

# Performance

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Focus on your strengths, white label the rest

Wealth managers at a crossroads

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May 2019

**Deloitte.**

A triannual topical digest for investment management professionals

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# Foreword



As we approach a milestone in Performance's history, this 29<sup>th</sup> edition continues its journey of crisscrossing the asset management industry, from a geographical, segment, and client perspective.

In this bumper edition, we hear from our Italian colleagues on how the introduction of Italian individual savings plans, similar in concept to those well-known counterparts in France and the United Kingdom, have stimulated the growth of the Italian economy (despite very tough criteria) to be recognized as a Piano Individuale di Risparmio (PIR).

From Italy, we head right across the globe to Australia where we delve into the challenges of liquidity risk management, as well as discovering the results of the Australian government's investigation into whether any behavior by financial services entities might have amounted to misconduct.

One interesting observation of this investigation relates to the connection between conduct and reward since the drivers of nearly every case considered were both the entity's pursuit of profit, and the individual's pursuit of gain.

Coincidentally, one of our articles analyses five features of a reshaped reward strategy to create a winning combination. We often hear the phrases "top down" or "bottom up" in relation to portfolio management, but how about applying this concept to a reward strategy? Potential food for thought. In almost every foreword, we encourage you, our readers to contribute and share your insights, challenges and success

stories. Today, almost half the magazine has been written by you. HSBC Securities Services asks whether we can quantify the effect of ESG on our industry. Given the very subjective construct of ESG, determined overwhelmingly by the moral compass of the end investor, this answer will most likely be biased depending on your point of view. In contrast, UBS sheds light on why the asset management should embrace the concept of white labelling which actually transcends industries. Focus on your strengths, white label the rest – definitely a phrase to retain. Perhaps the debate with Edmond de Rothschild Asset Management on the rise of outsourcing the middle office rather than the back office will help kick-start the revolution.

Taking a different perspective, our colleagues engaged in a lively discussion with renowned Placement Agents within the sphere of private equity – Cambridge Associates, Jasmin Capital and Moelis & Company. Just like a mature full-bodied bottle of wine, they predict that 2019 will be classed as a vintage year in terms of fund-raising.

To conclude this super edition, Citi Investor Services provides their insights into the future and how crystal ball gazing in 2010 on the trends of 2020 didn't prove to be so far from reality. Perhaps we can revisit their article in 2030 and see how accurate their predictions turn out to be.

All that's left for us now, is to wish you a sun-filled summer break and we'll be back in the autumn with our diamond anniversary edition full of pearls of wisdom.

**Vincent Gouverneur**  
EMEA Investment  
Management Co-Leader

**Tony Gaughan**  
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# Editorial

Dear Readers,

Let's talk about Italy – Italy is the fourth largest economy in Europe, accounting for 11.2 percent of the total GDP, and the ninth largest economy in the world. It had a gross domestic product amounting to €1,612 billion in 2018. The Italian economic structure – concentrated in the Northern part of the country and composed mainly of small and medium-sized family businesses – relies strongly on services and manufacturing. Notwithstanding, Italy is one of the most indebted countries in the world, with a public debt around 133 percent of its GDP, but it also exhibits one of the highest ratios of private wealth to public debt. So it's easy to understand why there is one arm of the Italian financial sector that is going from strength to strength, and that's asset management.

Keeping in mind this macroeconomic picture, we take a step forward, looking at asset management in Italy. Starting in the last months of 2012 through to the end of 2017, the industry has experienced a strong growth.

At the end of 2017, asset management products distributed in Italy exceeded the threshold of €2,000 billion, almost doubling 2012 figures. In recent years, the industry has benefited from the persistence of interest rates slightly above zero or negative, which led investors to seek alternative earnings opportunities rather than traditional securities. For banks, the asset management segment has been an important source of revenue during the years following the financial crisis and played a central role in their growth strategies due to reduced capital absorption compared to traditional banking services.

**Marco Miccoli**  
Audit & Assurance Partner

**Simon Ramos**  
Editorialist

The extremely positive state of the Italian asset management industry, which peaked in 2017, reaching 121 percent of GDP, began to show signs of distress in 2018. Overall, 2018 has been a turbulent year for asset management, the industry lost more than €68 billion in asset value and recorded a net outflow for €3.9 billion. The 2018 slowdown of net inflows is linked with the general worsening of the domestic situation and the downward correction of financial markets. This confirms the general behavioral theory that investors tend to be more risk averse when the economy is slowing down; and this is particularly true for risk-adverse savers like the Italian ones.

Looking at the distribution of mutual funds it is clear that the banking groups play a central role. Independent financial advisory did not gain a large market share in Italy. Moving on, while analyzing the industry structure it is worth highlighting that in recent years some business combinations have reshaped the sector; however, the industry remains fragmented compared to other European countries. Therefore, we expect further changes in the near future. Even if the Italian asset management industry - after a long period of growth - is now one of the largest and most dynamic across Europe, there are concerns about the long-term sustainability of the current structure and the number of new challenges, which are intensifying dramatically. A tougher competitive environment, operational efficiency – i.e. decreasing costs through data and technology but also increasing investments in artificial intelligence and robotic process automation – and new regulatory frameworks, like MIFID II and local tax rules, are creating challenges and opportunities for incumbents and new players in Italy. In this edition, we take a closer look at some of these challenges.



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# Rethinking reward strategies

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How the changing landscape of asset management is affecting the reward and retention of the industry's greatest resource – its people.

The landscape of the asset management industry is facing an impactful shift due to increasing complexity and fresh challenges. Two crucial factors drive this transformation: regulatory evolutions and industry trends. Reading and understanding these factors are essential in attracting, rewarding and retaining people who are fundamental to the long-term sustainable growth of the company. ➔

Promoting a (mid-long term) performance-related remuneration based on a combination of individual, business unit, fund, and overall management company performance, which considers both financial and non-financial indicators.

### The impact of regulation

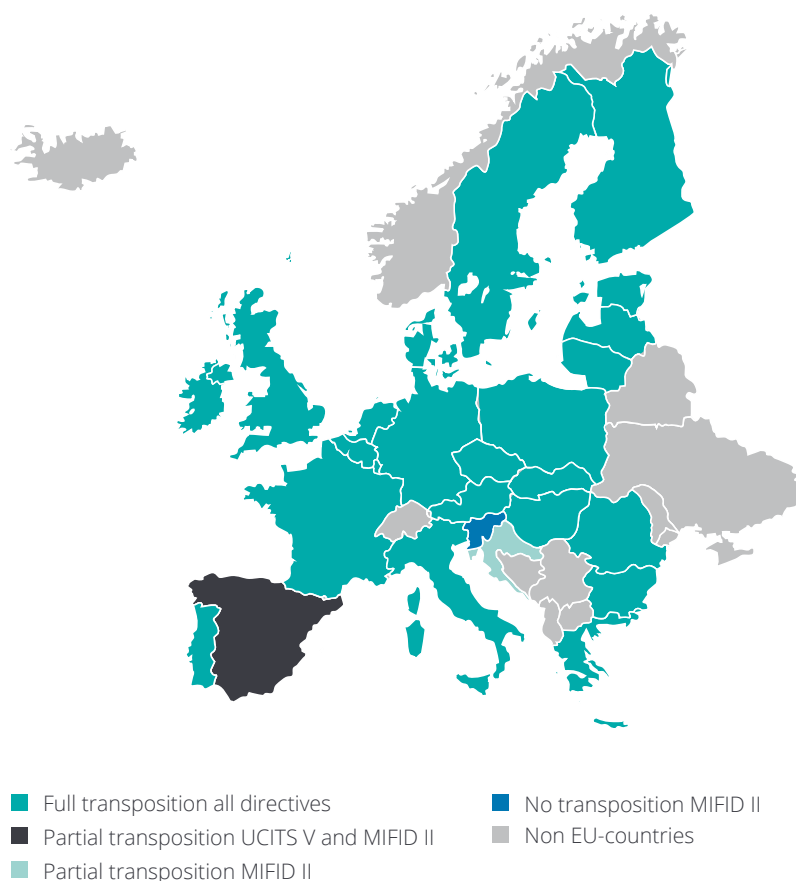
Following the economic and financial crisis, regulators have been paying increasing attention to reward systems and remuneration policies. These aim to guide market players towards the adoption of solutions that are consistent with and promote the principles of, sound and effective risk management.

The key directives (Figure 1)–transposed at local level by EU Member States, and which consider the guidelines provided by EBA and ESMA–are essentially: CRD IV, AIFMD/UCITS V and MIFID II. At the moment the European Regulator is working on an updated version of the banking Regulation and by the end of the year the CRD V and the CRR II are expected.

CRD IV and AIFMD/UCITS V focus, at different levels of detail, on a series of principles, such as:

- Promoting a (mid-long term) performance-related remuneration based on a combination of individual, business unit, fund, and overall management company performance, which considers both financial and non-financial indicators

Figure 1: The key directives as transposed throughout Europe



Source: European Commission – Transposition status



- Offering fairly balanced fixed and variable remuneration to allow a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component at all
- Providing specific terms and conditions for the payout of variable remuneration of the Code Staff that may have an impact on the fund manager’s risk profile
- Ensuring an ex-ante and ex-post risk adjustment, aiming to guarantee the sustainability of variable component payment
- M&A transactions: Defining a growth strategy, which may involve acquisition or consolidation to better address economic pressures, the need for new capabilities, and/or a shifting value chain
- Fee pressure: Asset management increasingly looks like other consumer businesses—dramatically changing buying demands, desire for a strong customer experience, and fee sensitivity. As fee pressure rises, the most active asset managers will need to provide more differentiated products
- Digitalization and the shift of operating models toward agile solutions: To better align organizational structures, governance, behaviors, processes and technologies with new competing priorities. ➔

MIFID II:

- Effective since January 2018, on the other hand, introduced new requirements heavily focused on customers’ protection. The aim was to limit the risk that incentive practices give raise to conflicts of interest. In this realm, one of the most impactful rules concerns sales targets, which shall not provide an incentive to staff to recommend a particular financial instrument when the firm could otherwise offer another financial instrument more appropriate to the customer’s needs.

Deloitte follows the evolution of the existing regulatory framework, both at a Global and single country level, through an observatory, which summarizes both local regulatory updates and best practices in implementing the regulations.

**Key industry trends**

Based on Deloitte outlooks on asset management industry trends emerged that asset management firms face an ever-evolving environment full of unprecedented challenges and complexities, which are characterized by the following trends:



### Reward strategy: The main challenges and best practices

This ever-evolving market needs to re-think reward strategy and practices using the latest regulations as a driver for change, while answering pressing questions, “How to address the decision process in this unstable scenario?”, “How to retain key employees?” or “How to reward new capabilities?”

Observation of market practices has identified a series of interesting solutions:

- Increasing adoption of **pure bonus pool solutions** (Figure 2): The overall amount for bonus payments depends on a key metric that synthesizes the most significant performances achieved. The pool is then allocated at individual level based on individual performance as measured by quantitative and qualitative metrics. It is very common practice—with the exception of AM subsidiaries that follow the logic of the target opportunity—that the bonus pool is calculated as a percentage of profits, fees or revenues. In most cases, there is no definition of an individual opportunity/target bonus (maximum levels of variable remuneration are set,

# This ever-evolving market needs to re-think reward strategy and practices using the latest regulations as a driver for change.

for regulatory purposes, as a percentage of the annual fixed remuneration). When analyzing, it is important to consider regulatory updates introduced in some EU Countries (e.g. Italy, UK, France and Germany), such as the possible derogation to the 1:1 bonus cap of asset managers in banking groups

- Identification of **innovative types of remuneration for managers**, such as carried interests and co-investment solutions. These types of reward were previously uncommon in specific segments of the market, yet in recent months, many clients have been investigating possible implementation.

Carried interests plans (or relevant phantom forms: cash payments replicating the carried interests performances) imply the share of profits in excess of the amount that the manager contributes to the partnership. This includes a shift towards hybrid structures, which incorporate a deal-by-deal portion in a way that is acceptable to investors and maintains tax efficiencies. Co-investment is a solution of increasing popularity too, which replicates an entrepreneur spirit by rewarding those who share the company’s risk.

- **Return to LTI plans:** Companies of AM (and in particular listed companies) use LTI plans based on shares. Only rarely is the LTIP in the form of cash, a non-viable solution for identified staff due to regulatory constraints. However, in order to meet regulatory requirements and align incentives, many companies pay part of the variable component through fund shares or phantom fund shares.

- **Need for retention plans design:** Typical in the case of M&A, it is a combination of “pay to stay” and “pay to perform”, usually paid in various instalments to a selected target population, the loss of whom would be highly detrimental to the overall business. Payment types of such plans fall into four broad categories 1) cash, 2) equity, 3) earn out, 4) hold back payments. Based on the length a company wishes to retain an employee, there are three main types: 1) a long-term retention bonus, 2) a stay bonus, and 3) a completion bonus.



**Investors voice impact on remuneration practices**

One of the key trends in the definition of voting guidelines is the focus on sustainability over the long-term, as opposed to short-term hikes in share prices (e.g. BlackRock Guidelines). In particular, incentive plans will foster the sustainable achievement of results and be based on new performance measures capable of sustaining shareholder returns in the long-run.

Broadly speaking, sustainability-related factors are increasingly incorporated into investment decisions. Companies are facing the dilemma of determining which aspects of environmental, social and governance (ESG) performance shall be included in pay incentives. More and more, goals are linked to affordable and clean energy, gender equality, ecosystems and responsible consumption.

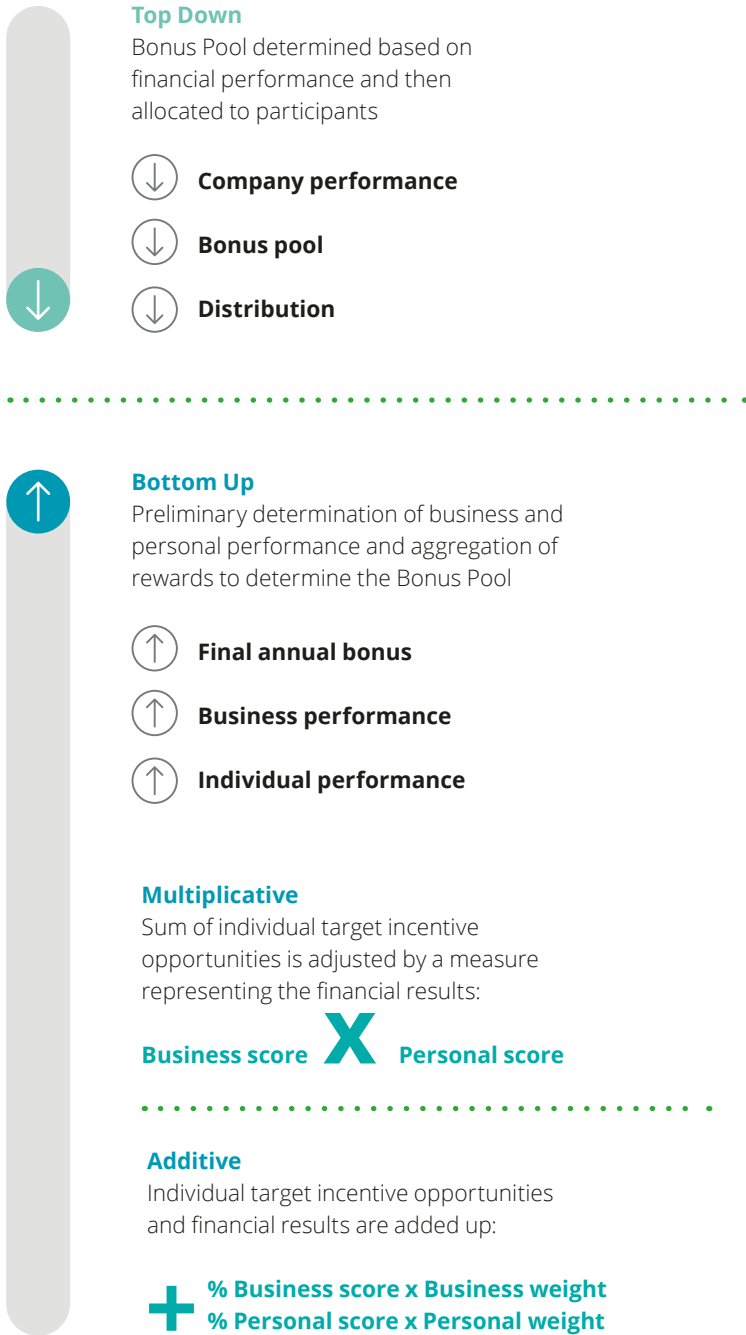
In this landscape, the role of reward and HR is progressively more crucial in supporting business strategy. There is increasing pressure to consolidate and find new ways to interact with other business functions. Specifically, a reshaped AM reward strategy needs to be:

- Market-based
- Differentiating
- Simplified
- Involving business leaders
- Adequately governed

These are described in greater detail in Figure 3 (page 12), A Reshaped Reward Strategy.

In this evolving landscape, remuneration policies within the industry need to be reviewed in light of these new trends. The consideration of the factors outlined above would ensure competitiveness to reward and retain key talents. ➔

**Figure 2: Observation on market practices has identified a series of interesting solutions such as the bonus pool system.**



Source: Deloitte 2019

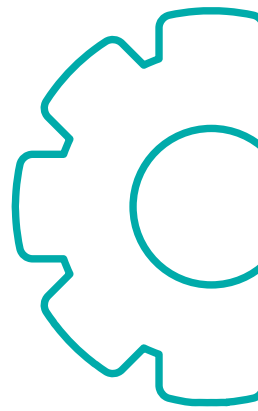
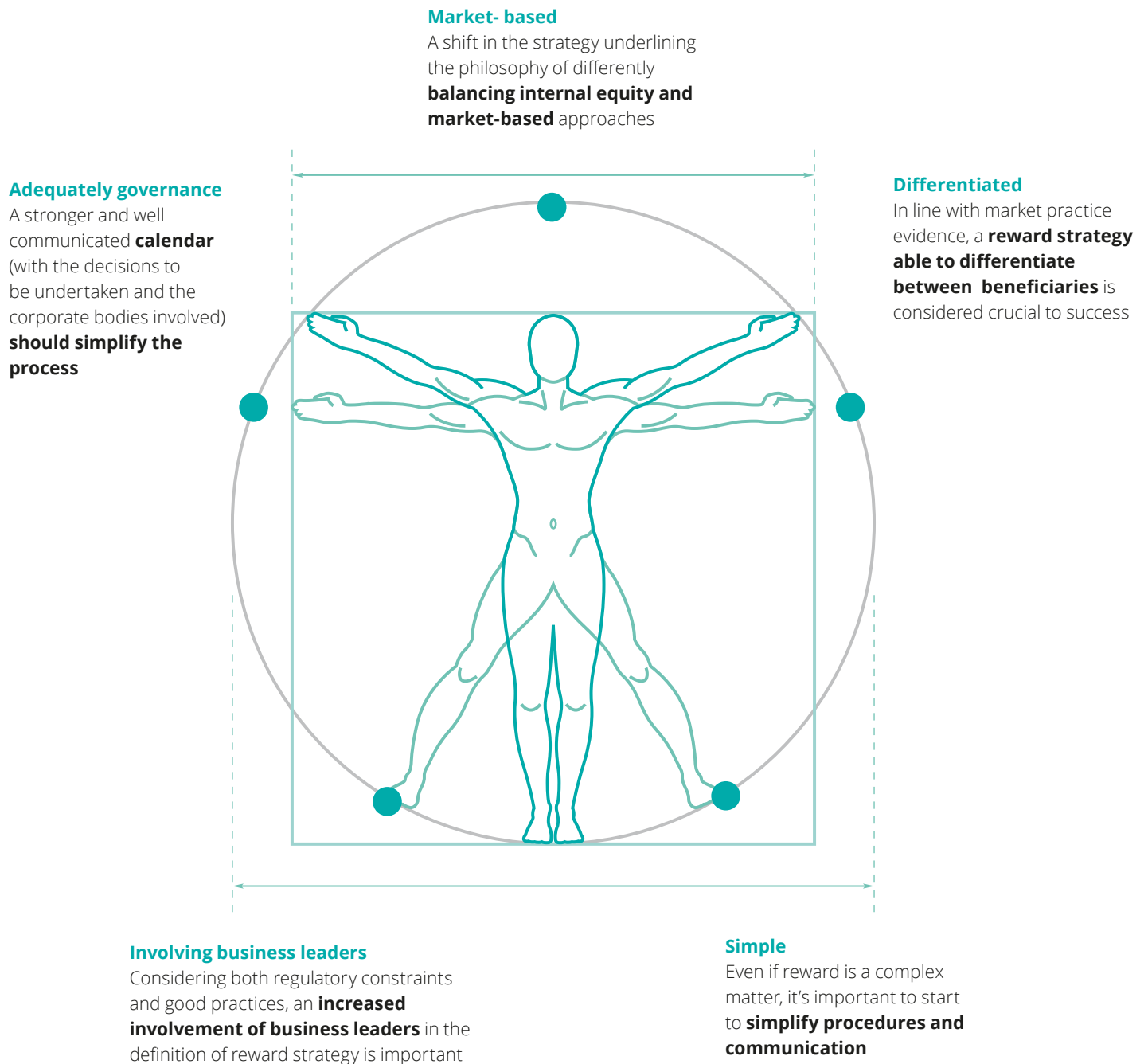


Figure 3: A reshaped reward strategy



Source: Deloitte 2019



**To the point:**

- Regulatory updates are one of the key drivers in the evolution of remuneration practices within the asset management industry, and it should be necessarily considered as an opportunity to better incentivize people.
- The need to adapt to an ever-evolving landscape is another driver for reviewing remuneration practices in light of the increased number of M&A transactions, fee pressure and digitalization.
- Increasing attention to investors' expectations in the definition of remuneration policies. Attention to Environmental, Social and Governance (ESG) performance is one of the key outcomes.
- Key remuneration trends emerging on the market are: increased adoption of "pure" bonus pool solutions, identification of innovative types of remuneration for managers (e.g. carried interest and co-investment), a return to LTI plans and a need for retention plans design.
- Five features of winning reward: market based, differentiated, simple, involving business leaders and adequately governed.





# PIR light and shadow

## Savino Capurso

Senior Manager  
Audit  
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How the introduction of long-term saving plans impacted the Italian SMEs capital markets. What shall we expect from recent regulatory changes?

In 2017, following the example of the French Plans d'épargne and the UK's Individual Saving Accounts, Italy encouraged its asset managers to create long-term saving instruments called Piano Individuale di Risparmio (individual savings plan or PIRs). PIR benefits from tax incentives to encourage savers to invest in small and medium-sized firms. [➤](#)

	<b>PIR</b> Piani Individuali di Risparmio	<b>PEA-PME</b> Plan d'épargne en action— Petites et Moyennes Entreprises	<b>ISA</b> Individual Saving Account
Country	Italy	France	UK
Date of inception	2017	2014	1999
Maximum investment (per year)	€30,000	-	£20,000
Maximum investment	€150,000	€150,000	-
Holding period	Five years	Five years	-

Essentially, the PIR is a mere "tax container" that will assume different technical forms such as UCITS, segregated accounts, insurance contracts, deposits of financial assets. Within these long-term saving plans, savers can place any type of financial instrument (shares, bonds, UCITS shares, and derivative contracts) or sum of money, while respecting certain investment constraints, with the benefit of an exemption from 26 percent income tax and inheritance taxes if savers hold their investments for at least five years.

The purpose of PIRs is to stimulate the growth of Italian enterprises and therefore the Italian economy, with a focus on a specific category of enterprises (i.e. Italian SMEs). In order to be PIR-compliant, there are some specific constraints that an investment plan must respect:

- Specifically, at least 70 percent of invested assets will consist of Italian companies
- 30 percent of the mentioned share must be directed to SMEs not included in the FTSE MIB index (equal to a minimum percentage of 21 percent of total investments)

Additionally, some limitations on the amount invested in PIRs and regarding counterparty concentration risks apply:

- It is not allowed to invest more than €30,000 per year (and more than €150,000 per investor over five years)
- It is prohibited to invest more than 10 percent in instruments from the same issuer, in order to ensure portfolio diversification

The PIR-compliant financial products shall be issued by companies residing in Italy, EU or EEA, with the exception of the "free" portion of the investment that may also include instruments issued by companies from "non-white list" countries.

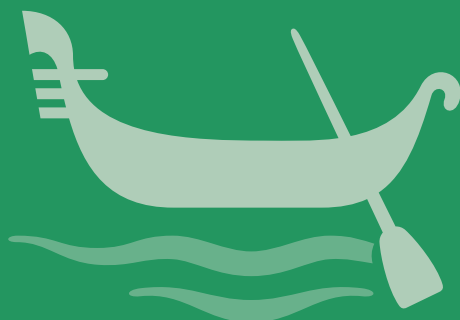
### An opportunity for support of SMEs growth: strengths and weaknesses of PIRs

After the 2008 financial crisis, Italian financial markets suffered from a major loss of confidence towards investment funds by private investors. Therefore, in order to support the direction of individuals' savings towards Italian companies, some specific economic policies were adopted by the Italian Government. In 2014, the PIR-compliant form of saving was introduced with the objective of facilitating long-term investments in Italian SMEs, and acting as a catalyst for the real economy.

The introduction of PIRs, fulfilling both social security needs and liquidity management purposes from an investor's perspective, has been particularly innovative. It underpins a flow of financial resources from private savers to Italian SMEs, which have historically experienced difficulties in achieving emancipation from the bank lending channel.

One important aspect to be highlighted is the level of diversification. A PIR allows the asset manager to craft a highly diversified portfolio and to considerably reduce the overall risk of the investment, making it an attractive solution for investors with different degrees of risk aversion. Nevertheless, it is clear that it has been designed for retail investors, unable to autonomously diversify the portfolio without incurring high costs, rather than for professional players.

When going through the main strengths of PIR, it is necessary to start off with duration. The Law states a minimum holding period of at least five years and, due to a further inheritance tax exemption, it results in a mid to long-term investment horizon. As a matter of fact, this instrument is characterized by lower flexibility when compared to traditional saving plans ("Piani d'Accumulo") and pension funds.



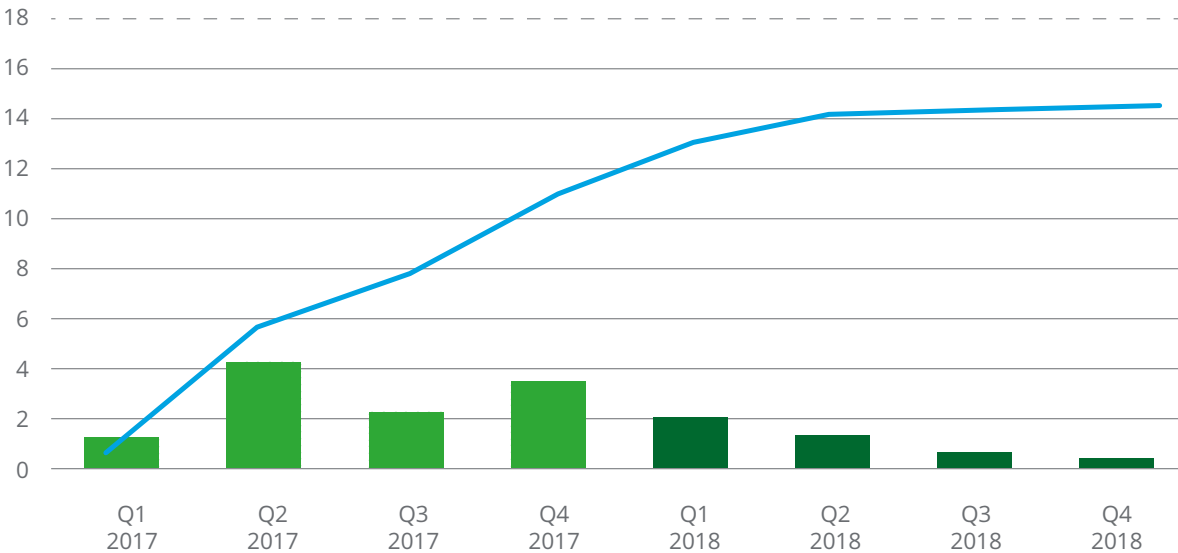


The overall impact on private investors has been positive. It has allowed them to channel a considerable and unexpected amount of resources towards domestic SMEs, help reduce their strong dependence on the banking system, and provided support to their IPOs.

The table shows the trend of PIR-compliant mutual fund net sales during 2017 and

2018. The great success in 2017 was slowed down by the negative market trend in 2018. In our opinion, the reduction in net sales only confirms that Italians investment decisions are strongly influenced by market trends. Asset managers and distributors confirm that investors' interest in PIR-compliant funds remains unchanged. ➔

**Net Sales 2017 - 2018**  
In €Billion



Source: Assogestioni (Italian association of Asset Managers)

**Net Sales 2017 - 2018**  
In €Billion



Source: Assogestioni (Italian association of Asset Managers)



Aside from these desirable attributes, it is also crucial to take into account some potentially detrimental aspects.

In the first place, the distribution of investments between different asset classes may not be appropriately balanced because most of the SMEs operate in a very complex and volatile environment. Moreover, since eligible instruments in the portfolios will be issued by Italian companies, an inherent country risk might be hardly diversified away .

Last but not least, some potential drawbacks are connected to the quality and reliability of the information available about shares issued by SMEs considering their nature and relative size, and given the difficulties in retrieving historical data related to their performance.

### Asset management industry in Italy, investors and PIRs

Over the past twenty years, the Italian asset management industry has experienced considerable renovation due to changes in legislation. During the 1980s in particular, an increase in the demand for a new form of investment took place, due

to the fact that Italy was living in a period of welfare growth. Therefore, collective investment funds were introduced to the Italian market, offering the opportunity to private investors to benefit from professional low-cost strategies in order to increase their financial income. Around the 2000s, a consistent growth in the market's dimension was observed. Asset under management (AuM) in particular saw an increase from €880 to 1,131 billion in just four years (2003-2007). In the same period, the products offered to investors shifted to more diversified solutions.

However, when the financial crisis reached Italy in 2008, the outflow of resources managed by investment funds caused by the loss in value of their financial products, resulted in a total reduction of around

€200 billion in AuM (causing an overall slump to €84 billion).

On the basis of this unforeseen experience, regulation became even stricter to ensure once again the transparency and to prevent other “black-swan” events. The Italian— and the greater European— financial regulators tightened the rules concerning rating agencies, hedge funds, and OTC markets.

Nowadays, investment managers and asset managers in Italy are offering a more international and modern approach to investment products. This has suited investors who are looking for less volatile and risky solutions, rather than those offered by the Italian financial markets before the financial turmoil.

On the other hand, the financial resources “crunch”, together with a restrictive fiscal stance, has weakened Italian SMEs and their ability to access capital.

In this context, the introduction of PIRs, mainly leveraging on the fiscal deduction and covering the gap between international and Italian financial existing tools, has been favorably welcomed by the markets.

In order to fully understand the positive effects of PIR on the Italian market, it is important to look at the profile of a typical Italian investor. In a nutshell, they are on average not sophisticated investors (lack in financial education is an issue that has been highlighted also by the Regulator), they are considerably risk averse, and continue to prefer the traditional banking channel.

A net overall fundraising of almost €68 billion from PIR introduction is expected by the end of the fifth year against an initial forecast of €18 billion.

Nevertheless, in the last two years, the share of people with positive saving rates has boosted from 43 to 47 percent. This figure is supported by the widespread increase in financial knowledge and the expansion in terms of number of investors within the overall population.

Furthermore, it is worth remembering that fiscal incentives are highly appreciated by investors considering the Italian hyper-taxed system.

The results surpassed expectations. The net sales of PIR-compliant products in the first year of their launch outperformed the annual target (€1.8billion), reaching an unforeseeable figure of €10.9billion in 2017.

This was particularly significant with respect to the €18billion of targeted collection originally expected by Italian regulators during a five-year period. It has been observed that AuM for 2018's year-end almost reached €17.4billion.

The means by which different asset managers have embraced the change and developed distinct ways of offering their PIR-compliant products can be broadly divided into three clusters:

- Institution of a new fund/product compliant to the PIR regulations
- Transformation of an existing fund/product into a PIR-compliant one
- A mixed approach combining new and existing funds

During 2018, the positive trend was confirmed with over 50 new PIR-compliant funds created.

After two years, the strong demand for PIR was not sustained by an increase of new investment opportunities in SMEs, which has exhibited soaring prices of their stocks though. For further context, before the introduction of PIR, the average Price to Earning was 12.4, while at the end of 2018

it had reached a ratio of 17.6, showing that resources invested were not matched by a sufficient variety of investment opportunities.

At the end of 2018, analysts confirmed the favorable trend showed no sign of slowing in the forthcoming years. A net overall fundraising of almost €68billion from PIR introduction is expected by the end of the fifth year against an initial forecast of €18billion. ➔





### The empirical evidence

Deloitte has promoted a study, carried out jointly with Jeme Bocconi and the law firm NCTM, aiming to understand the real impact of the PIRs introduction on Italian markets in terms of volume of transactions.

As mentioned, PIR's portfolios must be composed of at least 21 percent of instruments issued by SMEs, generally listed on AIM Italia market or included in either FTSE Italia SMALL Cap or FTSE Italia MID Cap indexes.

Applying a statistical mean-test among daily volumes of shares traded in 2016 and 2017 in the AIM market, there emerged a remarkable increase of 338 percent. It has been quite straightforward to assess a correlation between the flow of financial resources to the market connected with the PIR investments and the augmented average number of trades observed.

With respect to the SMALL and MID indices, the effect was slightly smaller in magnitude, but still statistically significant. The positive change drove the yearly average traded

volumes up by +39.6 percent and +35.0 percent respectively.

Furthermore, comparing the growth in volumes in Italy and France (where, as mentioned, a similar financial tool has been introduced in recent times) a significant correlation was noted between the French SME market (PEA) and the Italian one.

In a similar fashion, the number of subscribers also grew unexpectedly. Italians investing in PIRs were around 700,000 by the end of 2018 and half of them had subscribed to a fund for the very first time.

Thanks in part to the PIR, the total number of Italians owning investment fund units has grown to 12 percent of the entire population, with half of them holding more than €14,400 stakes. The main asset classes held are flexible funds (36.4 percent), bond funds (28.1 percent), balanced funds (10.9 percent) and equity (6.9 percent).

Despite the remarkable changes in market volume, it must be stressed that this was partially due to the initial dimensions of the domestic SME market that were considerably small. Nevertheless, the great impact on the overall transactions is clearly the aftermath of the investment funds' entrance in the market.

During 2017, SMEs' shares prices were growing, on average, more than the market index. Furthermore, during the bearish trend of 2018 prices of SMEs stocks were decreasing consistently less than the broad market index. Nevertheless, no abnormal trends have been observed to presage a bubble effect.

## Conclusion

The 2019 Italian Budget Law introduced new additional constraints, attracting much criticism from the sector's operators. For PIRs constituted from 1 January 2019 onward, it is stipulated that at least 3.5 percent of their underlying assets should be invested in small and medium-sized entities listed on unregulated markets (i.e. AIM/MAC) and a further 3.5 percent in venture capital funds.

The review of the standard was intended to expand the contribution that PIRs can give to the real economy and, in particular, to SMEs and start-ups.

Even if the intentions of the legislator are embraceable and praiseworthy, the drawbacks linked to these additional constraints appeared immediately clear to the operators. Both the AIM/MAC and the venture capital markets in Italy do not present the size and characteristics necessary to absorb the demand for investments that would presumably come from the PIRs.

Moreover, and most importantly, the new rules would oblige the PIR-compliant products to hold a minimum 7 percent of their portfolio in illiquid instruments (a figure approaching the maximum limit set by Bank of Italy, being equal to 10 percent). This "immobilized" component could represent an issue for open-end funds, which must guarantee the units are redeemable and which typically calculate their NAV on a daily basis.

The asset management industry and its stakeholders were hoping for a step backwards by the regulators. This potential regulatory misstep has meant

an interruption in the launch of new plans. In practice, savers who had started to feed a plan before 1 January 2019, were able to continue to do so on the basis of previous standards, while asset managers had put on hold the commercialization of new products, pending clarification of the new rules.

The implementation decree has been published in early May, confirming the new constraints included in the Budget Law. The Economic Development Department declared that the effects of the implementation Decree will be monitored in order to evaluate remedial actions.

Many market participants wonder whether the open-end funds may constitute the optimal PIR-compliant structure in light of the new standards, as opposed to closed-end financial products. In this regard, it is worth noting that the legislator is exploring fiscal incentive measures in favor of European Long Term Incentive Fund (i.e. ELTIF) subscribers.

In conclusion, the new legislation has so far inhibited the spread of a product that was giving fruitful results, actually achieving the economic policy objectives

that were originally set. Financing SMEs and diminishing their dependence on the traditional banking channels, are indeed fundamental aspects to ensure the competitiveness of the Italian economic system. The widespread sentiment in the industry is that the new constraints could represent the final blow to a successful and farsighted initiative and leading, ultimately, to a total eclipse of PIRs. ●



### To the point:

- PIR collections higher than expected, in particular in the first year (2017)
- Empirical analysis showing a significant impact on SMEs capital markets
- New constraints included in 2019 Budget Law: an attempt to amplify the impact on SMEs induced by PIR that could conversely bring to the final eclipse of the instrument



# Looking to the future

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A review in the approach to implementing change and innovation is integral to the success of the Italian asset management industry.



### Industry overview and innovation journey

In the last decade, a strong market expansion has characterized the global asset management industry. This is thanks to the continued positive market trend that has increased investment volumes, the growth in the insurance and pension products distribution, and the double-digit Chinese market growth.

Since the economic cycle is evolving, the ability to manage costs, preserve margins, and reinvest money into innovation is crucial to surviving in the competitive arena.

Asset managers are already coping with multiple key challenges (e.g. regulations, new competitors, and technology trends), which sometimes produce diverging results. On the one side, investing in

innovation puts pressure on costs; while on the other, reducing costs is crucial in maintaining profitability. While these are conflicting objectives, this is what the journey is all about.

The digital era increases both threats and opportunities, and asset managers must re-think their innovation approach in a strategic way. ➤

The industry has chosen its path and many enhancements have been implemented, such as automation of operations and channel digitalization for client experience improvement. However, much remains to be done and now, more than ever, asset managers have to embrace the change.

But what does innovation really mean for asset managers?

Meeting clients' needs and increasing profits are the focus; this is why product innovation is a natural process for asset managers. However, innovation means much more and the business and operating model as a whole must be considered—including channels, processes and people, and rule compliance.

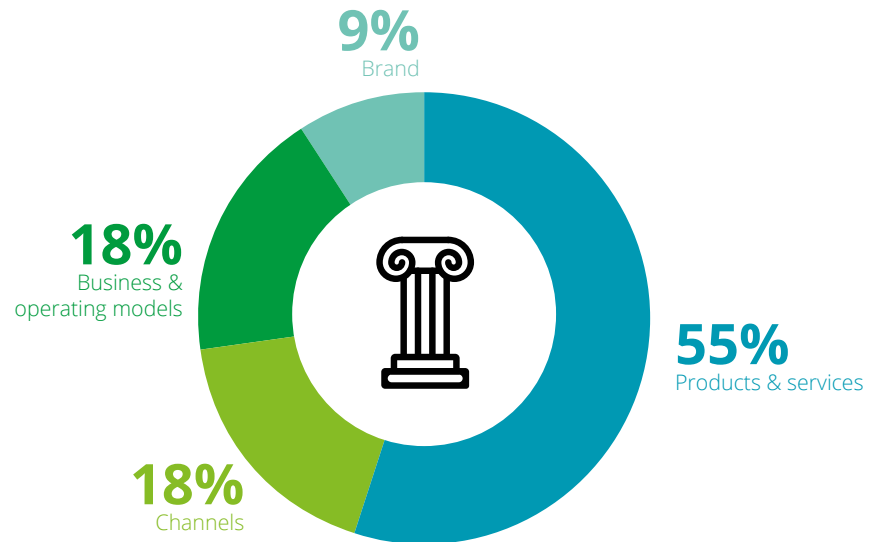
**Asset managers need to define their own governance innovation model, starting with organizational set-up and cultural change management.**

**Italian innovation perception overview**

A recent Italian survey on innovation perception, conducted in February 2019<sup>1</sup>, shows that Italian asset managers are conscious of opportunities in innovation. The survey confirms that the primary focus is on products and services. However, innovation in channels, and business and operating models are also relevant (i.e. customer experience and process efficiency) for margin retention.

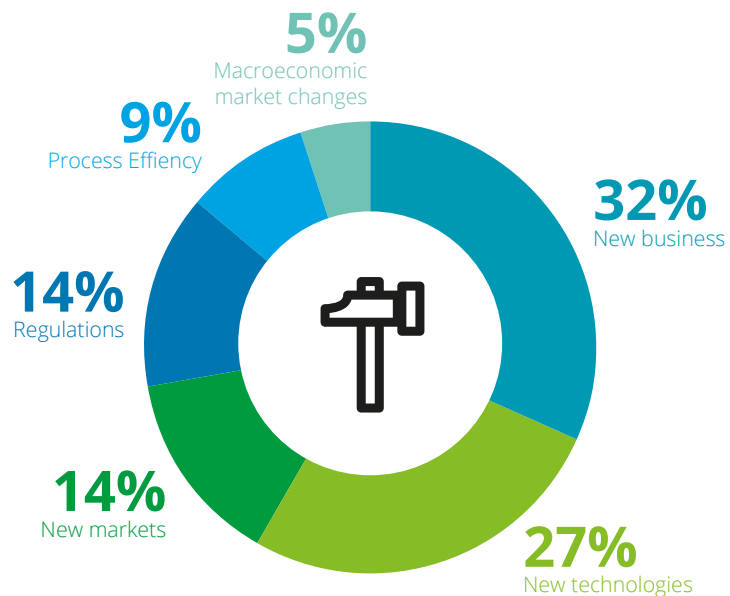
Looking to the future, even if new technologies grow in importance, it is the development of new business models, which appear to be the main trigger in fighting margin pressure (e.g. market expansion, competitors) and meeting customers' expectations (e.g. Millennials, Gen. Z).

**Main areas impacted by the innovation process in the asset management industry**



Source: Survey Deloitte & SIAT "What Innovation Really Means in Asset Management", 2019

**Innovation triggers considered in the asset management industry**



Source: Survey Deloitte & SIAT "What Innovation Really Means in Asset Management", 2019

1. The survey was conducted during the event What Innovation Really Means in Asset Management organized by Deloitte and SIAT (the Italian Association of Technical Analyst). The survey involved different operators of the Investment Management sector, including: Amundi SGR, Eurizon SGR, Pictect & Cie, Zurich Investment Life, BNL BNP Paribas, Borsa Italiana, Cordusio SIM.





There is increased attention to applying innovation, confirmed by a dedicated budget and an appointed owner in charge of such activities.



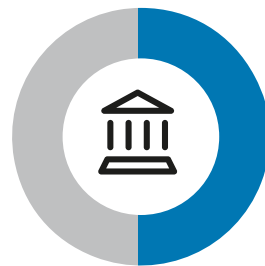
**75%**

of companies with devoted budget to innovation

**64%**

of companies with a responsible owner of innovation

Half of the interviewed Italian asset managers declared to manage innovation through a structured framework, while the remaining let that innovation spontaneously emerge from the organizational units. ➔



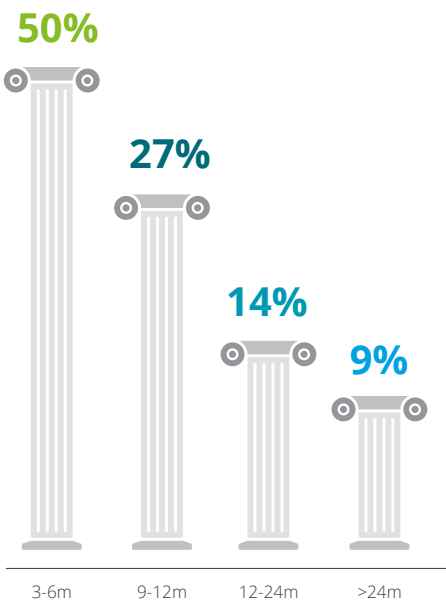
**50%**

of companies with a structured innovation process

Half of the interviewed Italian asset managers declared to manage innovation through a structured framework, while the remaining let that innovation spontaneously emerge from the organizational units.

On average, the brief time (less than one year) that asset managers spend on innovation suggests a short-termism with a focus on immediate returns on business results, rather than a strategic one aimed at disrupting the current business and operating model.

**Innovation process duration in the asset management industry**

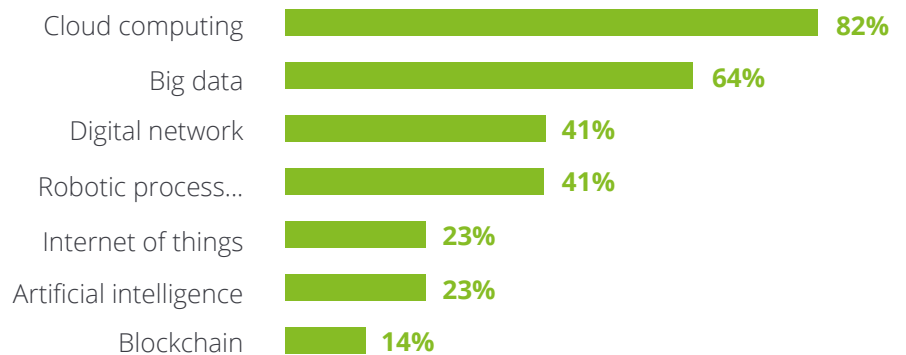


Source: Survey Deloitte & SIAT "What Innovation Really Means in Asset Management", 2019

Indeed, survey results suggest that Italian asset managers are on a "wait-and-see" basis, waiting for new technologies to mature.



**Innovations implemented in the last two years**



Source: Survey Deloitte & SIAT "What Innovation Really Means in Asset Management", 2019



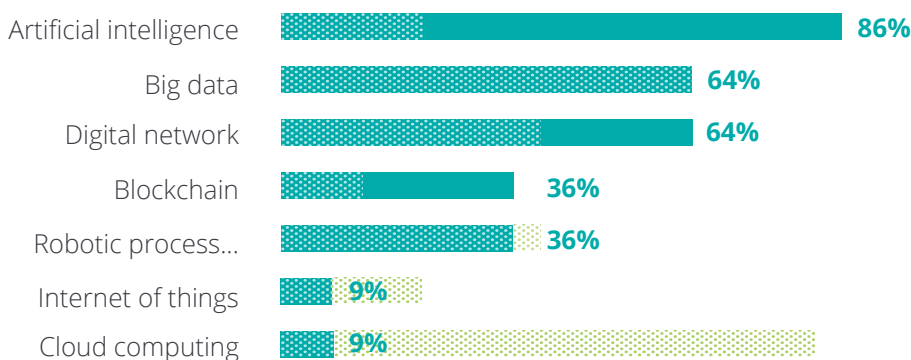
Re-thinking the approach in a more effective way, which considers a long-term view, is crucial for Italian firms in order to deliver transformation.

Artificial intelligence that leverages on Big Data is more than a trend in the asset management industry; it is already a reality. Global players are ahead of the game in adopting AI to alter their business model and replace core capabilities. For example, JP Morgan has introduced a machine learning in its valuation strategies to predict the “fair value” of stocks. iShares (by BlackRock) launched ETFs using a new approach to sector classifications powered by Artificial Intelligence. AXA set up a program hinge on Environmental, Social and Governance (ESG) issues that can affect investment performance.

These are only a selection of examples from within the industry, but they prove that in fact, it is not the time to wait, but to take action.

Italian asset managers seem to be in the early stages of the transition to an optimal innovation approach. Re-thinking the approach in a more effective way, which considers a long-term view, is crucial for Italian firms in order to deliver transformation. ➔

**Preferred innovations to be implemented in the next two years**



Source: Survey Deloitte & SIAT “What Innovation Really Means in Asset Management”, 2019



**A strategic innovation approach**

As confirmed by the survey, the focus of many asset managers is on product and services innovation, however expending energy solely in this area, is a narrow-minded approach.

To open up new possibilities and exploit the innovation outcomes, a wide approach that considers the multiple components of the business and operating model (not only product and services) is needed.

The 'Ten Types of Innovation' framework suggests a range of areas to be considered in order to modernize the enterprise configuration, products and services offering and customer experience. A structured innovation framework considers all these basics types and suggests asset managers need to select and combine some of them in order to set-up the best innovation strategy. They then need to define the key project initiatives to realize it.

<p><b>Configuration</b></p> 	<p><b>Profit model</b></p>	<p>Innovative profit models find a fresh way to convert a firm's offerings and other sources of value, into cash. Great ones reflect a deep understanding of what customers and users actually cherish and where new revenue or pricing opportunities may lie.</p>
	<p><b>Network</b></p>	<p>Network innovations provide a way for firms to take advantage of other companies' processes, technologies, offerings, channels, and brands, while capitalizing on its own strengths and helping collaboration in developing joint offers and sharing risk.</p>
	<p><b>Structure</b></p>	<p>Structure innovations are focused on organizing all company assets to create value and attract talent. Fixed costs and corporate functions can be improved through structure innovations, including departments such as HR, R&amp;D, and IT.</p>
	<p><b>Process</b></p>	<p>Process innovations, involving activities and operations, form the core competency of an enterprise that competitors simply can't replicate and enables the company to build market-leading margins using unique capabilities and function efficiently.</p>
<p><b>Offering</b></p> 	<p><b>Product performance</b></p>	<p>Product innovation is often the easiest for competitors to copy. Too quickly, it all devolves into an expensive mad dash to parity. Product performance innovations that deliver long-term competitive advantages are the exception rather than the rule.</p>
	<p><b>Product system</b></p>	<p>Product system innovations are rooted in how individual products and services are connected by value or bundle together to create robust and scalable ecosystems that captivate customers and defend against competitors.</p>
<p><b>Experience</b></p> 	<p><b>Service</b></p>	<p>Service innovations ensure and enhance the utility, performance, and value of an offering. They make a product easier to enjoy and elevate even bland products into compelling experiences that customers come back for again and again.</p>
	<p><b>Channel</b></p>	<p>Channel innovations encompass all the ways that you connect your company's offerings with your customers and users. Skilled channel innovators ensure that users can buy what, when and how they want, with minimal friction and cost.</p>
	<p><b>Brand</b></p>	<p>Brand innovations help to confer meaning, intent and value to a firm's offerings and ensure that customers prefer them. Those innovations aid to build a distinct identity and are implemented across many touchpoints between company and customers.</p>
	<p><b>Customer engagement</b></p>	<p>Customer engagement innovations are about understanding the deep-seated aspirations of customers and using those insights to build memorable and delightful – even magical – experiences connected to the company.</p>

## Innovation Framework

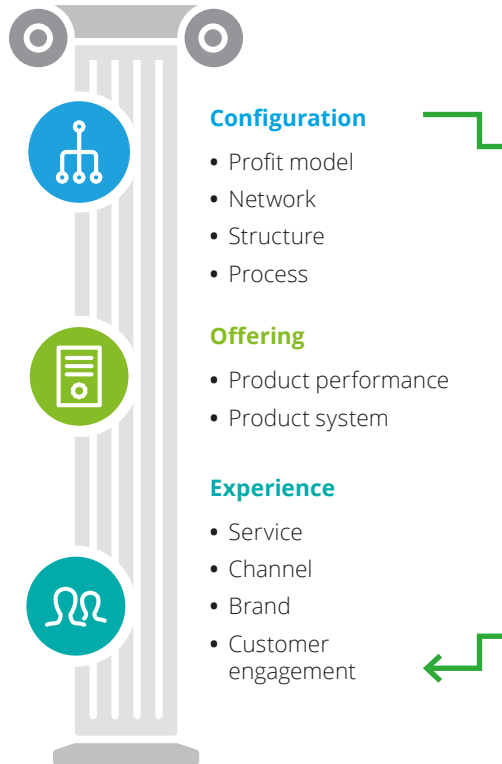
### Core processes

#### Innovation strategy

- Guidelines
- Funding

#### Portfolio management

- Idea generation
- Design
- Prototyping
- Scaling
- Activation
- Monitoring



#### Configuration

- Profit model
- Network
- Structure
- Process

#### Offering

- Product performance
- Product system

#### Experience

- Service
- Channel
- Brand
- Customer engagement

### Supporting processes

#### Ecosystem management

- Sensing/scouting
- Selection

#### Innovation culture

- Communication
- Engagement

#### Eminence

- External communications
- Events

Organizational enhancements are required to integrate innovation management processes into the operating model. Innovation core and supporting processes are both crucial for the success of the journey.

Considering all the potential types of innovation, asset managers require:

- **Innovation strategy:** A definition of the strategy and methodological framework for innovation with KPIs to monitor the related outcomes (ROI, eminence)
- **Portfolio management:** Adoption of a portfolio management approach that is linked to the innovation process and structuring of a continuous process of idea generation and management with paths and acceleration programs (Fast Track)
- **Ecosystem:** Monitoring of the ecosystem to catch missing capabilities and to boost innovation from outside (e.g. partnerships, M&A, Fintech collaboration)

- **Innovation culture:** Development of internal initiatives to spread a culture of innovation with development of the employees' skills through training (i.e. cross pollination of best practices)
- **Eminence:** Promotion and coordination of communities that facilitate cross-functional activities.

Asset managers must rise to the challenge and look towards a fresh perspective. Success is achieved through people, culture and a new framework, which is able to manage the end-to-end innovation process. It is this—and not small innovations used simply to reach results in the short-term—which will reap rewards for asset managers in the future. ●

#### To the point:

- Asset managers are coping with multiple key challenges, which sometimes produce diverging results. Investing in innovation is integral, but reducing costs is crucial to maintain profitability.
- The digital era increases both threats and opportunities, and asset managers must re-think their innovation approach.
- Italian asset managers seem to be in the early stages of the transition to an optimal innovation approach. Reviewing their method is crucial for Italian firms in order to deliver transformation.
- Success is achieved through people, culture and a new framework, which is able to manage the end-to-end innovation process.

# Mastering the art of ESG data

**Paul Ellis**

Global Head of Regulatory  
Product Management  
HSBC Securities Services

**Chris Johnson**

Product Management, Market Data  
HSBC Securities Services

How do we quantify the effect of environmental, social, governance on the asset management industry? [▶](#)





As a construct, ESG is a very subjective concept, determined overwhelmingly by the moral compass of the end investor.

1. HSBC GBM (September 2018) Sustainable Financing and ESG investing report
2. IPE (June 2018) ESG: Evolution of sustainable investing and modern practice
3. Pensions & Investments (September 3, 2018) More institutional investors putting money on ESG
4. Financial Times (September 18, 2018) Sustainable investing can propel long-term returns
5. CDP: (Formerly called Carbon Disclosure Project); CDSB: (Climate Disclosure Standards Board); IIRC: International Integrated Reporting Initiative; GRI: Global Reporting initiative; SASB: Sustainability Accounting Standards Board and CBI: Climate Bonds Initiative

The assimilation of ESG (environmental, social, governance) into institutional investment processes has transformed the industry and reshaped buy-side behavior. In its last report, the Global Sustainable Investment Alliance (GSIA) said global assets under management (AuM) incorporating ESG had risen 25 percent since 2014<sup>1</sup>, accounting for approximately US\$22.9 trillion, which is equivalent to 26 percent of all assets controlled worldwide<sup>2</sup>. Few expect this momentum to be lost as more investors demand asset managers integrate ESG into their mandates<sup>3</sup>. For many institutions, ESG is now firmly seen as a key fiduciary responsibility.

Several drivers have shored up ESG's rise, principally the growing wealth of quantitative data indicating that issuers, which score highly on ESG deliver better or neutral performance against organizations where ESG is on the margins<sup>4</sup>. Secondly, sustainability risk is now being absorbed into investment and credit risk analysis, with more institutions vetoing capital allocations into companies with ESG limitations. Regulators, including the

European Commission (EC), are also attempting to impose minimum ESG standards on institutional investors as they look to incentivize and broaden sustainable finance practices.

### What is ESG? Nobody quite knows

As a construct, ESG is a very subjective concept, determined overwhelmingly by the moral compass of the end investor. For instance, an environmental foundation may categorically oppose having investments in companies which have high carbon emissions, but may be less perturbed about obtaining revenues from other business activities such as alcohol production. The sheer depth and diversity of opinion about sustainability makes it incredibly difficult to come up with a demarcation of what ESG is, let-alone a method of properly benchmarking ESG performance.

However, institutions are not the only ones who have yet to formalize what ESG actually means.

Policymakers and regulators are also struggling to come up with a homogenous framework for ESG, and instead have published a series of different—and at times conflicting—initiatives. For example, there are multiple international reporting frameworks covering sustainability—most notably, the Financial Stability Board's (FSB) Task Force on Climate Related Financial Disclosures (TCFD), a template which HSBC submits and one that it encourages its underlying customers to report on as well. However, there are a groundswell of other disclosure requirements in addition to the TCFD, such as the CDP, CDSB, IIRC, GRI, SASB and CBI<sup>5</sup>, which can be somewhat overwhelming for participatory organizations. However, it is acknowledged better alignment is being sought via the Corporate Reporting Dialogue project. Complicating matters further is that local markets (e.g. France) are establishing their own reporting requirements for financial institutions in what many believe is exacerbating arbitrages in the application and supervisory oversight of ESG investing<sup>6</sup>.



### ESG data weaknesses

The paucity of industry agreement means there is an absence of standardized ESG datasets and reporting methodologies, making it difficult for issuers to disclose meaningful information on sustainability to investors. This is evidenced by a recent PIMCO study, which found that while 63 percent of issuers referenced the UN Sustainable Development Goals (SDGs) in their company reports, only 19 percent set quantitative targets and just 9 percent disclosed their progress against those targets<sup>7</sup>. As issuer-reporting is so fragmented across the board, asset owners and asset managers are struggling to accurately measure ESG in their portfolios.

Admittedly, some investors are increasingly leveraging the services of third party ESG research companies and data providers to rate the ESG credentials of issuers. Unfortunately, many of these data providers still face impediments. While scoring a company on certain ESG measurables—such as carbon emission volumes—is relatively straightforward as the underlying information is supported by a number of ESG data suppliers, other metrics (e.g. adherence to the UN Global Compact) can be harder to gauge, as the data is not as widely available. This leaves data providers with little option but to produce subjective qualitative assessments on underlying issuers.

Taking a qualitative approach creates other problems too as different ESG research companies and data providers use their own bespoke—often inconsistent—methodologies to generate ESG scores. This is resulting in an increasingly patchwork approach emerging in the entire ESG grading process, leading to companies receiving wildly different ratings from various providers. In the case of Tesla, FTSE ranked the company last in its global auto ESG benchmark whereas MSCI said it was the best, while Sustainalytics slotted it somewhere in between<sup>8</sup>. With so many investors now reliant on these

ratings, it is critical that data providers work towards improving and streamlining their underlying data sources and providing transparency about how they calculate ESG scores.

### Regulating ESG: is it the only way forward?

Mindful that the lack of ESG standardization was creating widespread problems for institutional investors, and risked subjecting them to greenwashing, the EC announced an Action Plan on Sustainable Finance<sup>9</sup>. As part of this program, there are proposals for a unified EU classification system outlining a set of harmonized criteria for determining whether an economic activity is environmentally sustainable<sup>9</sup>. These criteria, which are being drawn up by a working group comprised of technical experts, will provide financial institutions with greater clarity about which activities are considered to be sustainable or not, in what will help shape firms' investment decision-making processes<sup>9</sup>.

A taxonomy would certainly assist firms with benchmarking their sustainability, although some buy-side experts have warned European regulators against making the rules too prescriptive<sup>10</sup>. Comments by ESMA suggest that it has been receptive to these industry concerns, acknowledging there can be operational challenges involved with getting reliable data on sustainability risks and factors. While the EC's plans, if executed correctly, could help accelerate sustainable financing, achieving unanimity on the taxonomy will not be an easy process in such a crowded ideological field.

The systemic risk from climate change is a very real one. In fact, climate change already claimed its first S&P 500 bankruptcy in 2018, and it is unlikely to be the last. If organisations fail to adequately transition into a low carbon marketplace, they too will perish. Such is the severity of the situation that regulators have put financial institutions on notice that they will be assessing their preparedness for long and short-term climate risks. Through improvements in ESG data gathering techniques and analysis, industry and regulatory consensus will eventually emerge enabling companies to better insulate themselves against climate related risks. ●



#### To the point:

- ESG assets have seen significant growth as institutions increasingly recognise the performance and risk management benefits of sustainable investing.
- ESG's development is being constrained by an absence of common standards at a regulatory and industry level.
- While some ESG measurables are easy to quantify, others are not, which can lead to subjective and inconsistent data.
- An EC taxonomy could help firms benchmark ESG data, but it needs to be flexible.

6. Reuters (6 February 2019) Socially conscious mutual fund launches at record high

7. PIMCO (December 2018) Corporate reporting on the SDGs: Mapping a sustainable future

8. FT (6 December 2018) Lies, damned lies and ESG rating methodologies

9. EC (May 24, 2018) Sustainable finance: Making the financial sector a powerful actor in fighting climate change

10. Global Custodian (March 8, 2019) Asset managers voice concern on regulatory approach to ESG

11. IPE (November 27, 2018) EC addresses pension fund concerns over sustainable finance plans



# **Focus**

on your strengths

Whiteboard

# Focus on your strengths, white label the rest

## Hubert Zeller

Head Global Business  
Development  
UBS

## Eugène Del Cioppo

Head White Labelling  
Solutions  
UBS

## Francesca Prym

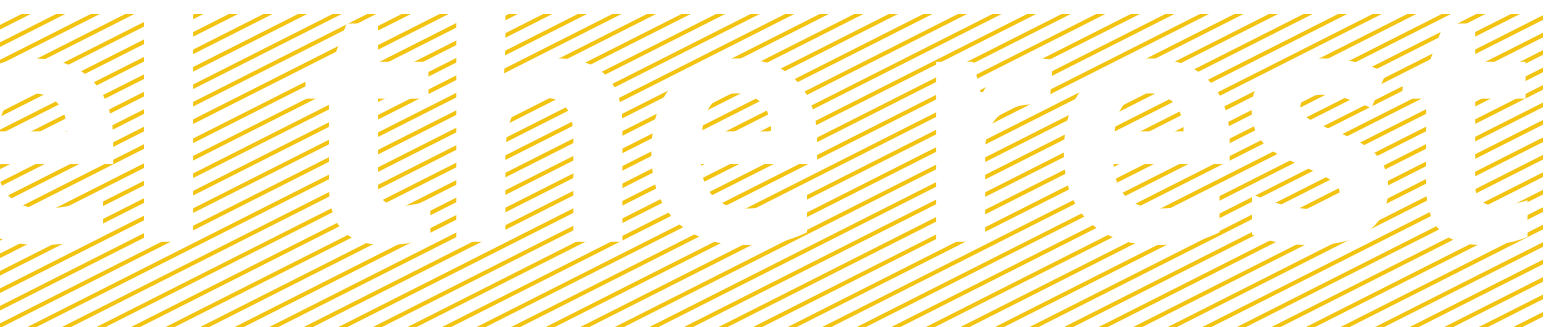
CEO UBS Fund Management  
(Luxembourg) SA

Why banks and asset managers are well-advised to use white labelling for full regulatory compliance, as well as for cost and time efficiency.

**A**long with a general pressure placed upon margins, the regulatory demands on fund management are also increasing. It is a business that thrives on investment skills, close customer relations and, technical and legal expertise – *is it any wonder that some banks and asset managers might struggle to excel in all areas?*

The good news is, you don't need to do everything yourself. Gone are the days when every bank and asset manager

would structure, set-up and maintain their own funds with the required manpower, know-how and sufficiently deep pockets. Today, elements such as the need for ongoing and increased regulatory compliance in managing and distributing investment capabilities, as well as tighter margins on revenues combined with cost efficiency requirements, drives a growing demand for white label funds. ➔



Strategically, white label funds contribute to efficiency gains in managing discretionary and alternative portfolios, but they also retain revenues of advisory mandates and support growth by increasing market visibility.

Hubert Zeller, Head Global Business Development

#### What is white labelling and what can it do for you?

Some services and skills are simply too costly to maintain in-house, and at times, quite frankly, much better sourced elsewhere. Outsourcing the production of specialized components is an efficiency-boosting strategy that we have witnessed in all business areas. Smart phones are assembled from many third-party pieces. Fashion brands combine unlabeled, pre-fabricated parts to create their distinctive look and feel.

And the same trend applies to asset management solutions. Banks and asset managers outsource their fund infrastructure management to so-called white label, or private label, specialists. This enables them to offer highly specialized and regionally compliant own-labelled funds. The benefit is that banks and asset managers can focus on their various strengths and strategic focus points (their unique investment and customer relations expertise) while outsourcing increasingly complex technical and legal know-how.

#### Fund infrastructure: Make or buy?

One of the fundamental questions the asset management industry faces is whether to make or to buy. Considering the costs and benefits, is it economically viable to take on the arduous process of launching and running your own fund? Is the necessary know-how available in-house and how much of the resources and budget will it use? Can you reach the investment volume needed in order to pay all the sunk costs needed to run your own fund structures?

The strict regulations, which vary according to country and distribution channel, as well as the complex, time-consuming process of setting-up a new fund have added to rising costs and a need for greater efficiency is certainly called for. While searching for alternatives, even institutions that have so far managed without their own fund, are starting to limit the number of third-party funds on offer. In addition, small and medium banks are realigning their portfolio to include fewer products and cooperation partners than in previous years.

The role of the white-label provider can be compared to that of a general coordinator who acts as main contractor, supervises all subcontractors, and takes care of regulatory requirements, accounting duties and project management along the life cycle of your fund solution.

Francesca Prym, CEO UBS Fund Management (Luxembourg) SA



### Shift towards long-term white labelling partners

The alternative lies in white labelling solutions, which include fund infrastructure and services provided by an asset management specialist with a proven track record and commitment to the business. You can offer your customers state-of-the-art fund products and services under your own brand with less effort and at a lower cost. The first to profit from this made-to-measure arrangement are your investors. They still enjoy flexible and personal customer service—customer interaction and distribution are generally not part of the outsourcing package and remain in-house—while also benefitting from the fund management expertise of a reputable financial institution.

The rationale is compelling and hard to argue with. However, asset management is also a matter of trust, and building a long-term strategic relationship with a responsible white-labelling partner might well prove the key to your success. In this respect, the role of the white-label provider can be compared to that of a general coordinator who acts as main contractor, supervises all subcontractors, and takes care of the regulatory requirements, the accounting duties, and the project management along the life cycle of your fund solution.

### Turnkey solutions provider

Suppliers of turnkey white-label solutions who commit themselves to the “one-stop shop” concept generally offer a wide range of services for a variety of investment products. The fund structures are adjusted to the jurisdiction of the countries of

domicile as well as the target markets. In addition to the regulatory fine-tuning for each country in which the fund is to be approved for distribution, this includes lean fund management and administration, together with trading and the provision of marketing and sales tools.

Turnkey solutions cover all services in the areas of risk management, compliance and governance, as well as project management for complete fund ranges. The delegation of the entire administration and reporting, which includes factsheets, brochures and marketing reports, as well as statutory reporting to investors, supervisory and tax authorities, is also often included in a holistic white-labelling package.

### Modular solutions for specific needs

It is helpful to think of all products and services as being part of a modular construction kit. They can be booked as a whole or provided individually. To come back to that fundamental question of making or buying, only what is desired and needed should be outsourced. Plus, the specific needs vary for each asset manager or financial institution. The trusted white-label partner in his general contractor role will be able to offer advice on the right bundling of resources, oversee the on-boarding and be responsible for the successful execution—while remaining discretely in the background.

For banks, insurance companies, asset managers, pension funds, family offices and other institutional investors, the benefits of outsourcing are obvious. They can focus on their own core competencies (maintaining

customer relationships and sales) and benefit from the extensive know-how and optimized processes of their white-labelling partner. White label solutions have prevailed in many industries. In the fund business, they are a serious alternative worth considering. ●

White label solutions have prevailed in many industries. In the fund business, they are a serious alternative worth considering.

**Eugène Del Cioppo,**  
Head White Labelling Solutions

### To the point:

- More than 20 years expertise in offering White Labelling Fund Structures
- 50 percent of our AuM are fund structures for White Labelling Clients
- More than 165 onboarded Third Party Asset Managers
- Global Registration Services supporting more than 70 distributors
- Fully licenced to service UCITS and AIFM structures



# The Placement Agent's View

In view of the changing times, political upheaval and record-breaking fundraising by private equity funds, Nick Tabone (Audit Partner at Deloitte) and Arnaud Bon (Advisory & Consulting Director at Deloitte) take the pulse of the PE industry by interviewing three placing agents. With a broad knowledge of the PE market, Will Lawrence (investment managing director of Cambridge Associates), Jean Christel Trabarel (founding partner of Jasmin Capital), and Raphael Cwajgenbaum (vice-president at Moelis & Company) divulge the signals received from both private equity fund managers and institutional investors.



**Deloitte:** What are your fundraising and performance predictions for the forthcoming months?

**Raphael Cwajgenbaum (RC):** The fact that PE as an asset class has delivered on its key selling points (diversification, alignment, absolute performance, and stability of returns) has enabled it to continue growing steadily. I don't see this trend changing in 2019, unless any meaningful macroeconomic correction takes place. I believe more GPs will continue actively exploring the secondary market, as it has now become a normalized tool for liquidity and good fund management. As the asset class continues to mature, investors will increasingly draw their attention to more niche strategies, be it sector-focused, regional strategies or even smaller club-type structures/deal-by-deal where they can achieve more discretion and even sometimes better economics.

**Jean-Christel Trabarel (JCT):** As regards to fundraising, 2019 should be a good vintage and in fact better than 2018 as many jumbo and mega funds (+€5billion) will be on the road this year. Private equity remains very attractive for LPs offering long-term double-digit IRR in a low interest rate environment and high volatility on public equities. Institutional investors continue to have a lot of cash to invest.

**Will Lawrence (WL):** Despite recent public equity declines, we expect the fundraising environment for PE in Europe and the US to remain robust in 2019. We already know of several established managers raising significantly larger pools of capital in 2019 and expect the supply side to be matched by continued strong demand from LPs. This demand should continue as seasoned private equity investors seek to reinvest proceeds gained from a strong decade of performance while

other investors, traditionally with smaller allocations to the asset class, will tilt more towards illiquid investments and the higher return potential. Many will continue to view private equity favorably compared with public markets and/or other alternative asset classes. All of this sets the scene for an asset class priced to perfection. For managers with good assets, we expect that they will continue to generate strong distributions. However, managers with capital to deploy will struggle to complete deals at reasonable valuations. ➔

We must also consider that if public market valuations decline significantly then some investors, with already established portfolios, may become over-allocated in private investments purely based on a denominator effect. Another effect of falling public markets, could be that larger funds, which often try to exit investments via IPO, will have to hold assets longer to achieve the targeted returns and may also be less willing to pay high entry multiples (Enterprise Value/EBITDA) when acquiring new assets.

**Deloitte:** While the appetite for PE investments remains very high as demonstrated by recent fundraising records and mega PE funds being raised, do you still see space for small and medium size players in this industry?

**RC:** Granted that some players have moved upscale, but the small and mid-cap PE market remains very active, largely off the back of good, risk-adjusted performances. While increased entry valuations have led to an erosion of performance across the board, the small and mid-cap space still benefits from the multiple arbitrage factor that can be extracted once smaller businesses grow in size and professionalization. What is more, diversification, which led to the development of the PE asset class in the first place, supports the rationale for investors to keep deploying capital

As regards to fundraising, 2019 should be a good vintage and in fact better than 2018 as many jumbo and mega funds (+€5billion) will be on the road this year.

**Jean Christel Trabarel, Founding partner of Jasmin Capital**

across the size spectrum and with a well-diversified number of GPs. This definitely leaves a meaningful space for small and mid-cap GPs. We continue to see large PE investors awarding dedicated mandates to third party consultants or funds of funds in order to get the small and mid-cap exposure they are not necessarily always equipped to develop internally.

**WL:** In fact, the more capital is raised by the mega-funds, the more 'room' there is at the lower end of the market for small and medium-sized players, and by definition, newer managers in the industry. The data that I have seen shows clearly the higher dispersion of return in the lower-end of the market. Managers operating smaller funds have the strongest potential to produce outsized returns. Furthermore, we continually see a number of new firms formed by investors spinning out from established GPs. The vast majority of these investors raise small funds targeting a market segment that their former employer has now left. This trend will persist as long as there is LP demand, and as long as private equity continues to perform.

**JCT:** There is indeed still place for small and medium-sized players in the private equity industry as LPs are looking for diversification while constructing their portfolio with Pan European midmarket funds and/or country focus small to lower mid funds. For these funds, the key success factor is being able to differentiate themselves from competition - for instance, with a thematic (ie. build-up, digitalization, etc.) or sector-focus approach. Moreover, we keep seeing first time funds coming up with fund sizes between €100-200million.

**Deloitte:** Nine out of 12 top PE players have substantially reinforced their presence in Luxembourg over the last couple of years. What do you believe the drivers for this trend might be?

**WL:** This appears to have been primarily driven by the uncertainty surrounding



Brexit whereby managers have been forced to take a proactive approach to 'futureproof' their businesses and continue to have unrestricted access to European investors by increasing their presence in Europe. While managers may have already had some form of presence in EU jurisdictions, whether for deal structuring or marketing purposes, it appears to have ramped up significantly in Luxembourg during 2018. Some of the bigger PE firms are establishing a presence as it becomes more apparent that the UK's exit from Europe will be a more complicated and drawn-out process due to the disparity of opinion in the UK parliament.

**JCT:** Brexit is indeed one of the drivers for this trend. Big players have moved their headquarters from London to Luxembourg, anticipating that the United Kingdom won't be AIFMD-compliant anymore. In addition, Luxembourg is the main financial center in Continental Europe benefiting from a regulation offering adapted vehicles to GPs and LPs such as the RAIF. Luxembourg offers political stability, high quality service providers and skilled people.

**RC:** The improvement of the limited partnership regime in 2013 is certainly also a big trigger for GPs to explore Luxembourg as a credible alternative. With respect to European mid-market

...the more capital is raised by the mega-funds, the more 'room' there is at the lower end of the market for small and medium-sized players...

**Will Lawrence, Investment managing director of Cambridge Associates**

Investors generally consider Luxembourg, nowadays, as a best-in-class jurisdiction where key topics such as transparency, alignment and ESG are upheld to the highest standards.

**Raphael Cwajgenbaum, Vice-president at Moelis & Company**

GPs, the strategic importance of the EIF's investment program has also served as a trigger for certain GPs to shift to a Luxembourg structure.

**Deloitte:** What feedback do you get from LPs on Luxembourg? Are they generally comfortable with the local environment?

**RC:** Investors generally consider Luxembourg, nowadays, as a best-in-class jurisdiction where key topics such as transparency, alignment and ESG are upheld to the highest standards. International investors are now used to investing in Luxembourg vehicles, which can only be a positive, and most European investors actually consider it as the new gold standard! The quality of service providers in general, large international contingent from all over Europe, and

excellence in the financial services industry also adds tremendous benefit to existing – and newly launched – funds in Luxembourg.

**JCT:** Luxembourg vehicles are now the market standard benefiting from a leadership position. LPs are very comfortable with the political environment and local finance industry (service providers and local staff). They appreciate the favorable regulatory framework that evolves accordingly to GPs and LPs. Even if Ireland and France have changed their regulation, Luxembourg remains the frontrunner on the market. When fundraising GPs create a domestic vehicle, they often also create a mirror or parallel Luxembourg vehicle, in order to address the expectations and needs of their non-domestic LPs. ●



# Wealth managers at a crossroads

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Shining a light on four scenarios, which illustrate the potential future and resulting implications of the private banking and wealth management sector of tomorrow.

#### The current state of wealth management

The wealth management sector is currently facing headwinds, but also opportunities such as technological progress, price sensitive yet highly demanding High Net Worth Individuals, and rising compliance costs, to name but a few. FinTechs, BigTechs, large insurers and asset managers are entering the market with new, highly competitive solutions powered by big data analytics. Moreover, the recent speed of change will likely only increase over the years to come.


To be successful in the future, wealth management players must consider emerging trends and uncertainties early on, evaluate them thoroughly, and conclude on a sound strategy as well as making conscious choices. The key will be to begin preparing today, rather than ignoring the dynamics for now, thereby limiting options to only re-active measures at some point in the future. While some trends are relatively predictable, others may open up unforeseen opportunities or create unexpected challenges. In order to deal with such uncertainties, Deloitte industry experts from Switzerland, Germany and the Center for the Long View developed four different scenarios for the future of wealth management

Two key uncertainties were identified as drivers for the resulting scenarios: perceived value creation by the wealth management industry, and the level of technology enablement and adoption.

jointly with executives from leading global private banks. The underlying scientific methodology included AI-powered trend analysis and extensive expert interviews.

Two key uncertainties were identified as drivers for the resulting scenarios: perceived value creation by the wealth management industry, and the level of technology enablement and adoption. The former relates to the question whether clients in the future appreciate the specific services of wealth managers as value-adding. If not, they might turn to more standardized offerings targeted at mass-affluent clients that are efficiently provided by universal banks, insurers, asset managers or even BigTechs.

Technology enablement and adoption, the second key uncertainty, describes the usage of channels of interaction. Will wealth management clients become increasingly self-empowered and use pre-dominantly digital channels? Or, will they continue to value high-touch, human-centric interactions for most of their interactions with the wealth manager?

Corresponding to these uncertainties and taking into account other trends, the four resulting scenarios can be described as follows. 



### The first scenario-‘Digital Detox’

The ‘Digital Detox’ world is characterized by clients who are willing to pay for personal human advice and who seek trust. Wealth management for High Net Worth Individuals remains a people business, driven by bankers at heart. Client advisors are supported, but not replaced, by digital solutions and offerings (e.g., robo-advisors). New tools are being used to create a superior, customized user experience that is tailored to the individual clients’ objectives and needs. While one goal of a wealth manager is to create alpha with its investment advice, clients trust wealth managers to support them in achieving more holistic objectives such as dealing with life events and business decisions, as well as protecting non-financial assets.

While personal interaction and trust are the key success factors of a wealth manager, they also represent the biggest market barrier for the large technology companies. This is supported by more stringent data protection laws, which prohibit tech giants to fully monetize client data. Nevertheless, collaboration of banks and other providers, such as FinTechs as enablers along the value chain, will increasingly emerge to provide the best service to clients.

### The second scenario-‘Wealth Manager Pacman’

The ‘Wealth Manager Pacman’ world is determined by the mindset of millennials

who prefer digital solutions and limited personal interaction. This evolving demand requires wealth managers to provide digitalized services 24/7, anywhere in the world, and seamless on any channel and device. Increasing transparency on price, performance and thus ever more demanding clients, drives the usage of low-margin, highly automated investment offerings. Wealth managers must focus on technological capabilities, such as artificial intelligence or advanced approaches towards client segmentation. Scale effects give larger players an advantage to consolidate. Asset managers and technology players increasingly target the wealth management market, but initially struggle to master the complexity of a differentiated High Net Worth Individual offering as demanded by clients. An outstanding user experience, technology-enabled, but with highly personalized advice delivered at transparent costs, differentiate successful players from the rest.

### The third scenario-‘Game of Scale’

The ‘Game of Scale’ world is characterized by clients who trust a brand. Differentiation by service quality or investment performance is hardly possible as services are heavily standardized across the industry. The survival strategy to retain clients is through heavy investment into marketing and technological capabilities. Successful wealth managers achieve scale, orchestrate an ecosystem and leverage

client data to provide an enhanced client experience. Smaller wealth management firms may find their spot in the ecosystem by providing specialized investment advice to their dedicated (niche) target segment. In this world, platform providers and digital-only banks, as well as asset managers successfully enter the High Net Worth Individual business, expanding from retail and affluent segments, as services from these two worlds converge. This is the world of democratization of wealth management.

### The fourth scenario-‘Purgatory’

In the ‘Purgatory’ world, wealth managers focus on the client experience in the absence of perceived core product differentiation. Clients strive for convenience, not sophisticated private banking. Accordingly, wealth managers differentiate their offering heavily pursuant to clients’ willingness to pay. While basic services are provided for a relatively low fee, wealth managers aim at upselling additional services through establishing a trusted, human-centric, long-term relationship. Only through relationship building and delivering an exceptional client experience, can wealth managers protect themselves against other players entering the market with low-cost models. The client preference for personal interactions help wealth managers to defend against new entrants, but at the same time represents a burden for scaling the business and running the business in a profitable way. ➔

**This is a world in which...**

**Purgatory**

- ...clients strive for convenience, not sophisticated private banking
- ...total client experience with human touch is a key differentiator
- ...low-cost offerings serve as entry-model to gain new clients



Value Creation by Wealth Management



Not differentiated

**Game of Scale**

- ...brand and technology are key differentiators for wealth managers
- ...successful wealth managers master the ecosystem play
- ...new entrants leveraging platforms gain market share



Technology Enablement



Analog Banks

**Digital Detox**

- ...wealth management is holistic and tailored to personal goals
- ...clients are willing to pay for personal, human advice
- ...personal relationships protect wealth managers from new entrants



Significant differentiation through value creation

**Pacman**

- ...clients expect seamless 24/7 service across all channels
- ...digital user experience, personalization and transparent pricing is key
- ...larger players are advantaged due to high investment needs

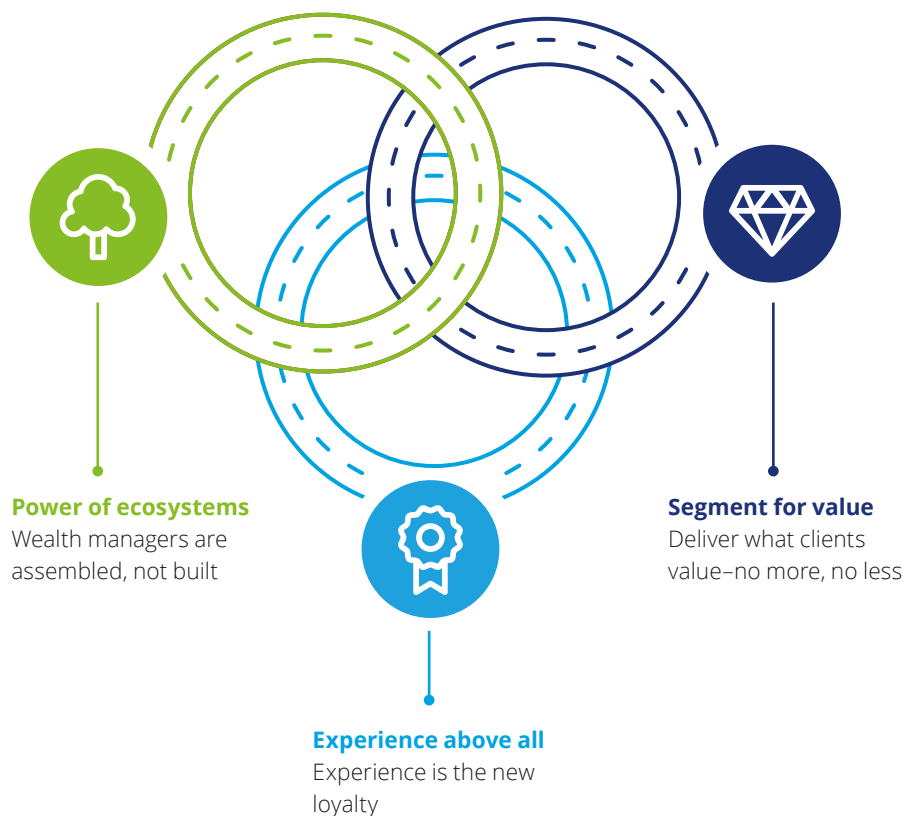


Human-Free Wealth Management





## Implications



Each scenario will result in its own complexities for wealth managers on the quest to establish a successful strategy. While it is currently unclear which future will emerge, we believe that three common themes can be gathered from all four scenarios, and a response to those will help private banks prepare for any future on the horizon.

The first theme identified is “**Segment for value**”. In each scenario, there will be highly sophisticated and less sophisticated clients. Those who view wealth management as a commodity might be interested in working with large-scale banks or new entrants that offer competitive pricing and rely on digital channels to grab market share. On the other hand, many private banking clients will continue to look for a sophisticated offering consisting of wealth planning, tax and legal structuring, complex products and long-term relationship. It will be key for private banks to clearly identify these different segments and to understand the size of each—and to make a clear, conscious choice on what to focus on, as in the future, banks will not serve all clients.



“**Experience above all**” is the second theme. Many of the services that were rendered by banks in the past are now seen as commoditized. At the same time, clients become used to more tailored and smooth experiences in other industries, while client loyalty is eroding in many commoditized industries. Services clients got used to in their (digital) interactions with a specific (non-financial services) provider or industry rapidly get transferred as requirements towards banks. Those players that deliver a superior and seamless client experience across all channels will increase “stickiness” and retention of clients. Banks should now start investing in creating a coherent client experience in line with their choices around segments. There is no one-size fits all.

The third theme, “**Power of ecosystems**”, relates to the increasingly networked value chain in wealth management. Hardly any wealth manager will be able to cover all parts of the value chain competitively in today’s complex environment. There will be very successful business models of niche players that focus on a subarea

where they can differentiate themselves and fully benefit from the ecosystem they are part of. In this manner, banks could focus on serving clients in areas they are strong in. This would enable them to deploy their capital and focus management on their areas of strength. Only a few players will be able to orchestrate the ecosystem, but they will be the most profitable ones. Getting there is risky, and players who neither cater for the individual client needs, nor serve the wider ecosystem with a specific offering, will be slowly squeezed out of the market.

### Conclusion

As with other industries before it, wealth management seems to be at a crossroads given the significance and magnitude of these change drivers. The scenarios described represent only four possible future worlds for the European wealth management industry. The reality might well emerge somewhere in between or as a combination of outlined options.

However, thinking in scenarios helps us to acknowledge the uncertainty, but also to discover the commonalities for which wealth managers have to prepare in any case. We believe that those players, who successfully understand the segments they want to serve, who focus on a tailored superior client experience and who master the ecosystem play, will be best prepared for future challenges. If on top they identify contingent strategies to deal with uncertainty, they should be prepared for any of the scenarios. This requires them being constantly on the outlook for change and to stress test their strategy on an ongoing basis.

### About the methodology

The methodology applied in this study follows the Dynamic Strategy approach of Deloitte’s Center for the Long View. Dynamic Strategy draws from leading scenario design methodology in combination with AI-supported research (CLV Deep View) and monitoring tools (Gnosis.strategy). A holistic gathering of social, technological, economic, environmental, and political drivers and influencing factors lays the foundation for

the identification of critical uncertainties. Based on these critical uncertainties, workshop participants develop four distinct, plausible, relevant and challenging narratives of alternative future states concerning a specific field—following a structured and well-proven process. These scenarios enable decision makers to map out a future-proof strategy including robust strategic elements that are valid in all scenarios. Moreover, flexible strategy elements allow for a near-time strategic response to the environment shifting towards an alternative scenario. ●

### To the point:

- Wealth Managers are going through challenging times of change.
- Client demands, digitalization, competitive forces and regulation can be interpreted as threats but, at the same time, looked at as exciting opportunities.
- Depending on the degree of perceived value created by wealth managers and the extent of technological enablement, different industry scenarios are possible.
- While nobody knows for sure where the market will be in five or 10 years, participants can prepare their organizations by incorporating three major themes into their thinking: ‘segmentation creates value’, ‘client experience counts above all’, and ‘the power of ecosystems is to be leveraged’.
- Future successful industry champions will be those who interpret trends, structure and manage uncertainties, and filter the information to reach relevant conclusions – plus, most importantly, those who are brave enough to make conscious decisions.

# Digitizing investment suitability

**Christian Gilmour**

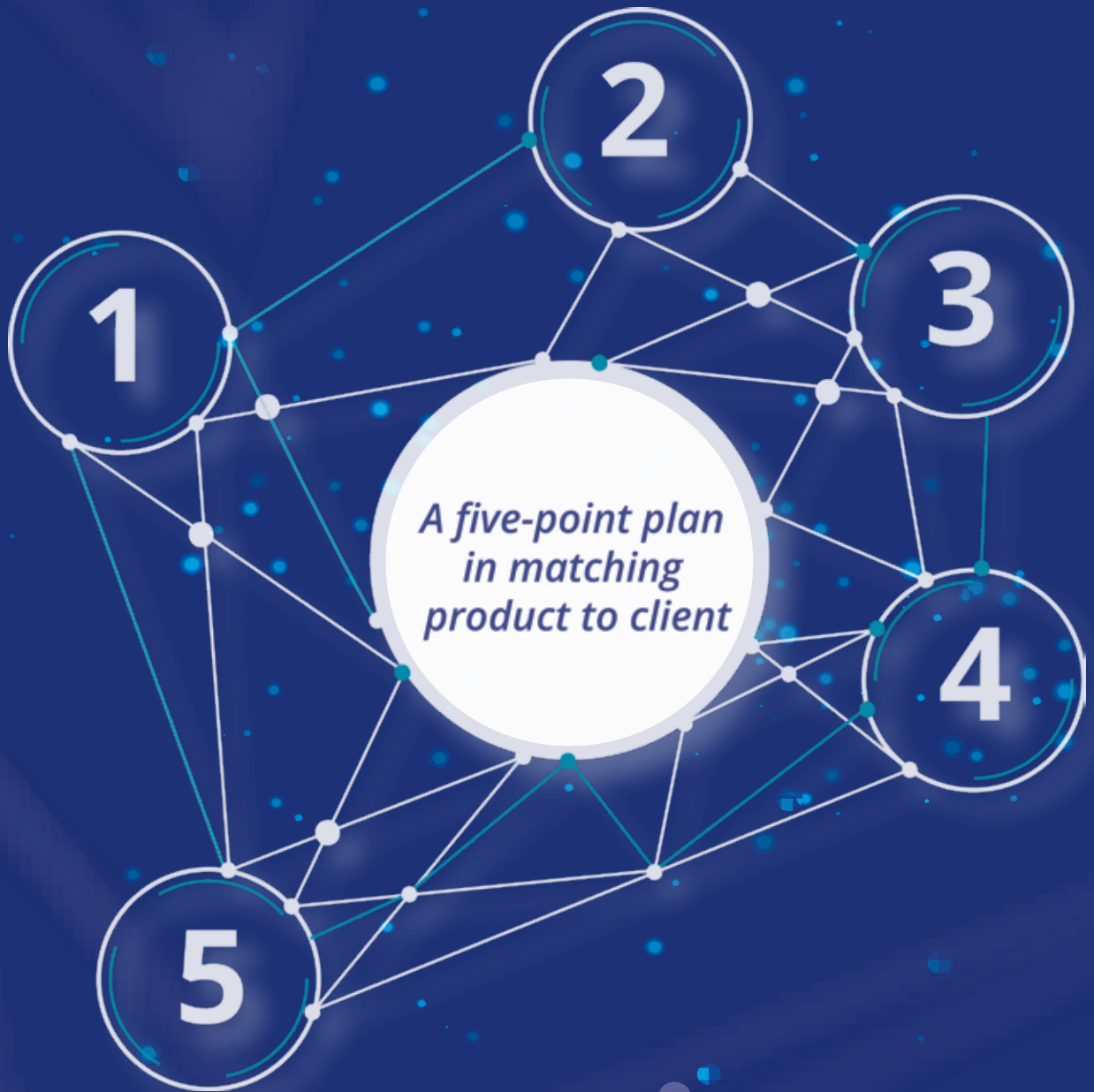
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A five-point plan for taking a proactive stance in matching product to client in the latest wealth management front-office digitization efforts. ➤





For private banks and wealth managers, investment suitability is a hot regulatory topic and should be at the heart of front-office digitization efforts. Increasingly, supervisors are expecting private banks and wealth managers to strive for good customer outcomes and demonstrate that their decision-making processes are centered on an understanding of customer needs.

Recent regional developments include the introduction of regulation on the offline distribution of complex products by the Hong Kong Monetary Authority in October 2018, and the Financial Service Agency of Japan's Principles for Customer-Oriented Business Conduct, which were finalized in March 2017.

Although regulatory specifics differ between jurisdictions, the underlying fundamental principle remains consistent: an investment product ought to be aligned to a customer's risk profile and appetite. In instances where the product is considered unsuitable, such as where there is a high probability of unacceptable losses, the obligation is on the banks to control the selling process and protect the customer.

### **Matching a product to a customer's needs is the core requirement**

For private banks and wealth managers, the regulatory pressures are pushing players to adopt a more proactive stance where a deep and ongoing understanding of the customer drives the selection of investment products.

To do this, private banks and wealth managers have to address five key themes, each posing their own unique set of opportunities and challenges:

#### **1. Enabling effective client suitability assessment**

In order to enable an effective client suitability assessment, the development

and rollout of an Investment Profile Questionnaire (IPQ) is paramount during the client-profiling phase (see sidebar: "Five stages of the investment suitability process"). It will need to take into consideration the volume of information that is required for an operating model to apply across different jurisdictions, where requirements on data capture may diverge. An effective IPQ is one, which supports a single operating model where client information can be compared across various client segments and jurisdictions to build a deeper understanding of client risk appetites and corresponding product suitability.

#### **2. Building a comprehensive product data suite**

Building a comprehensive product data suite is critical to ensure product attributes are consistently captured across locations and asset classes, while facilitating better comparability between different product types. This will also enable private banks and wealth managers to offer a better range of products to their clients. Although more complex asset classes may present challenges in terms of data sourcing, effective data laddering can also help to overcome some of these issues.

#### **3. Customizing product offerings**

Technology is a key enabler for private banks and wealth managers to offer their clients customized product offerings. By matching data from the client-profiling and product-profiling stages of the process (see sidebar), private banks and wealth managers can obtain greater client insight across multiple parallels and offer enhanced product offerings that are customized to their client's requirements.

#### **4. Standardization of disclosure requirements**

Disclosure requirements differ significantly across jurisdictions. Certain dominions allow the distribution of products with

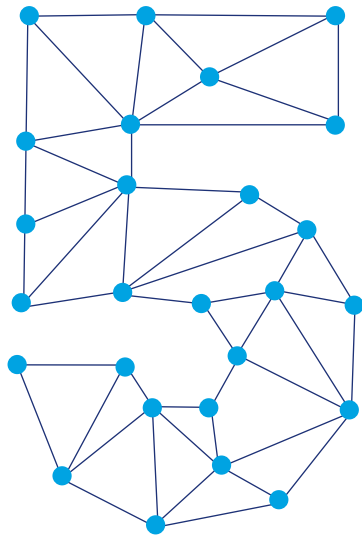
high-risk profiles to clients with low-risk profiles so long as the client has acknowledged a disclosure of the associated risk. The standardization of disclosure requirements is therefore critical to ensure consistency across risk disclosures to clients. In addition, by setting up standardized platforms to automate disclosures, private banks and wealth managers can also ensure minimal disruptions to their overall sales process, while retaining a clearly documented audit trail for their future reference.

#### **5. Ensuring consistent data capture**

Consistent data capture protocols across the entire suitability process is crucial to facilitate ongoing monitoring and assessment. This ensures that there remains a suitable match between a client's risk profile and a product's risk profile, even as both continually evolve. It requires the use of analytic platforms that are capable of efficiently consuming and assessing data. In contrast to legacy platforms where single position assessments were the focus, new technological platforms now enable first and second line controls to move beyond sample-based analysis. This in turn empowers private banks and wealth managers to leverage entire sets of data for greater accuracy and more comprehensive oversight.

#### **Conclusion**

Ultimately, regulators will not only be watching investment suitability but also the delivery of good customer outcomes. Safeguarding against firms serving the wrong types of customer is an ongoing regulatory priority. Robust procedures for understanding customer identity and associations, ongoing monitoring and analysis of transactions, and timely identification, and escalation and action on suspicious matters continues to be top of the agenda for regulators.



## Five stages of the investment suitability process

### 1. Client-profiling

The first stage entails understanding the client's risk profile and appetite. This is typically assessed through the use of an IPQ that covers details such as the client type, investment objectives, risk appetite, investment time horizon, and other key client metrics.

### 2. Product-profiling

The second stage entails understanding the product's risk profile. This includes assessing the associated risks of each product type, including its time horizon, liquidity characteristics, counterparty risks, and investment objectives, as well as other special features.

### 3. Matching

The third stage focuses on assessing the suitability of a product for a

specific client to ensure that the client's risk profile matches the product's risk profile. If these do not match, the focus then shifts towards mitigating the risk through appropriate disclosure or acknowledgment of a mismatch from the client.

### 4. Disclosure

At this stage, the client is informed about the risk of the product. If a risk mismatch has been identified in the previous stage, there may also be a requirement for the client to acknowledge that they accept the mismatch.

### 5. Maintenance

As market conditions and circumstances evolve, there is a need to put in place the necessary controls and ensure ongoing and regular assessments of the suitability of products to clients. ●

## To the point

- Investment suitability is a hot regulatory topic and should be at the heart of front-office digitization efforts.
- Private banks and wealth managers are expected to strive for good customer outcomes and demonstrate that their decision-making processes are centered on an understanding of customer needs.
- Regulatory pressures are pushing private banks and wealth managers to adopt a more proactive stance where a deep and ongoing understanding of the customer drives the selection of investment products.
- To do this, private banks and wealth managers have to address five key themes: enable effective client suitability assessment; build a comprehensive product data suite; customize product offerings; standardize disclosure requirements; and ensure consistent data capture.
- Robust procedures for understanding customer identity and associations, ongoing monitoring and analysis of transactions, and timely identification, and escalation and action on suspicious matters will continue to be top of the agenda for regulators.



# Just another day at the (middle) office?

Alessia Lorenti, Head of Business Development, Institutional & Fund Services at Edmond de Rothschild Asset Management (Luxembourg), and Annick Elias, Partner at Deloitte, discuss the rise of outsourced middle office offerings over the last five years and explore the specific needs of the investment management industry.

## What is Deloitte's perception on middle office as a fully-fledged outsourced service?

**Annick Elias:** Over the last five years, we have observed that outsourced middle office services have consistently been gaining traction. It has now become commonplace for asset management companies to include specific questions regarding middle office capabilities in requests for proposals when selecting a provider for delegated activities.

Consequently, a majority of larger asset servicers have included a middle office package in their product mix, in addition to their core depositary, fund administration and transfer agency activities. Smaller and medium central administrators, who have not all deployed these services yet, are also researching the topic, meaning that these services stir-up interest beyond the selected few global players who have already set them up.

More importantly, global asset managers have started to drive a paradigm shift by increasingly presenting themselves

as technology companies, and offering integrated middle office solutions on a SaaS ("Software as a Service") basis.

## What activities are typically included in these offerings?

**Annick Elias:** In the context of outsourced services for investment funds, the term "middle office" is often used as a hypernym. It can cover a broad range of services, from trade capture and matching, to performance attribution and risk reporting, from position keeping and IBOR, through to reconciliations, valuation, cash management, collateral management, FX management, and/or fund dealing.

Offerings will generally vary based on the scale of the provider. Global asset servicers may propose a full scope of services, all included in one middle office package. Smaller and mid-size organizations will often offer trade capture, matching and position keeping as part of their core MO offering, and other services such as various reconciliations, fund dealing or securities lending as part of their fund administration and depositary offerings. ➔

In the context of outsourced services for investment funds, the term “middle office” is often used as a hypernym.

Clients’ expectations may differ, depending on their segment. For example, a global asset manager will have an interest in a post-trade global solution covering their whole range of funds. This may involve trade capture and matching, asset valuation, and/or corporate actions, but also some specific services to better support their front office departments such as risk reporting, data analytics etc.

For the asset owner segment, insurance accounting is an additional service usually operated with middle office systems.

Finally, small and medium-sized asset managers might be interested in PMS tool hosting as they do not have such capabilities in-house.

**Figure 1**  
Scope of middle office services by segment

	Global asset manager	Lux’ fund flagship	Small asset manager
PMS tool hosting			
Trade capture and matching			
Position keeping/IBOR			
NIB assets and IB assets reconciliations			
Valuation			
Cash management and treasury			
FX management			
Collateral management			
Securities lending			
Fund dealing			
Performance attribution, Risk reporting, etc.			
Self-service reporting platform, data analytics for front office activities			

Included in the MO offering      Not included in the MO offering

Source: sample of services taken from Middle Office service providers’ websites

### What is the outsourced middle office's value proposition to asset managers?

**Annick Elias:** For global asset managers, an inclusive and global solution will help streamline processes, as they will benefit from a harmonized solution for the whole fund range. That being said, the main benefit of these offerings is to reduce the burden of non-core activities for the front office, so that asset managers can concentrate on portfolio management and on distribution, ergo generating performance and returns, and growing their asset base.

Due to increased regulatory scrutiny, it is essential for asset managers to have access to highly detailed information on transactions, fees or positions with minimum turnaround times. The middle office will act as a data aggregator, providing an umbrella solution for the front office to access data from providers and data vendors in a consistent format and in a timely manner. This is particularly relevant for asset managers with an international exposure, working with multiple providers locally.

**Alessia Lorenti:** I agree with Annick's earlier comment that middle office is a hypernym. However, the service offerings described by Annick are clearly back-to-front solutions. These are designed by back office service providers for the middle and front office departments, essentially focusing on post-trade activities, as their primary purpose is to support the back office tasks linked to fund administration and custody. As a result, such service providers often offer a very limited set of ex-ante functionalities. Essential tools including pre-trade investment restrictions controls, portfolio modelling, cash management and forecasts, as well as functionalities linked to hedging, are not always part of the package.

Some solutions also rely on pricing models that are inadequate for asset managers. For instance, providers will apply a fixed fee for the MO service, while the bottom-line

for an asset manager willing to outsource is doing so precisely to transform fixed costs into variable costs. Other offerings are service extensions to service agreements with funds rather than the asset manager.

We have been focusing on front-to-back solutions with ex-ante service offerings, such as portfolio management systems, data management services, with a risk management framework, pre-trade compliance, performance analysis tools, and reporting capabilities. These solutions have been built for the in-house portfolio management front and middle office and are today offered to third party managers as a mutualized solution.

We believe that such services will offer higher added value, especially for such clients as independent asset managers and family offices. Such clients may not have access to the large packages—mainly due to a size criteria established by some software providers as part of their strategy, and/or because they wish to avoid developing and maintaining their own IT platforms.

Data management services have become a key consideration for our clients. In addition to the maintenance of static data, middle office solutions need to offer connectivity to major data vendors for valuation and corporate actions' management purposes and to include a data redistribution component. Moreover, regulatory reporting requirements such as AIFM and Solvency II have significantly increased the need for middle office data.

There is also a demand for open architecture solutions. Asset managers may want to extend access of middle office data to multiple stakeholders such as their portfolio control teams, so that they can carry on their tasks regardless of a NAV calculation cycle. This responds to a specific need in certain European markets in which the management company remains responsible for the NAV review and validation, even when the calculation is delegated to a fund administrator. Likewise, this enables management companies to fulfil their general oversight duties in markets, such as Luxembourg and Ireland, in which the NAV calculation and validation is fully delegated to the fund administrator. ➔



**Commercially, are there any benefits for providers who are offering this service?**

**Annick Elias:** It allows the providers to enhance the scope of their offering and to bring new value added services to the market, including data management, IBOR maintenance, pre-trade compliance and new reporting capabilities. This can generate new revenue streams, whether middle office is offered as a stand-alone service to new clients, or as an extension to an existing service agreement.

We have observed a clear tendency to package middle office services as a separate contract, as opposed to a list

of sub-activities in the custody or fund administration agreements—although many providers may indeed chose to apply size criteria when selling the service as a stand-alone.

This also gives an ability to gain market shares and win clients who have selected another custodian and/or fund administrator should such service providers be willing to offer middle office on a stand-alone basis.

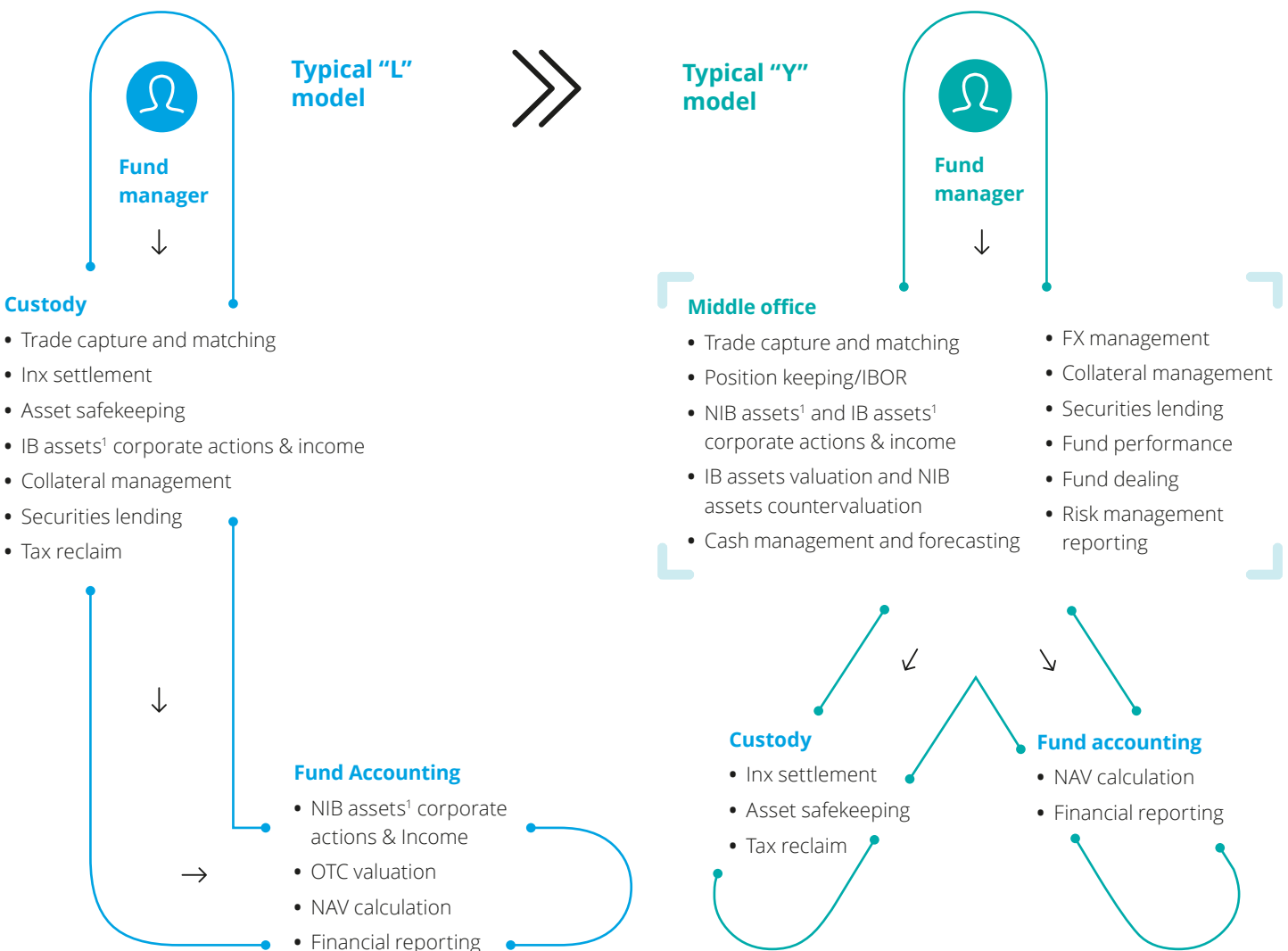
The front office to obtain key transactional, market and positions' data is an efficient way for the providers to "lock-in" their clients, thereby increasing their chances to

develop the accounts. Indeed, performing a migration-out is far more difficult than it is the case for other activities such as fund administration and custody.

**Can providers who offer middle office services achieve efficiency gains?**

**Annick Elias:** For asset servicers who still rely on L-models, whereby the custody function collects data before re-routing it to other units such as fund accounting for further processing, it could be an opportunity to revisit and modernize their operating models. By removing the dependency on custody, other functions could achieve time gains.

**Figure 2**  
From "L", to middle office "Y" Model



1. IB stands for In-Bank assets, i.e. assets that EFA holds with his network of custodians / cash correspondents





For organizations who have built their processes around Y-flows (i.e. whereby several units, like custody and FA, receive data simultaneously), the implementation of a middle office function could be useful to prompt discussion on the assumptions underpinning the operating model. The creation of a central middle office hub could create cross-functional synergies in the organization. Where different models are in use across different locations, it may be a good opportunity to align all cross-border activities on a single model.

**Alessia Lorenti:** According to us, offering MO services to clients is a good opportunity to streamline and optimise all processes from Front to Back across funds and managed accounts, as the PMS tool is interfaced with Back-Office systems, as well as with third party back office providers. For instance, implementing the MO service allows to maximise the number of STP transactions, as well as the number of reports automatically created and disseminated. In doing so, it is instrumental to leverage a robust and flexible IT platform to operate those activities.

#### **What further developments can we expect from outsourced middle Office services in the future?**

**Alessia Lorenti:** Private equity and real estate investment management has grown consistently over the last five years, but is currently under-served in terms of systems and processes. There are many smaller firms, who all still rely on a combination of legacy systems, databases and spreadsheets for control, follow-up and reporting purposes. There are multiple opportunities in this area for a provider who can deliver a solid, cost-effective solution to aggregate portfolio data from multiple sources (for instance, property managers, local asset holding vehicle providers...), assemble management valuation reports for investor reporting, and provide monitoring solutions for industry specific transaction types, such as bridge financing.

**Annick Elias:** I agree with Alessia. I also believe that information technology considerations will be paramount in these discussions. The increasing demand for real-time information, the development of direct connectivity to order management systems, APIs, data analytics, open-

architecture and self-service reporting platforms, all have the potential to reshape asset servicing in the years to come.

In terms of competition landscape, I expect disruption with new offerings from providers who are not incumbents in the asset servicing industry, bringing innovation and potential for future efficiency gains. We have recently seen an increased interest from large data vendors and major fund managers for activities further down the asset management chain, offering increasingly integrated solutions by leveraging on the strengths of their core front office activities. Similarly, asset servicers are now acquiring front office IT solutions to extend the scope of their offerings to the full asset management value chain.

Finally, we are beginning to see a trend towards the extension of middle office solutions to the private asset segment (external asset managers, IFA and HNWI). It will be interesting to see if global banks offering asset-servicing activities mainly to institutional clients will leverage on their middle office capabilities to support the private bank client segment as well. ●



# Liquidity risk management— a look at the tools available

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In this article, Deloitte Australian Investment & Wealth Advisory Team takes a practical look at the different tools available to fund managers for liquidity risk management and considers what Boards must keep in mind when managing liquidity risk.

Since the International Organization of Securities Commissions (IOSCO) published its seminal “Principles of Liquidity Risk Management for Collective Investment Schemes” report in 2013, there is hardly a major financial jurisdiction globally that has not turned its attention to the topic of open-ended fund liquidity risk management. Regulators in the US, UK, Singapore, Australia, and Hong Kong have all published guidance or requirements. IOSCO followed up its 2013 work with further publications in 2015, 2017, and 2018. The Financial Stability Board (FSB)

published policy recommendations on this topic in 2017 and the European Systemic Risk Board (ESRB) published its own recommendations in early 2018.

As this article explores, fund managers face a challenge in turning high-level, principles-based guidance and regulation into practical steps for the sound management of fund liquidity risk. The focus of this article is therefore the practical tools available to fund managers for the management of liquidity risk before and during a stressed scenario. ➔

### The fund manager dilemma

Fund Managers have a duty to diligently manage liquidity to meet the investor redemption frequencies that a fund offers. In addition to meeting redemptions, fund managers must clearly also consider other liabilities such as margin calls, the fund's performance (and importantly how any liquidity protection measures may impact performance), as well as the liquidity profile of the fund once any liabilities have been satisfied. When discussing liquidity risk therefore, this is the fund manager's dilemma – how best to manage these potentially competing needs? It's a very difficult ask - a fund manager must: Ensure at all times that the fund remains in line with how it has been developed, marketed and sold, strive for performance, satisfy outgoing redemptions with cash in a timely manner (avoiding fire sales), all whilst not adversely impacting the NAV for incoming and outgoing investors, or impacting the fund's liquidity profile for remaining investors.

Those fund managers that erected redemption gates or limited investor redemptions in some way during and post the Global Financial Crisis were viewed critically and suffered reputational damage, despite provisions set out in fund offering documents. Unexpected changes in market conditions and demand for liquidity to meet derivative / collateral obligations created problems in meeting investor expectations. Investor frustration was caused in part by mismatched expectations between investors and their fund managers and could have been (and can be in the future) prevented by clearer and more meaningful disclosure of such provisions. Fund managers should not take a legalistic approach when communicating with investors on such an important topic, because after all – fund managers need their investors' trust and buy-in when a stressed scenario does arise.

Fund managers today can be reluctant to make prominent the information about



liquidity management tools in offering documents because of the competitive nature of marketing investment products. The trend also reflects the current balance of negotiating power between investors and fund managers for traditionally liquid asset classes. For example, often the largest and most reputable hedge fund managers have the longest initial lock-up periods, despite being the most resilient to investor redemptions. The demand for immediate liquidity is also a primary reason for the rise of liquid alternative funds that offer strategies and risk/return profiles typically associated with hedge funds.

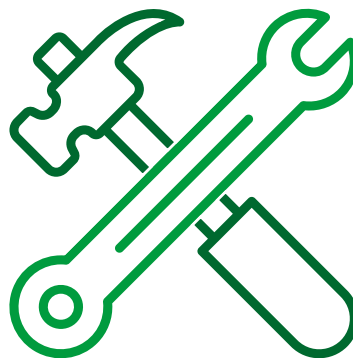
### The role of liquidity risk management tools

The term "tools" in this context is a broad one used to describe a range of design features, techniques, and processes available for the management of liquidity risk. They can be utilized by fund managers and regulators alike (depending on the

tool and the jurisdiction) and are aimed at preventing the emergence, or minimizing the impact, of liquidity squeezes in open-ended collective investment schemes (referred to throughout, for ease, as "funds").

IOSCO's FR28/2015 report entitled "Liquidity Management Tools in Collective Investment Schemes"<sup>1</sup> noted that, "The most common tools are: redemptions fees; redemptions gates; redemptions in kind; side pockets; and suspension of redemptions."

The use of tools is not black and white, and their deployment is subject to a degree of subjectivity and sometimes controversy. Despite this, evidence from regulators suggests that their deployment has been shown to be successful in protecting investor and market interests:



**"In the large majority of cases, these tools have been used without causing any broader effect beyond the fund(s) involved."**<sup>1</sup>

**"Fund managers' use of existing tools...helped to avoid an escalation of market uncertainty."**<sup>2</sup>

1. IOSCO FR28/2015, available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf>

2. FCA DP17/01, available at <https://www.fca.org.uk/publication/discussion/dp17-01.pdf>

**Why is liquidity risk an issue in funds?**

Liquidity risk in open-ended funds is the risk that a fund does not have enough cash, or liquid assets that can be quickly converted into cash, to meet its liabilities when they fall due. These liabilities could be investor redemptions or margin calls for example. Open-ended funds often allow investors to redeem their investments on a daily, weekly or monthly basis—the days on which an investor can redeem is also known as a “dealing day”. Funds for more sophisticated investors, or in more illiquid asset classes, may only have dealing days once per quarter or twice per year.

Theoretically, one would expect the liquidity profile of a fund’s underlying assets to match the dealing day frequency offered to investors. Investors could expect a daily dealt fund to be invested in more liquid assets (equities, government bonds etc.) and have cash balances on hand. A quarterly dealt fund may be invested in longer-term asset classes such as property or infrastructure—i.e. assets that take longer to liquidate if required. However, it has become entirely common for funds to offer daily dealing while investing in

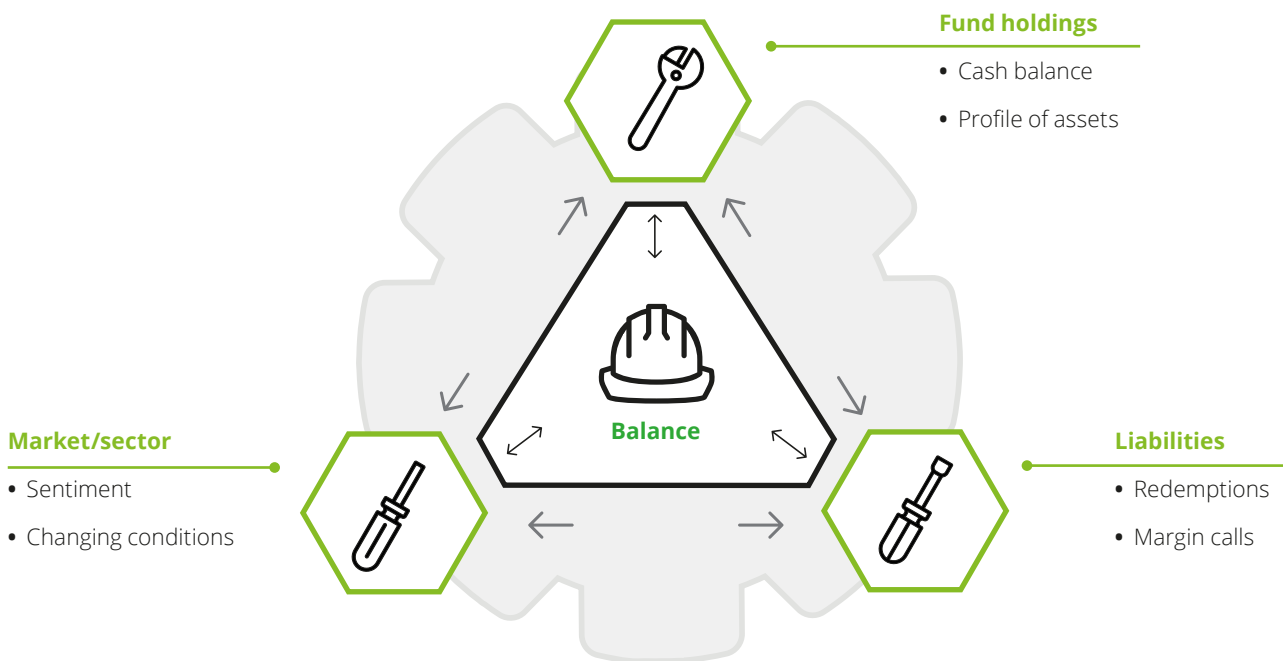
less liquid assets. Indeed, the Financial Conduct Authority (FCA) in the UK noted in its Discussion Paper DP17/01 that “A considerable number of managers have elected to offer daily dealing in their property funds”.

The difference between the liquidity profile of a fund’s assets and its liabilities presents the issue of “maturity” or “liquidity transformation”. The greatest liquidity risk arises where the amount of transformation required is high, for example in a fund that offers daily dealing to investors but invests in property that takes several months to liquidate. In this scenario, the fund is exposed to the risk that a sharp rise in investor redemptions—over and above the cash amount that the fund has on hand—will not be serviceable until property is sold and cash is generated.

However, maintaining large cash balances places a drag on returns. Therefore, fund managers must delicately balance the liquidity of the fund’s holdings, whilst monitoring market liquidity conditions and monitoring and managing liabilities. To this extent, it’s an art not a science. ➔

Liquidity risk in open-ended funds is the risk that a fund does not have enough cash, or liquid assets that can be quickly converted into cash, to meet its liabilities when they fall due.

**Figure 1**  
It’s more of an art than a science, but better data is making it more scientific



- Market/sector**
- Sentiment
  - Changing conditions

- Fund holdings**
- Cash balance
  - Profile of assets

- Liabilities**
- Redemptions
  - Margin calls

These two factors are correlated, with the correlation unhelpfully strengthening in stressed scenarios

Whilst there has been much high-level discussion on this topic, we see value in exploring the more practical aspect of the management tools available.

These tools can be broadly split into those that are pre-emptive and those that are reactive. Pre-emptive tools are really design features that are baked into the fund's development and establishment, giving the fund a strong foundation for managing liquidity risk. Reactive tools are those that need to be actively deployed in a stressed scenario and typically seek

to either control the cost of managing liquidity (and stop costs being unfairly shared among all investors), or to protect the fund's capital.

The below tables are non-exhaustive and certain tools may not be available in all jurisdictions. Local regulatory regimes will dictate the exact details of the tools available for use and how and when they may be implemented. IOSCO's FR28/2015 analyzes the tools that are available in a number of global jurisdictions and their conditions for use.

Good practice suggests that pre-emptive tools should be established as a matter of course for all open-ended funds during product development, whereas the use of any reactive tools will be subjective and a feature of the specific scenario. In this way, firms should expect to utilize a blend of techniques for robust liquidity management. Whilst not discussed in any detail in this article (it warrants its own article!), stress testing should equally form a significant part of a fund manager's liquidity framework alongside any tools. ➔

**Table 1. Product design features**  
Tools designed to prevent the emergence of stressed scenarios (pre-emptive)

Tool	Principles	⊕ Pros ⊖ Cons	Points to note
<b>Portfolio structure, cash buffer, internal limits</b>	Ensuring adequate asset diversification and an appropriate cash balance will help meet ongoing redemption demands and any (small) unexpected increases in redemptions. In addition to regulatory limits, internal limits can be imposed on asset concentration, illiquid investments, derivative use, leverage and asset maturity.	<p>⊕ Adequate cash balances enable normal redemptions to be met, plus minor stress events assuming a conservative buffer.</p> <p>⊖ Cash balances place a drag on returns.</p>	Funds need to ensure that they remain within the mandate despite liquidity considerations. Some regulations, such as UCITS, impose fund-level limits and so any internal limits should be within the regulatory limits.
<b>Redemption fees</b>	Charges that operate on a sliding scale, with a higher charge for withdrawals made within the first year (or other set time period) after investment, then diminishing over time.	<p>⊕ Acts as a disincentive to short-term investment in the fund, and/or frequent investment and withdrawal.</p> <p>⊖ Redemption charges may dissuade investment.</p>	Must be clear in offering documents.
<b>Understanding investor behavior</b>	Model, monitor, and understand the fund's investor base and use knowledge of typical investor behaviors to model what liquidity risk the investor base exposes the fund to. When permitted by the fund's legal establishment, it is possible to restrict the maximum proportion of the fund that can be held by a single investor or group of linked investors.	<p>⊕ Investor insights can provide fascinating insight into how redemptions may play out in a stressed scenario.</p> <p>⊖ However, qualitative information regarding typical investor behaviors cannot always be relied upon.</p>	Regulators from the UK, European Union, and Hong Kong all recommend this technique as being an integral part of a fund's liquidity risk management framework.



Tool	Principles	⊕ Pros ⊖ Cons	Points to note
<b>Dealing arrangements</b>	Daily dealing has become the norm for retail funds, but the dealing frequency chosen should be in line with the proposed asset and investor profiles rather than just being in line with what competitors offer.	⊕ Offering non-daily liquidity may aid in the timely management of investor redemptions.	–
<b>Hard/soft closures</b>	“Hard closure” can mean formally preventing any new investors from subscribing to a fund. “Soft closure” can mean halting active marketing of a fund to reduce, but not prevent, new investors entering the fund. A 'softer' hard closure may be to only allow existing investor top-ups but not new investors. Any of these would typically be deployed when a fund is approaching such scale that the size of its investments increases liquidity risk.	⊕ Soft closures are easily implemented and can slow up subscriptions into fund that is growing too fast.  ⊖ Hard or soft closures may harm existing investor confidence.	Hard closures require the use of a fund’s legal rights to prevent further investors from entering a fund. Soft closures by reducing marketing activity may be considered more informal.
<b>Valuation frequency</b>	A clause in the fund’s legal arrangements with the valuation agent/custodian/pricing agent that allows for more frequent valuation of illiquid assets under pre-specified conditions. In this way, illiquid assets, such as property for example, can be valued accurately more often than under BAU. This can aid with timely liquidity management.	⊕ Increased valuation frequency in a stressed scenario will allow a more accurate view of ongoing NAV and aid with investor confidence.  ⊖ Extra costs may be involved for the service.	The FCA’s analysis of property funds following the Brexit referendum vote found that property assets could not be valued quickly and regularly enough.

**Table 2. Cost management**

**Tools that aim to protect remaining investors by passing transaction costs on to redeeming investors (reactive)**

Tool	Principles	⊕ Pros ⊖ Cons	Points to note
<b>Swing pricing</b>	<p>A process for adjusting a fund's NAV to effectively pass on the transaction costs stemming from net subscription/redemption to the investors associated with that activity.</p> <p>"Full" swing pricing is when the NAV of a fund adjusts up/down every dealing day based on the direction of the net activity. (This would represent a pre-emptive design feature of the fund rather than a reactive tool.)</p> <p>"Partial" swing pricing is only invoked when the net activity is greater than a pre-determined threshold (i.e., in the case of major net subscription/redemption).</p>	<ul style="list-style-type: none"> <li>⊕ Can act as a deterrent against frequent trading and market timing activity, as well as against potential large redemptions (to a certain extent) when the liquidity cost increases.</li> <li>⊕ By protecting remaining investors from the dilutive impact of other investors' redemptions, at the same time it mitigates the first-mover advantage.</li> <li>⊖ If swing price is activated by one large redemption, any other investors looking to redeem at the same time may be.</li> <li>⊖ The percentage value of the swing may be capped in some countries; as such, not all transaction costs are passed on and remaining investors will have to bear the residual costs.</li> </ul>	<p>Swing pricing can have a positive impact on performance.</p>
<b>Anti-dilution levies</b>	<p>A single charge payable by investors, applied to protect other investors from bearing the costs of subscriptions and redemptions. It does not involve any adjustment to NAV, and it is flexible to apply. It is usually applied by:</p> <ul style="list-style-type: none"> <li>- Deducting the fee from the money paid to a redeeming investor</li> <li>- Deducting the fee from the money being invested by a subscribing investor.</li> </ul>	<ul style="list-style-type: none"> <li>⊕ No NAV adjustments are required.</li> <li>⊖ Liquidity issues may still exist if investors are willing to pay the levy to exit.</li> <li>⊖ Transparency may allow "gaming" of the system by investors (with known limits before application of levy).</li> </ul>	<p>The levy must be consistently and transparently applied according to the fund's offering documentation, avoiding any arbitrary application.</p>
<b>Valuation according to bid or ask prices</b>	<p>In situations where there are significant buying/selling activities, switching valuation pricing to ask or bid prices incorporates into the NAV calculation the effect of transaction costs the fund will face as a result of investor activity. This is implemented in the NAV calculation on a security-by-security basis.</p>	<ul style="list-style-type: none"> <li>⊕ Considers the entire market impact and fully reflects market movements.</li> <li>⊖ If the bid-ask mechanism is activated by redeeming investors, any investors looking to subscribe may be disadvantaged.</li> </ul>	-





**Table 3. Asset protection**  
Tools that aim to protect fund capital (reactive)

Tool	Principles	⊕ Pros ⊖ Cons	Points to note
<b>Redemption gates</b>	<p>Partial restrictions on investors' ability to redeem their capital, generally on a pro-rata basis.</p> <p>If orders at a given cut-off exceed the redemption limit, then they will only be partially executed. The non-executed part will either be cancelled or automatically carried over to the next dealing day.</p>	<p>⊕ Alleviates redemption pressures as it allows redemptions to be spread over time. Provides additional time for the dissemination of information that might change investor redemption motives and allows for fairer value to be achieved for sold assets.</p> <p>⊖ Unequal treatment of investors if carried over redemption requests above the threshold are treated on a priority basis above any new redemption requests.</p>	<p>The procedures and priorities that will be followed if redemption gates are implemented must be clearly disclosed in the fund's offering documents and applied fairly.</p>
<b>Side pockets</b>	<p>A mechanism by which the fund establishes separate accounts for the sole purpose of segregating specific assets from the fund's portfolio so that the overall liquidity of the various underlying assets can be better managed. When a side pocket is created, investors receive a pro-rata investment in the side pocket. When an investor redeems from the fund, they may not immediately be able to realise their share in the side pocket, but will receive this when the side pocket value does get realised.</p>	<p>⊕ Helps provide access to the liquid component of a portfolio without compromising the integrity of the entire portfolio.</p> <p>⊕ Can ensure fair treatment among investors as they receive an equal share of the illiquid portion of the portfolio.</p> <p>⊖ This technique can limit when and how investors can withdraw part of their investment.</p>	<p>Whilst effective, this mechanism is burdensome from an administrative standpoint. A more efficient mechanism may be to impose internal portfolio management standards dictating that a "vertical slice" of the fund's assets will be sold in stressed scenarios. This latter approach would need to be detailed within the firm's liquidity management framework.</p>
<b>Notice periods</b>	<p>A mechanism whereby investors must give the fund manager notice if they intend to redeem investments from the fund. This allows the fund to meet redemption requests in an orderly fashion without needing to sell assets at discounted prices.</p>	<p>⊕ Provides additional flexibility and transparency to the fund manager in meeting redemptions.</p> <p>⊖ Notice periods for redemptions may have the effect of discouraging investment in the fund, and splitting notice periods by investor classification can dissuade those that the restrictions are placed upon.</p>	<p>Institutional investors may be more accepting of notice period arrangements.</p>
<b>Suspension of redemptions</b>	<p>Prevents investors in the fund from withdrawing their capital. This is to prevent a run on the fund in times of market stress. It can also be used when the portfolio cannot be properly valued.</p> <p>Implementing a suspension is perceived as a more drastic measure than using other tools.</p>	<p>⊕ Provides time for the fund to address liquidity challenges and to perform accurate and fair valuations and sales of assets at less of a discount.</p> <p>⊖ Investor confidence and impact on fund manager reputation.</p> <p>⊖ Possible impact on other funds managed by the same fund manager, or on other funds in the same asset class.</p>	<p>A suspension of redemptions is generally considered to be a last resort tool that is only activated when no other option is available, or all other options have been exhausted. Likely to attract negative reputational impacts.</p>

**Table 4. Other tools**  
(reactive)

Tool	Principles	⊕ Pros ⊖ Cons	Points to note
<b>Redemptions in kind</b>	<p>A mechanism by which funds can distribute the underlying assets to investors, generally on a pro-rata basis, as opposed to paying cash to honor redemptions.</p> <p>This allows a fund to avoid having to sell assets quickly to honor a redemption in cash, thereby avoiding significant transaction costs and market price impacts that may disadvantage remaining investors.</p>	<p>⊖ Certain asset classes cannot be split and therefore a full, representative vertical slice of the underlying portfolio may not be possible for all funds.</p> <p>⊖ Investors may not be willing or able to accept assets in kind.</p>	<p>This mechanism is more appropriate for institutional investors rather than retail investors.</p> <p>Such a tool does not necessarily deal with contagion issues—it merely transfers the securities, and the associated liquidity problems, to an investor who may sell them into a falling market, which may ultimately have an adverse impact for investors. It also assumes investor capability and willingness to sell assets received in kind.</p>
<b>Temporary borrowing</b>	<p>Funds may be able to temporarily borrow in order to satisfy liabilities. This could be by establishing a new borrowing facility when necessitated by extreme investor redemptions, or by utilizing an established “overdraft” type facility that is already in place with the funds’ depositary or custodian.</p>	<p>⊕ Could allow for immediate liabilities to be met, without harming the asset mix in the fund and without requiring “fire sales” of assets.</p> <p>⊖ Establishes a liability on the fund for repayment, which must then be met at some future point, ultimately meaning that remaining investors may be harmed as the fund services the debt. Fees and interest are payable on borrowing facilities.</p>	<p>Such short-term borrowing facilities are typically used for a limited number of liquidity management scenarios, such as covering settlement fails. Use of this tool to cover investor redemptions is not common practice, nor considered typically appropriate.</p>

### What Boards must keep in mind when managing liquidity risk

Regardless of the pre-emptive and reactive tools that are put in place or deployed by fund managers and regardless of the regulatory requirements in each local jurisdiction, there are a number of overarching principles for Boards to keep in mind when approaching liquidity risk.

#### Transparency

Clear and meaningful disclosure of your liquidity management approach, a fund's liquidity management features, and the decision to implement any tools could not be more vital in a stressed scenario— for both investors and regulators alike. This links directly to the trust concept discussed below, whereby clear and fair disclosure and communication can help to build and maintain trust in a stressed scenario.

#### Trust

Reliable redemptions form a vital part of the trust relationship established between investors and fund managers. Investors being able to consistently redeem their investments on the timescale outlined by a fund's offering documents goes to the very core of a fund manager's service promise. Jeopardizing this trust by not being able to service redemptions owing to liquidity issues therefore presents a huge trust and reputational risk to managers. It is imperative for Boards to keep this in mind as they go about their business, since reactionary use of tools without due transparency will quickly break investor trust and can cause long-term reputational damage. ➔



Investors being able to consistently redeem their investments on the timescale outlined by a fund's offering documents goes to the very core of a fund manager's service promise.

### Making decisions

Boards are responsible for making important liquidity decisions long before a stressed scenario arises. The design of product features, the range of tools made available and the investor communication approach should all be set in line with the Board's stated risk appetite. If and when a stressed scenario then arises, the Board must set the tone and protocols for ensuring fair treatment of all investors—be they incoming, outgoing, or remaining in a fund. Importantly, Boards must also be able to show evidence of the decision-making process in such scenarios, whether they were made by the Board directly, or delegated to an investment committee. Boards should assume that regulators and investors (or even shareholders) will take the stance that “if it isn't written down then it didn't happen”.

### Adding value

Aside from using tools, liquidity risk management is not, and should not, be a compliance exercise. Showing that your firm is mature and developed in its approach, framework, and capability to monitor and manage risk can be a differentiator. It can equally add value to investment performance if liquidity practices are developed enough to allow you to turn market stress scenarios into investment opportunities (mispriced assets, arbitrage, etc.).

### Liquidity management framework

The Board should seek to gain confidence in the firm's ability to manage liquidity risk via the liquidity management framework. The framework is the overarching structure that considers and dictates the various elements that are required for robust management—governance, policies,

One of the better practices is for fund managers to set internal liquidity targets or indicators, in the form of minimum or maximum amounts that can be invested in assets under each liquidity bucket.

behaviors, product disclosures, instrument and market monitoring metrics, stress tests, and contingency plans. The framework should consider these elements during each stage of a fund's lifecycle. A robust framework would also be differentiated by the roles and responsibilities to be played by each of the three lines of defense.

One of the better practices is for fund managers to set internal liquidity targets or indicators, in the form of minimum or maximum amounts that can be invested in assets under each liquidity bucket (for example, “high liquidity”, “medium liquidity” or “low liquidity” buckets). Limits should be applied in the context of total liquidity risk exposure for each fund under normal and stressed market conditions. These liquidity buckets could be defined based on the following factors:

- Quantitative metrics: Days to trade (estimated time needed to dispose of the asset without materially affecting the value of the asset or the market for that asset) and costs to trade (defined as costs for executing a transaction in the market, which could comprise the bid-ask spread and other transaction costs).
- Qualitative factors such as level of leverage in the strategy, dependency on intermediaries for liquidity, credit quality of the underlying asset, age to maturity, outstanding issuance, investor concentration and percentage of each fund held by investor type. ●



### To the point

- Liquidity risk management should not be a compliance exercise
- A range of pre-emptive and reactive tools are available to fund managers
- A blend of tools is likely the most robust approach
- Liquidity risk management starts in the product design phase
- The liquidity risk management framework ties together the fund manager's appetite, approach, tools and governance for liquidity risk management



# If you think investment managers have flown under the Australian Royal Commission radar, think again

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## The Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry: So what was it all about?

Following a number of high-profile cases of misconduct in the media, the finance sector faced significant scrutiny by politicians and the general public through 2016 and 2017. This resulted in the Australian government establishing the Royal Commission by Letters Patent appointing The Honorable Justice Kenneth Madison Hayne AC QC as Commissioner.

The central task of the Commission was to investigate and report on whether

any conduct of financial services entities might have amounted to misconduct and whether any conduct, practices, behavior, or business activities by those entities fell below community standards and expectations. In many ways, this was similar to other government-led investigations that have taken place in the US, Europe, and the UK, such as the UK's Retail Distribution Review. [▶](#)

# Commissioner Hayne’s interim report focused on two key issues relating to misconduct: “why did it happen?” and “what could be done to prevent it happening again?”

Commissioner Hayne’s interim report focused on two key issues relating to misconduct: “why did it happen?” and “what could be done to prevent it happening again?” In responding to the issue of why, Commissioner Hayne observed that: “the answer seem(ed) to be greed—the pursuit of short-term profit at the expense of basic standards of honesty [...] From the executive suite to the front line, staff were measured and rewarded by reference to profit and sales [...] When misconduct was revealed, it either went unpunished or the consequences did not meet the seriousness of what had been done. The conduct regulator, ASIC, rarely went to court to seek public denunciation of and punishment for misconduct. The prudential regulator, APRA, never went to court.”

In responding to the issue of “what now?”, Commissioner Hayne opined that: “The law already requires entities to ‘do all things necessary to ensure’ that the services they are licensed to provide are provided ‘efficiently, honestly and fairly’. Much more often than not, the conduct now condemned was contrary to law. Passing some new law to say, again, ‘do not do that’, would add an extra layer of legal complexity to an already complex regulatory regime.”

The final report made 24 referrals of misconduct to regulatory agencies and made 76 recommendations for change. The final report has received bipartisan support from government.

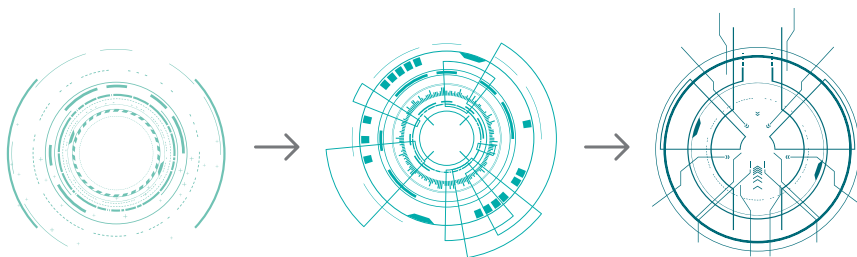
## Straight to the heart of the matter

Commissioner Hayne made four key observations that go right to the heart of what he thinks went wrong:

01. The connection between conduct and reward—since the drivers of nearly every case he considered were both the entity’s pursuit of profit, and the individual’s pursuit of gain. Advisers became sellers, and sellers became advisers.
02. The asymmetry of power and information—between financial services entities and their customers, which enabled firms to act in the way that they did.
03. The effect of conflicts between duty and interest—the interests of the client, intermediary, and product provider are not only different, they are opposed. Self-interest is too powerful a force in the end; in the face of self-interest, effective management of a conflict collapses. Intermediaries should act only on behalf of, and in the interests of, the party that pays them.
04. Holding entities to account—deterrence depends on entities actually believing that misconduct will be detected, denounced, and justly punished. Communities expect someone to be held to account. Issuing a media release just doesn’t cut it.

Drawing on these four key observations, Commissioner Hayne set out six norms of behavior that should guide all conduct:

01. Obey the law
02. Do not mislead or deceive
03. Act fairly
04. Provide services that are fit for purpose
05. Deliver services with reasonable care and skill
06. When acting for another, act in the best interests of that other



**14 December 2017**  
Royal Commission established

**28 September 2018**  
Interim report delivered

**1 February 2019**  
Final report delivered



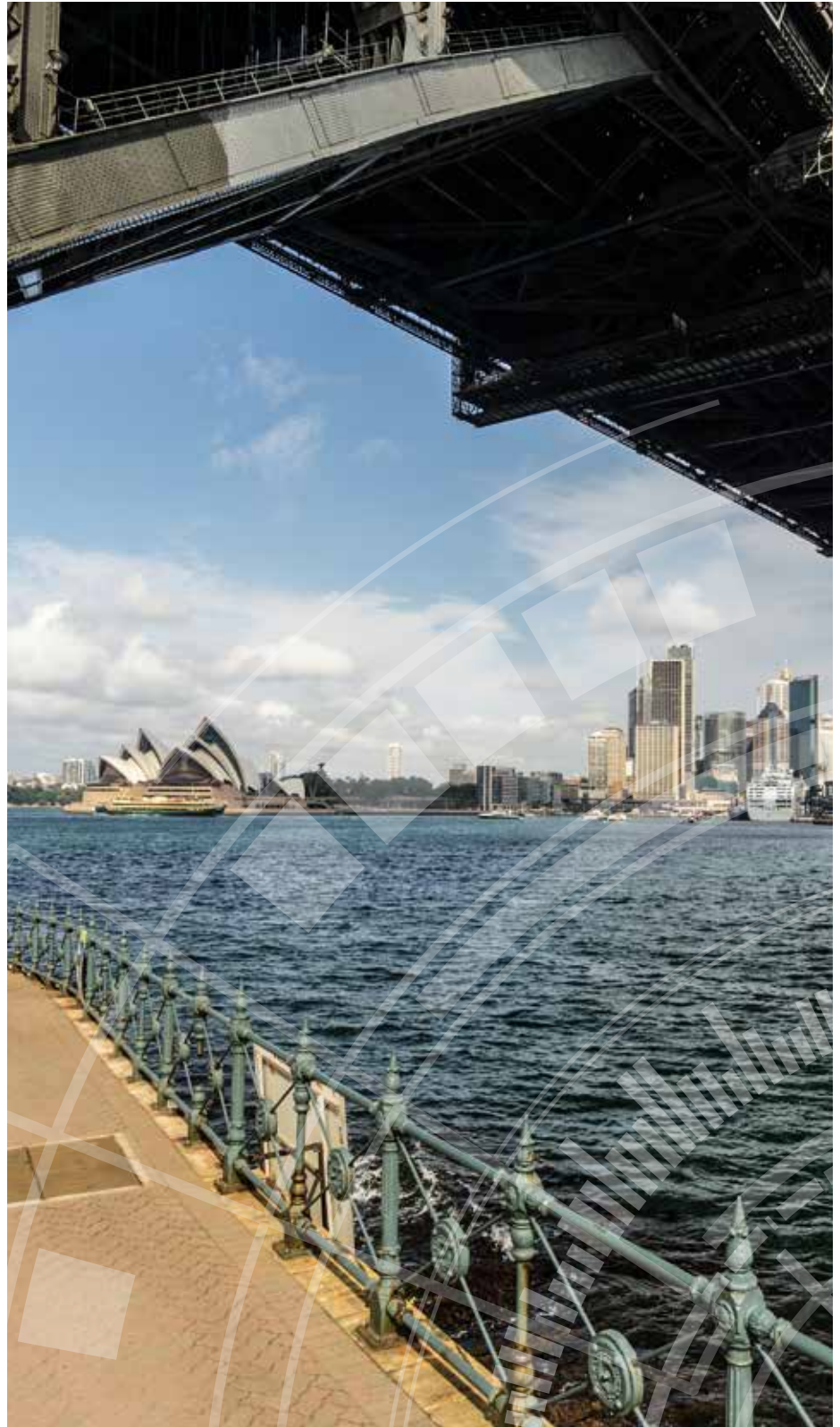
### So what impact will this have on investment managers?

Whilst the Royal Commission did not focus specifically on investment managers, it is important to understand that this sector will not escape the wide net of its broader implications, including the four observations and six guiding norms of behavior that Hayne identified.

Importantly, these observations and guiding norms are already shaping longer-term thinking across the financial sector. Investment managers are likely to face some ongoing tensions between the focus on quarterly performance (returns) reporting and the increasingly long-term focus of investors such as superannuation funds, which will be looking at broader measures of performance (e.g., ESG) post-Hayne.

The significant change that is likely to occur in the overall financial services market post-Hayne will have a number of longer-term substantial impacts. The major banks are divesting their wealth management arms, a number of financial planning business models are being questioned, and superannuation (pension) funds are continuing to grow. As a result, there will be longer-term impacts on distribution models, product design, and the relative split of institutional and retail markets, with the likely development of more direct-to-consumer products and channels.

At the same time, there will likely be increased accountability requirements as a result of Hayne's recommendations. The expected application of a regime similar to the Banking Executive Accountability Regime (BEAR) to all investment managers (Responsible Entity (RE)) licensees will mean that directors and senior management will be clearly personally accountable for the conduct of the entity. This reinforces the idea that the primary responsibility for the conduct and operation of a fund sits with RE boards and senior management. ➔

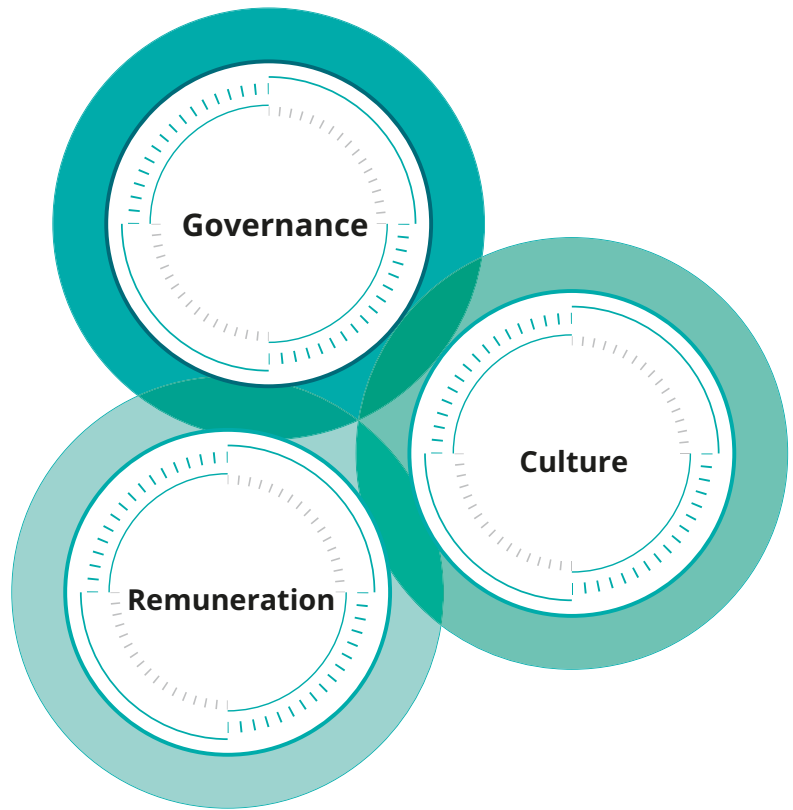


This increased accountability will be reinforced by greater regulatory sanctions. Civil penalties will also be introduced for breaches of Australian Financial Services Licensee responsibilities including Corporations Act section 912A (“efficiently, honestly, and fairly”).

In the face of such increased accountability, it will be important for investment managers to give serious consideration to conflicts of interest. Commissioner Hayne recommended that superannuation trustees have no other role or office and observed in direct relation to this that Dual Regulated Entities (i.e., entities that are both superannuation trustees and Responsible Entities) should be eliminated because of the inherent conflict between the duties of the trustee to members and of the RE to unit holders.

This increased focus on investment managers (via the RE) acting in the interests of unit holders will be further reinforced by a fiduciary-driven regulatory focus on governance, culture, and remuneration. While the basic regulatory architecture of the “twin peaks” model will remain the same, regulators will adopt a far tougher stance. Fiduciary-driven regulation will focus on governance, culture, and remuneration and prioritize the interests of unit holders. Hayne states that culture, remuneration, and governance need to be considered together because of the influence each has on the others. Remuneration shows what the entity rewards, culture drives behaviors, and governance challenges the entity to live up to its purpose.

In the face of such increased accountability, it will be important for investment managers to give serious consideration to conflicts of interest.



### **Governance**

Good governance practices are key to changing the culture within entities. Hayne calls for all entities to “look again” at the way that they govern themselves. The RE’s priorities should be consciously set on acting in the best interests of the organization, for a proper purpose, over the long term.

For investment managers, this is likely to require addressing changing investor demands and providing a better customer experience. As individuals, rather than institutions, begin to provide the industry’s future growth, fund management increasingly looks like other consumer businesses—changing buying demands, a desire for a strong customer experience, and fee sensitivity. Investors will be seeking to increase exposure to passive investment vehicles (to complement both traditional active management and alternative strategies) and will be more active on issues such as ESG. Product

suitability is likely to get greater attention, with investment managers having to have greater focus on how they are promoting products and who is buying their funds, and whether this is suitable for them.

### **Remuneration**

Hayne’s recommendations are targeted at regulatory and governance oversight of remuneration to ensure a focus on culture and both executive and staff behaviors.

Recommendations for reforms in conflicted remuneration are among the most substantial with implications for shelf-space fees, rebates, etc. Changes to grandfathered commission structures will fundamentally reshape key parts of the industry, and affect financial services more broadly. Commissioner Hayne has largely left it up to the institutions to determine the appropriate arrangements; albeit with greater regulatory oversight and heightened scrutiny.



## Culture

Hayne's report focuses on the profit-driven culture, and inadequate systems of risk management and governance, which ultimately reflect a failure of leadership. The top-line message is that good intent is not enough; executives and boards are judged on their outcomes in relation to culture and behaviors and need to continuously measure and adjust their actions. The board and executive team are responsible for determining their desired culture, and then ensuring it is being enacted in practice through measurement and management.

The recommendations will give new authority to regulators to oversee whether changes to culture and remuneration are actually delivering the right outcomes.

## Conclusion

The Hayne Royal Commission Final Report means different things to the industry, to regulators, to customers, and to communities. The overarching theme of

the report is balance. Commissioner Hayne has kept one eye on structurally reforming the system, while not rocking Australia's economic boat.

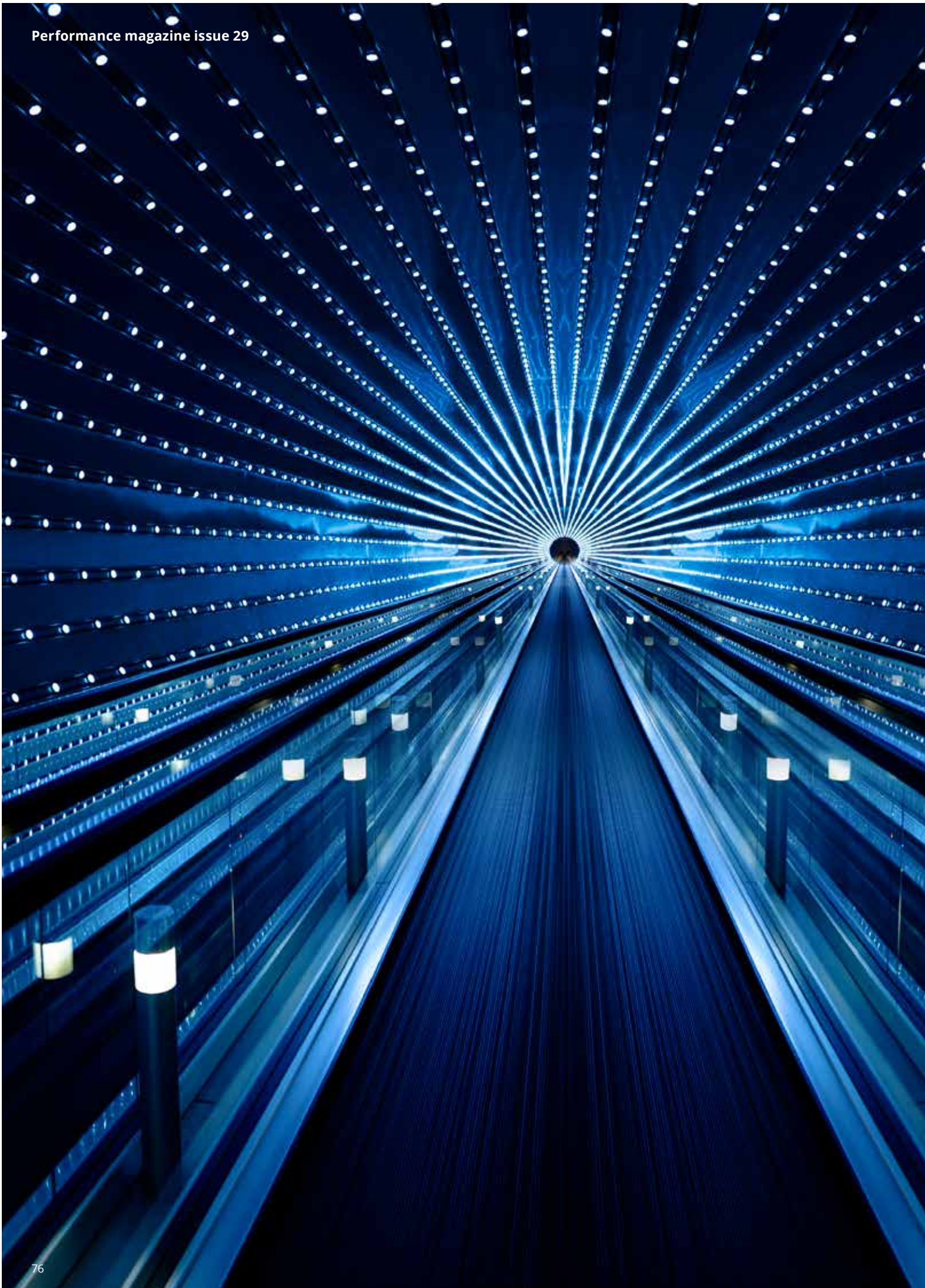
His unequivocal message to all was that the principles that underpin the rules for the industry should be clear, obeyed, and enforced. As actual reform plays out, as always, the devil will be in the detail. However, in the year up until now, there has been a clarion call to all Australians that we are in a "new normal".

Nevertheless, here we have it. Perhaps we are not yet seeing the expansive impact of the UK's Treating Customers Fairly regime, but these are still important guardrails within which to reshape and simplify the environment.

There is undoubtedly a long road ahead. Hayne himself has acknowledged that it is no simple task. But there is light on the horizon. ●

## To the point

- 76 change recommendations from the Royal Commission into misconduct in financial services industry found conduct falling below community standards and expectations.
- Fund managers must act in the best interests of the organization taking into account long term, sustainable value creation for shareholders by aligning with community standards and expectations.
- Existing laws and regulations to be interpreted by reference to intent, fundamental principles, and behavioral norms.
- Existing fiduciary duties of fund managers reinforced by tougher regulatory stance and increased regulatory sanctions
- New individual accountability regime to roll through the industry.



# The investment revolution?

## What will asset management look like in the future?

### Jervis Smith

Managing Director  
Citi Investor Services  
Luxembourg

Foreseeing the future has always been part of human interaction. Crystal balls, tealeaves, and animal intestines have all been adopted to help the cause, right the way back to Julius Caesar, whose demise on the Ides of March was infamously predicted by his soothsayer!

Predictions that accurate are less common in asset management. I was reminded of this the other day when perusing a review

by a Big Four firm (not Deloitte) written ten years ago called "Asset Management 2020". Knowing I had been asked to write this article, I browsed through in search of gem-like insights, intrigued by how accurate their analysis had turned out to be, now that we are only a year from the end of the period they tried to cover. [➤](#)

When it came to predicting the scale of asset management, they did not do badly:

Prediction	Reality
Total AUM will reach US\$100 trillion	Total AUM US\$94 trillion (end of 2017)
Passive AUM will be US\$22.7 trillion	Passive AUM US\$22.4 trillion

Real-time portfolio data will be cross-referenced to market data and activity to support regulatory oversight of market conduct and product appropriateness.

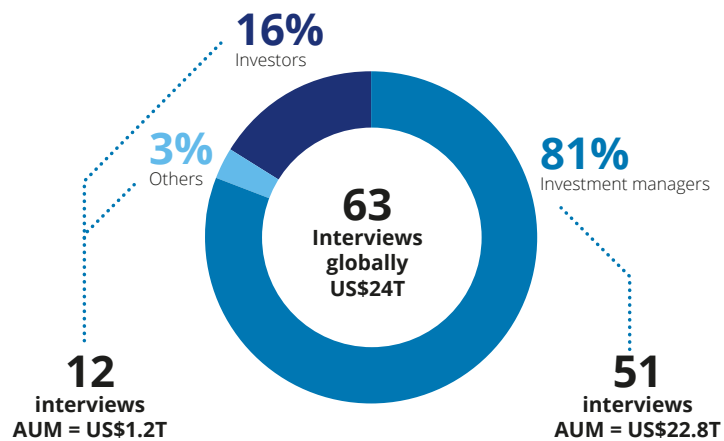
However, when it came to predicting the impact of technology, they proved wildly optimistic:

“By 2020, technology used by regulators may enable real-time access to the investment portfolios of asset managers, either via asset managers or from administrators. Real-time portfolio data will be cross-referenced to market data and activity to support regulatory oversight of market conduct and product appropriateness.”

On this one, there is still some way to go!

My ever-enterprising colleagues at Citi's strategy consultancy in our Markets division have recently published a powerful piece of analysis entitled “2018 Industry Revolution”<sup>1</sup>. This stemmed from face-to-face interviews conducted early in 2018 with over 60 Chief Executives and Chief Investment Officers of investment organizations’ managers and owners (Figure 1: Overview of survey participants.). This was complemented by quantitative data and the perspective from the 500+ annual meetings they have been conducting over ten years.

**Figure 1**  
Overview of survey participants



**Breakdown of interviews by region**



Interviews focused primarily on investment managers as we sought to understand how today's innovation initiatives may reshape the industry. Participants represented 30 percent of global AUM

Source: Citi Business Advisory Services

1. Industry Revolution Series Part II, How today's Innovation Initiatives Could Lead to a Re-Architecting of the Investment Management Industry published by Citi Business Advisory Services

The key findings of this well-researched and fascinating publication were:

**01. Higher conviction:**

Expanded use of real-time inputs is allowing investment teams to build conviction in their thesis more quickly rather than having to wait for an event to confirm or negate their view—this is reducing the “surprise” gap and over time could give an investor a window into a business’s fundamentals that might rival the company’s management view.

**02. More automation:**

Machines’ ownership of the investment decision-making process is extending over a longer time horizon, moving beyond less than 24 hours, into up to three-month strategies as a result of upstream fundamental analysis enabled by quants.

**03. Deeper understanding of returns:**

Improving attribution analysis to understand unique insights and their contribution to performance as opposed to market or systematic impacts.

**04. Growing insight into portfolio processes:**

Efforts are beginning to extend the quantitative approach to downstream investment processes beyond idea generation to include risk, portfolio optimization, and idea sizing.

This higher level of innovation in the investment process has knock-on effects on the distribution and sale of the designed solutions—whether in fund format or in more sophisticated structures.

This higher level of innovation in the investment process has knock-on effects on the distribution and sale of the designed solutions—whether in fund format or in more sophisticated structures.

After 40 years of stability, the past decade or so has seen the emergence of new portfolio models each offering different and distinct theories on how to assemble, manage, and source investment exposures.

**01. Leveraging investment models to create sub-portfolios:**

Product development teams are working with PMs to extract more sub-portfolios from the set of ideas that emerge from the models.

**02. Fund wrappers:**

Product teams want their entire range of portfolios to be delivered in a variety of fund wrappers including a wrapper where they just deliver the results of the portfolio in the form of Intellectual Property.

**03. Combining funds into solutions:**

New multi-asset class solutions are combining the ideas coming out of the investment teams into fund ‘bundles’ that are more akin to institutional portfolios. This appeals to smaller institutions and family offices.

**04. Adapting institutional solutions to meet retail demand:**

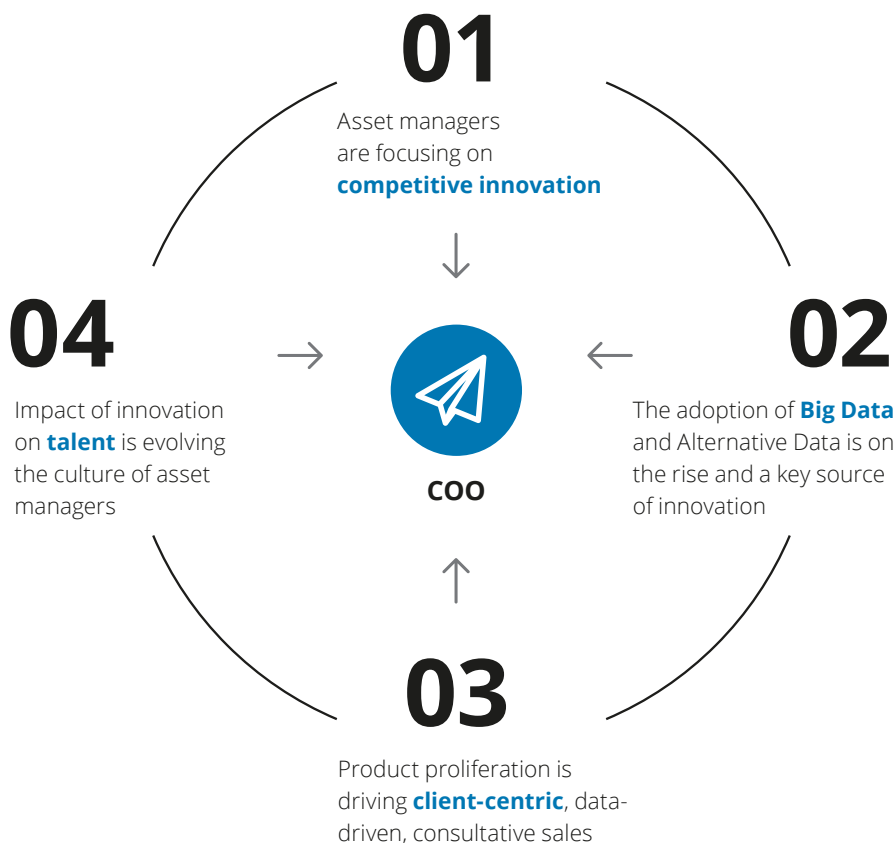
These multi-asset class teams are also redesigning the institutional solutions to be applicable to the required outcomes for individual investors. ➔



What are the key challenges innovation presents to asset managers, or indeed asset servicers?

Figure 2 sums up the issues facing a Chief Operating Officer (COO) of an asset management firm today.

**Figure 2**  
Four impacts of innovation initiatives for the COO to consider



COOs are not so much looking to use new technologies to restructure back office functions, but rather to cope with pressure on the investment process requirements and to meet the need for consultative sales solutions.

There is therefore a need for innovation around data requirements—whether it is mining existing investment data or accessing and processing alternative data. There is the possibility of creating units or tokenization for real and private assets. We hear talk of “corpits” or “ownits” in real assets, for example buying a share in money-spinning operations like the London Eye.

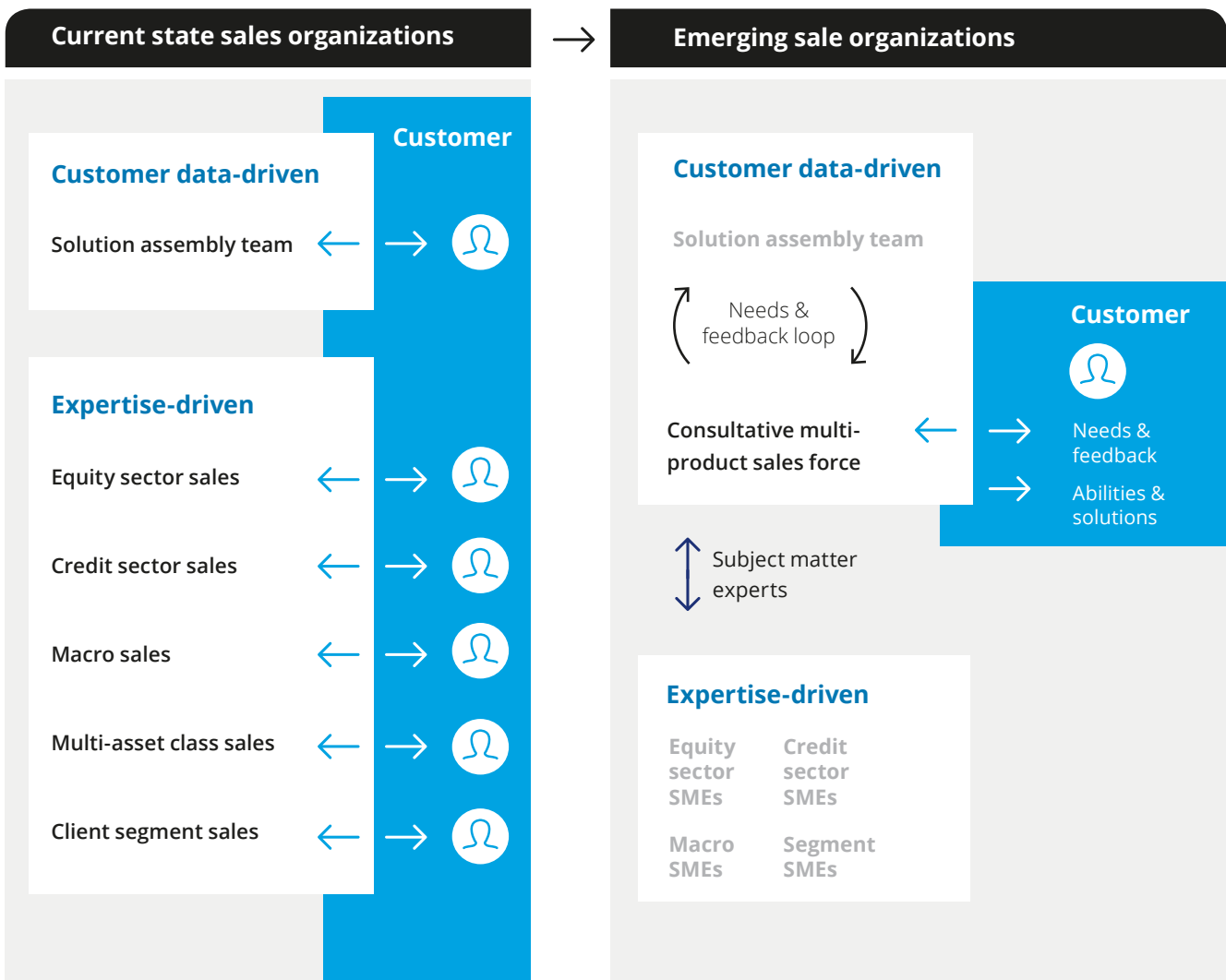
However, in my opinion these innovations present opportunities to solve two aspects of the industry that were in dire need of change—diversity of talent and client centricity.

Firstly, diversity—the changing requirements will, of necessity, bring about a change to the usual recruitment strategies of asset managers and asset servicers. Drawing on software programmers and “data junkies” to assist, and recruits who are sensitive to environment and social issues, for the production of ESG-conforming solutions, are measures that become inevitable and are welcome enhancements to the staid and conservative reputation of asset management.

Secondly, asset management has traditionally been a product-led industry with firms benchmarking their performance against their competitors rather than measuring themselves against their clients’ expectations and desired outcomes. Making the sales organization receptive to the clients’ needs, consultative and hence multi-product, creates a greater capacity to solicit feedback from clients and deliver the firm’s abilities and solutions.



**Figure 3**  
Emergence of consultative sales forces



**Conclusion**

As the content of Performance reflects, there is a plethora of innovation at work in the asset management industry. It starts and finishes with the trends in the investment process that I have sought to summarize. How we benefit from investing and how we access asset classes will be very different in 2030 to how we do it now. Crowd-funding, tokenization, and “corpits” will all be standard practice by then, along with ideas that have not even be dreamt up today.

This wave of change will test our organizations to their limits. The winners will be those who harness the change to further their own ambitions. They will undoubtedly meet setbacks along the path to success. The trick will be to stay alert, hire new talent, embrace technology, and listen to your clients.

As Abraham Lincoln so famously said: "The best way to predict the future is to create it." ●

**To the point**

- Investing in 2030 will be very different from today
- Crowdfunding will be standard practice
- Hire new talents
- Embrace technology
- Listen to your clients

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