, it can be very attractive for a pension fund or corporate to transfer some of the risks to third parties—especially for companies seeking to reduce balance sheet exposure and small pension funds with high individual longevity risks or high operating cost levels. In making such an important decision, it is advisable to use a roadmap and monitor the different risks, while at the same time, it is important to ensure an optimal outcome for stakeholders and lock the potential of future benefits.

Introduction to liability transfers

For most companies, pension schemes are no longer considered a key part of their human resource strategy in the pay/benefit package offered to employees. Final salary-based pension schemes are very scarce these days, as employers increasingly transfer pension risks to the employee. Instead of the final salary or defined benefit plan, where the employer offers a pension scheme at retirement and bears the associated risks, employers make a contribution to the individual's defined contribution plan. In a defined contribution plan, the participant bears the risks and the outcome is less certain, without the guarantees of the sponsor.

Figure 1: Overview of buy-in vs buy-out



Source: Deloitte

Furthermore, existing defined benefit employee schemes represent a risk to the corporate sponsor, and can place a significant burden on corporate profits. As a consequence, both corporates and pension funds are investigating the possibilities of outsourcing the risks involved with these contracts. Buy-outs are used to initiate the transfer of pension liabilities to insurance companies. In a full buy-out, this results in the liquidation of the corporate pension scheme, as all liabilities and the investment portfolio of the pension fund are transferred to a third party, an insurer for example.

After the buy-out, the insurer becomes responsible for the fulfilment of all pension promises and the former corporate pension sponsor no longer has any links with the pension scheme and its members. Instead, the pension scheme member (an employee, former employee or retiree) has a pension insurance contract with the insurer. The pension fund no longer has any reason to exist if the liability has been removed, except for the purposes of quality assurance with respect to the third party or insurer. Alternative options include a buy-in, where the pension fund insures a portion of the risk, in relation to longevity for example.

Opting for a buy-out is a major decision for a company board, a trustee board or a pension fund. Most central banks have specified requirements for approval of these liability transfers, due to the potential risks for the participants of the fund or scheme. Although, the liquidation process is often overlooked in the day-to-day funding process of a pension fund or corporate, it could be worth considering, since it can meet the needs of employees as pension promises are fulfilled. This option is likely to be re-examined, with interest rates set to increase and in light of the recent strong performance on the equity markets.

Market developments

The landscape for pension funds is changing rapidly as a result of increased pressure from the regulators on governance models. Pension funds are liquidating or consolidating due to environmental challenges. Only the largest pension funds are expected to have sufficient financial means and economies of scale to survive. For example, in the Dutch market, estimates show that a quarter of existing pension funds are in the process of, or are making preparations for, the transfer of their assets and liabilities to other pension funds or insurance companies, while the remaining Dutch funds are investigating the steps necessary for a buy-out in the short term. Similar trends can be observed in other European countries, such as the United Kingdom.

Collective transfers of liabilities are attractive for pension funds, corporates and other financial institutions aiming to decrease exposure to pension liabilities on their balance sheets. In the case of corporate pension schemes, the move to fair value accounting under IFRS introduced market risks to corporate balance sheets. Some large multinationals face large pension liabilities that are significant compared to their annual revenue, and those liabilities are also volatile. In December 2012, the Dutch postal service (PostNL) announced that it would make an extra payment of €84 million to the corporate pension fund¹.

Some companies have a significant value of a pension fund (assets and liabilities) on their balance sheet, sometimes this is multiple of the value of the company without the pension structure. It is questionable whether such companies are operational entities or pension funds in disguise.

Financial market conditions have added to the impact of the changes in accounting regulations, and have increased the trend towards the collective transfer of liabilities and assets, whereby pension assets and liabilities are outsourced to insurers, with the aim of reducing the volatility of pension fund liabilities for fund sponsors.



Consequently, the pension scheme participant sees a transfer of his pension payments from the pension fund or corporate to the insurance company. Additional assets can be used to buy indexation of the nominal liability structure as part of the transfer. Thereafter, the insurance company takes on responsibility for payments, indexation and execution of the asset investment portfolio.

¹ Source: ANP

Risks

Within the current turbulent financial environment, pension funds and corporates face one of the most important decisions in their history, the transfer of their legacy pension liabilities and assets to an insurance company in a one-off deal. Making the deal at the right moment can make a huge difference to the final payments the pension fund or corporate is able to make.

Most pension funds have the long-term goal of offering fully indexed pensions for their participants. In long-term bull markets, achieving this for closed pension schemes is more straightforward. With limited downward risk, as a result of large financial buffers (e.g. as expressed in a coverage ratio well above 100%), there is the possibility that excess assets will flow back to the corporate sponsor. The downward risk means that pensions fall short of full indexation and the upwards potential remains unfulfilled from a participant's perspective. This might not result in an optimal solution for all stakeholders, e.g. the pension beneficiaries.

In the current market environment—with low interest rates and low (although increasing) coverage ratios—opportunities for a full transfer are likely to be limited. However, a buy-out can be used to transfer a portion of the different risks:

- **Investment/market risk**—the risk that investment performance is below target and the investment portfolio is not sufficient to meet the (fully) indexed pension promise during the participants' lifetime
- **Inflation risk**—the risk that the returns on the investment portfolio are not sufficient to make pension payments during the participants' lifetime due to high inflation
- **Longevity risk**—the risk that increasing life expectations mean that pension payments are required over a longer period than funding is available

- **Employee sponsoring risk**—the risk that the sponsoring company is no longer able to cover deficits in pension contributions
- **Duration risk**—the risk that the pension promise cannot be met at maturity due to floating interest rates
- **Operational risk**—the risk that the pension fund is not able to make pension payments as a result of flaws in the operational process involving issues relating to governance, investment management or operational execution
- **Credit risk**—the risk that the pension fund provider defaults

Alternatives

When risks are moved from the pension fund balance sheet, it is reasonable to make a distinction between existing pension rights (of retirees and former employees and past rights from current employees) and future pension rights. These various rights holders might face different interests with respect to asset-liability-driven investments. Securing pension payments at retirement is the main objective for pension fund participants, which will mean a high percentage of fixed income investments. For pension payments to be built up in the accumulation phase, the objective will be to generate returns. If a full buy-out—where all the existing risks are transferred—is not possible, a partial buy-out may be used to transfer some of the risks.



A number of risk reduction options are available, depending on the risk appetite of the pension fund or the participants. The most common way of reducing balance sheet exposure is the shift from defined benefit plans to a defined contributions model. In the case of a company insolvency, there is no secure future for its pension scheme, and a buy-out should be considered. A transfer of liabilities might be considered by:

- Companies seeking to reduce on-balance sheet liabilities
- Smaller pension funds exposed to large risks due to undiversified longevity risk
- Pension funds with high operating costs



Should a full buy-out not be possible, the options for transferring a portion of the risks are:

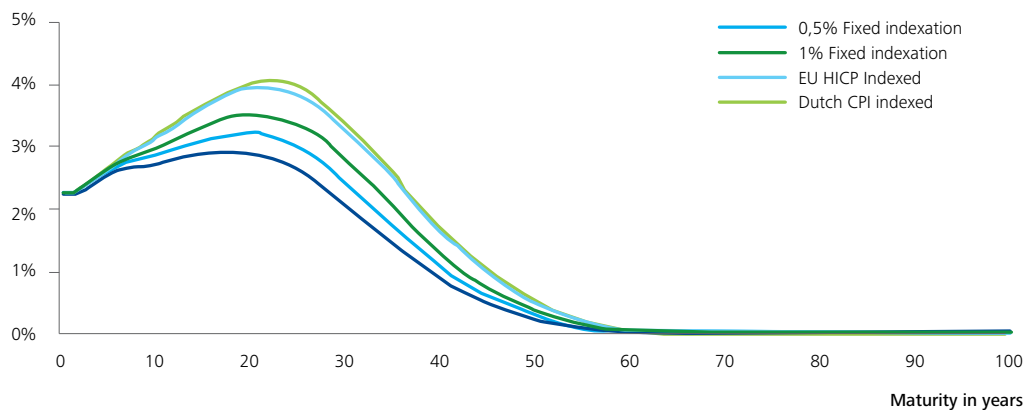
- A buy-in, with a third party or insurer becoming responsible for all or part of the pension promises. However, the corporate pension sponsor retains its relationship with the pension scheme members, and the corporate or pension fund transfers the risks to an insurance company
- A partial buy-in, based on the risk appetite towards different risks corporates might choose to execute a partial buy-in. For example, where only longevity risks or inflation risks are transferred
- A deferred buy-out, where the transfer of existing liabilities and assets is made in a number of tranches over the following years. With this option, the risk parameters can be fixed or adjusted in relation to market movements (respectively inflation or interest rate subject to market fluctuations)

In both the buy-out and the buy-in, the transfer of the pension liability to the insurer can be accompanied by a premium payment from the corporate pension fund sponsor. The premium is expected to cover the deficit between the current pension fund assets and the future liabilities. This premium is often used to buy fixed indexation or indexation based on a variable index, such as a consumer price index.

Pricing drivers

A collective transfer of a pension balance sheet for a company or a pension fund is essentially a discounted cash flow calculation of the liability structure, based on the scheme and the actuarial assumptions, such as mortality expectations. The overview of the cash flows at different indexation levels are presented in figure 2. The lowest possible price for these liabilities (as paid by the third party) will result in the highest possible indexation for beneficiaries. The market for collective buy-outs has expanded significantly, with new entrants and even non-traditional market players trying to get in on the act, thereby putting pressure on pricing methodologies. The increased competition has forced insurance companies to look at these deals from an investment management and financial engineering perspective. Whereas cash flows were previously discounted at zero rates derived from swap rates, nowadays spreads on discounted curves are commonly used, resulting in higher amounts of fixed indexation or indexation matched to inflation. The main pricing drivers are interest rates, spreads, longevity parameters, indexation targets, inflation commitments and the cash flow pattern of the liability structure.

Figure 2: Indexed Pension liability scheme with fixed and variable indexation



Assumptions: Dutch inflation based on a premium of 10 basis points above EU inflation and based on an average maturity for a pension fund scheme.

Source: Deloitte Analyses

These complex pricing deals, referred to as the mergers and acquisitions of the pension market, are depending on lots of different parameters impacting the pricing. For participants of a pension scheme matching inflation has always been a major item in the realisation of continuous purchasing power. These detailed pricing parameters, like expected inflation, inflation capping or providing floors on inflation to compensate deflations have a significant impact on the pricing.

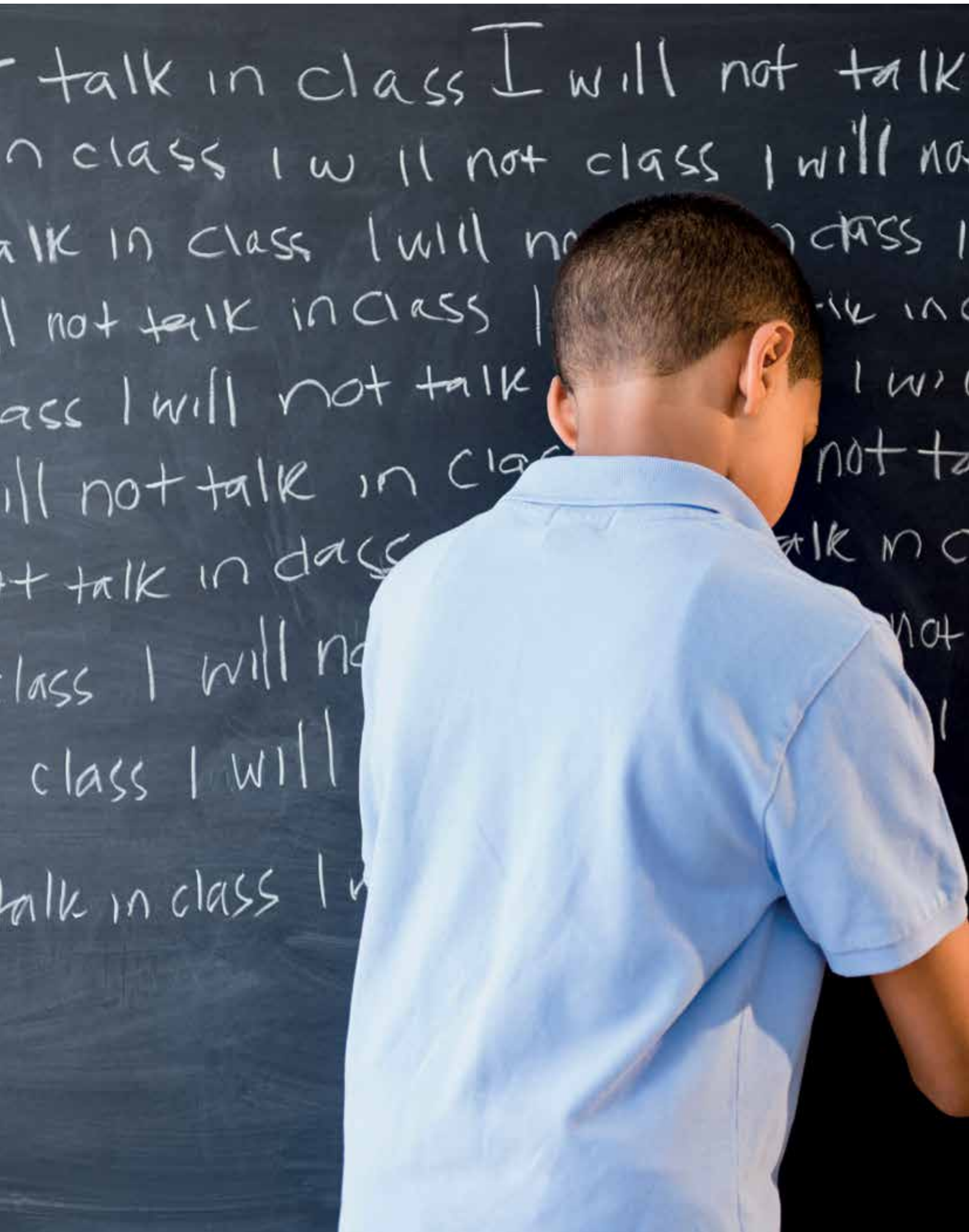
Conclusion

Pension liabilities represent a substantial risk for corporates, and the removal of these risks from the balance sheet needs to be managed carefully. This can be accomplished either through buy-outs or (partial) buy-ins. Market competition among third parties has increased the opportunities to outsource all or some of the risks, and led such entities to price these deals more precisely and competitively. Effective risk reporting in these one-off deals is key to retaining control over the process. It could be worthwhile to continue the pension scheme, and outsource some of the risks, depending on the fund's risk appetite. In this way, the upward remains, but certain risks are limited so a more efficient outcome can be reached for all stakeholders. This is a continuous assessment for pension funds and their third-party counterparties involved in these deals.

To the point:

- Most pension funds and corporates are considering options to reduce the volatility of the pension liabilities on their balance sheets
- Liability transfers such as buy-ins and buy-outs can be an efficient way of removing this volatility
- As coverage ratios increase, liability transfers will become more viable





What does the UCITS V sanction regime aim to address?

The main aim of the sanction regime under UCITS V, which was adopted into European law on 28 August 2014, is to determine the rules for a consistent approach to the application of administrative sanctions and to ensure that each member state implements the rules into national law with a minimum level of consistency. UCITS V determines the levels of sanction measures for non-compliance or repeated breaches and provides clarification on the parties responsible for compliance.

The overall intention of the regulation is that the end result will be a regulatory framework for the registration and reporting of infringements, consistently applied across Europe.

One of the key points of the regulation is that each member state will be required to ensure a competent authority publishes any decisions on sanctions. This 'naming and shaming' should go some way to ensuring that investors have access to the same information. It will also be interesting to see how each member state transposes UCITS V into national law, especially with regard to the definition of 'repeated' in relation to breaches.

Key areas of the sanction regime—article 99 (amending Directive 2009/65/EC)

The replacement of article 99 covers six main areas: authorisation to conduct business, operating conditions, risk management, notification requirements, publication of sanctions and whistleblowing. Each member state will be required to reduce administrative sanctions into national law by February 2016, where a criminal sanction does not already exist. Under this regime, there is a focus on the requirement to publish findings and a strengthening of the requirements for companies to implement procedures for whistleblowing.

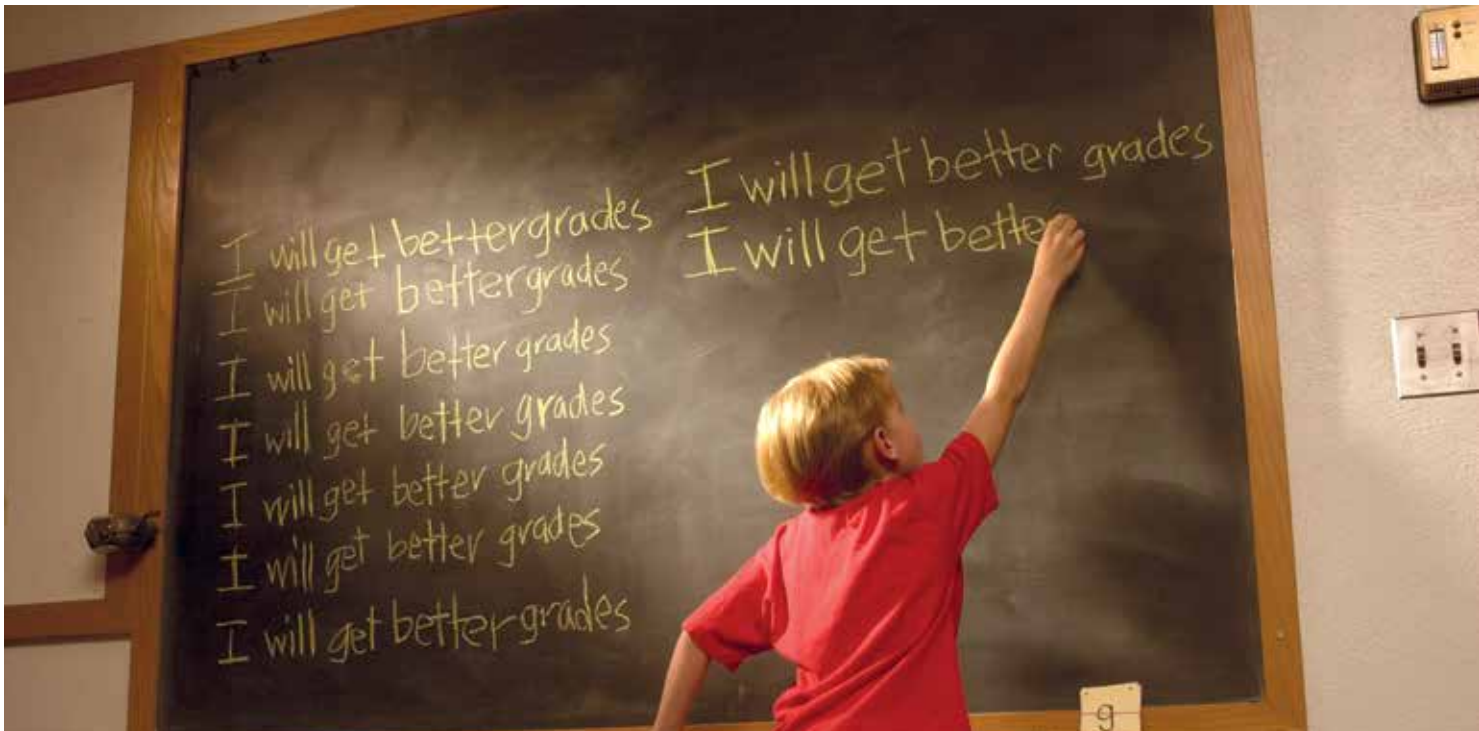
Category	Application of sanction
Authorisation to conduct business	<ul style="list-style-type: none"> • Failure to obtain proper authorisation prior to conducting UCITS activity • Non-compliance with obligations for annual reporting of qualifying holdings
Operating conditions	<ul style="list-style-type: none"> • Absence of sound administrative and accounting procedures, control and safeguarding of electronic data and internal control measures • Absence of personal transaction rules • Non-compliance regarding delegated functions • Rules of conduct failure • Depositary regime failure
Risk management	<ul style="list-style-type: none"> • Absence of sound risk management processes. Focus on independent assessment of value of OTC derivatives • UCITS investment policy failure
Notification requirements	<ul style="list-style-type: none"> • Failure concerning obligatory investor information • Failure of UCITS notification requirements
Publication	<ul style="list-style-type: none"> • Public statement of responsible persons and details of failure
Whistleblowing	<ul style="list-style-type: none"> • Failure to establish measurement and reporting procedures • Failure to implement procedures for employees to report failures • Failure to provide protection of employees

Sanction penalties

The regulation provides that, in the event of an infringement, management companies, investment companies and depositaries may be subject to the following administrative penalties:

- In the case of a UCITS or a management company, suspension or withdrawal of its authorisation. This may take the form of a temporary suspension or for repeated infringements, a permanent ban against a member of the management body or any other natural person who is held responsible exercising management functions in those or in other such companies
- The person responsible will be issued with an order to cease the conduct and desist from a repetition of that conduct in the initial phase
- In the case of a responsible person, the maximum fine under the administrative sanction regime will be €5 million (or equivalent in another currency) for natural persons and €5 million or 10% of annual revenue for legal entities

One of the key points of the regulation is that each member state will be required to ensure a competent authority publishes any decisions into the public domain





What is the impact on the the industry?

Aside from the requirement to have obtained the necessary authorisations, asset managers and investment companies will be required to ensure they have the right organisational and governance structure in place to comply with these regulations and previous versions. This not only applies to their own organisation but it also means that they will have to monitor any activities they have delegated to ensure that they are being administered appropriately.

An example of this is ensuring that depositaries provide regular reporting on the services they provide to the management company through adequate supervision and the establishment of risk committees. In particular, process failures must be recorded. Since the regulations do not contain an explicit explanation of 'frequent errors', it will be interesting to see how each member state defines this—hopefully with a consistent approach in terms of definition and application.

The parties responsible for delegated functions should be aware of the requirement for greater due diligence on behalf of asset managers, as well as the need for effective reporting detailing the performance of obligations, and more importantly, the nature and frequency of failures.

Given that the regulations provide for fines to be imposed on natural persons or legal entities, it may be appropriate to consider ensuring that adequate insurance cover is in place, protecting those persons that may be held responsible for non-compliance. These persons should ensure they have obtained the appropriate authorisations to act in the capacity of a responsible person. The new regulations may lead to a modification or expansion of the responsibilities of Chief Operating Officer (COOs)/conducting officers. In addition, consideration could be given to rotating the COO/conducting officer role on a more frequent basis. This can have the added benefit of reducing risk and allowing for a greater understanding of the obligations of responsible persons across the management team.

Of course, an insurance policy cannot protect against the reputational damage a sanction represents. As the publication requirements stipulate that both companies and natural persons are identified, organisations need to ensure that whistleblowing procedures are implemented appropriately. The risk of reputational danger greatly increases the need to ensure full compliance.

What are the next steps?

The industry awaits the definition and clarification of the classification of 'repeated failures', as interpreted by member states, as this is likely to be the most common area of concern. It is to be hoped that this is viewed pragmatically, thereby negating the need for extensive reporting. What is key in this regard is the implementation of clear procedures for employees to report events, and for appropriate escalation. The reputational risk of 'in good faith' or 'in bad faith' reporting of failures can have a negative impact. With regard to reporting, ESMA has been requested to provide further guidance on the procedures and forms for submitting information.

While there is a common view that most of the measures mentioned in the regulations are not new, it is prudent for asset managers, investment companies and depositaries to get started on the process of reviewing their organisations to ensure that they have the appropriate corporate and governance structure in place and reassure themselves that delegated functions are administered in accordance with expectations. It will also be essential to ensure that employees and other persons involved in the activity of UCITS are aware of their obligations, especially in the area of whistleblowing and personal transactions. The consequence of a rigidly enforced regime could, in the event of a failure to fulfill obligations, result in significant penalties being imposed on both organisations and responsible persons.

Member states are required to transpose UCITS V into national law by February 2016.

To the point:

- The current European landscape of administrative sanctions is disharmonised and inconsistently applied
- UCITS V aims to address this with the outlining of a common approach to be implemented into national law
- The UCITS V sanction regime will be required to be implemented into national law by February 2016
- Investment companies, management companies and depositaries should start to anticipate these requirements
- In the midst of regulation after regulation, this important regime may be overlooked
- Service providers should also be aware of the requirements, in order to be compliant towards their clients
- Breaches of the regime will result in pecuniary measures against both the company and responsible persons
- The regime foresees a publication of pecuniary damages into the public domain
- In addition, guidelines for employer/employee whistleblowing procedures are outlined



Distribution fiction

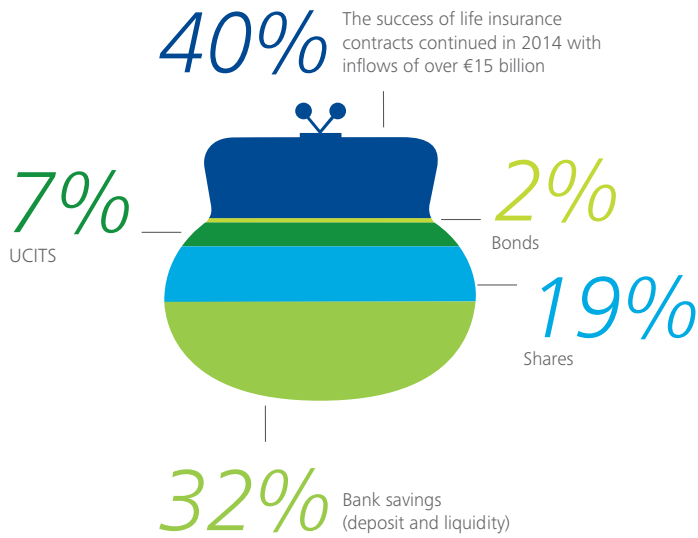
Pascal Koenig
Partner
Advisory & Consulting
Deloitte

In France, UCITS are primarily distributed through traditional distribution channels (63%): banking networks, insurance companies and private banks, and mainly under special tax schemes (unit-linked life insurance contracts, etc.).

Nonetheless, current studies show:

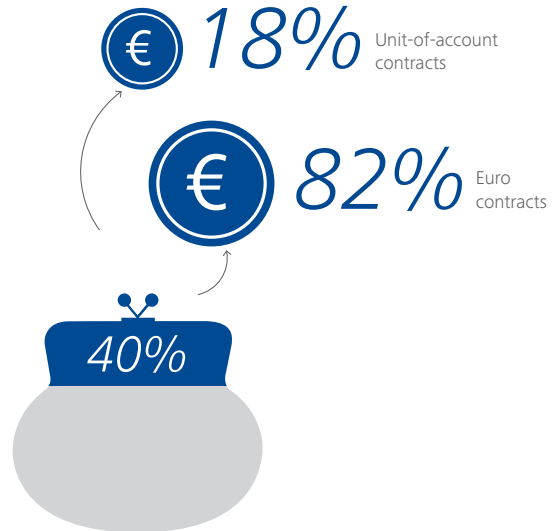
- Private individuals do not fully trust their banks to provide advice on savings products (source: 'Bank-customer relations', Deloitte 2013 Barometer)
- An unsatisfied need in terms of pension products (nearly half the active population places pensions issues in the top three savings priorities and more than half the active population says they require help when making pension choices (source: 'The French prepare their retirement', Deloitte 2012 Barometer)

Figure 1: Structure of French households' financial assets in 2013



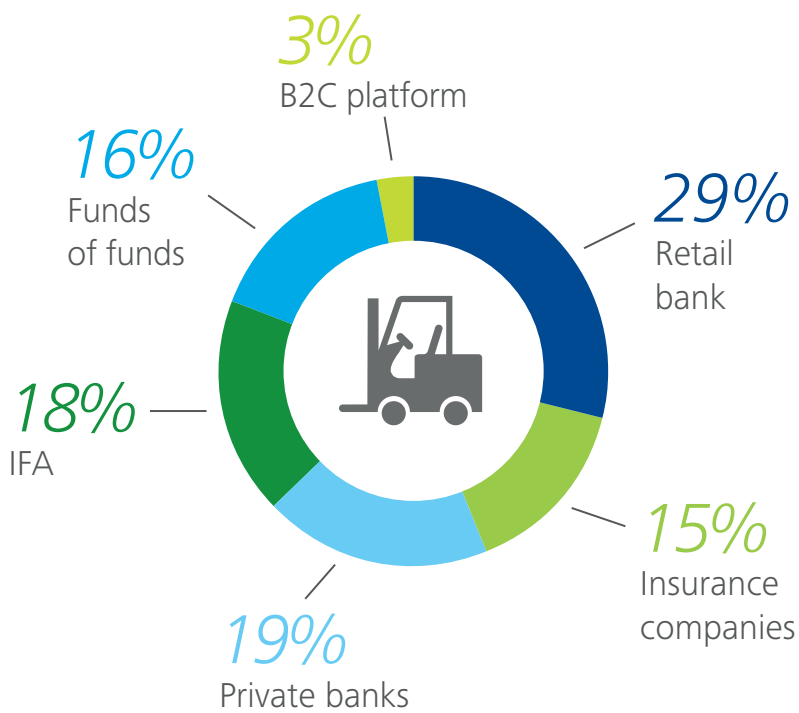
Source: Banque de France

Figure 2: Life insurance policy - respective amounts of euro denominated life insurance and unit-linked life insurance in 2013



Source: Banque de France - FFSA

Figure 3: UCITS distribution (directly or via tax schemes) by channel in 2014



Source: "How French management companies/groups distribute their funds?", AFG survey, 2014

A profound change in consumer behaviour related to the customer experience of the X, Y and Z generations, characterised by a preference for online information and the need to compare and choose for oneself

The entry into effect of MiFID 2 (2017), and more particularly, IMD (2018) could accelerate these underlying trends and trigger structural change in the asset management business model in continental Europe. Accordingly, an analysis of U.S. and UK precursors in terms of regulation and savings behaviour could provide insight into future developments in the organisation of savings distribution. In the United

Kingdom, where advisory services became directly payable (banning retrocessions for all advisors) in 2012 (application of the Retail Distribution Review, the text that inspired MIF2), consumers have become particularly attentive to the cost of asset advisors and the value of advice provided. As a result, 32% of investors now prefer to do their own financial research and planning, according to a Deloitte UK study covering a sample of 2,140 British adults in June 2012. In the same study, 27% of individuals questioned favoured direct investment with financial product providers. Such platforms naturally have a disruptive influence on traditional distribution channels, and now account for close to 50% of sales to private individuals (compared with 37% in 2010, according to IMA statistics). This digitalisation of the distribution of financial products to private individuals can, of course, also be observed on the other side of the Atlantic.

According to a Deloitte Consulting survey, Digital Disruption in Wealth Management, over 50 Wealth Management start-ups developing a B2C model (for private investors) have emerged over the last ten years. This is a universal phenomenon, with the increasing importance of online stemming from mistrust of traditional intermediaries and investors' appetite to manage their investments themselves. Another important factor is the fintech sector, which, after seeking to shake up the payment industry, is enjoying uninterrupted growth in the asset management sector.

Inflows are unaffected by the economic crisis (Wealthfront: US\$35 million in April 2014, Betterment: US\$32 million, Learnvest: US\$28 million, Futureadvisor: US\$15.5 million, Motif Investing: US\$35 million, etc.).² In the United States, the potential market for digital savings management is estimated at US\$1 trillion. At the same time, we are beginning to see the first tangible results (Wealthfront announced US\$1 billion under management at the beginning of June, and in April, Betterment CEO Jon Stein referred to an objective of US\$100 billion of assets managed on the platform by 2020).³

2, 3 Source: Communauté AGEFI, Juillet 2014 "Ces start-ups qui secouent le monde de la Finance", Jonathan Herscovici



In Europe, while certain traditional platforms have adapted their model, innovation can be found among new entrants such as Nutmeg or MoneyFarm, operating in the UK and Italian markets respectively. French players are also seeking to make things happen, with their first successful steps in digital savings, notably BforBank, which offers a range of savings products, and Générali Epargne (management mandate or free investment in life insurance contracts), demonstrating the existence of a market. BankCare, launched by the start-up Anatec, is clearly positioned in the CSP+ personalised asset management sector and won the Concours Mondial de l'Innovation 2030.

How do these 'Robo-Advisors' differ from the offering already available on the market? Obviously, they target private individual customers directly (recommended minimum investment of €5,000 or €10,000). They share a user-friendly interface (easy access, dynamic investment monitoring, simulations, mobile solutions, etc.), while financial education aspects are well developed, accounts can be credited in a variety of ways (including by bank card), the remuneration model consists of fees based on the amount invested (explicit absence of retrocessions) and, in certain cases, they allow past allocations to be corrected (scraping technique).

MiFID 2 – IMD2

Ban on intermediaries presenting themselves as independent and mandate managers receiving trail fees. A potentially very strict framework for other ISP (dependent advisors, RTO, etc.) governing the right to receive trail fees. Member states may go beyond the texts. In France, it will depend on IMD2 and the extension of the life insurance regime.

Nonetheless, we can fear:

- An impact primarily penalising asset management products
- The end of open architecture
- A preponderance of life insurance contracts as a fund distribution channel
- The need to reinvent the relationship with the IFA

The services proposed focus on personal budget management and investment, whether directly or with support:

- Personal budget management
- Fund supermarket (execution only): funds of variable size offered (fund presentation, comparison, reception/transmission of orders)
- Buy list (targeted fund selection, low cost, non-complex, etc.): selection of the best funds based on objective criteria (passive management is often preferred)
- Allocation planner (standardised portfolios based on investment objectives, investment period, risk aversion, etc.): proposed standard allocation models based on objectives/investment period/scaled risk aversion, arbitration advice
- Allocation advice (wide offering potentially extending from standard + to personalised): determination of an investor profile based on a questionnaire/meeting, tailoring of the personalised savings solution with a consultant (call centre or direct contact), arbitration advice

As the banking networks have been required to move away from promoting long-term savings products and positioning themselves globally in the execution market, they have left the door open to new players, and particularly:

- Independent structures, investment companies adopting the MoneyFarm or Nutmeg model
- Management companies, subsidiaries of banking institutions or insurance firms, complementing the intermediated savings system of the networks and proposing a selection of asset and liability products taken from their multi-store model, as part of proven allocation models under tax schemes and based on the customer's objectives

Figure 4: Why the mass affluent left their advisors

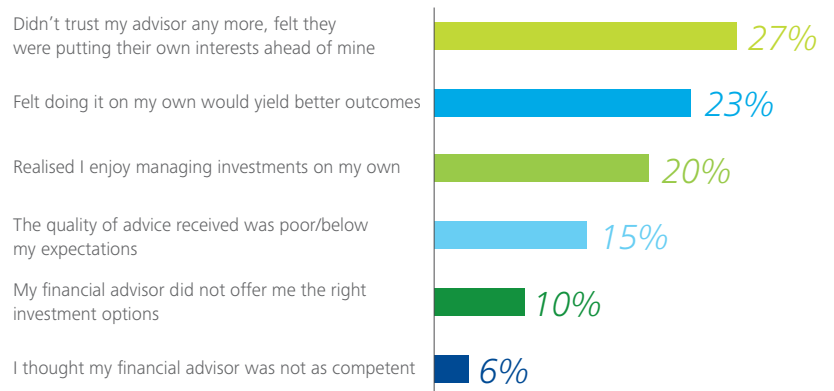
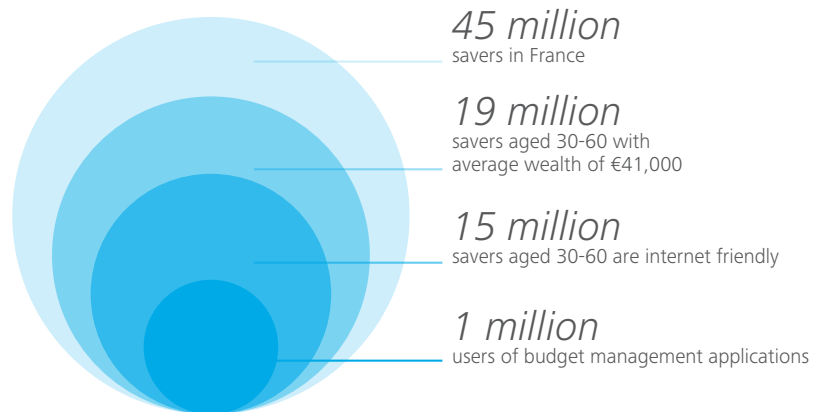


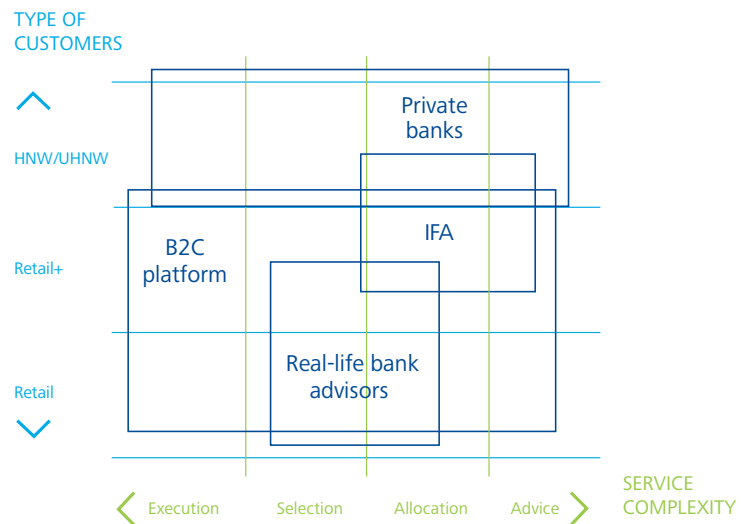
Figure 5: Attractive market: needs of 'Internet-friendly' savers are not satisfied today



Source: Report Berger-LeFebvre, April 2013, INSEE, TNS Sofres

In the latter case, questions arise regarding the positioning with respect to intermediated distribution, the use of a more or less open architecture, partnerships, technology and, of course, momentum. Nonetheless, the challenge is such that they cannot avoid considering changes in the business model. While fully justifiable from an economic point of view, trail fees are probably now a thing of the past, and banning them entirely would appear to be an inevitable part of the regulatory process. An analysis of these developments is more than necessary, particularly with respect to the customer experience of the new generations (digital native and digital dependent). If these platforms are not launched locally by the industry, there is a clear risk in the medium term of the emergence of global online or telecom players.

Figure 6: What will be the distribution system of the future





Platform

Services

Revenue source

Hargreaves Lansdown



- One-off financial advice
- Discretionary management
- Wealth engineering
- Ad hoc investment review
- Type of wrapper offered: ISA (savings account) & SIPP (retirement savings)
- Open architecture -> use of **traditional** funds and **ETFs**

Fixed (% of AUA)

- Financial advice: 1% initial
- Portfolio management: 1% initial + 0.365% p.a.
- Wealth engineering: 2% initial maximum
- Ad hoc investment review: 0.5%

Nutmeg



(Main investors: Schroders and Balderton Capital)

- Portfolio management: creation of **model portfolios corresponding** to investment objectives
- Open architecture -> virtually exclusive use of **ETFs** Blackrock iShares, HSBC and ETF Securities
- Type of wrapper offered: ISA (savings account)

Fixed (% of AUA)

- No entry fee
- Between 0.3% and 1% p.a. depending on the amount invested, the number of funds in the portfolio, loyalty scheme points, etc.

Moneyfarm



- Ongoing financial management
- Portfolio management: creation of **model portfolios corresponding** to investment objectives
- Open architecture -> exclusive use of **ETF**

Fixed (% of AUA)

- No entry fee
- Financial advice: 0.9% p.a.
- Portfolio management: 1.1% p.a.

To the point:

- The unsatisfied need for retirement savings products associated with private individual distrust of banks regarding savings solutions and the new generational customer experience are all catalysts of change in the savings product distribution model
- MIFID2 and IMD2 will only accelerate this process
- The emergence of digital platforms positioned in asset allocation and financial advice based on the investment objectives of private individuals should not be ignored
- The model tailored to the constraints and aversions of continental Europe still has to be defined, however, the arrival of new entrants in this market necessitates the mobilisation of traditional industry players

While fully justifiable from an economic point of view, trail fees are probably now a thing of the past, and banning them entirely would appear to be an inevitable part of the regulatory process





Information technology will be the next game changer for investment managers

Jordy Miggelbrink
Deloitte Alumnus

Investment management organisations are struggling with their day-to-day operations, as the industry faces the challenges of a constantly changing market, regulatory and technological landscape.

“Do you think every single software vendor can do as much as one big collaborating community containing visionaries and practitioners: all with a passion for technology?”

In our earlier publications, we explained the impact of new regulations, such as Solvency II (applicable to the insurance sector), which is having a major impact on investment managers. These enhanced regulations require investment managers to modify their operational procedures, also known as ‘trade cycle management’. They have to deliver increased transparency, demonstrable risk-based modelling, improved look-through reporting and other complex functionalities.

All these challenges, which are handled under pressure and may impact on operational excellence, have led to many organisations evolving a complicated and error-sensitive technological architecture. The well-known software vendors seem to be finding it increasingly difficult to anticipate change and adapt their off-the-shelf solutions to the functional challenges of the market. This new environment can produce the kind of data-related incident that impacts on financial results and/or investment decisions and distracts investment management organisations from their key objective: meeting their clients’ (financial and/or pension) needs. Moreover, the price of primary software packages and the costs involved in maintaining and supporting the required infrastructure (operating systems, databases and transportation platforms) have been increasing over the last decade.

The cumulative impact of these developments has inflated IT budgets to a level often considered to be unacceptably high, resulting in multiple cost reduction programmes. Such programmes have forced IT departments to manage an increased amount of work on a lower budget, with the resulting pressures making organisations more inflexible and unable to take opportunities to introduce innovation or improvement.

IT is changing

These environmental developments are not limited to the investment management sector. The world is experiencing a record pace of technological innovation. Technology today enables competitive advantage, and developments in diverse areas like big data and (emerging) analytics, engagement, (dynamic) cloud or social media are bringing myriad opportunities for enterprise.

Information technology was once considered as ‘hardware centric’ with limited flexibility. Then the IT world moved to a ‘client-server’ approach, and later to ‘internet applications based on virtualisation’, where applications are isolated per virtual machine and the application runtime is abstracted from the hardware. One of the downsides is greater redundancy caused by duplication in full operating systems, libraries and binaries per virtual machine. In the near future, IT will provide cost-efficient solutions for big data, analytics and cloud technologies that will bestow competitive advantage on organisations that are able to adapt.

Open source

One of today’s most wide-ranging and dynamic aspects of software development is the ‘open source revolution’. A number of large technological companies have predicted the structural shifts driving this change. IT already relies heavily on open source development, which enables large-scale innovation through collaboration by the community instead of one company trying to do everything itself. It’s no surprise that the current number of open source projects exceeds 600,000 and continues to double every 24 months. An example of a rapidly growing project is the OpenStack platform. This platform has already been rolled out at financial organisations and covers open source software for building private, public and dynamic



clouds, open-sourced by the hosting giant Rackspace. These big data, dynamic cloud, open source solutions have re-architected the foundations of existing trade cycle management solutions. This new approach will provide new features and solutions to run modern infrastructure stacks and enable organisations such as investment managers to scale hardware, services and applications to deliver a flexible infrastructure tuned to meet business requirements.

Open source projects

Among the most recent and interesting developments, we would highlight the Docker open source platform. This portable, lightweight runtime and packaging project has been designed to build, ship and run distributed applications using a flexible, structured and agile approach. This methodology enables enterprise organisations to quickly assemble software from containerised components and eliminates the friction between development, quality assurance and production environments. As a result, IT departments can ship faster and run the same application, unchanged, on the user side, data centre VMs, and any cloud.

Alongside the Docker containerisation platform, the technological environment has also seen rapid enhancement in other areas, for example, the CoreOS open source project, which covers a lightweight server OS that has been built from the ground up for the modern data centre based on running Docker containers. CoreOS provides tools and guidance that give organisations a clustered platform that is secure, reliable, and stays up-to-date automatically. These strategies and architectures are based on the same criteria that allow companies like Google, Facebook and Twitter to run their services on a massive scale with high resilience.

Open source projects also exist in the area of programming languages. One of the recent developments is the Go language, which has been developed by Google with the help of many contributors from the open source community. This language has been designed to be expressive and efficient, and concurrency mechanisms make it easy to write programs that get the most out of multicore and networked machines.



Helping investment managers reach 'alpha'

Investment managers' operational departments have to process vast volumes of data on transactions, positions, cash movements, financial events, corporate actions, price adjustments and much more. The diversity of these events and the number of financial positions taken means that investment managers need to be flexible, adaptable and robust, without losing sight of their key objective: investing their clients' (pension) assets while reaching their financial goals. Investment managers that are able to turn information technology from an expense into a game changer by applying the new technologies described earlier to the trade cycle management process can achieve excellence in the following areas:

Scalable infrastructure supporting the trade cycle management process

Implementing these new flexible, scalable and robust technological concepts will be extremely valuable in the trade cycle management processes. Such concepts allow the investment manager to upscale the technical infrastructure for processes that rely on heavy and complex operations such as the calculation of a fund's net asset value (NAV) or historical value-at-risk (VAR), when the trade cycle management process requires this. The infrastructure can then scale down as soon as the heavy processing has finished. This instant flexibility can reduce the operational costs related to hardware, CPU, network bandwidth and internal memory. From an information technology (budget) perspective the investment manager is able to 'hire' infrastructural resources as required, instead of always having them available within budget for exceptional circumstances at a specific moment during the day. Furthermore, this technical approach can be extended to resource accounting, which enables cost-efficient allocation accounting and will reduce operational costs in the long term.

IT budgets will also be reduced when investment managers implement open source projects as they currently use trade cycle management support platforms that are built on top of expensive database or operating systems. The extra licenses and maintenance fees associated with this infrastructure are added to the costs related to the trade cycle management platform itself, and the investment manager must negotiate and maintain two contracts, each with its own standards and services.

Shorter time-to-market

Investment managers that have adopted the technological strategies described can implement real-time, secure connections to and from clients, brokers, custodians, data vendors and exchanges in minutes instead of months. These opportunities can lead to the opening of new distribution channels and unexpected possibilities with new trading platforms—all based on secure, real-time, flexible information requirements that will reduce implementation and operational costs.

“Innovation contains more than the underlying technology. It’s about culture, passion and attitude.”

New connections and interfaces can be integrated within a shorter time-to-market, with less effort and time, and a smaller budget. The investment manager can use the freed-up resources for (emerging) analytical capabilities in order to harvest the best financial investment opportunities available. Turning trade cycle management data from an expense into an asset enables investment managers to focus on their core processes with greater analytical skill and support.

Trade cycle management optimisation

Trade cycle management software should be developed more quickly, and deployed with increasingly flexibility to any device or server, without needing to rebuild from

scratch. This will enable the investment management organisation to implement the required functionality in a controlled and structured framework. Moreover, it can reduce operational concerns where uncertainties currently exist in relation to:

- The investment manager’s trading position
- Trades that are open with counterparties
- The quality of securities and cash held by custodians
- The net asset values of the funds
- The reports sent to regulators, clients or other stakeholders

To the point:

- The latest technological developments enable investment managers to dynamically (de)allocate technological resources as performance, scale, network space and stabilisation requirements demand. This means that the investment manager can implement a flexible, defined resource usage for each application instance whereby applications can be upgraded, enhanced, rolled back or removed in seconds
- Instead of implementing trade cycle management platforms as one big blob of files, investment managers now have the opportunity to decompose functionalities into several pre-installed, well- configured isolated containers that can be orchestrated intelligently: resulting in an architecture or software solution that is flexible, elastic and changeable on short timelines. These

functionalities can be deployed to reflect (regulatory) reporting requirements and distribution opportunities, as well as offering a solution to increase the stability of the current infrastructure. By adopting these new fundamentals within the trade cycle management process, the investment management organisation is now able to fully devote its resources to its key objective: generating stable absolute returns, while accepting minimal risk within an extended investment horizon. This can be achieved without operational expenses outpacing the return on investment

- Whether or not investment managers should use these technologies is not in question; if they intend to survive the next decade, they ought to be considering how such technologies should be applied

Collateral is a core competence for the buy side

David Little
MD Strategy and Business Development
Calypso Technology Inc.

It was in October 2012 at the Amsterdam collateral conference that Juan Jose Fortun from BBVA Asset Management made the statement that collateral was becoming a core competence for the buy side. I remember thinking at the time what a strong statement that was and wondering how widely the view was shared among his buy side peers.



Today, few would disagree about the prominent role that collateral has come to occupy on the buy side. In this article, we will briefly look at the reasons for this and the drivers of collateral's rise to prominence, before considering the implications for buy side firms.

It was undoubtedly the global financial crisis of 2008 that was the trigger of the many changes we now see in the collateral world, and it is worth reflecting on why so much emphasis has been placed on collateral since then; because one thing is for sure—it was not a collateral crisis. It was both a credit crisis and a liquidity crisis, and the reason that collateral is so important is because it proved to be very effective at mitigating both credit risk and liquidity risk. Where collateral was in place, in most cases the losses were fully covered. When liquidity dried up, it was only by pledging collateral that loans could be secured. In a very real sense, it was collateral that fuelled the recovery from the crisis. So it is not surprising that both regulators and the industry have been focused on collateral ever since. It is not that collateral failed, but because it is so important it has been thoroughly examined, and any weaknesses—and there were many—are being addressed to ensure that the protection collateral affords can be as effective as possible going forward.

And it is not just regulators that are driving improvements to the collateral systems. During the crisis and afterwards, the industry itself recognised the importance of collateral and implemented many initiatives both at firm level and at wider industry level through groups like ISDA. And the reviews really have been comprehensive: every link in the collateral process chain from valuations to margin call processing, disputes to delivery and reporting has been examined in detail. The frequency, velocity, quality and concentration of collateral have been measured and stress tested. The legal and contractual terms, enforceability and default processes, eligibility and haircuts have all been put under the microscope. And while it is probably true to say that the collateral system was not broken before, it is certainly a much more robust and greatly improved situation today.

So what are the key changes that will affect the buy side, and why do those justify a change in the status of collateral at buy side firms? In summary:

- The number of margin calls will increase by tenfold or so
- The range of collateral assets deployed will broaden from predominantly cash to include bonds and other assets

- The security of collateral—where is it, when and how will I get it back, could it be lost or trapped? The risks need to be understood and managed more effectively
- Increasingly, front office traders need to understand how trades will be collateralised and what the costs will be, as these factors can affect trading decisions
- The direct and indirect costs of collateral are set to rise significantly
- The choice of which collateral services and which service providers to use needs to be actively managed and monitored

Let's look in a little more detail at each of these key changes—not all the items will affect all firms equally, some might be more or less relevant depending on the products, markets, currencies and geographies, and how the business is collateralised and managed.

Increasing number of margin calls

In the past, many buy side firms might have faced collateral margin calls on a weekly or monthly basis, but daily margin calls are becoming far more frequent under the new regulations. There is also pressure to reduce thresholds and minimum transfer amounts, and as a consequence there will be more frequent deliveries of smaller amounts of collateral and fewer days when no call is required. In addition, portfolios are becoming more fragmented, as some OTC derivatives move to clearing houses. Margin calls will originate from each clearing broker and clearing house combination used. A variation margin is increasingly being charged in the currency of the exposure, so for firms with exposures in several currencies there is a multiplier effect on the number of calls.

Many buy side firms will start paying initial margin for the first time on their derivatives portfolios. As soon as derivatives move to clearing, initial margin is payable. For non-cleared OTC derivatives, two-way initial margin is being introduced in phases from 2015 to 2019. Ability to use cash and securities as collateral
Today, most firms pay collateral in cash only. The variation margin is likely to remain cash only, but initial margin can be paid in cash or eligible securities—typically high-quality bonds. Many buy side firms do not have sufficient cash on hand to easily fund initial margin and the problem will become more acute as two-way initial margin on bilateral portfolios is phased in. Therefore, many firms would like to be able to deliver non-cash collateral as well as cash. Decision making about what to use can then be based on funding costs, interest rates and the availability of cash and eligible securities.



The frequency, velocity, quality and concentration of collateral have been measured and stress tested

Security of collateral

The segregation models used for collateral vary by product type, jurisdiction, broker and clearing house, although what is actually available to any particular firm through its brokers may be very limited. The risk a firm faces is of losing all or part of its collateral assets for a period of time or forever in the event of the default of their clearing broker, clearing house or even another client with commingled collateral. Unsurprisingly, higher levels of protection—if they are available at all—come at a higher cost. The trade-offs are, frankly, unappealing.

Front office impacts

Due to the costs, risks and capital implications of collateral, the front office trading and risk teams are increasingly interested in the detail of margin and collateral. A trade might be risk-increasing if directed to one clearing house or risk-reducing at another, and the margin costs can be significant enough to affect trading decisions. Pre-deal margin estimation and smart order routing requirements mean that real-time information is required. If securities are pledged as collateral, then it becomes important that traders understand the impact on inventory—which securities are pledged and when inflows and outflows are expected.

Increasing cost of collateral operations

Unsurprisingly, costs are increasing. It is worth separating the funding cost of collateral from the operational costs. Funding costs today are low due to low interest rates and plentiful liquidity, however these conditions will not last forever. Minimising funding costs is the aim of collateral optimisation where sophisticated algorithms are used to select the cheapest option, taking many factors into consideration such as

availability, eligibility, haircuts and concentration limits. The operational costs of collateral are rising inexorably, and although the impact has perhaps not been fully felt yet at many buy side firms, it is certainly coming. As described above, the increasing number and complexity of margin calls will inevitably increase costs, although these factors are also driving efficiency improvements and higher levels of STP. Regulatory and compliance costs are going up, as more oversight and reporting is introduced along the collateral chain. An example is the dispute regulation introduced during 2014, which has driven improvements in collateral systems and processes, as well as the increased use of reconciliations. Any long-running disputes now have to be reported to regulators, and it is almost certain that the costs of non-compliance would be higher than the cost of an efficient and robust collateral operation.

Collateral service providers

All the factors described above affect buy side firms, but it is clear that they also affect sell side firms that provide collateral and derivatives services. An additional factor for sell side firms that handle clients' collateral is the balance sheet impact as the collateral passes through their books. The situation is complicated and depends on jurisdiction, segregation model, security type and other factors, but in general, there is a significant level of balance sheet utilisation at sell side firms from processing this business. As a result, several sell side firms are either reducing or exiting from the business, and the remaining firms are frequently reluctant to expand their customer base. It is important that buy side firms understand these pressures and take the necessary steps to ensure continuity of access to markets.

Unsurprisingly, costs are increasing. It is worth separating the funding cost of collateral from the operational costs

Despite these pressures, sell side firms have service providers including clearing houses, custodians and CSDs, which have continued to invest in collateral systems and processes and in developing new collateral models such as tri-party and quad-party collateral and collateral transformation services.

Implications for the buy side

Given all the factors described above, I think it is clear that collateral has become and will remain a core competence. So what are the implications of that, and how should buy side firms prepare for the future? What operating models are appropriate, and which aspects of the collateral operation should be outsourced and which kept in-house? How should the in-house operation be supported?

We can start with some high-level objectives: minimising cost, minimising risk and maximising control would be some obvious targets, but they do not suggest specific actions. If we consider the general structure of buy side firms, whether they are asset managers, insurance firms or hedge funds, they typically have many funds and possibly many business lines or entities. It may or may not be possible to combine margin and collateral across funds. It would be impractical for each fund to manage its own collateral independently, so typically, firms are setting up a central collateral operation to oversee collateral at a group level. It normally makes sense to combine collateral management with liquidity and funding and any securities lending operations into an integrated treasury function.

The responsibilities of an integrated treasury function would include governance and policy decisions; communications both internally and externally to fund managers, trustees, regulators and service providers; oversight of daily collateral operations, including monitoring and checking of valuations, holdings and transfers; cash and liquidity management; and regulatory reporting.

Firms have traditionally used sell side service providers for much of the post-trade processing including collateral management, and it is likely that will continue. But I hope it is becoming clear that not everything can be, nor should be, outsourced. Overall governance and responsibility for collateral cannot be outsourced, and a level of monitoring and oversight is essential. In order to support even a minimally scoped collateral operation there is a requirement for accurate, complete and timely data in a robust application. Manual processes and spreadsheets were extensively used in the past, but these will struggle to cope with the changes that are coming and are not looked at kindly by regulators. So, if collateral operations are becoming centralised within a treasury function and some level of system is put in place, where should the line be drawn between what is done in-house and what is outsourced?



Once the decision has been made to support an internal collateral operation with a competent system, it then becomes easier to make tactical decisions based on costs and benefits about what to outsource and what to insource. It is likely that those decisions will be reviewed periodically as market conditions change and opportunities arise.

At Calypso, we believe that as collateral has become a core competence for the buy side, it is now essential to have a collateral competence within the firm that can properly understand the complexities and support the many stakeholders in providing a secure and cost-effective collateral capability in line with current best practice standards that can adapt to future changes.

To the point:

- The number of margin calls will increase by maybe 10-fold
- The range of collateral assets deployed will broaden from predominantly cash to include bonds and other assets
- The security of collateral – where is it, when and how will I get it back, could it be lost or trapped. The risks need to be understood and managed more effectively
- Increasingly the front office traders need to understand how the trades will be collateralised and what the costs will be as it can affect trading decisions
- The direct and indirect costs of collateral are set to rise significantly
- The choice of which collateral services and which service providers to use needs to be actively managed and monitored



Webinars Programme 2015

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Regulatory

- Regulatory outlook for 2015 - 22 JAN
- AIFMD developments - 19 FEB
- UCITS V & VI - 5 MAR
- Loan Funds - 2 APR
- Anti Money Laundering - 16 APR
- European Fund Distribution - 30 APR
- EMIR SFT Regulation - 21 MAY
- Remuneration (CRD, MiFID, AIFMD, UCITS) - 11 JUN
- Basel 3 and Solvency II - 25 JUN
- AIFMD II: EMSA submission - 23 JUL
- MiFID II - 17 SEP
- MAD II - 15 OCT
- AIFMD II: European Commission's response - 29 OCT
- 2015 in Review - 3 DEC



Risk & Asset Management

- Money Market Funds – International Development - 5 FEB
- Client Assets - 19 MAR



Operations & Techniques

- Derivative Financial Instruments - Introduction to Valuation - 9 JUL
- Derivative Financial Instruments - Valuing Complex Instruments - 3 SEP



Investment Funds Introduction

- Introduction to Investment Funds - 28 MAY
- Investment Management Tax - 1 OCT
- Hedge Funds - 12 NOV
- Private Equity and Property Funds - 26 NOV

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