

# Performance Magazine

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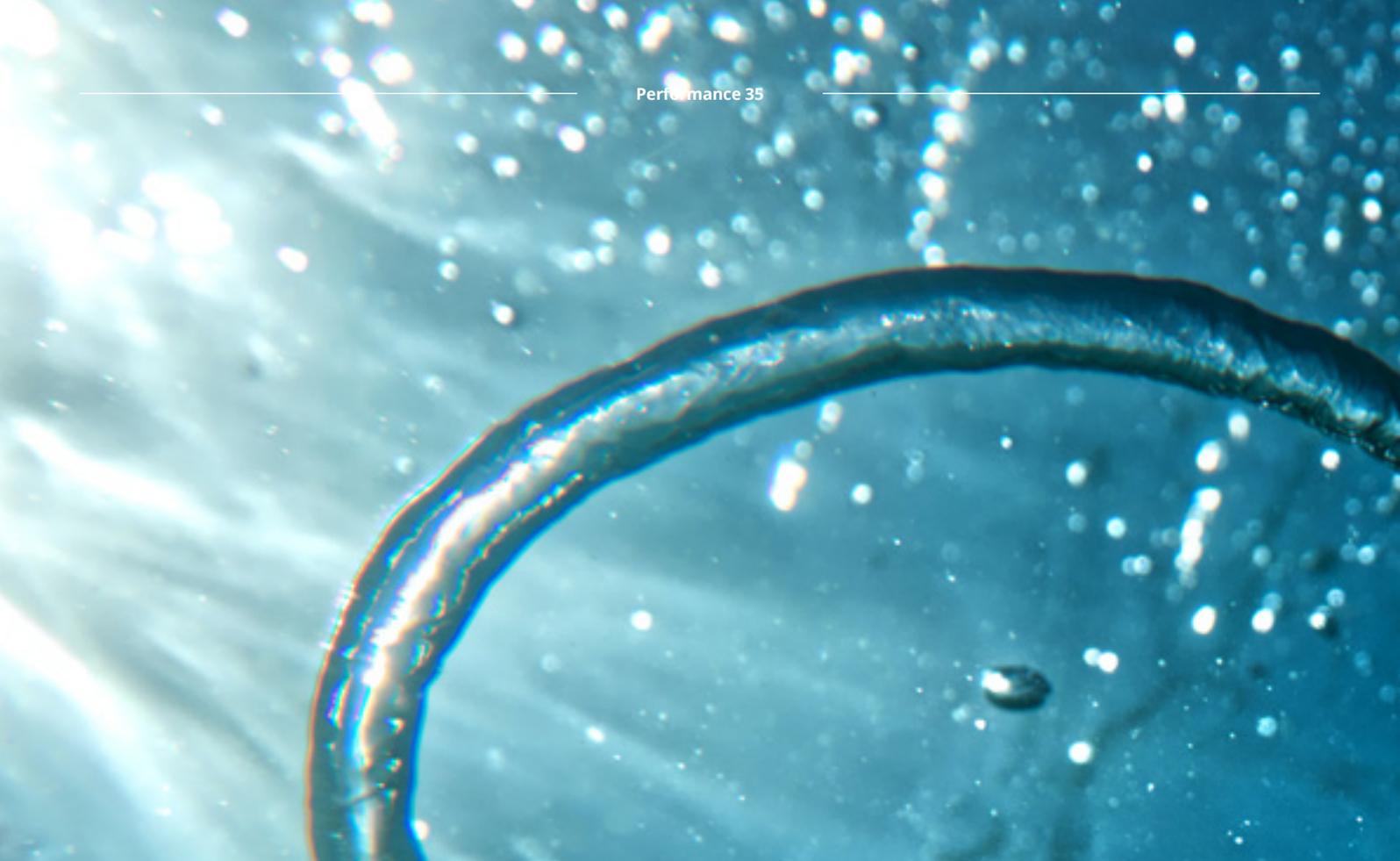


**Deloitte.**



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# FOREWORD



**VINCENT GOUVERNEUR**  
EMEA INVESTMENT MANAGEMENT CO-LEADER  
DELOITTE



**TONY GAUGHAN**  
EMEA INVESTMENT MANAGEMENT CO-LEADER  
DELOITTE

It is ironic to think that in a time when travel eludes many of us, this latest edition of Performance criss-crosses the globe. With contributions from our colleagues in the Netherlands and coverage from Asia to America, as well as insights from closer to home here in Luxembourg, the pages of this, the publication for the investment management industry has taken flight and brings you valuable views from around the world.

In this edition we deep dive into investment management platform providers; their dependence on modular design and visualization in order to succeed, how they are able to address asset managers' business and operational needs, and the clear technology trends that have emerged over this past year. It is the latter that Bas NieuweWeme, CEO of Aegon Asset Management discusses in his interview with Marieke van Eenennaam, Partner, Deloitte Luxembourg. NieuweWeme looks to the future and examines how the advancement of technology will continue to evolve the industry and how, despite the hardships of COVID-19, the pandemic has in fact accelerated his organization's transformation.

NieuweWeme also talks at length about the presence of joint ventures and how

wholly foreign-owned enterprises are widening the market in China. We go into greater detail on this subject in, Opportunity knocks, an article which looks to see how global asset managers can succeed in the country. From focus on investor education to empowering local teams, we identify the five best practices to bear in mind when overcoming the challenges outlined by the Chinese asset management market. Further views and opinions can be analysed in, China isn't emerging; it's returning, a conversation between Claude Hellers of Fundbridge and private investor, David Baverez. Plenty of takeaways and interesting comments to mull over.

A mere couple of pages later and you can land on the findings from Deloitte's 12<sup>th</sup> global risk management survey. The latest in a series

of surveys to assess the industry's risk management practices and the challenges it faces, 57 financial institutions engaged and provided feedback on refocusing risk and resiliency amidst continued uncertainty.

Again, ever-evolving regulations continue to be a high-priority topic of debate. A decade on from the review of AIFMD, what changes are on the horizon Europe's alternative investment fund market? With an evaluation at the end of the year likely pending, we take a look at the potential impacts for the Grand Duchy of Luxembourg and how changes could affect this €5 trillion industry as a while. Meanwhile, March 2021 marked the first milestone of the Sustainable Finance Disclosure Regulation (SFDR) and Deloitte conducted a benchmarking survey and analysis; read on for the

results which uncovered a wide spectrum of approaches by those in the financial market.

In this edition, we also reviewed how the ESMA is promoting a sound pricing governance for investment funds in the EU, and a breakdown of what data really means, its relationship to your organization, and how a comprehensive strategy can be implemented across the board.

As ever, there's plenty of ground to cover. Performance continues to bring its readers an informative appraisal of the latest topics and trends within the investment management industry. This edition seeks to collate global opinion-makers and industry leaders, and bring them to your desk, wherever you are in the world.



# EDITORIAL

In all likelihood, you and other asset management professionals around the world are reading this magazine at home, the place where we have spent most of our working and non-working hours in this past year.

Whatever we think of the world's current situation, one thing it has done is level the working playing field. All the people we usually engage with—from board members to analysts to clients—are predominantly conducting meetings from their home offices whether they're in Brussels or Beijing. Our colleagues, consultants, and clients are equally far away, and curiously near being just one mouse click away. All of them are locked in the same battle against the time zones, struggling to keep sight of the fading boundaries between their professional and private lives.

As challenging as 2020 was, the good news is that, despite the pandemic, asset levels on the whole have held up very well. In 2021, as economies gradually open up and governments phase down their massive support programs, asset managers will need to get their act together to keep their business growing in a shifting landscape.

Fee pressure has been a major factor in the investment

industry for some time now, and market watchers foresee no change in its main drivers: the low-yield environment and technology. In a time when our customers are embarking on digital journeys of their own, our industry, where caution and conservatism are held to be virtues, needs to reimagine itself. It is good to see that some front runners are already doing so, adopting (global) efficient operating models by replacing IT legacy with new technology, using the data at our fingertips.

Ongoing market consolidation is an inevitable part of this process, as size gives more scope to boost efficiency with serious technology investments. Meanwhile, regarding the large players, an increasingly diverse ecosystem is evolving of niche actors, outsourcing partners, and new fintech entrants.

This 35<sup>th</sup> issue of the Deloitte Performance magazine tours the entire line-up. We are delighted to present an in-depth interview with Bas NieuweWeme, CEO of Aegon Asset Management, who is reshaping his company's business units around the world into one efficient and truly global firm, with an eye on market leadership in carefully chosen product niches. These insights from the industry shine a light on the bright, post-pandemic future of asset management. A future all of us cannot wait to be a part of.



**MARIEKE VAN EENENNAAM**  
PARTNER  
RISK ADVISORY - DELOITTE

## PLEASE CONTACT

**Marieke Van Eenennaam**  
Partner  
Risk Advisory

Tel : +31882882500  
Mobile: +31650170945  
mvaneennaam@deloitte.nl  
www.deloitte.nl



# Aegon Asset Management stepping up to the global challenge

**BUILDING A COMPETITIVE INVESTOR**



**MARIEKE VAN EENENNAAM**  
PARTNER  
RISK ADVISORY  
DELOITTE



**BAS NIEUWEWEME**  
CEO  
AEGON ASSET MANAGEMENT

Aegon Asset Management, an active global investor and part of the insurance giant Aegon, has 380 investment professionals and some \$475 billion in assets under management (year-end 2020). The firm is a leading international player, with established units in the US, the UK and the Netherlands and growing activities in China, previously each catering to their own regional markets. But Bas NieuweWeme, CEO since 2019, believes his company can be more than the sum of its parts. His ambition: radically stepping up cross-border teamwork to make distribution and operations truly global.

Marieke van Eenennaam, partner at Deloitte Netherlands, spoke to him at length about the challenges in the current competitive landscape. Client demands in the asset management market are changing. ESG criteria are climbing the priority list in investment mandates, for example. And the hunt for yield in the current low-interest environment is fueling interest in alternative investments. They discuss how the industry is responding

to these challenges and how Aegon Asset Management is transforming itself to meet them head on.

**Q. What are the key changes that you see in the market in terms of client demand?**

**A.** The main driver of change, in my view, has been the low-yield environment we have been in for quite some time now. This has been dampening returns on traditional equity and fixed income investments. With returns lower, the fees of active asset managers have come under increasing scrutiny. This

environment has offered a perfect breeding ground for passive asset managers, who base their investments on an index rather than on active research, engagement and conviction. In the past five to ten years, with their low-cost asset management products, passive asset managers have captured quite a bit of market share among pension funds and high net worth individuals – at the expense of 100% active managers like Aegon Asset Management. With demand for active asset management softening, competition has

become fiercer and fees have been under tremendous pressure. Meanwhile, costs for asset managers have been rising, too, for example costs for people, and so have investments in the latest technology and compliance, as regulation has become increasingly rigorous post 2008. This combination has squeezed operating margins. Luckily our industry is healthy, and that has cushioned the blow.



**Q. How has the growing importance of ESG affected these dynamics?**

**A.** Lately, the shift in the market from active to passive asset management seems to be slowing down. This may be due to the recent uptick in US capital market rates, but I think ESG is a significant factor here. More and more corporations are committing to making their operations carbon-neutral by 2050 or even 2030. Once CEOs and CFOs have signed up for sustainability, this sentiment trickles down to the pension funds. Dutch and Nordic pension funds have always been front runners in integrating environmental, social and governance standards into their investment policies, but now more and more funds in the UK and mainland Europe are joining their ranks. Even in the United States, where I spent twenty years of my career, the ground is shifting. Five years ago, if I even mentioned ESG, I would be accused of being a tree-hugger, but these days American asset managers are coming to realize that they have to get on board, otherwise they can no longer compete for assets in Europe. Right now, European competitors have a ten-year head start on them. In catering to ESG-minded clients, active asset managers have an edge over passives. ESG data is still relatively patchy in coverage, particularly for fixed income universes, and subject to interpretation. Correlation between different ESG data providers' scores is low, which means there is value to be obtained in uncovering and interpreting ESG data yourself. That is our approach as an active manager – to fully

integrate ESG into our bottom-up fundamental research process.

**Q. While assets under management are traditionally concentrated in Europe and America, the focus of economic activity and investment flows is shifting eastwards where markets are vibrant, but also less mature and less transparent. What does this mean for asset managers?**

**A.** China is now the world's second largest asset management market, behind the US, and this initially closed market is gradually opening up. For example, Chinese regulators now allow foreign asset managers to acquire majority stakes in joint ventures with wealth management banks or mutual fund companies. And today there is even such a thing as a wholly foreign owned enterprise (WFOE). So, the options for playing this market have widened spectacularly, and all the large asset managers have recently been building a presence there. Aegon was an early mover, though. In 2008, we partnered up with the Chinese brokerage firm Industrial Securities, buying a 49% stake in Aegon Industrial Fund Management Company Limited (AIFMC), which is now a top-10 asset manager in China in terms of effective AuM and has won the country's Golden Bull asset manager award 11 times in the last 13 years. We contribute our extensive knowledge of ESG, manager selection, portfolio construction and risk management. AIFMC caters mainly for retail clients, but we also have our eye on the up-and-coming pension market. To further support the China efforts, last year we received

regulatory permission to set up a WFOE (Wholly Owned Foreign Enterprise) and we are now in the process of applying for a QDLP (Qualified Domestic Limited Partnership) quota, which will allow us to market offshore (European and US-made) products to Chinese high net worth clients.

We contribute our extensive knowledge of ESG, manager selection, portfolio construction and risk management.



**Q. Aegon Asset Management has decided to ride these trends, given your new strategy to grow your business and specifically to “build a globally competitive asset manager”. Can you tell us more about your strategy? How cost-driven is it?**

**A.** When I joined Aegon Asset Management, it was made up of two regions, one in Europe and one in the US. We were using three different brands. But in a market where margins are under pressure, companies need to be extremely efficient. So, the key strategic imperatives we saw were to avoid duplication of efforts and to fully align our operations. You cannot afford to work with a few different risk management systems, with two different front office systems, with analysts in three different locations analyzing the same company. So last year, we brought all our activities under a single brand, Aegon Asset Management, retiring TKP Investments in the Netherlands and Kames Capital in the UK. We appointed one

global management board. Furthermore, we created four global investment platforms: Fixed Income, Real Assets, Equity and Multi-Asset & Solutions. Every employee in the original regions that worked with bonds is now part of the global fixed income platform. All our equity analysts across markets now work together in the global Equity platform. And so on. We call this “Investing Beyond Borders”. The next step was aligning our back and mid-office. We are making that a global platform as well. Simplifying and consolidating the technology systems is a two-year process, and we are now in our first trimester. The result will be one front office system, one risk management system, one client reporting system and one accounting system. All state of the art. The number of applications we use will drop from 330 to 170, with two third-party vendors playing a key role in our processes. For this massive project, we have hired two external providers who are supporting us globally.

This is going to significantly lower our cost levels over time, plus enhance our service to clients, which is absolutely necessary to operate in today’s tough market at a competitive price.

**Q. What is the timeline for this project?**

**A.** We developed our plan in 2020, chose our providers before the end of that year and started implementing in 2021. We expect to complete the project by the end of 2022.

**Q. What will the transition mean for employees? How do you keep them motivated?**

**A.** During the transition, we still have to keep operations going, so we added 60 new people to help us implement the new systems and maintain business as usual. Existing employees were very excited at the opportunity to be part of the project team, and help implement this leading technology. The front office people are just thrilled to be switching. That said, we are all

human and sometimes hesitant for change, but with extensive training and coaching we will make sure our workforce gets comfortable with the new situation. Last year, in parallel with the IT upgrade, we moved away from the existing regional structure to a truly global one. So, a UK fixed income employee will be working for the Global Fixed Income platform, for instance, rather than the UK country unit. We will be seeing a lot more cross-selling across regions. We have just sold our first European Fixed Income product to a client in Canada and a UK manufactured Equity product in Korea and Brazil. This is proof that global works! I believe the new global model will not only boost our revenues, but also create a more inspiring and dynamic working environment.

**Q. How will clients benefit from these changes?**

**A.** A benefit our clients will immediately notice is far faster reporting. Currently, they receive our investment reports between 5 and 25 days after month’s end. When the new system goes live, the main reports will roll in on business day one or two of the following month. Overall, we will be delivering faster, better quality service at lower cost, and we will be able to sustain this in the years ahead, offering our clients continuity.

**Q. For clients, what differentiates your firm from other global asset managers?**

**A.** First of all we are active asset managers. We seek an information advantage over other investors in the market with our proprietary research





and engagement, which enables us to outperform an index (in other words, create alpha). But what gives us an edge over our competitors in the active management segment is that we are part of the global insurance giant Aegon. We manage their general accounts, \$150 billion in assets, as well as around \$320 billion for external clients. This means we can build on Aegon's infrastructure, human resources and financial strength. Developing and launching new products is a lot easier when you have a parent company with sizable investment portfolios that can seed or co-invest alongside external clients. That money helps us to build a track record and attract external clients faster and with more confidence. We have the luxury that we can partner with Aegon's insurance investment portfolios to jointly develop products that they can co-invest in along with our external clients. External clients

are very comfortable with this set-up. They like the fact that we are putting our money where our mouth is.

**Q. Which product niches are you targeting?**

**A.** This year alone, we will be launching four new products - with co-investments from Aegon's insurance investment portfolios - in the illiquid, alternative fixed income space. Two in the US and two in Europe. This is a market niche where yields are higher and passive managers cannot compete. Institutional clients are prepared to give up some liquidity to get a little more yield in a growing part of their investment portfolio. For example, we repackage and sell Dutch mortgages originated by our parent Aegon, but also SME loans. Pension funds and insurers in the Netherlands were eager to get on board, and others in the rest of Europe are buying this paper-Dutch mortgages - now, too. And we are talking to Asian

investors as well. Real Assets is another illiquid asset class that produces higher yields and is hard for passive managers to replicate. Aegon's general accounts make investments, and we are able to leverage that for third-party clients in agriculture lending, commercial mortgage loans and workforce and affordable housing. This has given us a differentiating position in the US in particular. Traditional equity and fixed income, by contrast, are easier for passive managers to replicate, so to stand out in that crowded space we focus more and more on products with an ESG or sustainable angle. We have an edge over our Anglo-Saxon rivals in this corner of the market, thanks to thirty years of ESG investing experience and a 15-people strong dedicated responsible investing team with very highly skilled experts. Last year we launched four responsible investment products, including a Sustainable Equity and Fixed Income fund in the US,

an ESG HY fund and in the Netherlands the Global Equity Impact Fund, developed in partnership with the Dutch bank ABN AMRO. Just recently, we received the Insurance Asset Risk Award 2021 in the Investment Innovation category for the development of the Aegon Global Sustainable Sovereign Bond strategy, and we are transforming our Global Diversified Growth fund to a sustainable mandate.

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In all three markets, we offer employees the opportunity to work in one of our global teams, interacting with colleagues in the next office or the next continent.

**Q. What differentiates you for employees? What is your edge in the battle for talent?**

**A.** Currently, about a third of our staff is based in the Netherlands, a third in the UK and a third in the US. In all three markets, we offer employees the opportunity to work in one of our global teams, interacting with colleagues in the next office or the next continent. A lot of people enjoy that global energy. Also, our focus on sustainability is highly attractive to today's university graduates, who are done with old paradigms and

keen to make a difference. In line with that mindset, I am proud to say we appointed a Global Head of Diversity and Inclusion last year as well.

**Q. You mentioned regulatory compliance, along with salaries and technology, as a key cost driver for asset management companies. Will compliance get any easier with Aegon Asset Management becoming a global company?**

**A.** We engage primarily with the SEC in the US, the FCA in the UK and the AFM in the Netherlands. They oversee our

local legal entities. Following the launch of our WFOE in China, we also have dealings with the Chinese authorities. As we engage in more cross-selling between our markets, this certainly adds complexity. Take for example the EU's recent Sustainable Finance Disclosure Regulation (SFDR). It is unclear whether the UK and the US are going to more or less copy this legislation or introduce something different. The UK Stewardship Code is already demanding comprehensive reporting that is quite different to that demanded by the EU legislation. Our best chances of staying compliant globally may be to just apply SFDR, the strictest set of rules in today's market, to all our global activities. It would be so much easier, though, if there was a global regulator. I sometimes dream about helping to establish one before I retire.

**Q. What does the competitive landscape for Aegon Asset Management look like? Who are your key competitors?**

**A.** For every asset class we bring to market, we have a different competitor. In Dutch mortgages, local Dutch players are close on our heels, but we are still the largest. In the US commercial real estate market, our rivals are US insurance affiliate asset managers. In the UK, our global sustainable equity product faces other competitors. One of the aims of going global is to help us cross-sell our products between regions, and that is already gaining momentum. I do not necessarily see other global asset managers like J.P. Morgan as our key competitors. This has a lot to do with our

heritage. We happen to be the asset manager of Aegon Asset Management, the assets of which we invest in the US and Europe. Aegon is also a huge originator of Dutch mortgages. We have built our strategy around who we are and where we come from. We are trying to leverage our global footprint and our global distribution channels to play in market niches where we have an edge and can differentiate ourselves. In the traditional large-cap equity space, there are four hundred asset managers looking for business. Good luck trying to convince a pension fund they need to hire you as opposed to one of your competitors. If you focus on ESG, then the credible competition becomes much smaller. Because we have a big insurance company behind us, we can also compete in the alternative investment space, where we are up against just a handful of players. The trick is to narrow the competitive landscape by differentiating yourself.

**Q. Looking back on the past year, has the fallout of the COVID-19 pandemic slowed down your transformation?**

**A.** I can hardly believe it myself, but in hindsight, I think it has actually been an accelerator! All 1250 of our employees were working from home, behind their screens. And they found to their surprise that interacting with colleagues in other regions was just as easy as with their usual office companions. COVID-19 has actually helped us build a global culture and enhance teamwork between time zones.

**Q. Where do you see Aegon Asset Management in five years?**

**A.** In 2026, I see us as an active manager that has made very clear choices where we do and do not want to play. Our key markets geographically will still be the US, the UK, Europe and China, because that is where we are now investing. Product-wise, I believe we will be leaders in the alternative fixed income space, in the real asset space and in the responsible

investment space for both equity and fixed income. With a smoothly operating global franchise.

**Q. And what about the market as a whole? What changes do you foresee in the years ahead?**

**A.** Advances in technology are likely to change the way asset management firms operate. Artificial intelligence and blockchain technology will change the way we invest money. They will also change the way retail and high net worth investors access the market. We are already seeing investment apps flooding the market, and they are lowering the threshold for consumers to start investing. Another trend fueling growth in the asset management market is that people will not be able to rely on governments and pensions for their retirement. They need to start accumulating wealth on their own, through personal investing rather than savings. We can help here. This will tip the balance towards investing

and away from savings, where the asset management industry can be a partner.

**Q. Do you expect any of the alternative strategies emerging in the asset management industry today to create the kind of problems we saw in the financial crisis of 2008?**

**A.** I think the industry has learned a lot from the financial crisis. About disclosures, about Know Your Customer (KYC) and about confirming whether your investors rank as sophisticated enough for the products they are investing in. The bar is much higher for an asset manager now to onboard a client for an illiquid investment, and rightfully so. There are far more checks and balances than there were before 2008. Meanwhile, the industry has also invested significantly in compliance and risk management professionals to monitor product development and distribution. The investment risks are fully disclosed to our clients, to ensure they understand the trade-off between liquidity, risk and return, as it should be.

**TO THE POINT**

- With significant AuM in China, NieuweWeme explains how allowances in foreign asset managers ability to acquire majority stakes in joint ventures and the presence of a wholly foreign owned enterprise have widened the market—and how Aegon Asset Management gained an early advantage.

- Despite the hardships created by the COVID-19 pandemic, it has in fact accelerated Aegon Asset Management's transformation as it builds its position as a globally competitive asset manager.
- Looking to the future, NieuweWeme discusses the advancement of technology in the evolution of the industry and what the future holds for investment over savings – and how the AM industry is here to help.



# INVESTMENT MANAGEMENT PLATFORM PROVIDERS

**ARE PLATFORM PROVIDERS READY TO ADDRESS ASSET MANAGERS'  
EMERGING BUSINESS AND OPERATIONAL NEEDS?**



**MARIEKE VAN EENENNAAM**

PARTNER  
RISK ADVISORY  
DELOITTE



**PHILIPPE HIJAZIN**

DIRECTOR  
CONSULTING - IM & PERE  
DELOITTE



**DAAN BROEKHUIJSEN**

SENIOR  
CONSULTING  
DELOITTE



**ABRAM STEWART**

SENIOR  
CONSULTING - IM & PERE  
DELOITTE



**COEN VAN DEN BRINK**

JUNIOR  
RISK ADVISORY  
DELOITTE



Before the health crisis of 2020 threw global markets into turmoil, asset managers were already grappling with systemic changes in their industry and were conducting a detailed review of their product suites and operating models. In many ways, COVID-19 has brought the impetus for change to the fore, but the main themes still remain: margins are under pressure from the rising prevalence of passive management and cost pressures remain strong due to increasing regulatory demands.

As competition intensifies, asset managers will face increasing pressure to consolidate in order to achieve scale across profitable strategies while shedding non-core products. In-line with multiple high profile mergers within the asset management space, asset servicers are also expanding

their functional offering in order to appeal to a wider audience of managers by servicing the mosaic of needs created from these mergers.

An added evolution is the fact that alternative investments are playing an increasingly important role in even 'traditional' strategies,

requiring a higher level of integration with systems and processes—and not every asset manager is well-equipped to face these changes alone. However, one vital piece of their infrastructure provides the means to strategically orient their firms: the Portfolio Management System (PMS).

**Asset managers are responding by adapting their operating models**

In December 2020, Deloitte produced a survey covering the market’s leading PMS providers. The objective of the survey was to investigate PMS’ ability to meet asset managers and asset servicers’ business and operational needs along the front-to-back value chain. The PMS underpins every aspect of an asset manager’s operations, from originating trades and managing portfolios, to supporting risk management and client reporting. Having a clear, long-term, strategic view is essential when considering PMS selection, as well as the spectrum of functionality within the various platforms. Many asset managers are revamping their data-warehousing and servicing models to position themselves for future growth opportunities by pivoting away from on-premise legacy systems—which weaves in demands from the PMS itself. We see a main trend towards managed services with an overall emphasis, but not exclusivity, on application service providing (ASP) and software as a service (SaaS) models due to the technological and operational advantages of that service. While some PMS providers still service clients with on-premise installations, they strongly advocate for new clients to accept ASP/SaaS offerings. As such, a fundamental change to the target operating models involves time and resources. Offering additional managed services is a useful facilitator for on-premise clients; addressing cost (both for client and provider) on the

one hand and preparing for SaaS transformation on the other. Some PMS providers also position business process outsourcing (BPO) solutions as a way for asset managers to outsource non-core operations, while ensuring that these operations are supported by the underlying data and infrastructure of the PMS.

Asset managers are increasingly shifting to cloud-based services as they concentrate their resources on servicing their core mission and PMS is no exception. Even though PMS offered through the cloud appear to have become an overall standard, the level of applied cloud technologies and the maturity of related architecture varies between providers. Managing end-points in commercial clouds is important to integrate with cloud-savvy customers, while native investment management participants provide their PMS solutions within a private cloud, making the hosting aspect less relevant.

Asset managers are increasingly shifting to cloud-based services as they concentrate their resources on servicing their core mission and PMS is no exception.

Asset managers are also consolidating service providers across the value chain to streamline operations and reduce expenses. They increasingly value specialized skillsets that match the scope of their products. The PMS serves as a conduit to integrate front-to-back office operations, provides one single source of truth and improves the overall investment decision-making process. By moving away from an ecosystem which encompasses multiple best-of-breed applications towards a target operating model (TOM) with integrated PMS functionality, asset managers are able to reduce recurring expenses and the complexity that arises from managing

multiple vendor relationships. Transformational shifts such as these motivate asset managers to reinforce their data capabilities. While data may be structured or unstructured and may come from non-traditional sources, a key differentiator is the ability to aggregate and normalize the data. PMS providers are acutely aware of this, with four of our survey participants offering separate data management solutions. Ensuring the flow of data across the PMS and other specialist systems is crucial in facilitating smooth daily operations—allowing managers to focus on getting the most out of their funds.

**Figure 1**  
**Profitable growth investment managers make greater strategic investments into distribution, transformation and outsourcing**



### How Portfolio Management Systems fit in

Let us take a closer look at how aligning the correct PMS with the asset manager's unique needs unlocks value. First, the PMS provides a bedrock of data management capabilities across the Order Execution Management (OEM), Investment Book of Record (IBOR) and Accounting Book of Record (ABOR) systems. The OEM is a core functionality and a universal must-have that clients don't want to spend time questioning. The depth of pre-integrated brokers and venues is a point of interest, as well as the ability to add further connectivity post-deployment. The IBOR serves as the single source of truth on which all other functions are based. All PMS providers have a data-centric approach and allow for the enrichment of the data model with additional customer-specific data. The ABOR is not a universal offering, as accounting functionality is occasionally outsourced to MO/BO actors.

When it is a native option, it is fed data by the IBOR.

For most solutions metadata administration functionality is provided, however the level of coverage varies. Sophisticated solutions implement a fully-fledged data framework that can cover the flows alongside the whole value chain and can interrogate data at all levels. Apart from a large library of existing checks, any client-specific requirement could be integrated. PMS leaders come up with an enterprise-wide metadata driven data model. Authorization and configuration management seems to be a common focus, whereas the provision of relationships and calculation dependencies is an extended approach. All PMS have data quality checks in

## BPO oriented vendors are able to take care of the data correction on behalf of the client.

place, but not all vendors allow customers to modify the rule sets. BPO-oriented vendors are able to take care of the data correction on behalf of the client.

Risk management has arguably never had a more important seat at the table of asset managers' steering committees. The PMS permits managers to not only test the impact of hypothetical trades on their live portfolios,

but to slice and dice their strategies' holdings across new risk metrics ex-ante. We found that native risk analytics and customizable stress tests are limited in most PMS (though select leaders have a robust offering of historical and customizable tests built-in).

Existing calculations are rudimentary (yield curve, spreads, market volatility,



inflation) although the spectrum varies. Most solutions prefer to populate risk figures via external engines through APIs. Another key problem for asset managers is understanding their cumulative exposures to a sector, asset class, volatile security, etc. Aggregate views vary in quality and depth and the ability to provide this insight is a key differentiator. Once live portfolios are being monitored, compliance workflows based around notifications and breaches vary in completeness and synchronization—differentiating solutions in their ability to provide timely reports. The best solutions offer clean visualizations of current and past incidents so that risk officers can partner with portfolio teams to identify recurring issues and correct processes in short order.

Due to the increasing regulatory burden faced by investment management actors across numerous geographies, PMS focus a great deal of attention on the depth of their compliance functionality. The ideal state is to offer an engine which permits asset managers to rapidly adapt their compliance protocols for any jurisdiction where they currently do business, or where they might plan future distribution of their funds. As such, leading PMS allow compliance officers to set and modify rules directly in the PMS without any programming knowledge. All providers have recognized this approach is a “must have” as asset managers focus their risk staff on their core roles and dual risk-programming profiles are exceptionally rare.

When it comes to managing strategies, portfolio managers require flexibility around key functionalities to adapt the PMS to their needs. This includes customization of different views and analytics. Pivoting from portfolio view to trade to risk, for example, should be a seamless experience. Among the PMS on the market today, dashboards and aggregated graphical depictions of the portfolios vary in style and functionality, with a focus on the ability to customize and save “views” after initial set-up. It must be mentioned that the user experience within different PMS varies widely: tabular designs, Excel-based systems and even terminal connections are a few examples of these frameworks.

Portfolio managers increasingly rely on look-through functionality to provide a means to further scrutinize funds, alternative investments and securities by their underlying constituents; however, this leading analytical approach is not available across all providers. Leading offerings also provide the same tool for cash flow analysis—with a focus on liquidity within and across strategies. Cash forecasting and liquidity management are growing in importance among asset managers as a means to better understand their liquidity risk in volatile markets. In this context, few providers offer fully integrated solutions providing historical and projected cash positions, as well as reinvestment capabilities.

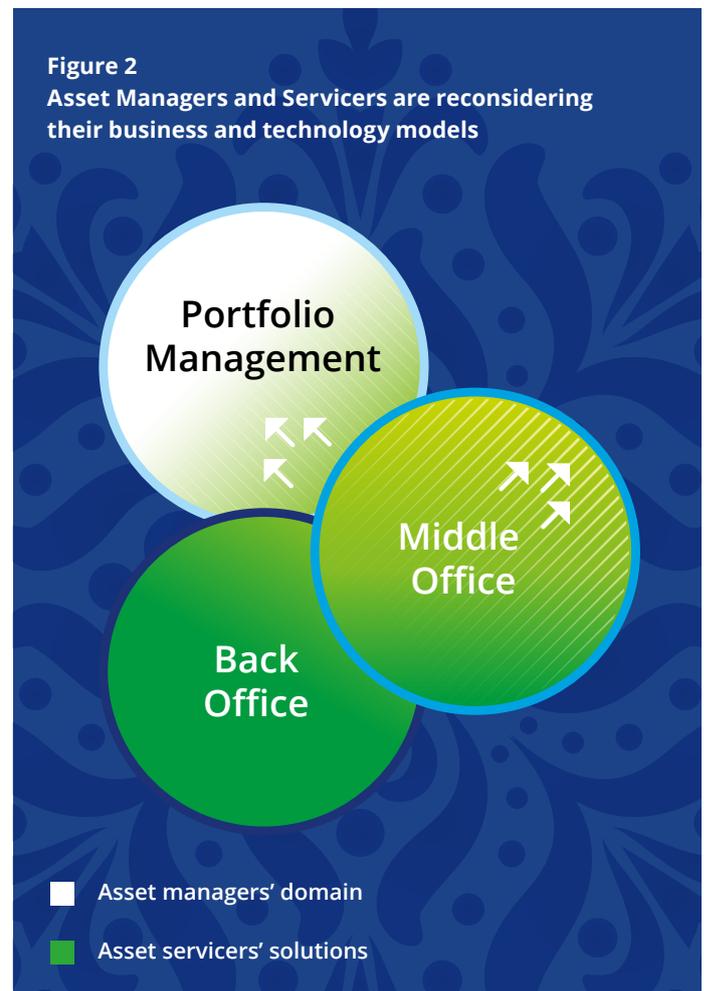
The ambition of PMS providers is to integrate all key front, middle and back office functions in one solution. All providers understand the importance of data apart from a pure operational data store perspective and either have an enterprise wide consistent data management solution in place as an integral part of their solution or offer their own additional data warehousing modules with different scopes. All PMS offers reviewed by Deloitte include integration with the operational data store, allowing for an easy data synchronization with the core product(s). Furthermore, the inclusion of external sources

is mostly offered, as solutions facilitate the downstream usage of data (e.g. for system feeds, reporting tools). In some cases, the upstream application(s) can leverage the EDM capabilities and use it as a proxy for data feeds, data quality and integration. An interesting consideration for CIOs is that some EDMs are source system agnostic and could provide additional benefits and synergies within the overall IT architecture of the asset manager.

**PMS providers’ future success**

The proposed solution’s success is dependent on

**Figure 2**  
Asset Managers and Servicers are reconsidering their business and technology models



integrating appropriate modules and furnishing robust data to execute the client’s portfolio strategies. Four focus areas in particular are likely to predict the future success of PMS providers.

Deloitte found that five out of six PMS providers believe clients prefer integrated solutions. All six surveyed providers believe that an open architecture model where modular functions are seamlessly integrated into the client’s operational process is the best approach. A software system with modular design is aimed at subdividing a system or operating model into smaller divisions. Independent interchangeable solutions for these separate components are provided and integrated, which, together, serve the desired system. The advantage of this method is that standard capabilities can balance and support out-of-the-box connectivity. To help clients achieve this ideal operating model and to offer them a sample of their platform’s capabilities, four PMS providers in our survey offer “sleeves” or modular components of their integrated solution—allowing for a smoother transition from one system to another.

Secondly, data visualization will provide insight in what information is available, possibly by using web-based tools, without the need of external engines. Data analysis is used to provide context from the data, but also in finding the common threads. Intuitive, customizable visuals embedded in the user interface are not yet universal, however they go a long way in allowing

portfolio managers to gain insights as they run their various investment strategies.

By combining the previous components with agile data delivery, a continuous flow of relevant information is provided to ensure high-quality insights for customers. Not only are data flows streamlined, but the physical implementation of the PMS is delivered in an agile format as well. Agile delivery not only ensures learning from the data and the correct prioritization, but also provides agility when the client environment changes and lessons learnt need to be applied. Reprioritization of backlogs can be optimized by applying agile data delivery.

The fourth area is the integration of the PMS by providing an easy-to-use system for the clients’ core operation. This ensures a system where the modular designed components of different providers and/or asset servicers collaborate, increasing the use of pre-integrated systems to offer a smoother onboarding experience. With a unified core PMS in place, asset managers are better able to focus on their core activities of responding to market activity and developing their pipeline of products.

Partnership and teamwork are at the center of the strategy of platform providers. The collaboration between asset managers and asset servicers are evolving along three trends. First, the asset servicers now go beyond the back office activities and offer services for middle and some front-office activities.

The servicers also develop technologies themselves or cooperate through strategic partnerships. As such, asset managers increase focus on portfolio management and outsource an increasing share of front- and all middle- and back office functions to reduce fixed costs. Asset servicers leverage these strategic PMS partnerships to unlock added synergies and value for their asset management clients by unifying workflows between the two agents within the same

system. The third trend involves asset managers bringing in new technology and advancing the cooperation of internal infrastructure with vendor systems, as well as optimizing efficiency and effectiveness of management of operations. As PMS providers establish more strategic partnerships with asset servicers, they demonstrate the depth of their systems’ capabilities and more easily lock clients into their ecosystem.

**Deloitte PMS Survey**

Aladdin by BlackRock  
Bloomberg AIM  
IHS Markit  
Profidata  
SimCorp  
Alpha by State Street

Holistic analysis of the entire Investment Management value chain including both functional dimensions and technical capabilities.

**Deep-dives**  
Strategies | Partnerships | Trends | Solution Roadmaps



**TO THE POINT**

- To cope with reshaping trends, platform providers plan to reinforce their focus on data, risk and portfolio management.
- From a technology standpoint, BPO and SaaS have emerged as clear trends and cloud offerings have become the overall standard.
- Platform providers’ future successes depend on their focus on modular design, data visualization, agile delivery and integration.



**CHEE HOONG TONG**  
HEAD OF APAC  
CASEY QUIRK - DELOITTE



**BEN F. PHILLIPS**  
CHIEF STRATEGIST  
CASEY QUIRK - DELOITTE



**SHARON LEUNG**  
SENIOR CONSULTANT  
CASEY QUIRK - DELOITTE



**LYDIA ZHU**  
CONSULTANT  
CASEY QUIRK - DELOITTE

# Opportunity knocks

## HOW GLOBAL ASSET MANAGERS CAN WIN IN CHINA

Foreign managers have long been enticed by the vast potential of the Chinese asset management market, but until recently have faced significant regulatory barriers. The “11 measures” introduced by Chinese regulators in 2019 made great strides in removing these barriers, and foreign asset managers can today, from a regulatory standpoint, access all client segments in the Chinese market.

However, while these regulatory barriers have been removed, foreign managers still face significant challenges when looking to enter the Chinese market. China remains a unique and strongly domestic market, and foreign managers need to navigate a wide range of challenges from unique investor preferences to a lack of distribution network.

While firms are rushing to take advantage of the regulatory relaxation, there is still no clear formula for success and building a real presence in China requires heavy investment. In the paper *Opportunity knocks: How global managers can win in China*, we cover the recent regulatory changes and subsequent market entry options for foreign firms, and identify five best practices for foreign firms looking to pave a path to success in China:

- 1) Invest in regulatory relationships;
- 2) Focus on investor education;
- 3) Exploit opportunities in digital distribution innovation;
- 4) Identify a differentiated product or value proposition; and
- 5) Empower local teams.

Asset management firms globally have faced several challenges in recent years that include slowing organic growth, fee pressure and increasing costs. In this world

of increasingly challenging economics, China continues to stand out as the only at-scale asset management market with continued double-digit organic growth. Consistent with

the conclusions of our paper *Leadership in Times of Plenty* back in 2017, we expect China to be the world's second-largest market by 2022 and to reach about USD10 trillion by 2025.

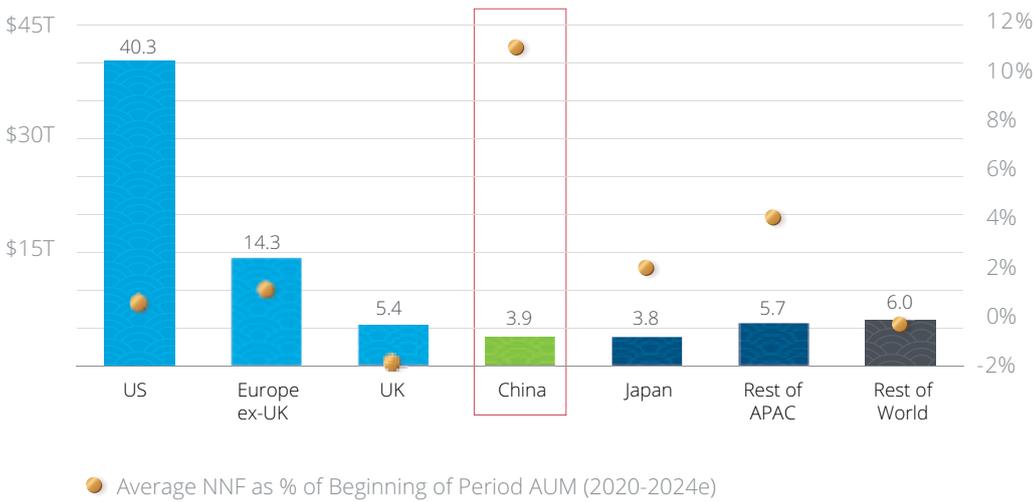
For the first time, foreign managers were allowed to fully own FMCs, with access to all client segments.

**Exhibit 1**

**China is the only at-scale market globally that will experience double-digit organic growth...**

**Global vs. China assets under management (AUM<sup>1</sup>) & net new flows (NNFs)**

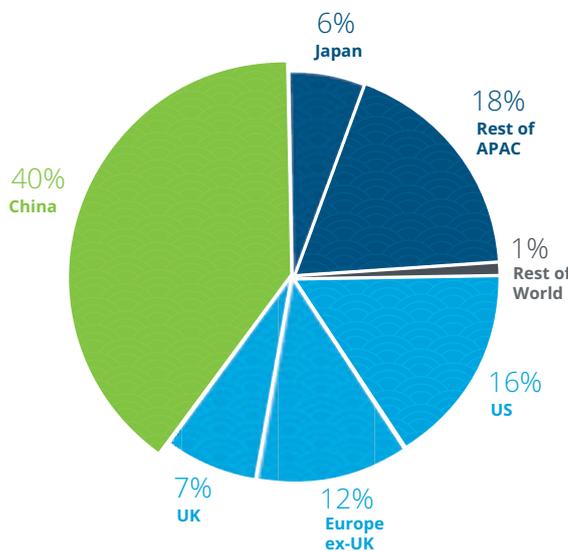
By Region, 2019 AUM in USD \$T, 2020-2024e average NNF as % of BoP AUM



Foreign asset managers have been interested in the China opportunity for decades, and many have long-established footprints in the country. Until recently, however, regulations strictly limited foreign managers' participation in the Chinese market. Foreign managers have generally established presences in China either via a minority joint venture (JV) with a local fund management company (FMC) or a wholly foreign-owned enterprise private fund manager (WFOE PFM)—both of which held significant limitations.

**...accounting for 40% of new assets globally over the next 5 years**

**5-Year Cumulative NNF**  
By Region, 2020-2024



In 2019, the Chinese government introduced 11 measures that delivered substantial opportunities for foreign asset managers. For the first time, foreign managers were allowed to fully own FMCs, with access to all client segments. The government also encouraged newly established wealth management subsidiaries (WMS) owned by domestic banks to partner with foreign managers.

Source: Casey Quirk Global Demand Model, Casey Quirk Analysis

1. Externally managed AUM

**Exhibit 2**

The 11 Measures announced by the Chinese government in 2019 open up new routes for foreign managers to access China's asset management market ...

**New routes for foreign managers after the 11 Measures**



**WFOE FMC**

Foreign asset managers can fully own fund management companies from April 2020

**Wealth Management Subsidiary**

Foreign asset managers can now establish majority-owned JVs with wealth management subsidiaries



**Insurance Asset Management Companies**

Foreign firms can set up its wholly-owned insurance asset managers, and will no longer be limited to 25% ownership

**Securities Asset Management Companies**

Foreign firms can take 100% ownership of a securities firm and apply for a wholly-owned securities asset management company

Source: 11 Measures

**Exhibit 3**

...effectively, foreign managers now have unfettered access to all segments of the market

**China AUM<sup>2</sup> by asset manager type**

2019E, %

**Addressability for foreign managers**

	Pre-11 Measures	Post-11 Measures
<b>Bank WMP</b> 35%	Not addressable (X)	Addressable through a majority owned JV (✓)
<b>FMC</b> 32%	Ownership capped at 51% (○)	Addressable through a WFOE FMC (✓)
<b>Private Equity &amp; Venture Capital</b> 15%	Addressable through WFOE PFM (✓)	Addressable through WFOE PFM (✓)
<b>Insurance Asset Management</b> 7%	Ownership capped at 25% (X)	Addressable with no cap on ownership (✓)
<b>Securities Asset Management</b> 6%	Ownership capped at 51% (○)	Addressable with no cap on ownership (✓)
<b>Private Securities Firms</b> 4%	Addressable through WFOE PFM (✓)	Addressable through WFOE PFM (✓)

Source: Casey Quirk Global Demand Model, AMAC, WIND, NSSF, China Wealth, IAMAC, CICC, HWABAO Securities, Casey Quirk Analysis

2. Externally managed AUM, excludes principal guaranteed WMP, trust asset manager, futures asset manager, and other private fund licenses



The path to success in China will be a long and non-linear one, with foreign firms facing constant uncertainties throughout the journey. Also, as no stories of true success by foreign asset managers yet exist, achieving growth in China means covering largely uncharted territory, and firms will have to accept the risks and uncertainties that accompany the potential rewards.

China is a long-term play, and foreign managers wishing to reap the vast potential of its market must also accept the significant resource expenditure required. Post-COVID-19 resources will likely be more constrained than before, and not all firms will have the appetite to take on the cost of tackling the Chinese market.

In 2017, our team published the whitepaper *Leadership in times of plenty: Future winners in China's asset management industry*, where we estimated that foreign firms will account for 6% of the market by 2030. The penetration of foreign firms will remain limited, but those choosing to commit to the market today will likely be rewarded handsomely for addressing the substantial market opportunity that China brings.

Although there is no silver bullet, five “good practices” can help foreign firms differentiate themselves, reduce risks, and maximize their chances of success.

### 1) Invest in regulatory relationships

Regulatory relationships are key in China, so developing a strong relationship with regulators should be a priority for any foreign manager looking to establish a presence in China. These include the China Banking and Insurance Regulatory Commission (CBIRC), China Securities Regulatory Commission (CSRC), People's Bank of China (PBOC) and State Administration of Foreign Exchange (SAFE).

As licensing conditions can be difficult to interpret and regulators can have unspoken rules, cultivating relationships with regulatory bodies can not only help managers navigate a challenging regulatory landscape but also expedite licensing approvals. In our experience, regulators such as the CSRC and CBIRC, in line with new policies, are

increasingly operating an open-door policy where they are very willing to have ongoing dialogue and communication with foreign managers.

Leading foreign managers have gone beyond developing these regulatory relationships to helping regulators form new regulations as the Chinese asset management market develops. Leading foreign managers have been discussing pension reform with Chinese regulators for years, including introducing tax benefits for pension contributions. As regulatory barriers recede, Chinese regulators have often rewarded managers that have shown a commitment to the market with first access to licenses. Therefore, it is not difficult to imagine that firms that contribute to shaping the pensions landscape will also be among the primary beneficiaries.

**2) Focus on investor education**

Foreign managers have chased the large, high growth mass affluent and high net worth channels for years, but Chinese investors have different preferences and expectations from their global counterparts. China is marked by high churn, with investors historically chasing short-term, attractive yet unsustainable market returns over products with long-term financial goals. Investor preferences have also been shaped by the existence of the wealth management product (WMP) market, which historically provided high guaranteed returns.

However, as the WMP market declines and the asset management market continues to mature, Chinese investors will shift towards longer-term, more solutions-based investing. Leading foreign managers are investing substantial resources in educating retail investors in a variety of investment topics, from retirement to environmental, social and corporate governance (ESG), through leading digital channels such as WeChat and Ant Financial. Foreign managers should leverage these digital channels to drive investor education, but also consider innovative new channels, such as providing financial literacy education in universities and high schools.

**3) Exploit opportunities in digital distribution innovation**

In a market where domestic brand names and distributors dominate, it is difficult for foreign managers to achieve large market shares without forming strong distribution relationships. Bank partnerships are the obvious place to start, as local banks have long dominated the Chinese mutual fund distribution space. But competition is tough, with shelf space highly competitive and often dominated by banks' own products. Foreign managers will have to show the distinct value propositions they offer.

Foreign managers can also consider independent wealth managers and growing digital channels. Online third-party distribution channels (e.g., Ant Financial) have revolutionized this space in recent years, but until recently have largely been confined to money market fund distribution. Foreign managers can capitalize on the opportunity to grow market share through

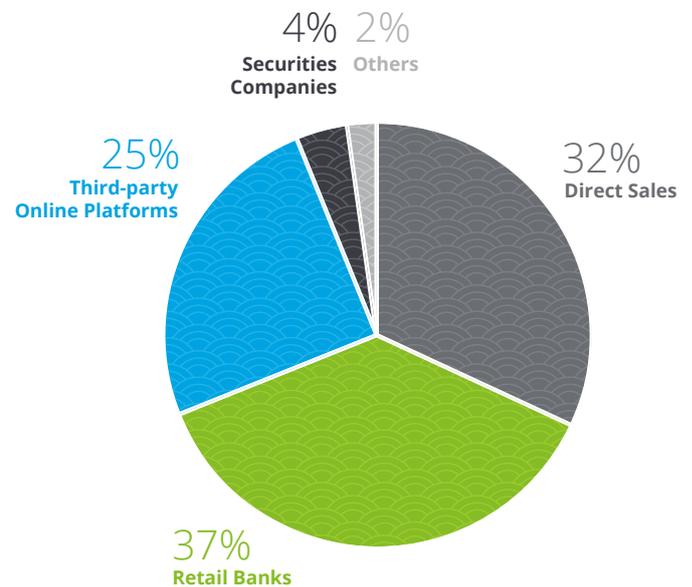
**For the first time, foreign managers were allowed to fully own FMCs, with access to all client segments.**

**Exhibit 4**

**The growing importance of third party online platforms gives foreign managers a viable alternative distribution channel to win new flows by innovating outside of bank-controlled distribution models**

**Share of mutual fund AUM by distribution channel**

2019, % of mutual fund AUM



Source: Casey Quirk Analysis

online platforms, which have reached 25% market share in mutual funds and are expected to only increase in popularity. The growth of third-party distribution channels allows foreign managers to bypass bank networks and can provide interesting wealth advisory partnership opportunities.

Foreign asset managers, especially those familiar with open-API environments, are in an advantageous position as they can leverage data and technology to redefine the relationship between asset managers and clients. China has a unique digital ecosystem, so while these foreign asset managers have a potential head start, they will need to adapt their approaches to this specific market environment.

#### 4) Identify a differentiated product or value proposition

Foreign managers often struggle to differentiate in China's domestic market, where investor preferences are vastly different from their home markets. It is tempting to first establish a presence before thinking about differentiation, but having a unique differentiator is critical to the success of foreign asset managers in the Chinese market.

Given the historical quotas limiting access to the onshore market, foreign managers are unlikely to have strong track records in managing domestic products. In addition, China has cultivated its own investment manager brands and stars, and foreign branding carries little weight when it comes to domestic products.

This retirement fund opportunity could be the key competitive differentiator that so many foreign firms struggle to find in China.

The product areas in which firms seek to differentiate will vary. Foreign managers have an edge on certain product sets, including overseas investment, retirement funds, smart beta and ESG.

#### Overseas investment

This has always been an obvious area of differentiation for foreign managers, although strict capital controls have made it extremely challenging to gain new quotas. However, with the continued demand for overseas allocations and confidence in China's currency, there are signs the qualified domestic (QD) investor quotas will be expanded. Although the size of new QD quotas is uncertain, it is likely to be small compared to the overall market. Nevertheless, any fresh issuance of QD quotas by SAFE will provide a distinct space in which foreign managers can differentiate themselves from their domestic counterparts.

#### Retirement funds

The pension space is another area in which foreign managers can differentiate. The CSRC approved its first target-date funds in 2018, and the market has seen strong growth in these products since then. The high growth third pillar pension market is only in its infancy—it will likely see enormous growth in the coming years as regulators potentially introduce tax incentives and other measures to boost penetration.

Foreign managers hold a distinct competitive advantage in the retirement space across accumulation and decumulation product development, tax incentives, client servicing, risk management, and digital engagement for long-term investment. This retirement fund opportunity could be the key competitive differentiator that so many foreign firms struggle to find in China.

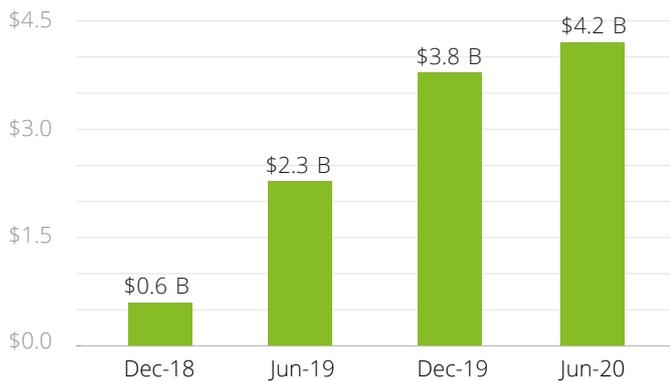


**Exhibit 5**

**Foreign managers have an edge in capturing the rapid growth of China’s retirement market**

**Size of target date retirement funds (TDRF)**

December 2018 – June 2020, USD billion



Source: WIND, Casey Quirk Analysis

**5) Empower local teams**

Asset management is a people-first business, so attracting and retaining the right talent is key to any firm’s success. China’s pool of local talent with the experience and language capabilities to navigate local and foreign management styles is small and highly sought after. A lack of brand exposure or scale can also hinder foreign firm’s recruitment efforts, so firms will have to find other incentives to attract the right people.

Some foreign asset managers have often long-established presences in China. However, although China is often a stated key objective, local teams usually hold little power and face layers of management between key decision-makers at corporate headquarters. This creates a disconnect between management teams with decision rights (often at global or regional headquarters) and local teams with essential

knowledge of China’s unique market. This disconnect results in inefficient and inaccurate decision-making, which will only become more prominent as foreign firms begin to ramp up their presence in China.

Hiring the correct management in China with strong local knowledge is a priority for foreign managers, but the benefits of a strong local team cannot be reaped if they are not empowered. Local management should be granted direct access to fund managers’ executive committees and sway over large business decisions such as budgets. Day-to-day management of local entities should be completely under the control of local management.

An empowered local team can also help foreign managers address talent recruitment and retention issues—local teams will be more incentivized if they are part of a business in which

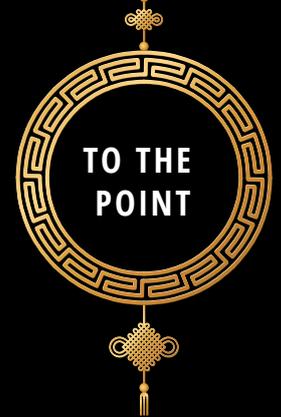
they have the ownership to build, rather than an outpost that is far from the center of activity.

**CONCLUSION**

The recent regulatory changes in the Chinese asset management market have granted foreign players unprecedented market access. Foreign firms now have attractive options at their disposal, from establishing an FMC to partnering with a newly established wealth management subsidiary. However, while regulatory barriers have been removed, foreign managers will still face a wide range of challenges when looking to penetrate this unique and strongly domestic market.

With the current market dominated by local players, there is no clear path to success for foreign players. Establishing a real presence in China is a formidable task that requires patience, agility, and considerable resources. As foreign firms pave their way in China, they should keep these five best practices in mind: building regulatory relationships, investing in investor education, exploiting digital distribution, identifying a value proposition, and empowering local teams.

The Chinese asset management market is vast, growing and constantly evolving, and foreign managers that position themselves for success today are likely to reap great rewards in the future.



Regulators have opened up the Chinese asset management market to foreign players in recent years, but key challenges remain for those who want to build a profitable franchise in this market. As global asset players move beyond their immediate focus of gaining regulatory approval, we have identified five best practices they should bear in mind to allow them to win in China:

- 01 Invest in regulatory relationships;
- 02 Focus on investor education;
- 03 Exploit opportunities in digital distribution innovation;
- 04 Identify a differentiated product or value proposition; and
- 05 Empower local teams.





**J.H. CALDWELL**  
PARTNER  
GLOBAL FINANCIAL SERVICES  
RISK ADVISORY LEADER  
DELOITTE



**BOB CONTRI**  
PARTNER  
GLOBAL FINANCIAL  
SERVICES INDUSTRY LEADER  
DELOITTE



**ANNE CELNER**  
PARTNER  
GLOBAL BANKING AND  
CAPITAL MARKETS LEADER  
DELOITTE



**NEAL BAUMANN**  
PARTNER  
GLOBAL INSURANCE LEADER  
DELOITTE



**CARY STIER**  
PARTNER  
GLOBAL INVESTMENT  
MANAGEMENT LEADER  
DELOITTE



# A moving target: Refocusing risk and resiliency amidst continued uncertainty

FINDINGS OF DELOITTE'S 12<sup>TH</sup> GLOBAL RISK MANAGEMENT SURVEY

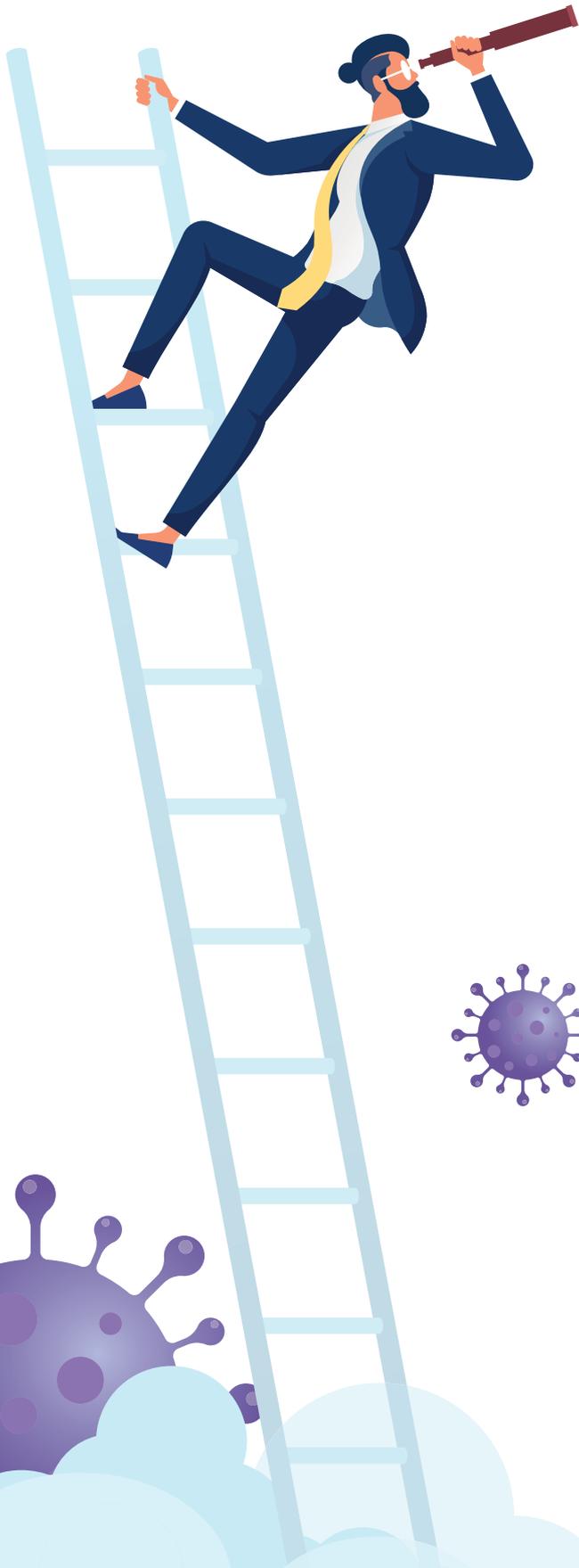
The impact of COVID-19 on financial institutions, the economy, and ways of working has had broad implications for risk management. But how have the industry's risk management functions responded and where do they go from here?

When respondents were asked to name the most important issues they expected to face over the next two years, these included global financial crises (48%) and global pandemics (42%).

In 2020, as the world grappled with the COVID-19 health crisis, financial institutions' risk management faced challenges of a scale and scope that has never been seen before. The measures taken by governments, businesses, and consumers to hold back the spread of the novel coronavirus triggered a sharp economic downturn and far-reaching social impacts.

COVID-19 has also had a direct financial impact on financial institutions. The economic contraction significantly increased credit risk from both retail and commercial customers, and many institutions responded by tightening credit standards. There also may be a greater risk of fraud resulting from the misuse of customer data, invoicing for work not completed, or collusion with disreputable third-parties.

The 12<sup>th</sup> edition of Deloitte's global risk management survey was conducted from March to September 2020 during unprecedented times. When respondents were asked to name the most important issues they expected to face over the next two years, these included global financial crises (48%) and global pandemics (42%).



The pressure on revenues is likely to intensify many institutions' drive to reduce their ever-increasing risk management expenditures. Several key risk management trends emerged from the survey results:

- Increasing credit risk.** As credit risk concerns typically peak during economic contractions, it is no surprise that 20% of respondents named credit risk as the most important risk type for their institutions over the next two years, with 62% stating credit risk measurement will be an extremely or very high institutional priority.
- Greater focus on nonfinancial risks.** While almost all respondents rated their institutions as extremely or very effective at managing financial risks, the figure dropped to 65% for nonfinancial risk overall and even lower for specific types and aspects of nonfinancial risk. Many institutions have work to do to enhance their capabilities in this area.
- Continuing concerns over cybersecurity.** While institutions have already faced cyberattacks for several years, the threat has only grown with many employees working from home. Only 61% of respondents considered their institutions to be extremely or very effective at managing cybersecurity risk, and 87% said improving their ability to manage cybersecurity risk will be an extremely or very high priority over the next two years.
- Addressing third-party risk.** Third-party relationships present a distinctive set of risks including data privacy, nonperformance, unethical conduct, and the loss of business continuity. However, only 44% of respondents rated their institutions as extremely or very effective in managing third-party risk.
- Spotlight on environmental, social, and governance (ESG) risk.** As concerns over climate risk grow and focus on the social responsibility of business increases, 47% of respondents said it will be an extremely or very high priority to improve their institutions' ability to manage ESG risk, including climate risk.
- The potential of digital risk management.** There has been a growing recognition of digital technologies' potential to reduce risk management expenses while simultaneously boosting effectiveness. However, despite their expected benefits, most institutions have not yet implemented these technologies.
- Substantial challenges of risk data management.** Leveraging emerging technologies requires comprehensive, high-quality, and timely risk data. But many institutions continue to struggle to obtain this data, especially for nonfinancial risks. In this regard, most respondents said their institutions found two issues to be extremely or very challenging: maintaining

As concerns over climate risk grow and focus on the social responsibility of business increases, 47% of respondents said it will be an extremely or very high priority to improve their institutions' ability to manage ESG risk, including climate risk.

reliable data to quantify nonfinancial risk and drive risk-based decisions, and the ability to leverage and source alternative data such as unstructured data.

- **Clarifying the three-lines-of-defense model.**

All the institutions surveyed use the three-lines-of-defense risk governance model, but many reported significant challenges, especially concerning the responsibilities and capabilities of the first line (business and functions).

- **Greater focus on stress testing.** Most respondents reported that their institutions employed stress tests for capital and for financial risks such as liquidity, market, and credit. However, even though regulators are now expanding stress tests to include nonfinancial risks like climate, only 38% of institutions reported conducting stress tests for nonfinancial/operations risks.

- **Continued progress on risk governance.** At the board of director level, 72% of respondents said that one or more board committees are responsible for risk oversight, which is a

sign of progress in effective governance. Eighty-seven percent reported that their board risk committees have independent directors, and 82% stated these committees have one or more identified risk management experts.

- **Universal adoption of the chief risk officer (CRO) position.** The percentage

of institutions with a CRO position or equivalent has increased over the course of Deloitte's global risk management surveys, and all participants in the current survey reported having this position. However, the CRO is not always given the appropriate authority to effect change.

## CONCLUSION

Risk management functions will need the flexibility to respond quickly to volatile economic conditions and changing work practices, while continually monitoring which changes are either temporary responses to the pandemic or are destined to become permanent.



## TO THE POINT

The 12<sup>th</sup> edition of Deloitte's global risk management survey is the latest in an ongoing survey series that assesses the industry's risk management practices and the challenges it faces. The survey was conducted from March to September 2020 and 57 financial institutions around the world took part.

# A naturally intelligent approach to investing

HOW AI TECHNOLOGIES ARE IMPROVING  
MAN-MACHINE COMMUNICATION  
WITH NATURAL LANGUAGE PROCESSING



**DILIP KRISHNA**  
MANAGING DIRECTOR  
REGULATORY &  
OPERATIONAL RISK  
DELOITTE



**DOUG DANNEMILLER**  
SENIOR MANAGER  
DELOITTE CENTER FOR  
FINANCIAL SERVICES  
DELOITTE

## HUMAN AND MACHINE LANGUAGES CONVERGE

People communicate using a variety of somewhat subjective tools—words, tone, facial expressions, posture—while machines communicate with clearly defined labels and quantities. This incompatibility has challenged those aiming to effectively integrate the two realms in order to enhance decision-making processes. Fortunately, a branch of artificial intelligence has recently reached a sufficient level of sophistication to potentially close the gap.

The emerging capability in natural language processing and natural language generation (NLP/G) creates an opportunity to enhance the process that is the lifeblood of all active investment managers: the investment decision process.<sup>1</sup> These technologies have many applications across industries and functions, of course, but this article will explore how investment firms are beginning to use NLP/G in idea development, at the investment decision point, and in portfolio report creation.

1. Larry Cao, AI pioneers in investment management, CFA Institute, September 30, 2019.



### RELEVANT NLP/G CAPABILITIES

Basically, NLP technologies enable machines to translate unstructured data, such as voice and video, into structured data with labels and quantities that machines can readily process.<sup>2</sup> Completing the loop, NLG can create conversations and written reports from structured data that look and feel like human-created responses and prose.

Now, consider the investment decision process. NLP can decipher, connect, and merge disparate data sources into a common platform; it can also normalize data to

enable comparisons and connections—a critical step that securities analysts traditionally perform. The NLP advantage? It can vastly expand the volume of information that can be considered. The sources can be from regulatory filings, analyst reports, e-commerce activity, speeches, video, geolocation data, and satellite imagery. Basically, any information that can be linked to an industry, company, or economic activity has the potential to be source data for the investment process—and NLP can process more of it than any group of humans. This technology can

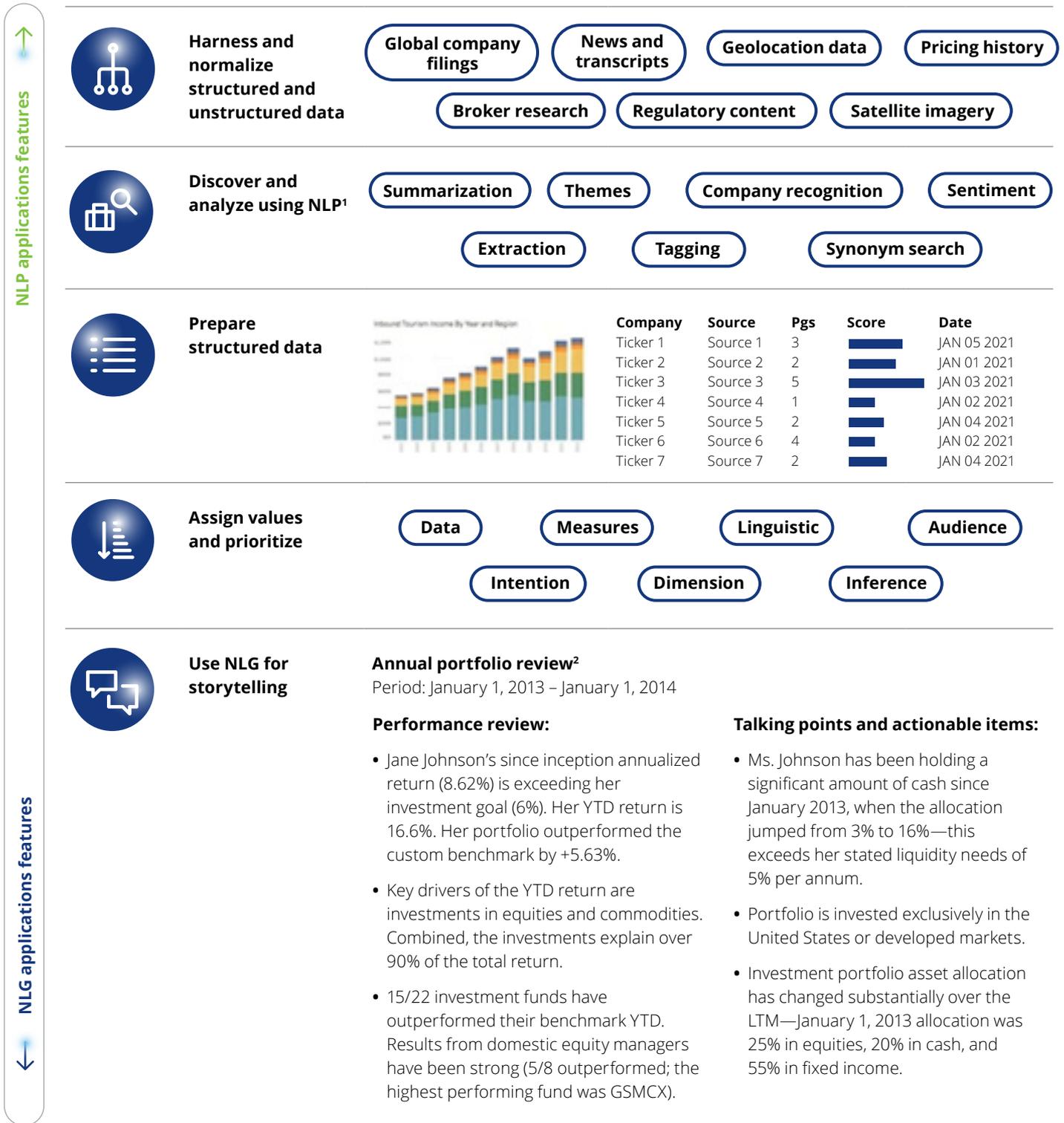
harness unstructured data and convert it to structured data that can then be used for further analysis or read by other machines. NLP can also normalize and merge structured datasets.

NLG platforms can turn machine-readable or structured data into human-understandable stories; it can even customize stories for specific audience and linguistic requirements.

NLG can create conversations and written reports from structured data that look and feel like human-created responses and prose.

2. William D. Eggers, Neha Malik, and Matt Gracie, Using AI to unleash the power of unstructured government data: Applications and examples of natural language processing (NLP) across government, Deloitte Insights, January 16, 2019.

**FIGURE 1**  
**NLP platforms convert unstructured information into structured data; NLG turns this data into stories**



<sup>1</sup> AlphaSense      <sup>2</sup> Narrative Science

Sources: Discussions with NLP and NLG solution vendors; subject-matter specialist discussions; Deloitte Center for Financial Services analysis

Figure 1 illustrates the refinement path of investment data using NLP/G. NLP's primary function is to convert unstructured data into structured data that can be utilized by analysts or read by other programs, such as AI decision engines. NLP performs this function by recognizing patterns in the data relative to known patterns or data elements such as dates, ticker symbols, numerical values, dictionaries, and report title codes. A subsequent stage of processing in NLP creates new data elements based on the patterns that are discovered. This stage is where tagging and scoring of patterns in the data occurs. These two types of data allow a system to generate easily comprehensible tables and charts.<sup>3</sup>

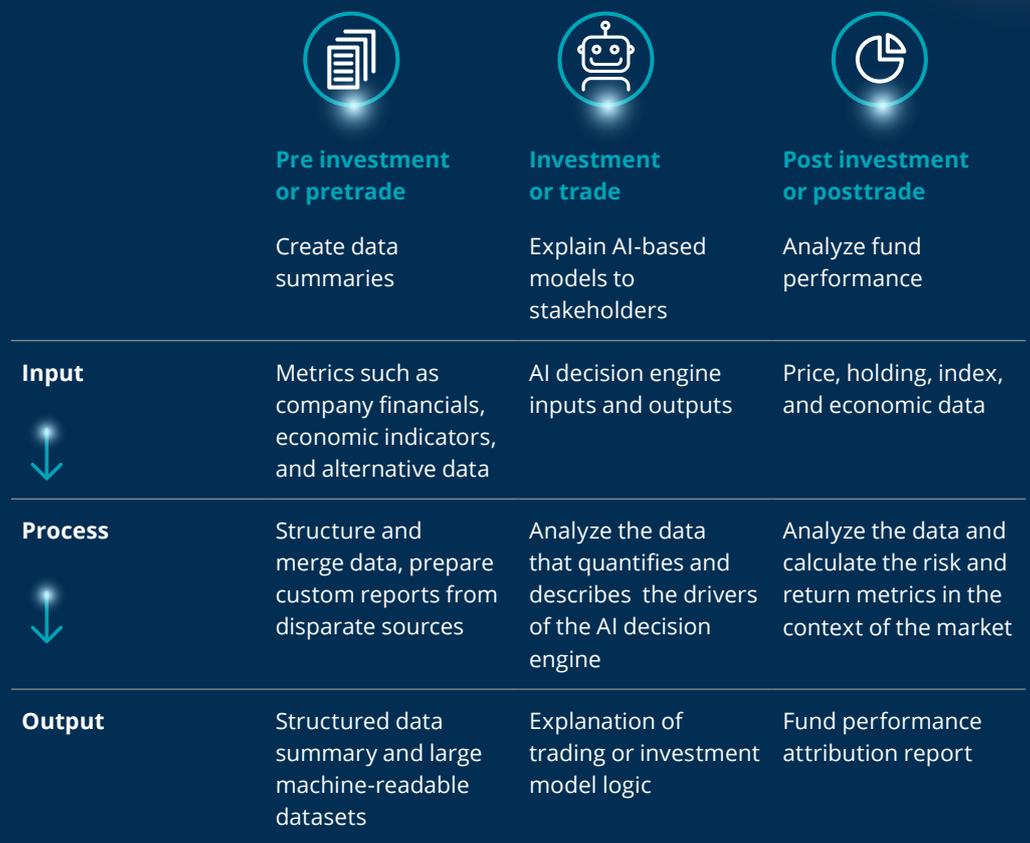
Assume you have the audio and video data from the last decade of quarterly earnings calls of a particular industry's leading firms. NLP can find patterns in the word choice, tone, and facial expressions; then it can create themes and scores based on the relationships among the data elements for each company. At this stage, analysts can readily work with the information or feed it into an AI investment decision engine, to be considered with other datasets, to arrive at buy/ sell/hold ratings for securities. The final step in the refinement path is to add NLG features such as linguistics and intentions to the data, enabling the machines to complete a loop by creating what appears to be human-created prose that is completely data-driven and unbiased.

### NLP/G PLATFORMS MAP INTO THREE AREAS OF INVESTMENT DECISION-MAKING IN VARIED WAYS

With this basic understanding of what NLP/G does, let's dive deeper into how this technology can apply to the investment decision process. Firms may utilize NLP/G differently depending on the stage in the process: NLP/G can support information gathering and curating pretrade, AI decision engine oversight for AI-supported trading, and portfolio and performance reporting posttrade (figure 2).



**FIGURE 2**  
NLP/G applications across the investment decision process



Sources: Discussions with NLP and NLG solution vendors, subject-matter specialist discussions, Deloitte Center for Financial Services analysis.

3. Discussions with NLP solutions vendors

## PRETRADE PHASE

The goal in the pretrade phase is to surface and evaluate investment ideas. Analysts, without the aid of AI, spend significant time identifying, searching, sorting, and organizing relevant information. A survey of 450 research analysts found that they spend roughly two-thirds of their time, on average, collecting and understanding data before knowing whether the information is material.<sup>4</sup> NLP/G can do much of that work for them by digesting and merging structured and unstructured datasets, seeking themes and patterns in the data, and assigning scores to the discovered relationships. Research analysts recognize the technology's potential to generate new opportunities: 45% of surveyed research analysts expect their roles to be substantially different in five to 10 years.<sup>5</sup>

Indeed, many expect technology to reshape the pretrade workstream. AlphaSense, Sentieo, Yseop,

A survey of 450 research analysts found that they spend roughly two-thirds of their time, on average, collecting and understanding data before knowing whether the information is material.<sup>7</sup>

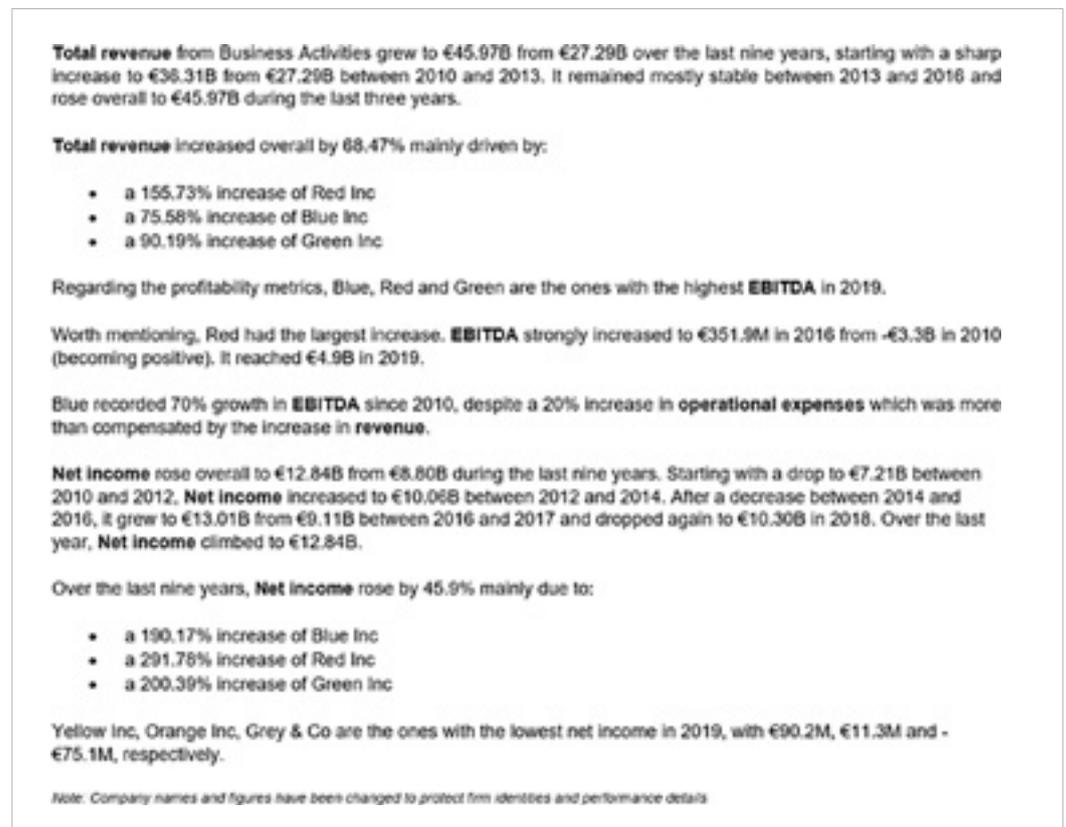
and other maturing service providers in the pretrade phase offer Software-as-a-Service solutions for the investment analyst function; they have NLP/G technology at their core and have recently been enhancing their applications to support remote collaboration among analyst teams. Users can feed various file formats and set the parameters for a standard report, based on the data in the files—for example, figure 3 is an automated output

from Yseop, synthesizing the past 10 annual financial statements for 15 public firms in the same industry. Analysts can feed quarterly data, customize the data fields, and specify the analysis to perform, and templates can be saved and enhanced over time.

Implementation of these technologies has the potential to significantly reduce the time analysts spend collecting and

understanding data without even knowing whether the information is valuable.<sup>6</sup> Analysts would still spend their time analyzing, but the shift would be to working with data that has higher potential for insight. To adopt a mining analogy, NLP/G performs a refining step that concentrates the ore before analysts spend time on evaluation.

**FIGURE 3**  
Sample machine summary of industry financial performance



Source: Yseop

4. FundFire, "Managers ready more automation, AI and data science for 2020," accessed January 28, 2021.

5. CFA Institute, "Investment professional of the future," May 2019.

6. FundFire, "Managers ready more automation, AI and data science for 2020."



### INVESTMENT DECISION POINT PHASE

The objective in this phase is to arrive at a buy, sell, or hold decision. NLP/G do not perform these tasks—a portfolio manager does it either directly or with the aid of an AI decision engine—but NLP/G can help in this phase by writing the story of an AI-supported decision. Proprietary technologies subject data to a series of shocks or stress tests to explain the drivers of an AI decision engine, including investment engines, and NLP/G can process the combined input and decision data to produce a standard unbiased report explaining the decision, including potential contrary factors. Portfolio managers can use this story to review and approve or reject the trade or to manage and update AI decision algorithms. Firms can use it to report to portfolio managers, clients, or regulators on the drivers or the why of the trade.

NLP/G do not perform these tasks—a portfolio manager does it either directly or with the aid of an AI decision engine—but NLP/G can help in this phase by writing the story of an AI-supported decision.

For clients and regulators, the firm can use the technology to demonstrate understanding and control of the trading algorithms—they can tell the why of every trade, objectively. In this phase, NLP/G acts as a support technology to the decision, as opposed to the AI component that directly performs the investment decision.

### POST INVESTMENT PHASE

NLP/G technology is most mature in the post investment phase, with applications already in use at some large investment management firms. Because portfolio and index performance are naturally structured data, NLP/G engines

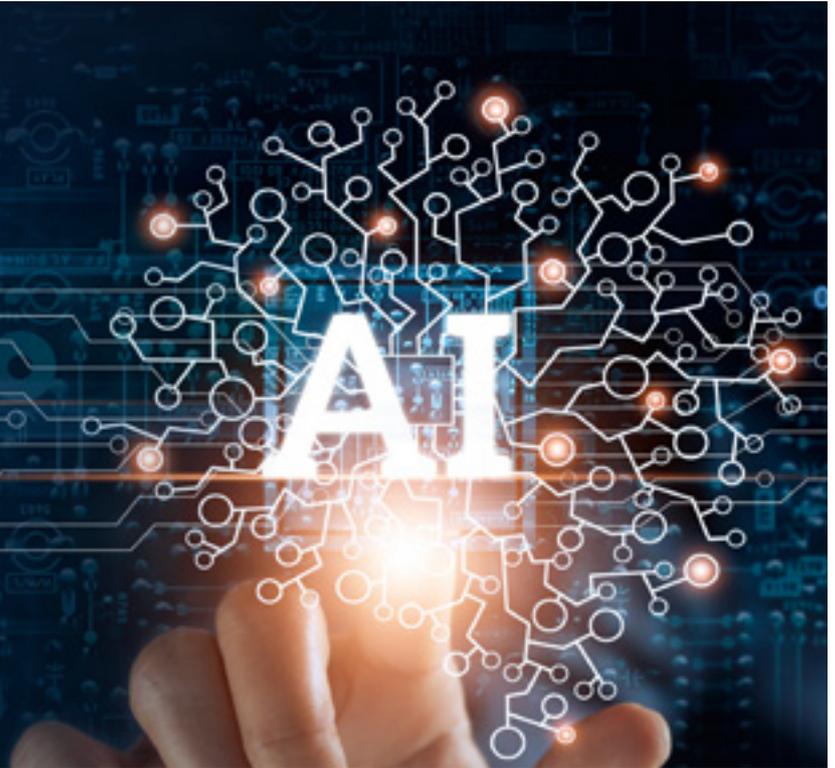
can readily use these inputs to generate performance attribution reports and periodic investor reviews. Many see this technology altering the performance analyst role, with 19% of performance analysts—highest among all investment professional roles—expecting that their current roles will not exist in five to 10 years.<sup>7</sup> NLP/G is expected to improve the timing, accuracy, and cost of producing reports based on investment portfolios' performance and strategy. These outputs' programmatic nature combined with NLG's ability allows for the creation of client on-demand reporting. Figure 4 shows a machine-generated portfolio narrative that was written with NLP/G technology and made available to investors shortly after period close.

**FIGURE 4**  
Screenshot of Portfolio Commentary Report



7. CFA Institute, "Investment professional of the future."

Close collaboration between technology, investment, data science, and strategy teams can help drive NLP/G adoption.



### Positioning to adopt NLP /G platforms

To convert the possible benefits of NLP/G adoption into reality, investment managers may benefit from reexamining their strategic vision and talent approach. There is a long adoption curve ahead, and firms may help drive initial adoption by balancing short- and long-term objectives. Leading practices suggest that implementation and execution are best supported with a refresh of talent strategies, including positioning technology as an enabler rather than a threat.

Senior leadership buy-in is often key for adoption. Both the chief investment officer and portfolio managers should be onboard to help with challenges and integrate the technology and investment teams. Once the objectives

of NLP/G adoption are truly shared, an organization can pursue them in a coordinated fashion.<sup>8</sup> Close collaboration between technology, investment, data science, and strategy teams can help drive NLP/G adoption.

Four areas in talent management will likely contribute to long-term NLP/G success:

**Recruitment and training.** Appoint experienced data science professionals in key roles. Early AI leaders have made it a point to recruit people with skills such as mathematics and advanced physics.<sup>9</sup> Train new analysts in coding and AI applications.

**Team organization.** Start with small teams, focusing on using AI to automate routine, repetitive tasks. Have a mix

of capabilities within teams to drive innovation. Work toward creating “superteams” that have a mix of analyst, technology, and investment strategist skill sets.<sup>10</sup>

**Performance management.** Realign incentives from span of analyst control to innovation using technology. Manage redeployment of investment professionals based on skill sets and experience. Align processes and performance management to adjust for AI’s inclusion on the team.

**Culture.** Shift the mindset to technology as a business partner for the investment team, training not as a service. Inculcate a culture of regular training and upskilling for all members of the investment team.

A leading investment firm followed many of these

principles in their path to NLP/G adoption.

Leaders within the firm sprinkled data scientists across the investment groups, added coding and analytics to the requirements for new junior-level portfolio managers and analysts, and offered existing investment staffers training in those skills, to free up the investment team’s time. For hiring, the firm began approaching not only schools’ finance majors but physics departments and other areas where someone might have expertise in coding and analytics. The firm also created training camps for anyone else who was interested. In all, the firm has trained 75 investment staffers—analysts, portfolio managers, and traders—on coding and analytics.<sup>11</sup> Talent and technology strategy go hand in hand; to be successful

8. Cao, AI pioneers in investment management.

9. FundFire, “Point72, Two Sigma: How to build an elite data team,” accessed January 28, 2021.

10. Volini et al., Superteams.

over the longer term, talent develops the organizational capability to drive the strategy.

### Path forward for investment managers

Investment managers are at a juncture where the adoption of NLP/G platforms today may create a competitive advantage for years to come. In a recent Deloitte survey, 86% of financial services adopters predicted that AI will be very or critically important to their business success in the next two years, in line with investment management respondents.<sup>12</sup> NLP/G platforms could be good candidates for a place to start, with more than half of investment management firms surveyed planning to implement these technologies in 2021.<sup>13</sup>

NLP/G support the three phases of the investment decision process in very different ways, and the decisions to deploy this technology in any of the phases are independent. Firms using NLP/G may identify investment opportunities sooner and improve operational efficiency. The time saved by analysts gathering data in the pretrade stage can be used to broaden the coverage universe or conduct a deeper analysis of already-covered companies.

These improvements may enable analysts to identify the strongest investment ideas and potentially increase alpha. In the investment phase, the NLG engines can help firms communicate the rationale behind AI-supported decisions

rather than treating them as black boxes. This capability can help firms continuously improve the existing decision-making algorithms and develop new ones. Finally, in the posttrade phase, NLP/G engines can generate portfolio commentaries from performance data on demand in seconds, instead of requiring days of manual effort each time.

### CONCLUSION

The technology's greatest benefit comes from being able to process large amounts of data quickly. There are no difficult prerequisites for implementation of NLP/G in the pre and posttrade phases of the investment process. Many firms will likely start their AI journey with NLP/G technologies in these phases. For the investment decision point, NLP/G is likely best used to explain an AI decision engine's output. This implementation often comes in conjunction with developing an AI decision support capability.

As investment management firms set out to digitally transform their operations, leaders will likely increasingly look to AI technologies. It should be encouraging that NLP/G has the potential to play a key role in reimagining the heart of active management—the investment decision process.

## TO THE POINT

- Natural language processing and natural language generation (NLP/G) can summarize and normalize structured and unstructured data from varied sources to aid analysts in efficiently evaluating investment ideas in the pretrade phase. Analysts can save time spent on collecting data, and instead focus on analyzing data with a higher potential for insights.
- The technology can explain in human language the rationale behind AI engine-supported investment decisions. These insights can be used for client communications and regulatory purposes, and improving AI decision algorithms to generate alpha.
- Firms can generate on-demand performance attribution reports and periodic investor reviews using NLP/G engines. The benefits can include reports that tell the story of investment portfolios' performance and strategy.
- NLP/G implementation involves a refresh of talent strategies, including positioning technology as an enabler rather than a threat. Long-term success will likely depend on four aspects: hiring and grooming the right talent, creating cross-functional "superteams", recalibrating performance management, and instilling a technology-oriented mindset.<sup>14</sup> improved timing, accuracy, and cost of producing
- In line with investment management respondents, 86% of financial services adopters predicted that AI will be very or critically important to their business success in the next two years.<sup>15</sup>
- NLP/G platforms could be good candidates to start, with more than half of investment managers surveyed planning to implement these technologies in 2021.<sup>16</sup>

14. Erica Volini et al., *Superteams: Putting AI in the group*, Deloitte Insights, May 15, 2020.

16. Beena Ammanath, David Jarvis, and Susanne Hupfer, *Thriving in the era of pervasive AI: Deloitte's State of AI in the Enterprise*, 3rd Edition, Deloitte Insights, July 14, 2020.

16. The Deloitte Center for Financial Services' 2020 survey of investment management firms.

11. FundFire, "Managers ready more automation, AI and data science for 2020."

12. Ammanath, Jarvis, and Hupfer, *Thriving in the era of pervasive AI*.

13. The Deloitte Center for Financial Services' 2020 survey of investment management firms.

# China isn't emerging, it's returning!

CLAUDE HELLERS OF FUNDBRIDGE AND PRIVATE INVESTOR,  
DAVID BAVEREZ IN DISCUSSION



**CLAUDE HELLERS**  
MANAGING PARTNER  
FUNDBRIDGE



**DAVID BAVEREZ**  
PRIVATE INVESTOR



Claude Hellers, Managing Partner at [Fundbridge](#) had the opportunity to share views and opinions on the latest developments in China with David Baverez, a former portfolio manager who resides in Hong Kong and remains close to the market as a private investor.

**CLAUDE HELLERS (CH): WHEN WE FIRST MET TWENTY YEARS AGO, YOU WERE A PORTFOLIO MANAGER. TODAY, YOU ARE A PRIVATE INVESTOR, AN AUTHOR, AND A COLUMNIST FOR A LEADING FRENCH NEWSPAPER. WHAT HAS CHANGED AND WHAT DO YOU DO DIFFERENTLY TODAY?**

**DAVID BAVEREZ (DB):** Nothing has changed! My intellectual curiosity still drives me as I try to understand the world we are living in. The importance of different regions is changing and so are the investment opportunities along with it. What drives me remains the joy of making discoveries.

**CH: WHEN WE MET YOU WERE A FRENCH CITIZEN LIVING IN LONDON. AM I SPEAKING TO THAT SAME FRENCH PERSON WHO NOW LIVES IN ASIA? AND IS THIS A REFLECTION ON WHERE YOU SEE THE FUTURE INVESTMENT OPPORTUNITIES?**

**DB:** OK, you are right; something has changed. The universe of investment opportunities that I am applying my intellectual curiosity to has been altered. In 2008, the stock market fell 50% in one year. This only happened once in the

twentieth century, in 1929. When the Great Financial Crisis happened back then, the whole world changed—and not for the better. A whole generation was misplaced. When I look back to 2008, I had a comfortable life. If I had stayed in London and continued to look at large companies from the ‘Old World’, I would never have been able to understand the ‘New World’ that is now emerging. So, at the end of 2010, I took the unusual step of closing the European fund I was managing and returned the money to my investors. I travelled during 2011 to figure out where this New World was emerging. That is when I arrived in Hong Kong. I realized that this new phenomenon was being driven by the return of China. I had never seen anything like it on such a scale. Approximately 15-20% of the global population were now officially returning to the global economy. The second thing that struck me was how ignorant I was about what was going on in China. This was despite having access to a huge amount of information when I was based in London. That is why I believe that over the next 20-30 years I should be able to benefit from this trend. The return of China was something I was unaware of

What is fascinating is to try to understand why this system has managed to thrive: how over the last forty years it has managed to reinvent itself at the end of each decade.

before, along with most my friends in the Western world. As an investor, you always want to look for something big, which the rest of the world has not seen coming. The major bet I made in 2012 was that the magnitude of the return of China would surprise the rest of the world, and I continue to stick to it. It has now been eight years since I moved to Hong Kong and it has been an exciting experience. Every day I learn something new. And the more I learn, the more I realize how little I knew about China. The more I learn, the more I feel I still have to learn, which is incredibly exciting!

**CH: WHEN YOU REALIZED THAT THE EMERGENCE OF CHINA WAS BIG, WHAT WERE THE LARGER SCALE THEMES THAT YOU DISCOVERED? FOR INSTANCE, WAS IT THE POLITICAL SYSTEM THAT YOU MENTIONED IN YOUR BOOK, PARIS-PÉKIN EXPRESS? BACK IN 2017, YOU SAID THAT THE FUTURE PRESIDENT OF**

**FRANCE SHOULD LEARN FROM CHINA. WHAT WAS THE BIGGEST EYE OPENER FOR YOU?**

**DB:** The European Commission just last year deemed China to be a “systemic rival”, which I think is adequate. We all have rivals in our lives, so we are used to the concept—but the word “systemic” is interesting. China has a completely different system from our own, so we have spent the last forty years in the West praying for the Chinese system to collapse. However, what we have witnessed has been the opposite. What is fascinating is to try to understand why this system has managed to thrive: how over the last forty years it has managed to reinvent itself at the end of each decade. That is where I have been spending most of my time. I want to understand how China is going to change post COVID-19 for the next ten years, in the same way it changed after the Great Financial Crisis.

**CH: YOU MENTIONED THE COVID-19 CRISIS. CHINA IS NOW IN RECOVERY MODE AND IT IS WELL AHEAD OF EUROPE. IT MAY HAVE MASTERED THE SITUATION BETTER THAN EUROPE. DO YOU THINK THAT THIS WILL NOW BE A HUGE ADVANTAGE FOR CHINA GOING FORWARD?**

**DB:** The crazy thing is that for the first time in my investing life, we are seeing an economic cycle starting only in China.

Economic cycles have always typically started in the US. We used to see it emerge in California and then move on to New York. After that it spread to London, the rest of Europe and then finally Asia. In 2008 following the Great Financial Crisis, the economic cycle started both in the US and in China at the same time. In 2020, we now see economic growth coming only from China. This is something I have never seen before. You cannot be an investor today and say: "I am not interested in China". You cannot be a global investor without looking at China. It has just become impossible.



**CH: WHEN YOU SAY CHINA, DO YOU MEAN CHINA, OR THE ASIAN REGION AS A WHOLE?**

**DB:** I look at Greater China, which for me includes Taiwan and Hong Kong. That means studying the economic activity of 1.4 billion people, which keeps me pretty busy during the day.

**CH: WHAT AMAZES ME IS HOW CHINA HAS A STRATEGY. IT'S ALL IN THEIR FIVE-YEAR PLANS. JUST LOOK AT THE INFRASTRUCTURE THEY ARE DEVELOPING TO HELP EXPORT THEIR GOODS. MEANWHILE, EUROPE REMAINS MORE FOCUSED ON MANAGING WHAT THEY HAVE NOW. WHAT DO YOU THINK ABOUT THIS?**

**DB:** Let's take an example, like the environment for instance. China has just announced that they will be carbon neutral by 2060. In Europe and the US, we very rarely mention goals beyond three years and when we do, we are not able to articulate the

execution plan. I find it amazing when China makes such an announcement, they commit to a huge technological gamble of multiplying their solar energy production by 20 times by 2060. China has a very different system.

**CH: TO WHAT EXTENT DOES THE CHINESE SYSTEM REPRESENT A POLITICAL RISK FOR INVESTORS? DO FOREIGN INVESTORS' EXPOSURE TO A CHINESE COMPANY REPRESENT A RISK?**

**DB:** Let me first address the idea of a US-China 'Cold War' which for me is rather a 'Cold Peace'. We are in the opposite situation to 1947: today, the war is impossible, given the

China has just announced that they will be carbon neutral by 2060.



because of the trade surplus it had with various countries including the US.

Since then, you have \$200 billion at risk from the 'US Trade War', you also have a further \$200 billion at risk from Chinese tourists potentially going abroad and spending, and China will need to import more services from the rest of the world. Therefore, the balance of payments for China is now closer to breaking even, which drives China's need for further foreign capital inflows or FDI (foreign direct investment).

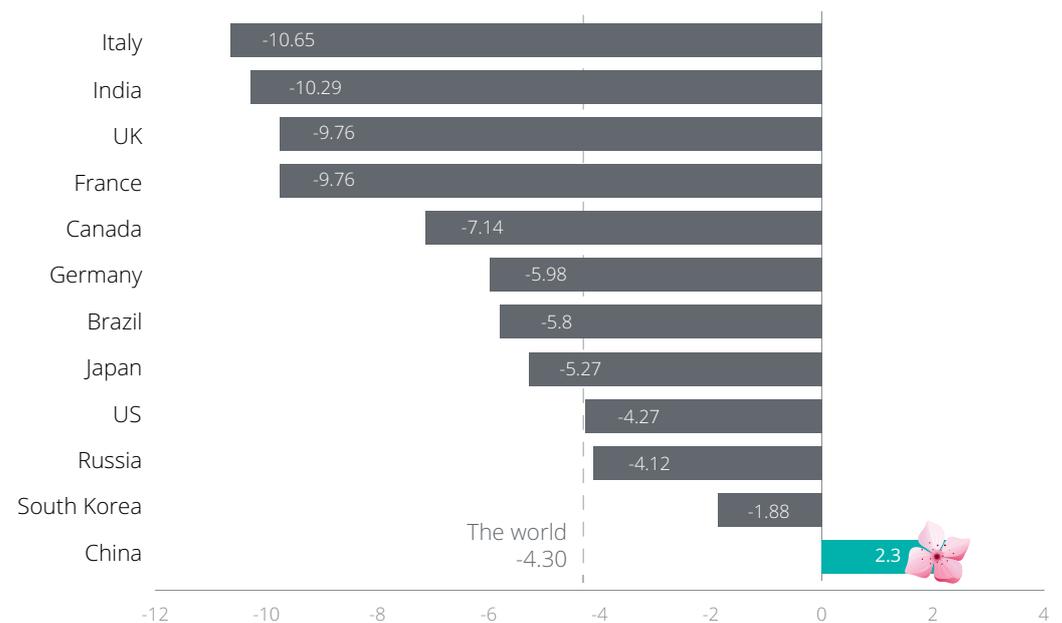
Consequently, Chinese companies will have to become more investor friendly. That is why for example, they insist that the weighting of Chinese equities in the MSCI Asia should be increased

at a time when many of the best Chinese companies are relisting in Hong Kong from the US. They are also encouraging what is known as the so-called 'Northbound Connect' with Hong Kong. This is the ability for Hong Kong investors to invest in Mainland China. There is also China's currency to consider. China has the only central bank of a large country, the PBOC, that refuses to monetize its local debt. What we are seeing is the opposite to what the ECB and the US Federal Reserve are doing. The reason is because China's government and central bank both want to make the renminbi a strong currency. This is the complete opposite to what is happening with the euro and the US dollar, whose devaluation is seen as necessary to reignite growth.

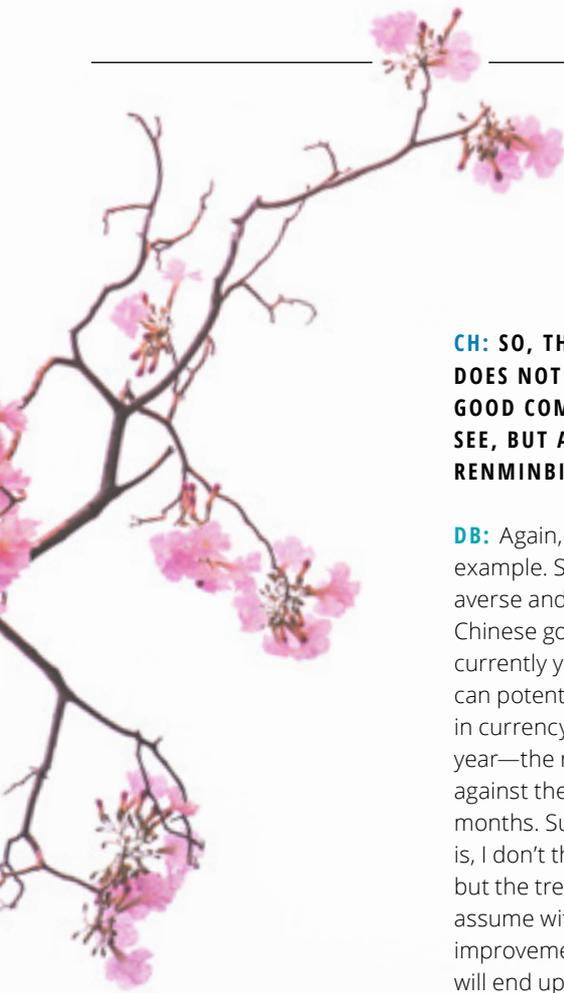
existing economic links, but the peace is improbable, given the two fundamentally different systems. What matters to me as an investor is that, in a 'Cold Peace' environment, China still needs to have a positive balance of payments, it needs a strong currency to attract savings and investments from Europe and Japan, which have for the last forty years been financing the US. China is therefore going to have to be very friendly to foreign investors to attract more foreign capital in the future. There is a reason for this. When Xi Jinping ascended as the country leader in 2012, the balance of payments for China was hugely positive to the tune of \$500 billion. This was

**China`s economy grew 2020**

GDP for 2020, change from a year earlier (in percent)



Source: China, National Bureau of Statistics; Internationa Monetary Fund (estimates for all other countries)



This non-convertible currency—the renminbi—is where investors will want to put their money.

**CH: SO, THE OPPORTUNITY DOES NOT COME ONLY FROM GOOD COMPANIES THAT YOU SEE, BUT ALSO FROM THE RENMINBI CURRENCY?**

**DB:** Again, let's take a concrete example. Say you are risk averse and buy the 10-year Chinese government bond. It currently yields 3.2%, plus you can potentially add also 3-4% in currency appreciation per year—the renminbi rose 10% against the US dollar in six months. Such a rapid increase is, I don't think, sustainable, but the trend is there. Let's assume with productivity improvements in China, you will end up with 6-7% return in euros or US dollars per year. This is a dream for any US or European large institutional investor. And, here we have not even started taking on any risk by investing in a specific company. Amazingly, this is just the return you can get on the currency which is not even convertible! Welcome to a completely upside-down world! It is the reason why I have so much fun in trying to understand things which are very counter-intuitive. This non-convertible currency—the renminbi—is where investors will want to put their money. So, imagine what kind of return you can get if you also add a good stock picker to identify good Chinese companies.

**CH: BOTH OF US ARE EUROPEAN (FRENCH AND LUXEMBOURGISH). WE ARE BOTH PROBABLY OPEN TO TAKING A RISK AND INVESTING IN ASIA. HOW LONG DO YOU THINK IT**

**WILL TAKE BEFORE OTHER WESTERN INVESTORS DISCOVER WHAT YOU HAVE IDENTIFIED AND SUBSEQUENTLY, INCREASE THEIR ALLOCATION TO ASIA?**

**DB:** Today, I am told that the exposure of global funds in China is around 3% of their assets, yet China accounts for 15% of global GDP and provides a good third of global economic growth. This underweight position is going to take years to close. You cannot close it in one or two years. But I expect 2021 to be the first year that there will be a reduction in this underweight position. Fixed income investors will have to go into equity. And within equities, China will increase its weighting for diversification purposes, in addition to the potential growth attractiveness that China presents.

**CH: SO, ON THE ONE HAND, YOU HAVE THE OUTLOOK FOR CHINA, WHICH IS VERY ENCOURAGING: MORE INVESTORS ARE LOOKING AT THE REGION, SO YOU HAVE IDENTIFIED THE RIGHT SPOT FOR OPPORTUNITY. BUT LET US GO ONE STEP DEEPER. WHEN I SPEAK TO PEOPLE IN THE MARKET, THEY ALL SEEM TO FAVOR TECHNOLOGY OR HEALTHCARE FOR THE LONG TERM. WHEN YOU LOOK AT CHINA, WHAT ARE THE SECTORS YOU FIND THE MOST INTERESTING? WOULD YOU ALSO RATHER INVEST IN GLOBAL COMPANIES THAT HAVE EXPOSURE TO CHINA OR IN COMPANIES WHO SUCCEED REGIONALLY?**

**DB:** The big difference between China and the rest of the world is the narrowness of the market for these themes in the West. For instance, when we say that there is an acceleration of digitalization in China, this is because digitalization in China is now invading every sector. Whereas in the West, so far, the vision is that the digital disruption has really affected only three sectors: commerce, media, and the leisure and travel sector. The other sectors so far have experienced little digital disruption. What we see in China post COVID-19, is the whole service sector becoming digitalized. Here, I am speaking about the financial sector (banking, insurance, and asset management), education (whose digital penetration broke the key 10% threshold), healthcare and nutrition. Each time, it is the same driver: a personalized offering through AI at an affordable cost to the people on the streets of Shanghai, China who make \$700-1,000 per month. So, the big difference between the West and China is that this big theme of digitalization can be found in every sector.

**CH: I WANTED TO COME BACK ON ONE POINT WHICH WE TOUCHED ON EARLIER. YOU MENTIONED THAT CHINA WILL BE CARBON NEUTRAL BY 2060. IN GERMANY, ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) IS A BIG THEME, AND IT WILL BECOME A KEY CONSIDERATION FOR EVERY INVESTMENT DECISION MADE. WE SPOKE ABOUT THE E, WHAT ARE YOUR**

**THOUGHTS ON THE S AND G IN CHINA? CHINA WILL PROBABLY HAVE AN ISSUE ON THE S. TO WHAT EXTENT DO YOU THINK THAT WOULD BE A HURDLE FOR FOREIGN INVESTORS?**

**DB:** The problem I typically have with ESG is that all of these risk factors are placed in the same basket, while these are three topics that are completely different in nature. Subsequently, China is going to treat them differently. On the environment, I believe China will surprise us positively, especially in comparison to the US. When it comes to the social aspects, China is going to approach it very differently just because the sociology of China is completely different to our own. For instance, you have had the one child policy for thirty years, which means that you have a society of single

children, with an unmatched urban density versus the rest of the world. To give you an example, in Hong Kong, half of its population are living in a tower above the sixteenth floor. This has created a completely new form of family structure, with single children living in an extremely dense urban environment. Therefore, the social organization will be completely different from the West. Finally, you have governance, where a company should be aligned with the interests of its shareholders. Personally, that's why I have never invested in a SOE (State Owned Enterprise).

I only look at private companies with a large equity holding held by the founder, in order to make sure that our interests are aligned. We have this perception in the West that most Chinese

companies are not profitable. This is completely wrong. What I find interesting about China is that you can find some very unusual opportunities which you cannot find in Europe or in the US. These are super-growers which are growing their top line by more than 20% and who are delivering a return-on-equity of more than 20%. Due to the compounding effect, these companies can self-fund their super high growth rates. Even if you are paying a very high multiple today, this multiple can decline over time at a rapid pace and if you can sustain this growth, you are bound to make money. This is what Warren Buffett calls very high compounders. I can find many of these in China, but I'm struggling to find these types of companies in the West. As a stock picker, there are incredible opportunities in China.

**CH: I UNDERSTAND YOUR REASONING ON THE ENVIRONMENT AND GOVERNANCE. BUT WHAT ABOUT THE SOCIAL ASPECT? AS AN INVESTOR YOU PROBABLY NEED TO MAKE SOME CONCESSIONS DUE TO THE DIFFERENCES IN SOCIETY AS YOU HAVE EXPLAINED. WILL CHINA EVER ALIGN TO THE WEST'S STANDARDS FOR S?**

**DB:** I think the problem is that you shouldn't apply Western standards to Chinese companies. Obviously, there are a few things on which we should never compromise, like child labor, which is completely unacceptable. However, there are other aspects of S that define the West, which you cannot copy-paste into China.



**CH: DAVID, I REMEMBER IN ONE MEETING WE HAD BACK IN LONDON A LONG TIME AGO; YOU CAME WITH ALL YOUR FINANCIAL ANALYSIS, ANNUAL REPORTS AND THREW THEM ALL INTO A BIN. YOU SAID THAT EVERYONE KNOWS THIS ALREADY, SO I NEED TO LOOK AT THINGS DIFFERENTLY. IN A WORLD LIKE TODAY, WHERE YOU GET TOO MUCH INFORMATION, WHERE DO YOU GET UNIQUE INSIGHTS THAT HELP YOU FORM YOUR CONVICTIONS?**

**DB:** The main issue you have with China is that all the official statistics are wrong. You cannot rely on them. So again, let's take a concrete example. China is usually the first country in the world to give you its quarterly GDP, which China publishes 10 days after the quarter end. I never pay attention to these. I rather pay attention to the indication that the government wants to send to the market. That is more important. That's why I take these official numbers with a pinch of salt.

There is no one magic source of information. What you need to do is to multiply the sources where you get information from. There are a lot of industry blogs organized vertically, thematic blogs with high quality information, which are free to access over the internet. It is a lot of work and it is very time consuming. There is not one single site I could refer you to. If I get from

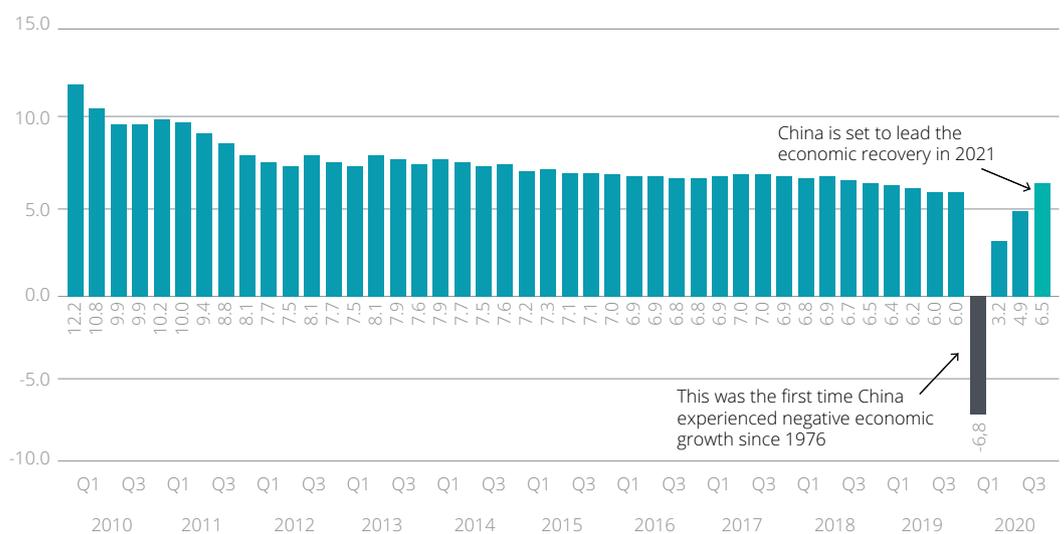
a source once a year a valuable piece of information, then I am happy. That is the way I am working.

I do not think that AI is the solution because AI tends to send you back to what the consensus thinks. The biggest challenge that I have is that when I look at an issue, very often, one data point tells me that China is bankrupt, while another tells me that China is number one in the world. To be open-minded, you also need to hear the opposite of what you think. You need to talk to the management teams of the companies you look at, and check as much as possible if what they are saying is truthful.



**Chinese leads the global recovery**

Quarter year-on-year growth (in percent)



Sources: China, National Bureau of Statistics



**CH: YOU HAVE TALKED A LOT ABOUT CHINA AND YOU ARE ALSO A PROMINENT COMMENTATOR IN THE FRENCH MEDIA. WHAT WOULD YOUR RECOMMENDATIONS BE, FROM AN INVESTOR POINT OF VIEW?**

**DB:** The biggest risk with China is not with Beijing, it's with Luxembourg, Paris and Frankfurt. It is our ignorance. And for me, this is the biggest country risk we face. Here is a statistic. There are 600,000 Westerners (including those from the EU and US) in Mainland China: 200,000 in Beijing, 200,000 in Shanghai, and 200,00 across the rest of Mainland China and they are there to understand

1.4 billion people. Meanwhile, China has a diaspora of 70 million people living in the West. We therefore, have an information disadvantage of 1:100. So, my biggest wish for now is that we, Westerners, start learning about China, and try to develop an objective unbiased analysis of the country. It is just fascinating to try to understand what is going on there.

**CH: THANKS DAVID. I FEEL THAT THE MOST SIGNIFICANT POINT WE HAVE TOUCHED ON TODAY IS THE MISALLOCATION OF ASSETS. THE WEST REMAINS DRAMATICALLY UNDERWEIGHT TO ASIA, NOTABLY CHINA, AT A TIME WHEN THE WHEEL OF HISTORY IS TURNING. THEREFORE, WE NEED TO ASSESS WHETHER OUR ASSET ALLOCATION IS RIGHT AND WHETHER WE HAVE CORRECTLY IDENTIFIED THOSE CHINESE NATIONAL CHAMPIONS THAT ARE LIKELY TO EMERGE AS GLOBAL CHAMPIONS IN THE FUTURE. IF YOU HAVE NOT STARTED LOOKING AT THIS YET, YOU SHOULD START NOW.**

#### TO THE POINT

- For the first time, an economic cycle has begun in China. Investors can only call themselves truly global, if they also invest in China.
- Western investors' ignorance of Mainland China poses a huge risk and there must be a concerted effort to learn about and understand China as a country.
- Regarding the topic of ESG, China proposes that it will be carbon neutral by 2060. There also needs to be the understanding that the social organization is completely different from the West. This can be overcome by investing in companies with a governance aligned with the interests of its shareholders.







# India's 2021 Budget

## WHAT'S IN IT FOR FOREIGN PORTFOLIO INVESTORS?



**RAJESH H GANDHI**  
PARTNER  
GLOBAL BUSINESS TAX  
DELOITTE



**KARAMJEET SINGH**  
DIRECTOR  
GLOBAL BUSINESS TAX  
DELOITTE



Presented by the Minister of Finance Nirmala Sitharaman on 1 February, the 2021 Union Budget of India did not announce increased tax rates nor, was a 'COVID-19 cess' introduced. Sensing the need of the hour, the Government focused instead on measures to spur economic growth, undertake reforms, provide tax certainty, and reduce litigation. Many proposals to increase public spending in infrastructure and healthcare were included. Yet, it is interesting to note, the resources needed for such increased spending is not to be raised from additional taxes but from the monetization of certain infrastructure assets and strategic disinvestment of public sector enterprises. Some other bold steps included privatization of two public sector banks and a general insurance company, the planned IPO of Life Insurance Corporation of India, and the establishment of asset reconstruction/asset management companies to take over stressed assets from

public sector banks. Certain tax amendments have also been made to provide relief to foreign portfolio investors (FPIs).

The tax amendments proposed in 2021's Budget were approved by the Indian President, enacted into the Finance Act, 2021, and were effective from 1 April. Until 31 March 2020, Indian companies were required to pay a distribution tax on dividends and consequently dividends were exempt from tax in the hands of shareholders, including FPIs. Effective 1 April 2020 dividend distribution tax was abolished. The tax rate for dividends arising to all the foreign investors including FPIs was prescribed at 20% (plus the applicable surcharge and cess) which could be reduced under tax treaties. However, this relief of lower tax rate was not available at source and Indian companies were required to withhold tax at 20% disregarding treaty benefits. This resulted in a situation

where FPIs would either have to reclaim the excess tax withheld as a refund in the annual tax return or offset the excess tax against capital gains tax payable during the year. The Finance Act, 2021 has now enabled Indian companies to withhold taxes at treaty rates where such rates are lower than the 20% tax rate under domestic law. This is a welcome move and will provide relief at source to FPIs. However, providing timely and sufficient documentation to the satisfaction of Indian companies on treaty eligibility and compliance with general anti-avoidance rules or the PPT provisions under the BEPS MLI could be challenging for FPIs. Custodians are suggesting a need for standardization of documents and a repository for easy and timely access by Indian companies.





### Tax relief for sovereign wealth and pension funds

Last year, the government introduced tax exemptions for sovereign wealth funds (SWFs) and pension funds (PFs) on dividend, interest, and long-term capital gains arising from their investments made in the infrastructure sector in India, but only available subject to satisfaction of certain conditions. The Finance Act, 2021 has relaxed some of these conditions to provide greater flexibility to SWFs and PFs to invest directly or indirectly in infrastructure companies. These include:

- Previously, investments made by SWFs/PFs in a category-I or category-II alternative investment fund (AIF) in India would qualify for tax exemption provided the AIF invested 100% of its corpus in specified infrastructure entities. This investment threshold has been reduced to 50%.
- Tax exemptions will be extended to special purpose vehicles (SPVs) set up by SWFs/PFs provided the SPV is a domestic company established and registered on or after 1 April 2021 and invests at least 75% in one or more infrastructure entities or in an infrastructure investment trust.
- Investments made in a non-banking finance company registered as an infrastructure finance company or infrastructure development fund will also qualify for tax exemption provided the investee company/fund lends at least 90% of its corpus to infrastructure entities.
- The restriction that SWFs/PFs should not undertake any commercial activity has been removed and replaced with the condition that SWFs/PFs will not participate in day-to-day operations of the investee entity in India.
- PFs which are liable to tax in their home country but exempt from tax on all income in the home country will be eligible for tax exemption in India.

These relaxations showcase the government's resolve to remove difficulties and encourage SWFs and PFs to make long-term investments in Indian infrastructure facilities. As per recent press reports, the government has designated special officers as a single point of contact for each SWF/PF.

### Tax incentives for offshore funds

India established its first international financial services center (IFSC) in 2015. Since then, the government has been doling out tax sops to attract foreign investors to set up operations in the IFSC. The Finance Act, 2021 has widened the tax incentives to encourage existing offshore funds to move their investments to the IFSC.

The Finance Act, 2021 has made the following relaxations:

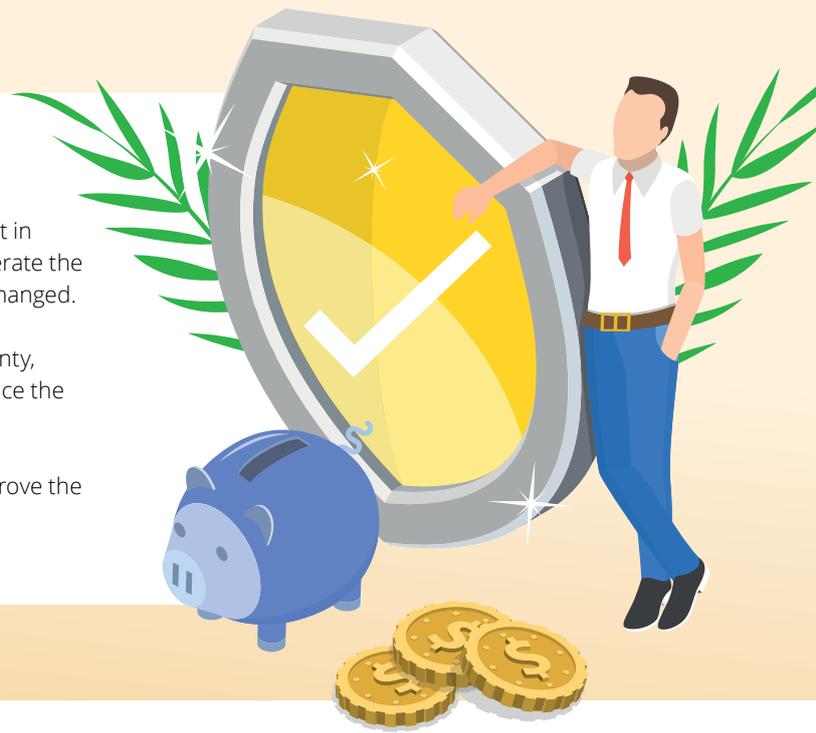
- Under the previous tax law, an offshore fund was not construed to have a business connection or place of residence in India merely because its fund manager was located in India, provided the conditions stipulated in the law were met both by the fund as well as the fund manager (known as 9A conditions). These conditions are set to be relaxed for fund managers set up in the IFSC.
- Banks which have set up offshore banking units (OBUs) in the IFSC can avail similar tax exemptions/reliefs available currently to category III AIFs set up in IFSC. Non-residents which enter into non-deliverable forward contracts with such OBUs in the IFSC will not be subject to tax in India.
- In order to encourage offshore funds set up in

**TO THE POINT**

The 2021 Union Budget of India is a growth-oriented budget in which the Government has focussed on measures to accelerate the country's economic growth while keeping the tax rates unchanged.

Certain amendments have been made to provide tax certainty, enable treaty relief at source, reduce tax litigation, and reduce the statute of limitation.

These amendments are encouraging and could help to improve the country's taxation framework.



foreign jurisdictions (e.g. Mauritius, Singapore) to relocate to the IFSC in India, transfer of assets of such offshore funds to the fund set up in IFSC will be tax exempt. Furthermore, any grandfathered shares held by the offshore funds and transferred to the IFSC fund would continue to be grandfathered in the hands of the IFSC fund as well.

**Limitations, boards, and definitions**

The Finance Act, 2021 has revised the statute of limitations from seven years to four years from the relevant fiscal year to which the income pertains. However, in a case where the tax authorities have evidence that the income chargeable to tax of INR 5 million or more, represented in the form of assets (including securities) has escaped assessment, the statute of limitations has been extended

to 11 years. Beginning 1 April 2021, the time limit to complete regular tax audit has been reduced to 21 months. For instance, for the income arising to an FPI during fiscal year 2020-21, tax authorities will have until 31 December 2022 to complete the regular audit proceedings.

In order to reduce litigation, the Finance Act, 2021 provides for the establishment of a Board of Advance Ruling which would replace the current Authority for Advance Ruling framework. Also, a Dispute Resolution Committee will be set up for small and medium taxpayers where the returned income does not exceed INR 5 million and the variation proposed in the tax audit order (which is the matter of dispute) does not exceed INR 1 million. Hopefully, these steps will indeed reduce tax litigation in India which can otherwise be lengthy and unpredictable.

The Finance Act, 2021 has also amended the definition of the term "securities" to include real estate investment trusts (REITs) and Infrastructure Investment Trusts (INVITs). With this change, it is unclear whether the interest income arising from such instruments would be taxed at 5% or 20% being the tax rate for income from securities earned by FPIs.

**CONCLUSION**

The key highlights of the tax amendments were recognition of treaty benefits for withholding tax on dividend income, relaxation of conditions to enable SWFs and PFs to invest indirectly in infrastructure companies, and certain relaxations in tax procedures. Though there have been calls to lower taxes on public market investments, these were not relaxed. Also, certain other issues impacting FPIs such as abolishment of buyback tax,

non-applicability of indirect transfer tax provisions to category II FPIs, extension of long-term grandfathering benefits to shares received through corporate actions on the basis of shares held on 31 January 2018, reduction in income tax rates on exchange traded derivatives, and tax exemption on restructuring of funds outside India were also not considered.

However, overall, the reform measures announced in the 2021 Budget and the fact that no additional taxes were introduced by the government were well received by FPIs and taxpayers.



# AIFMD at a turning point

LOOKING BACK AND FORTH





**ARNAUD BON**  
PARTNER  
CONSULTING – PRIVATE  
EQUITY AND REAL ESTATE  
DELOITTE



**BENOIT SAUVAGE**  
DIRECTOR  
STRATEGY & REGULATORY  
CONSULTING  
DELOITTE



**SEBASTIAN SCHIECK**  
SENIOR MANAGER  
CONSULTING  
– INVESTMENT  
MANAGEMENT  
DELOITTE

In light of the European Commission’s ongoing efforts to establish the Capital Market Union, focus has turned to the alternative investment manager’s market in Europe. The Commission has launched the legislative review cycle of the Alternative Investment Fund Managers Directive<sup>1</sup> (AIFMD), thereby giving the industry its first chance to weigh-in on the proposed changes and to discuss the future functioning of the alternative investment fund market.

The review of the AIFMD comes nearly a decade after the finalization of the original directive—and, as Figure 1 clearly shows, the path to change is the fruit of a rather long labor. As we reach the directive’s 10-year anniversary, we can trace the necessity to review the AIFMD to two factors:

- As inscribed in the AIFMD itself; and
- The second, as a consequence of Brexit.

Contrary to the Undertakings for the Collective Investment in Transferable Securities (UCITS), the AIFMD enables non-EU managers or funds to be considered within the scope of the Directive. However, questions surrounding the control of non-EU based entities created some anxiety among the regulatory community. In response, and a year after the Brexit referendum, the European Securities and Markets Authority (ESMA) released a

communication paper on the outsourcing and delegation to third countries (non-EU countries) in the summer of 2017, before the debate on passporting to third countries resurfaced in 2019. Since then, EU authorities have looked at the working conditions of the AIFMD which has since paved the way for an in-depth review.

1. Directive 2011/61/EU

**Figure 1: AIFMD timeline**



In June 2020, the European Commission issued its review report addressed to the European Parliament and Council on the application and scope of AIFMD, concluding overall that AIFMD was successful in establishing an internal market for alternative investment funds, providing a high level of investor protection, and enabling EU-wide risk monitoring by the authorities.

Positively, if one could say, since that moment, the AIFMD was viewed as a good tool to help the EU economy get out of the crisis, and as a way to channel investors' money to appropriate targets across the EU, hence a will to open AIFMD to more—qualified—retail investors.

By analyzing the different developments and in a way that pre-empted a future consultation, the ESMA sent to the EU Commission a letter outlining 19 areas to tackle to reinforce the AIFMD and continue its success. This was a rare move, which had the advantage of clearly stating which topics were of importance for the European Authority, such as the outsourcing to third countries as well as investor expansion and protection. It also highlighted the possibilities of better framing and understanding the risks stemming from leverage and liquidity making a link with the Investment Firm Regulation and Directive (IFR/IFD) that will be live in June 2021 and will require minimum capital requirements for investment firms.

The EU Commission did also identify a certain number of topics for review, to strengthen and adjust the framework. Subsequently, a market-wide consultation was issued, asking the industry for feedback covering 11 headline topics, across more than 100 questions.

During the consultation period a number of hot topics emerged, where industry participants' views differed on the best approach to take and whether or not it will require the Commission's attention.

These points further differed by member state, driven by the respective local flavor towards the alternative investment fund industry.

The issued consultation closed on January 29 2021 and the industry has—at length—shared perspectives and views on the functioning of the market and operating within the European framework. The general conclusions attest to the well-functioning market and discourages the European Commission from changing the Level 1 provisions of AIFMD,

instead focusing any review and changes to Level 2 and 3 legislative texts. There appears to be a large consensus along the line of, "if it ain't broke, don't fix it"—but only the future will tell.

In the following paragraphs, we outline some of the hot topics and briefly explore what they could mean for the industry, should they be tackled within this review cycle.

**Figure 2: Number of EU Consultation Questions per headline topic (in percent)**



### The European Depository Passport

The fact that depository banks can only provide their service in the country where they are domiciled has long run counter to the idea of the Capital Market Union. It even runs counter to the heart of the European single market and its principles of freedom of establishment and freedom to provide services. Numerous European authorities have pointed to this fact and the situation, where a limited number of depository banks in certain countries lead to quasi-monopolies, something a European-wide passport could certainly address. The chance comes now to rectify the situation with the AIFMD Review.

The market, however, has rather mixed feelings about this passport. While large groups and top European depositories might see a chance to streamline and consolidate their operations, it does introduce a new bar for market entrants, who will not only compete on their local market, but against the entire European market of depository banks. In fact, at least one of the large depository groups have voiced against such a passport due to its practical implications.<sup>2</sup>

One counter argument has been the possible strain on consumer protection of the alternative investment market presented by such passports. By increasing the distance between investors

and depository banks, whose strong control function contributes to the investor protection standards within the European Union, the protection standard may fall and present new cross-border hurdles at the cost of the investors.

The call for such a passport pre-dates AIFMD and the point was first raised in the context of the UCITS regime. While ESMA has studied such a passport under both, it has not issued an outright recommendation to introduce the passport. It merely asks the European Commission to thoroughly assess risks and benefits.

### Outsourcing and delegation: the age-old question of substance

In recent years, Luxembourg has developed a strong notion of minimum substance requirements for alternative investment fund managers when they outsource and delegate certain functions. This ensures that no letterbox entity can exist within the

country, servicing billions of assets under management with skeleton staff. It also ensures that any manager retains at least one part of the crucial functions of portfolio management and risk management and can effectively service the retained function.

This call for substance is not a harmonized call, but rather a national driven agenda. While other member states slowly follow suit (i.e. the recent push of Ireland towards more local substance), expectations are placed on the AIFMD Review to harmonize the rules towards substance and introduce a minimum level that is deemed acceptable Europe-wide. Potentially a contentious topic but with the recent political

environment surrounding Brexit, it has come to the forefront of the discussion. The United Kingdom has historically been a center of expertise for portfolio management. In the past, these inter-European outsourcing and delegation arrangements have received little scrutiny, as the fundamental requirements applying were the same. With the UK being a third country since January 2021, the requirements for outsourcing and delegation have changed and with this, a renewed focus on substance has come along. In Luxembourg for example, a stern warning was issued in the run up to Brexit, re-enforcing that European market access cannot be achieved by simply operating skeleton structures in the country.



2. CACEIS Investor Services, "The AIFMD review: an incremental change or a major revamp" January 14, 2021 <https://www.caceis.com/whats-new/news/spotlight/article/the-aifmd-review-an-incremental-change-or-a-major-revamp/>

### Liquidity reporting: from money market funds to all alternative investment funds

The Money Market Fund Regulation<sup>3</sup>, issued in 2017 and targeting UCITS and alternative investment funds (AIFs) alike, introduced a new type of liquidity reporting. Alongside the well-established reporting obligations on assets, risks, and other key metrics to authorities in Europe, this regulation requires money market funds to report on the investors invested in the fund, what category they fall in, if there are investor concentrations, and how these investors behave in times of stress. This data allows money market funds

to have a more sophisticated liquidity management in place, anticipating investor reactions before a liquidity crisis could potentially occur. With the AIFMD Review, the European Commission is looking to extend these reporting obligations to all types of AIFs. Drawing on lessons learned from the money market fund regulation, AIFMs will need to significantly increase transparency on the investor base invested in their AIFs and achieve a certain look-through on omnibus accounts and large block positions to enable their risk management function

to properly implement the liquidity monitoring obligations.

### Investor access to alternative investment funds

One topical question raised is should the AIFMD provide a broad investor access to alternative investment funds? In the current market, alternative investment funds are only accessible to professional investors, as defined under the Market in Financial Instruments

Directive<sup>4</sup> (MiFID), with member state potential provisions. While some national laws allow a broader access (i.e. the well-informed investor under Luxembourg laws), such national flavors are not harmonized and many clients are left out of the significant rise in assets and returns on the alternative market. With private equity, real estate, and infrastructure delivering the much sought for returns in a low interest rate environment, European investors are looking for easier ways to access these products, especially considering that not all retail investors are equal. It should be noted that the definition of the investor status is defined by reference to the MiFID regulation under which even ultra-high net-worth investors may still qualify as retail investors, despite having the necessary resources and experience to understand and manage the risks involved. At the same time, the 2018 revamp of the MiFID framework left the criteria of client categorization largely unchanged, showing no appetite from the European regulators to increase the population of professional investors in the market.

One key focus therefore is, whether and how will the AIFMD Review tackle this access obstacle? Is reliance on MiFID (also up for review) necessary, or could a clever path be found within the AIFMD itself to let more investors access and support the financing of the EU economy?



3. Regulation (EU) 2017/1131

4. Directive 2014/65/EU

MiFID II and PRIIPs have shown that such change should not exclusively be seen as burden and compliance challenges, but equally as opportunity to reposition, strengthen, and explore new sectors and activities.

#### Sub-threshold alternative investment fund managers: amendment or extension?

In 2013, AIFMD introduced a sub-threshold manager regime, whereby managers of alternative funds below a certain total assets under management (AuM) size did not need to apply for a license, but merely register themselves with authorities. While practical for new market entrants in theory, the applied AuM size (500m EUR /100m EUR when leveraged) is very quickly exceeded in practice and has done arguably little to increase the new player entries. Applying for a full license is often an expensive process, requiring substance and expertise and therefore can deter even large third country players from entering the European market.

The consultation instigated a discussion on either extending the existing sub-threshold regime to allow for larger asset bandwidths considered “below threshold”, or introducing a “light” license, for example for players of up to 2bn EUR, to reignite the market growth and attract more players to the market. Whichever way to go, a study should be undertaken

to assess the relevance of the sub-threshold regime in today's climate and the average size of players in the alternative investment market in Europe.

Ultimately, the final extent of changes will be noted in the first draft of the regulatory text expected for end of Q2 or early Q3 2021. It will remain to be seen how far the European Commission will honor the industry's wish of effecting changes through Level 2 and 3 regulatory texts, rather than a fundamental re-work through a Level 1 instrument.

For the industry as a whole however, it is prudent to follow the discussions already at this stage and to observe the feedback given to the consultation, which at least provide an insight into market opinions and directions proposed. While the Commission is of course free in how far it orientates itself on these opinions, in the past they have not ignored the feedback.

Overall, the industry has only recently concluded the work around MiFID II, which at least indirectly affected alternative fund managers as product providers, and the work around

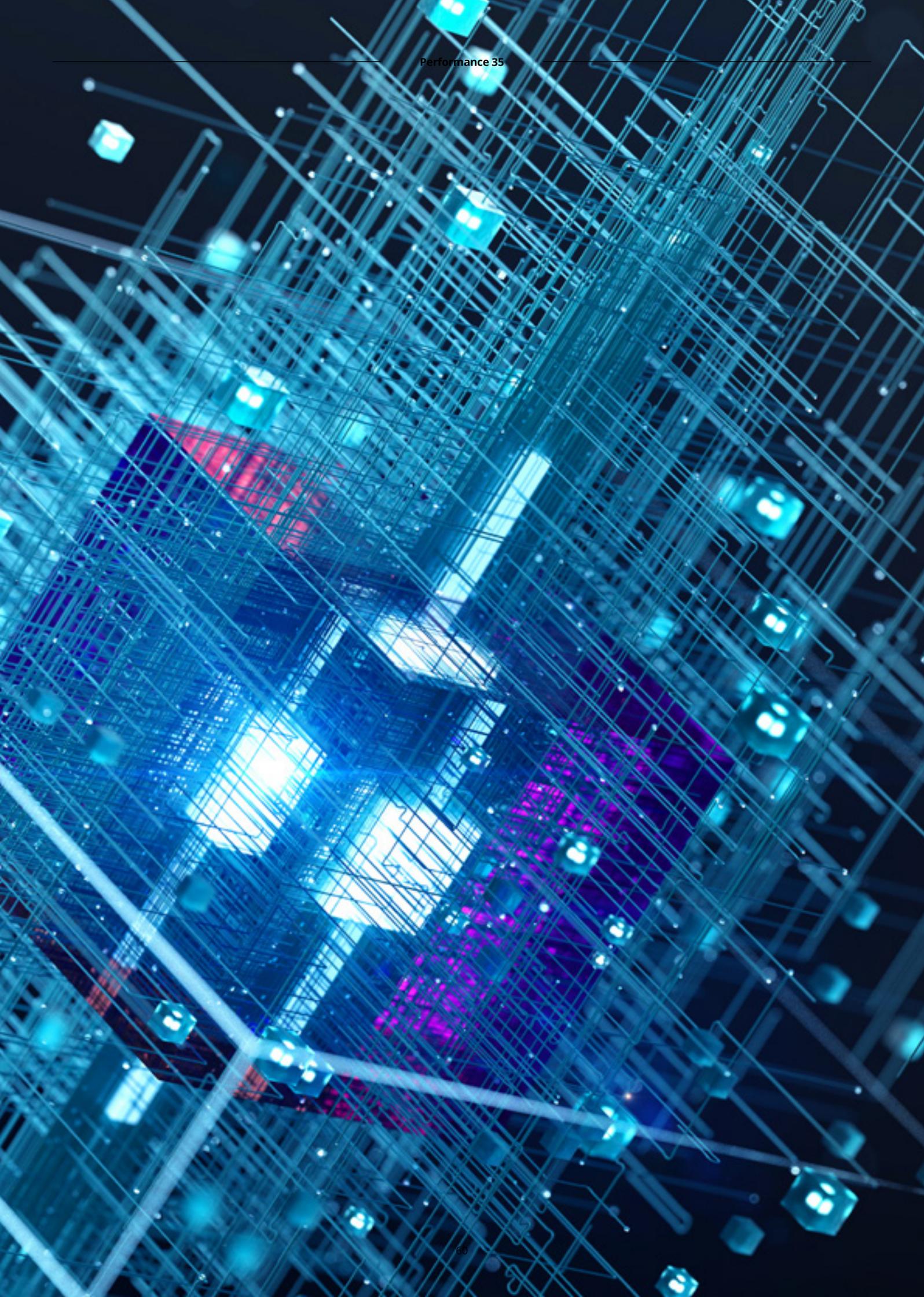
Packaged Retail and Insurance Based Investment Products (PRIIPs). The European Commission presents us now with the next major change for the industry. MiFID II and PRIIPs have shown that such change should not exclusively be seen as burden and compliance challenges, but equally as opportunity to reposition, strengthen, and explore new sectors and activities. If anticipated well in advance, all of the above presented topics can be seen as opportunities for market players, further strengthening the dynamic alternative investment fund market in Europe.

#### CONCLUSION

From our current vantage point, and despite all comments from stakeholders, it is a near certainty that AIFMD will be reviewed. If we have to prioritize topics, then delegation will more likely than not face evolution, and the enlargement and alignment on a revisited MIFID definition of authorized retail investors will surely be visited. To these, one may add enhanced reporting to better manage leverage and liquidity views of regulators and prepare a more impacting arrival of IFR/IFD in case the level of capital protection are not deemed adequate. On top of this, there may be one additional trend covered which is investor value for money. This topic has gained momentum over the past year, debate is active in the UCITS world, and it will more than likely extend to MIFID firms and AIFs, but to know that, we will have to wait until the last part of this year when the AIFMD II draft should be presented.

#### ★ TO THE POINT ★

- AIFMD Review has been launched with EU Commission Consultation Questionnaire
- More than 100 questions across 11 headline topics
- Hot topics discussed by the Luxembourg market – Depositary passport, outsourcing and delegation, liquidity reporting and investor access
- AIFMD II draft text expected end of 2021



# Breaking the silos

THE JOURNEY TOWARDS SHARED MEANING  
AND ORGANIZATIONAL KNOWLEDGE



NICOLAS BUCK  
CEO  
SEQUOIA

**What does the data you hold really mean? It's a subject that asset managers should pause and think deeply about. On the surface, data appears to be expressed by a simple formula, a number or sentence but that is not enough to build a comprehensive view. In reality, data resides in siloed systems resembling a town market where each trader speaks a different language—and naturally, this is ineffective for the long-term.**

**The way forward should be to build a common understanding of data within the organization—a shared dialogue for both people and machines. It is a crucial objective for all asset management firms in today's industry.**

The relationships of a particular data point to other data points is just as important as the individual meaning.

At its core, data is just that: data. Disintegrated numbers, letters, or symbols that provide little meaning on their own. Ordering, structuring, and presenting these data points in a useful manner and context makes them informative, enabling audiences to extract meaning from them and make sense of the world.

Given the abundance of data that asset managers face daily, it matters that data per se is not actually that useful. Instead, people need to adopt a broader perspective, assigning meaning and relationship context to data. Only by doing so can they form a holistic, non-siloed data strategy across the entire organization.

The crux of the problem is the siloed approach to managing information. Every in-house software application has been built with a specific business function in mind, implying that most software applications have their specific way of organizing data (database model). In addition, the meaning of the data varies from one application to the next because they were built to specifications which reflected the understanding of data (and data usage) in a narrow business context at one point in time.

Going forward, I believe that we should adhere to two principles:

The first one is that establishing a clear and shared meaning of particular data points should be a priority. Secondly, the relationships of a particular

data point to other data points is just as important as the individual meaning.

#### **The aim towards meaningful data**

By meaningful data I mean data that can be understood both by humans and machines: we cannot allow ourselves to restrict our ambitions to the mere interoperability of computer systems without considering the need for humans to fully understand the data.

For the sake of entertainment, think of concepts and ideas when thinking about data. The name of a fund represents a string of information i.e., data. Thus, what becomes interesting is what exactly we mean when we refer to a fund.

The aim is by no means to propose a novel scientific approach but rather to make use of philosophical concepts and how these can be applied in computer science to allow asset management practitioners to think of this subject in a different way or view the problem from a different angle.

The current challenge the industry—composed of individual firms—is facing with data is a problem with two dimensions. The first dimension is that the people within an asset management firm define concepts expressed as data differently. They do not share a common language, which is a prerequisite for understanding. Secondly, the computer systems within a specific asset management organization will define the meaning of data differently because they have been built by people who did not share a common language. This results in data incomprehension both at a human level and at a system level.

Far be it from me to suggest the creation of a common language across the industry, yet a first step should be the creation of a common understanding of meaning inside specific firms, which already constitutes a significant challenge not to be underestimated.

Let us think about what we mean by meaning and knowledge. We acquire knowledge through understanding meaning—meaning we acquire through understanding concepts that can be expressed through symbols, e.g. words. Humans use informal language to express concepts. Machines, conversely, require formal language (e.g. mathematics) to express concepts. Thus, if our objective is to radically augment the understanding of data, we must strive to keep this duality of human and machine understanding in mind.

Thomas Davenport from IBM once famously quipped “people can’t share knowledge if they don’t speak a common language”.<sup>1</sup> But what does it mean to speak a common language? The first step is to agree on symbols (alphabet) and concepts. This is the field of syntax. Then we would need to agree on literal and contextual meaning. This is the field of semantics. A next step would be an agreement of the classification of concepts (i.e. taxonomy) and a shared understanding of the associations and relations of these concepts (like a thesaurus). Finally, we may need to agree on which relations make sense and are allowed, which is what could be defined as an ontology.

I believe that if we are to achieve knowledge through an understanding of the meaning of concepts, expressed contextually and temporally through data used in asset management, firms should invest in a better understanding of syntax, of semantics, of taxonomy and of ontology in the context of asset management. This understanding should not be restricted to computer scientists but should be shared across the whole of the organization, at different levels of complexity.

I challenge anyone to find a common answer in one firm to the simple question: “What is a product?”.

An important step to meaningful data is to consider the intellectual groundwork provided by computer science in the field of ontology. I stress

the word consider, which entails a form of skepticism, realism, and curiosity rather than embracing ontological theory without due restraint. What can we learn from this particular discipline, which is a subset of information science?

In philosophy, ontology has traditionally been defined as the theory of what exists.<sup>2</sup> It is the study of entities in their reality and the relationship between these entities. Essentially, ontology as part of metaphysics deals with a systematic account of reality and existence. In recent times, the use of the term ontology has become prominent in computer science.

A useful definition of ontology has been provided by the very prominent computer scientist Thomas Gruber<sup>3</sup>: “An ontology is an explicit, formal, specification of a shared conceptualization [...] For computer systems, what exists is what can be represented”. At this stage, it is important to

define the meaning of each of these words: **explicit, formal, specification, shared** and finally, **conceptualization**.

In the context of asset management, the word conceptualization refers to the creation of an abstract model that would represent the reality of that industry or, more realistically, of the individual firm. The reality would strive to define entities and the relationships between these entities. An investment fund, for example, would be an entity (concept) or benchmark. And then, what would be the relationship between the fund and the benchmark?

The objective of this conceptualization would be the sharing of knowledge. Here again I am insisting on the dual objective of sharing this knowledge with humans and machines. In order to represent knowledge that can be shared between machines, that representation needs to be formal.

An important step to meaningful data is to consider the intellectual groundwork provided by computer science in the field of ontology.

1. Thomas Davenport, IBM 1997

2. Building Ontologies with Basic Formal Ontologies, Arp, Smith and Spear 2015

3. [2] Gruber, T. R. A Translation Approach to Portable Ontology Specifications. 1993

**Building a common data language**

The first word to define, in the definition provided by Gruber, is the word, explicit. This means that all concepts should be defined because leaving one concept undefined would mean that concept could take up any number of different meanings. Here, we are in the realm of semantics and there is an element of subjectivity, because the concepts that I will give as an example could be defined differently across different asset managers. Here are four examples.

- **Investment vehicle:** An investment vehicle is a product designed by an asset manager to offer investment solutions to its investors. It can take many forms such as an umbrella investment company or a stand-alone common fund.

- **Fund:** A fund is the aggregation of pooled capital from multiple investors which is invested according to a prescribed investment policy.

- **Portfolio:** A portfolio is the total of all assets held by a fund manager as part of the delivery of an investment service in line with a prescribed investment policy.

- **Share class:** A share class or unit class is a group of investors who pooled their capital into the fund under the same conditions (class type), the same currency and pay-out model.

Here, we are in the realm of semantics and there is an element of subjectivity, because the concepts that I will give as an example could be defined differently across different asset managers.

Explicit in this case entails defining every concept within the domain of knowledge i.e. asset management company X. The word shared reminds us of the importance of consensus across the ontology, consensus on the meaning of the concepts, of the relations between the concepts, their specific name/value attributes and the logical rules that limit these relationships (e.g. an

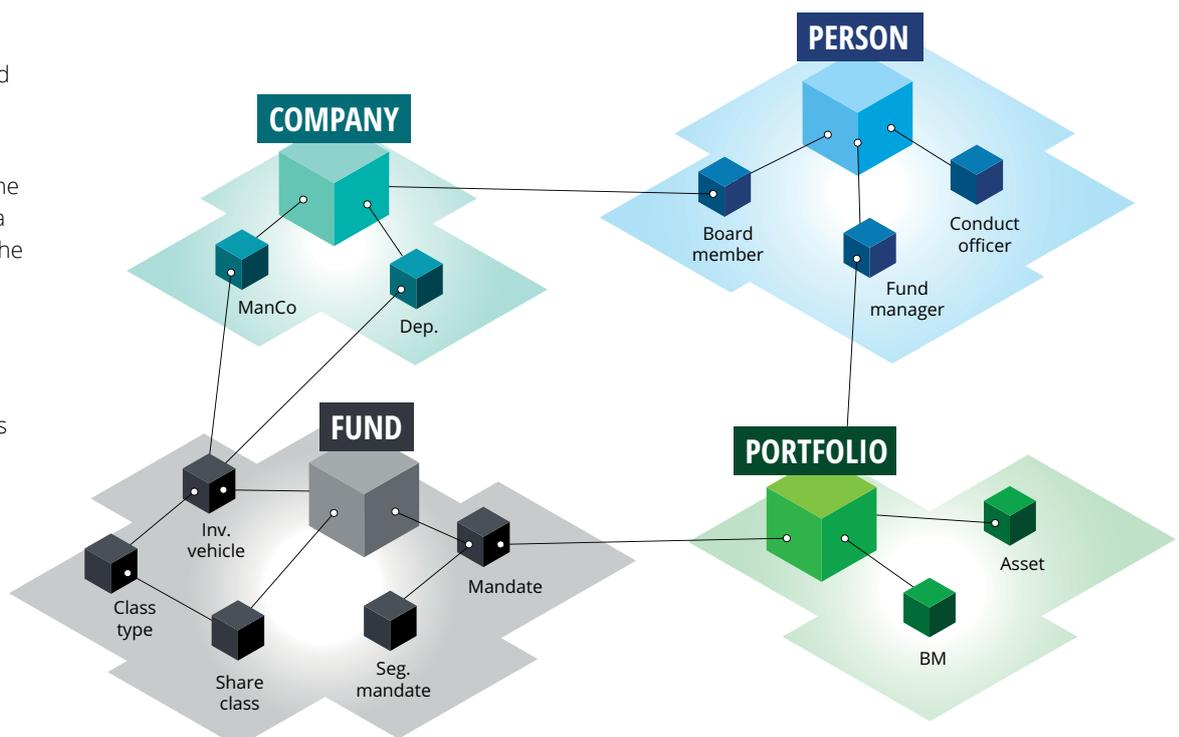
ISIN cannot be shared by two investment funds).

This shared consensus that we advocate within asset management organizations represents the single largest impediment to achieving the objective of shared understanding of meaning of concepts expressed as data points across staff and computer systems. The

representation of the knowledge domain, the ontology, is twofold:

- 1) The organization should determine the classification of concepts (objects) into classes, subclasses, entities, relationships between the classes and finally the properties linked to each class.
- 2) This can be represented through a graph commonly referred to as a knowledge graph. The graph will illustrate the objects called nodes and their relationships called edges. The relationships can be described through language and hence be called semantic relationships because the sentence using informal or formal syntax will prescribe a literal meaning that can be understood by a human and a machine.

**Graph 1: Fund data relationships**



Let us use a simple example: A portfolio of investments is a class; a benchmark is a class. The semantic relationship between the two classes can be one-directional or two-directional. A one-directional relationship would be a portfolio of investments that uses a benchmark.

At this point, I would like to stress that the effort of knowledge representation (abstract modeling of a reality i.e. asset management) implies a radical change in the way asset managers think of data.

Such knowledge representation should deal with large complex parts of the organization and the larger that effort, the more likely it is that classes, attributes, and relationships will be represented that refer to data that lives uniquely or often duplicated in a number of distinct systems without sharing a common meaning of the data.

Here we have finally reached the core of the problem: staff and systems within one particular asset management firm will not share a common language around the key concepts that define their

reality. The problem is not data, the problem is much more significant—do we share a common understanding across our organization?

The data challenge is the result of a lack of shared comprehension of the concepts used on a daily basis and the processes which use these concepts to create value for investors. In essence, the challenge is not only of a technological nature. The digitalization imperative facing the asset management industry requires firms at an individual level to take a step back and reflect on what knowledge means, how it is shared, enhanced and expanded between humans and humans, between humans and machines and between machines and machines.

These challenges are not insurmountable but require a period of reflection and also a healthy interest in how other communities of professionals, especially scientists, have and still are continuously attempting to model the physical reality that we call life.

## CONCLUSION

“Data is the new gold” may be an accurate saying, but it represents a consequence of intelligent abstraction of both concepts and processes. Data is just the expression of the level of conceptualization maturity that the organization can fathom. It is sometimes accurate, meaningful, and shared but unfortunately often lonely, misleading, and potentially misunderstood. To put an end to the cacophony of data, I believe that asset management firms need to work on their proprietary syntax, semantics, taxonomy, thesauri, and ontology. In other words, they need to develop proper frameworks for sharing and internalizing knowledge that helps establish a common context or frame of reference.

The benefits of this approach would be quite significant. Each asset management firm would be able to fully reap the benefits of digitalization. Obviously, this will not happen

overnight, and continuous effort will be required by those who deeply understand their firm’s internal value creation processes. By value creation I mean the process of transforming inputs into outputs: from investment analysis to delivering rewards to investors via the distribution of a product (fund or segregated mandate). Data is a concrete expression of the concepts underpinning this value creation process. The concepts are not immutable and can change over time.

Thinking is the new gold. There is nothing fundamentally new about this. But thinking as a group, with shared concepts and deeper understanding, might just be the new black.

## TO THE POINT

- Think of what your data means. Is the meaning shared across the organization?
- Then think in terms of relationships. Data does not exist on its own: it is related to other data expressing other concepts.
- Step back and take the long view. Once meaning and relationships have been established, a comprehensive data strategy can be implemented across the organization.

# On the highway to transparency in a world of proper costs and charges

HOW ESMA PROMOTES A SOUND PRICING GOVERNANCE  
FOR INVESTMENT FUNDS IN THE EU





**ANNE RICCI**  
DIRECTOR  
AUDIT & ASSURANCE  
DELOITTE



**ALICE LEHNERT**  
DIRECTOR  
CONSULTING – INVESTMENT  
MANAGEMENT  
DELOITTE



**BEATE TWELLMAYER**  
SENIOR MANAGER  
CONSULTING – INVESTMENT  
MANAGEMENT  
DELOITTE

The idea of the prevention of undue costs is not new. The UCITS IV<sup>1</sup> and AIFMD<sup>2</sup> have already introduced cost-related provisions with the goal of preventing undue costs being charged to investors.

These standards have been further elaborated by the Markets in Financial Instruments Directive II (MiFID II) that strengthens the requirements to disclose costs to investors and further requests that the cost-element of a product is considered at the product launch, as well as during its distribution stage. In addition, further disclosure requirements have been introduced by packaged retail investment and insurance products (PRIIPs) regulation, through the publication of cost estimates in the key information documents (KID).

In parallel to regulatory evolvments, the macroeconomic environment of low interest rates has forced investors to pay close attention to funds' performance and fees. It favors the growth of

passively managed funds and increases pressure on fees.

Therefore, investors continue to look for cheaper ways to access investment funds, through channels such as robo advisers.

Regulators believe that low fees are good for return on investment and will play an active part in the increasing pressure on funds' fees and charges by monitoring the European Union investment fund managers (EU IFMs).

Against this backdrop, the European Securities and Markets Authority (ESMA), conducted a survey in 2019 among National Competent

Authorities (NCAs) to understand how they supervise the cost-related provisions under the UCITS and AIFMD frameworks during 2019.

The survey results showed a lack of convergence across EU member states concerning the different supervisory processes on costs. Therefore, in June 2020, ESMA responded with a briefing on supervision of costs charged in UCITS and Alternative Investment Funds (AIFs) in order to promote convergence on the supervision of costs, to reduce the risk of regulatory arbitrage, and to ensure equality of investor protection throughout the EU.

In parallel to regulatory evolvments, the macroeconomic environment of low interest rates has forced investors to pay close attention to funds' performance and fees.

1. Undertakings for Collective Investment in Transferable Securities Directive IV

2. Alternative Investment Fund Managers Directive

ESMA has set high expectations for the formalization and monitoring of the cost-related provisions to ensure that no hidden costs are charged to investors.

**EU IFMs: key actors in banishing undue costs**

One of ESMA's main objectives is to help NCAs identify costs that should be considered as "undue" to investors. The notion of undue costs has to be assessed based on the best interests of investors

and investment objectives of a fund. This implies that the payment of any cost must always remunerate a service provided to the fund and its investors and must not impair compliance with the EU's investment fund manager's (IFM's) duty to act in investors' best interests.



ESMA's objective is to harmonize and increase the supervision of costs. To do so, ESMA uses the supervisory briefing to give market participants and, in particular the investment fund managers, indications on how to build and monitor a sound and formalized pricing process. This pricing process should clearly allow the identification and the analysis of all costs charged to a fund. This analysis consists of qualitative and quantitative elements and include the costs charged:

- Indirectly to the investors via the fund (i.e. the costs can be paid to EU IFM itself or to any third party (e.g. depositary, broker, lawyers)); as well as
- Directly to the investors (e.g. entry and exit cost).

ESMA has set high expectations for the formalization and monitoring of the cost-related provisions to ensure that no hidden costs are charged to investors. Besides the formalization, the periodic review of the pricing process has to be developed and adopted by the EU IFMs. ESMA expects also that the pricing process focuses on:

- Setting out responsibilities among the management bodies of the EU IFM and the fund in determining and reviewing the costs charged to investors; and
- Identifying potential conflicts of interest.

Following ESMA's expectations, EU IFMs have a key and active role to play in the implementation of the pricing process and the design of robust controls around costs charged into a fund.

EU IFMs require a strong governance that will allow acting with due skill, care, and diligence in conducting their business activities in the best interests of the funds they manage. Challenging costs and charges, ensuring that costs are not detrimental for a fund to achieve its investment objectives or that they do not prevent the investor from the expected return on investment should clearly be the priority of EU IFMs and a key indicator of the quality of their governance.

In January 2021, the ESMA launched a common supervisory action (CSA) with NCAs across the EU that will be conducted throughout the year. The aim of the CSA is to assess the compliance of supervised entities with the relevant cost-related provisions in the UCITS framework, and the obligation of not charging investors with undue costs.

### **Pricing process covers 10 principles**

The ESMA has defined 10 principles that IFMs should address in order to assess the notion of undue costs within the pricing process:

01. Validity: The costs charged to a fund/its investors have to be necessary and linked to a service, which is in the best interests of the investors.
02. Proportionality: For each type of service, the costs charged to internal or external counterparties of a

fund and the costs charged directly to investors should be in line with market standards.

03. Consistency: The fee structure of a fund should be coherent and consistent with its characteristics and complexity.
04. Sustainability: The costs charged to a fund should not impair significantly the expected net return of the fund and the investors.
05. Fair treatment of investors: The implemented cost structure must not be detrimental to a certain category of investors. Where different fees apply between different types of investors, the fee level must be justified.
06. No duplication of costs: Each cost has to be properly separated and accounted for and the same type of fee must not be included in two different cost categories.
07. Transparency: The disclosures to the investors around costs should be compliant with all EU (AIFMD, PRIIPs, and UCITS) and national requirements.
08. Cap fee application: When implementing a cap fee, the application and the level of fee should be clearly disclosed to investors.
09. Performance fees: The performance fee model and related disclosures should be compliant with the provisions of the ESMA guidelines on performance fees.
10. Documentation: Formalization of the pricing process including all the data used is required, to enable an ex-post recalculation of the different computations done.

### The UK FCA: a pioneer in challenging UK fund managers' value for money model

In April 2018, the Financial Conduct Authority (FCA) released its Policy Statement PS18/08 on Value for Money Reporting (Policy Statement) that entered into force on 30 September 2019 with the overall goal to provide greater scrutiny of the costs and the performance of funds while ensuring the best interests of the investor.

The Policy Statement applies to UK authorized fund managers (AFM) and their funds, and requires fund managers to carry out a self-assessment against a set of quantitative and qualitative criteria to prove that the fund brings value to the investor, based on a minimum of seven points:

01. Quality of service: Consideration of the range and quality of services provided to unitholders.
02. Performance: Analysis of the performance of the scheme, after deduction of all payments out of scheme property as set out in the prospectus, and by considering an appropriate timescale having regard to the scheme's investment objectives, policy, and strategy.
03. General AFM costs: Review of the relationship between cost and service to which the charge relates.
04. Economies of scale: Scrutiny of AFM's ability to achieve savings and benefits from economies of scale, relating to the direct and indirect costs of managing the scheme property and while taking into account the value of the scheme property and whether it has grown or contracted in size as a result of the sale and redemption of units.
05. Comparable market rates: Comparison of costs in relation to each service with the market rates for any comparable service provided by the AFM, or to the AFM or on its behalf.
06. Comparable services: In relation to each separate charge, analysis of AFM's charges and those of its associates for comparable services provided to clients.
07. Classes of units: Appropriateness for unitholders to hold units in classes subject to higher charges than those applying to other classes of the same scheme with substantially similar rights.

The results of the self-assessment must be published in a summary report, the so-called "Assessment of Value" (AoV) statement, which must be reviewed and republished on an annual basis.

Given that the Policy Statement has been enforced since 2019, we have already seen the first rounds of AoV reports. The majority of those issued so far, still leaves room for improvement. A first assessment has shown that AoV statements follow a "tick-the-box" approach, rather than demonstrating the value for money for funds' investors.

The Chartered Financial Analyst Society United Kingdom (CFA UK) has assessed a selection of AoV statements issued in 2020 and expressed recommendations to fund managers on how these may be improved in the future. Some of these lessons learned, which show parallels to the ESMA principles, are worth exploring, as they may inspire EU IFMs on how to structure and challenge their pricing process.

- With regards to the net performance, UK fund managers are advised to disclose complementary relevant information, such as the investment objectives and the appropriate investment time horizon. Explanatory comments should be added regarding the linked risks, for example drawdowns of historical volatility. Any over or under performance should be commented to indicate the related time horizon.
- Regarding the cost disclosure, the ongoing costs to the fund (OCF) should be presented

in a breakdown to show its material constituents. Any technical terms that are used (e.g. OCF, AMC) should be clearly explained to ensure that also retail investors who are not familiar with the terms understand their meaning.

- More attention should be applied when explaining and interpreting the economies of scale. UK fund managers are advised to provide more quantified guidance on this topic and to demonstrate how the economies of scale will result in actual cost savings for retail investors.
- When comparing market rates, UK fund managers are reminded to use an independent peer group category or benchmark and to provide quantitative data to allow investors to compare and thus improve the usefulness of this section.

In addition to these guidelines, the CFA UK has also voiced several recommendations to the FCA, requesting, amongst others, to produce more prescriptive rules and guidance with the goal to standardize and align the AoV statements produced by fund managers.

Furthermore, the CFA UK expressed concerns in view of the many documents that retail investors receive when investing (e.g. KIID/KID, prospectus, factsheet, AoV statement). The investors might feel overwhelmed by the different information not necessarily comparable to each other. Time will tell whether the FCA will move on to standardize and trim down the various disclosure documents used as of today.



**CONCLUSION**

The first priority for EU IFMs in 2021 is to define and formalize a pricing process in line with ESMA's ten principles. IFMs need to assess their current processes and take the necessary actions towards a transparent pricing framework for their funds and their investors.

Secondly, EU IFMs can expect their regulators to put the review of funds' costs and the IFM's pricing process at the focus of attention in 2021.

Finally, the UK's AoV statements have shown that the road towards transparent costs in relation to performance is not a straight-forward one and that more guidance is needed to produce an outcome which meets the ultimate objective: the protection of investors.

**TO THE POINT"**

- ESMA seeks convergence and harmonization of supervisory actions around UCITS and AIF costs throughout the EU
- EU IFMs have a key and active role in preventing undue costs being charged to investors
- The pricing process implemented at the IFM level should cover the 10 principles as defined by ESMA
- Market participants can expect supervisory actions from all European NCAs in the near future.



# An update on sustainability disclosure

DID THE INVESTMENT INDUSTRY PASS THE  
SFDR INTERMEDIARY DISCLOSURE TEST?

10 March 2021 marked the first milestone of EU Regulation 2019/2088, also known as the Sustainable Finance Disclosure Regulation (SFDR). The SFDR aims to increase the transparency of non-financial information disclosed by financial market participants (FMPs) and financial advisers (FAs) to limit greenwashing and make it easier for investors to assess and compare sustainable and responsible investment strategies and products.

Over the past few months, Deloitte has helped various clients implement the SFDR and was involved in many discussions with FMPs, FAs and industry associations. To gain a holistic view of current practices and to take the temperature of the market's reaction to this regulation, Deloitte also conducted a benchmarking analysis and survey of the main market players entitled "Implementing the SFDR: Your views, approaches and perceived challenges".

The SFDR's lack of detail and the prolonged wait for the final regulatory technical standards ("RTS", the regulation's second-level requirements) meant concerned entities navigated an uncertain regulatory environment when preparing for the March 2021 deadline. Consequently, FMPs and FAs have approached the SFDR in different ways. Further amplifying this diversity of practices was the lack of established market standards for the policies and procedures that entities needed to establish.

This article shares the main market practices that have emerged on sustainability disclosures so far, highlighting good practices and providing guidance on how to move forward with the implementation of the SFDR.



**FRANCESCA MESSINI**  
DIRECTOR  
RISK ADVISORY  
SUSTAINABILITY LEADER  
DELOITTE



**ELODIE VAN DE WOESTYNE**  
MANAGER  
CONSULTING IM & PERE  
SUSTAINABILITY TEAM  
DELOITTE



**KATHARINA LAMPARSKI**  
ANALYST  
CONSULTING IM & PERE  
SUSTAINABILITY TEAM  
DELOITTE

Please note that the SFDR benchmarking analysis and survey results presented in this article capture only a fraction of the entire European market. As such, Deloitte's assessment of the identified market practices is based on its own understanding and interpretation of the regulation.

### Where do we stand?

For the first SFDR application date, FMPs and FAs were required to provide entity and product level disclosures on their website. If applicable, they also had to update their pre-contractual documents to include the consideration of sustainability risks, principal adverse sustainability impacts (PASI) and, for more sustainability-ambitious financial products, how these ambitions were met.

For most concerned entities, meeting these disclosure requirements demanded the setting up of new policies and procedures to embrace a sustainability journey. Indeed, the majority of Deloitte's SFDR survey respondents confirmed this regulation pushed them to revise or even build a new sustainable investment strategy.

### Approach towards sustainability disclosure

The SFDR's main objective is to maximize FMPs' and FAs' transparency towards end-investors regarding their consideration of sustainability risks and adverse impacts. This requires organizations to ensure their disclosures are easily identifiable and accessible through their website. However, this is not a given in practice; in our SFDR benchmarking analysis, we identified that while some firms do provide the required information, it is not always labeled as an SFDR disclosure.

The SFDR's main objective is to maximize FMPs' and FAs' transparency towards end-investors regarding their consideration of sustainability risks and adverse impacts.

Based on our interpretation of the regulation, we have identified the following sustainability information website disclosures as good practices:

- 01 **Label disclosures as being required under SFDR** to allow end-investors to quickly identify what they are searching for.
- 02 **Group all SFDR website disclosures in one place** for clarity and completeness, be it in one website section, tab, or a single file.
- 03 **Adopt SFDR terminology** (e.g., "sustainability risk", "principal adverse sustainability impacts" and, "sustainability factors") to further facilitate the identification of mandatory disclosures and adopt the regulations' definitions.
- 04 **Refer to the specific SFDR article** that applies to the disclosure and potentially detail each article's requirements.

## Sustainability risk disclosure

Before 10 March 2021, only a few players had drafted dedicated sustainability risk policies at the entity level; therefore, no well-established market practices yet existed for these policies. As the regulation does not detail which aspects these policies should present, disclosure practices particularly diverge around the transparency on the consideration of sustainability risks.



Although we observed a range of different approaches in our analysis, we have identified the following aspects of sustainability risk disclosure policies as good practice:

- 01 **Define key terms** (e.g., “sustainability risk”) in accordance with the SFDR’s definitions.
- 02 **Describe the governance structure** in place that continuously monitors the sustainability risk policy’s execution, by identifying responsible stakeholders and their roles, disclosing information about the lines of defense, and/or referring to the risk management policy.
- 03 **Define and provide practical examples of the different types of sustainability risk** (e.g., physical, transitional and reputational) stemming from environmental, social and/or governance (ESG) factors that could affect investors.
- 04 **Explain the sustainability risk identification and prioritization process**, considering the existing types of sustainability risk, the products’ management style (e.g., active, open architecture, or index-tracking), and their investment strategy and sectors (e.g., referring to the sectoral materiality matrices of internationally recognized frameworks like GRESB or SASB).
- 05 **Provide information about the limitations of the sustainability risk assessment** in terms of subjectivity regarding the expected likelihood and impact.
- 06 **Disclose how sustainability risks are monitored** (e.g., exclusion lists, controversies screening, and respecting international norms).

Regarding sustainability risks at the product level, our analysis points to an emerging market trend. While the FMPs we surveyed tended to always consider sustainability risks for their light green (Article 8) and dark green (Article 9) products, they did not consider these risks for many of their ESG neutral (Article 6) products because they were deemed irrelevant. This appears contradictory: light and dark green products are typically exposed to less material sustainability risks than ESG neutral products, due to better assessment and monitoring of ESG factors through an in-depth sustainability investing strategy.

This may be due to some market players potentially misunderstanding the regulation’s intended approach towards the disclosure of product-level sustainability risks. Whereas the SFDR allows FMPs and FAs to identify that sustainability risks are not relevant, this is not an “opt-in or opt-out” option. Instead, the regulation requires players to analyze the sustainability risks before they can deem them not relevant.

## PASI disclosure

The delay of the final RTS muddied market players’ decisions of whether to consider PASI for 10 March 2021, and most of our survey respondents chose the SFDR’s option to not consider PASI by this date. Some respondents confirmed that they are waiting for the adoption of the level 2 requirements that will, amongst others, detail the key performance indicators (KPIs) to be monitored as of January 2022.

As the SFDR provides relatively detailed provisions regarding PASI statements, FMPs’ and FAs’ practices are mainly aligned. We have observed these additional good practices regarding PASI policies:

- 01 **Specify in which stage(s) of the investment process PASI are considered.**
- 02 **Define and list the mix of quantitative and qualitative measures** used to assess PASI while waiting for the final list provided by the RTS.

### Product classification

Morningstar performed a preliminary assessment of Luxembourg-domiciled funds' classifications and found that approximately 18% of European funds are classified as light green (Article 8) and 3.6% as dark green (Article 9), together representing approximately 25% of European fund assets. Therefore, all other European funds are classified as ESG neutral (Article 6). This classification tendency is also reflected in the results of our SFDR survey, where respondents were asked to provide their product classification ratio. The observed trend of dark green products being relatively rare can be explained by the low proportion of "impact funds" on the market.

As the SFDR does not define the precise criteria and thresholds to classify a financial product as light or dark green, differences in product classification have emerged. One example is the continuing discussions on whether investments into green bonds can automatically be considered as having a sustainable investment objective. Another example is light green products falling under the French AMF Doctrine 2020-03 on sustainability disclosures respect the 90% minimum rate of non-financial analysis, while other light green products outside the doctrine's scope adopt lower thresholds, for instance 67%.

The lack of pre-defined classification criteria, the absence of the final RTS, and gold plating attitudes from some EU member states seem

to have contributed to the market's hesitancy around product categorization. We observed two main concerns when working with our clients. Firstly, some FMPs were unsure as to whether their products were ESG-ambitious enough to qualify as light or dark green. Secondly, some actors were skeptical whether they could meet the level 2 product disclosure requirements by January 2022. This uncertainty resulted in many FMPs adopting a conservative approach by "downgrading" their financial products, which is confirmed in our SFDR survey results.

### Disclosures in pre-contractual documents

To apply the level 1 disclosure requirements, some FMPs decided to add SFDR disclosures across different sections of the main body of the pre-contractual documents, while others chose to provide all their SFDR product-level disclosures in one appendix. In our view, both options work equally well as long as the disclosure is clear and concise.

We observed these clear and concise disclosure practices for pre-contractual documents:

- 01 **Clarify the difference** between ESG integration (ESG neutral) and more sustainability-ambitious products (light and dark green).
- 02 **Name the product classification** in the "investment objective" or "investment policy" sections by making explicit reference to the SFDR and using its terminology.
- 03 **List the classification of all financial products** to provide end-investors with an overview of all the FMPs' products.

However, as the RTS were not mandatory as of March 2021, none of the entities we analyzed have adopted the proposed template of pre-contractual documents of light and dark green products yet.

2021, none of the entities we analyzed have adopted the proposed template of pre-contractual documents of light and dark green products yet.

Still, some respondents provide additional information linked to the level 2 requirements, such as describing the different steps of the investment process; explaining how ESG criteria are incorporated and monitored; or disclosing the percentage of net assets that do not promote environmental or social characteristics or do not have a sustainable investment objective.

The draft RTS published in February 2021 provided a template for entities to insert into the annex of pre-contractual documents. However, as the RTS were not mandatory as of March



## CONCLUSION

Although the SFDR level 1 text leaves much room for interpretation and the level 2 requirements are still pending at the time of writing, all FMPs and FAs captured in our study managed to meet the ambitious March 2021 deadline—even in the context of the COVID-19 pandemic.

Consequently, the adopted market practices are quite varied today. However, we expect them to become more harmonious over time, as regulators provide additional details about their expectations and market actors learn from each other.

Nevertheless, the most challenging implementation period still lies ahead. Moving forward, the top concerns of our survey respondents are the pressure to implement the final RTS (once published) in time for January 2022 and the availability and quality of ESG data.

When asked how the respondents' firms plan to approach the interim implementation period between March 2021 and January 2022, "I don't know" was a relatively popular answer. Still, most respondents expected to have already integrated the draft RTS by then, which can be adapted if necessary. Only a few respondents preferred to wait for the final RTS before preparing for the January 2022 due date.

While we acknowledge that there is no "perfect answer" of how to approach the next SFDR deadline, and despite

the uncertain regulatory expectations, we advise our clients to identify any gaps between their available ESG data sources and expected data needs. Based on the results of this gap assessment, actors should promptly engage with their current ESG data vendor(s) to clarify how much of the required data can be collected and identify whether these gaps could be remedied by contracting another data vendor.

Some of the FMPs we surveyed are also concerned about ensuring a smooth alignment between SFDR and the EU's Taxonomy regulation, which amends the SFDR and will also apply as of 1 January 2022. This means that pre-contractual disclosures and periodic reports of all light and dark green financial products will also need to respect the Taxonomy disclosure requirements. ESG neutral products will only have to include pre-defined statements in these documents.

Lastly, we urge FMPs not to underestimate the efforts required to meet the ongoing data collection and reporting requirements. Actors should already be assigning duties and responsibilities within their firms for preparing product periodic reports and entity-level PASI statements. They should also evaluate whether their current internal resources are sufficient to meet the disclosure requirements and take remedial action if needed.

## TO THE POINT

- March 2021 marked the first milestone of the SFDR. To gauge the investment industry's reaction, Deloitte conducted an SFDR benchmarking survey and analysis.
- Our results uncovered a wide spectrum of approaches by financial market participants and advisers to tackle these new mandatory sustainability disclosures. The type of information communicated and the level of detail varied considerably from one entity or product to the other.
- This article provides a holistic view of the current SFDR market practices and addresses the challenges faced by regulated entities going forward.

# Webinars Programme 2021

Since 2009, Deloitte has decided to open its knowledge resources to the professionals of the Financial Services Industries community. We are happy to present to you the calendar of our new Lunch'n Learn season which, as in previous years, will be moderated by our leading industry experts. These sessions are specifically designed to provide you with valuable insight on today's critical trends and the latest regulations impacting your business. An hour of your time is all you need to log on and tune into each informative webinar.

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- **02 June 2021**  
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The ManCo as a key stakeholder
- **16 June 2021**  
Trends in cyber risk and regulation for financial  
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- **30 June 2021**  
Sustainability impacts and opportunities for  
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Transfer Pricing dimension of regulated management  
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.....

# Contacts

## Africa - East, West, Central and South



**Dinesh Munu**  
Partner - Audit  
+27 011 806 5767  
dmunu@deloitte.co.za



**David Nchimbi**  
Partner - Audit  
+255 222 169 000  
dnchimbi@deloitte.co.tz



**Joshua Ojo**  
Partner - Audit  
+234 190 421 30  
jojo@deloitte.com.ng

## Australia



**Neil Brown**  
Partner - Assurance & Advisory  
Wealth Management  
+61 3 967 171 54  
nbrown@deloitte.com.au



**Siew-Kee Chen**  
Partner - Tax  
+61 2 9322 3823  
skchen@deloitte.com.au



**Declan O'Callaghan**  
Partner - Assurance & Advisory  
+61 2 932 273 66  
deocallaghan@deloitte.com.au



**James Oliver**  
Partner - Assurance & Advisory  
+61 3 9671 7969  
joliver@deloitte.com.au

## Austria



**Dominik Damm**  
Partner - Advisory  
+431 537 005 400  
dodamm@deloitte.at



**Nora Engel-Kazemi**  
Partner - Tax  
+431537005420  
nengel@deloitte.at



**Robert Pejhovskyy**  
Partner - Tax & Audit  
+431 537 004 700  
rpejhovskyy@deloitte.at

## Bahamas



**Lawrence Lewis**  
Partner - ERS  
+1 242 302 4898  
llewis@deloitte.com

## Belgium



**Maurice Vrolix**  
Partner - Audit  
+32 2 800 2145  
mvrolix@deloitte.com



**Tom Renders**  
Director, Audit  
+ 32 474 62 43 78  
trenders@deloitte.com

## Bermuda



**Mark Baumgartner**  
Partner - Audit  
+1 441 299 1322  
mark.baumgartner@deloitte.com



**James Dockeray**  
Partner - Tax  
+1 441 299 1399  
james.dockeray@deloitte.com



**Muhammad Khan**  
Partner - Audit  
+1 441 299 1357  
muhammad.khan@deloitte.com

## Brazil



**Cristina Yong Hae Soh**  
Partner - Consulting  
+55 11 5186 1305  
csoh@deloitte.com

## British Virgin Islands



**Carlene A. Romney**  
Partner - Audit  
+1 284 494 2868  
cromney@deloitte.com

## Canada



**Natan Aronshtam**  
Partner - Tax & Legal  
+14 166 438 701  
naronstam@deloitte.ca



**Rob Galaski**  
Partner - Consulting  
+14 166 014 594  
rgalaski@deloitte.ca



**George Kosmas**  
Partner - Audit & Assurance  
+14 166 016 084  
gkosmas@deloitte.ca



**Mervyn Ramos**  
Partner - Audit & Assurance  
+14 166 016 621  
merramos@deloitte.ca



**Lilly Zhou**  
Partner - Tax & Legal  
+14 165 214 549  
lilzhou@deloitte.ca

## Cayman Islands



**Dale Babiuk**  
Partner - Audit & Assurance  
+13 457 436 225  
dbabiuk@deloitte.com



**Anthony Fantasia**  
Partner - Tax  
+13 457 436 244  
anfantasia@deloitte.com



**Norm McGregor**  
Partner - Audit & Assurance  
+13 458 142 246  
nmcgregor@deloitte.com



**Stuart Sybersma**  
Partner - Financial Advisory  
+13 458 143 337  
ssybersma@deloitte.com

## Chile



**Ricardo Briggs**  
Partner - Consulting  
+56 2 2729 7152  
rbriggs@deloitte.com



**Pablo Herrera**  
Partner - Financial Advisory  
+56 2 2729 8150  
paherrera@deloitte.com



**Alberto Kulenkampff**  
Partner - Audit  
+ 56 22729 7368  
akulenkampff@deloitte.com

## China (Southern)



**Sharon Lam**  
Partner - International Tax  
Services  
+852 28 52 65 36  
shalam@deloitte.com.hk



**Anthony Lau**  
Partner - International Tax  
Services  
+852 2852 1082  
antlau@deloitte.com.hk

## China (Easter and Northern)



**Natalie Na Yu**  
Partner - Tax Services  
+86 10 85207567  
natyu@deloitte.com.cn



**Lily Fang Wang**  
Partner - Audit  
+86 2161412431  
lilyfwang@deloitte.com.cn

## Colombia



**Ricardo Rubio**  
Partner - Financial Advisory  
Services  
+57 1 546 1818  
rrubio@deloitte.com

## Denmark



**Anders Oldau Gjelstrup**  
Partner - Audit  
+45 20 41 68 02  
agjelstrup@deloitte.dk

## Finland



**Ilkka Huikko**  
Partner - Consulting  
+358 40 740 3529  
ilkka.huikko@deloitte.fi



**Sami Toivoniemi**  
Director - Regulatory Risk  
+358 207 555 808  
sami.toivoniemi@deloitte.fi



**Juha Hyttinen**  
Senior Manager - Strategy  
and Operations  
+358 207 555 653  
juha.hyttinen@deloitte.fi

## France



**Hélène Alston**  
Partner - Tax  
+33 1 55 61 60 32  
healston@taj.fr



**Yoan Chazal**  
Partner - Risk Advisory  
+33 1 40 88 72 19  
ychazal@deloitte.fr



**Stéphane Collas**  
Partner - Audit  
+33 1 55 61 61 36  
scollas@deloitte.fr



**Bruno de Saint Florent**  
Partner - Consulting  
+33 1 58 37 04 46  
bdesaintflorent@deloitte.fr



**Jean-Marc Lecat**  
Partner - Audit  
+33 1 55 61 66 68  
jlecat@deloitte.fr



**Sebastien Manelfe**  
Partner - Financial Advisory  
smanelfe@deloitte.fr  
+33 1 40 88 85 54

## Germany



**Andreas Koch**  
Partner - Audit  
+49 892 903 687 39  
akoch@deloitte.de



**Dorothea Schmidt**  
Partner - Consulting  
+49 699 713 734 6  
dschmidt@deloitte.de



**Nina Schrader**  
Director - Consulting  
+49 173 258 5554  
nschrader@deloitte.de



**Christof Stadter**  
Partner - Audit  
+49 89 29036 8269  
cstadter@deloitte.de



**Alexander Wenzel**  
Partner - Tax & Legal  
+49 69 75695 6111  
alwenzel@deloitte.de

## Greece



**Alexandra Kostara**  
Partner - Audit  
+30 210 67 81 152  
akostara@deloitte.gr



**Despina Xenaki**  
Partner - Audit  
+30 210 67 81 100  
dxenaki@deloitte.gr

## Guernsey



**John Clacy**  
Partner - Audit  
+44 1 481 703 210  
jclacy@deloitte.co.uk

## Hong Kong



**Anthony Ming Young**  
Partner - International Tax Services  
+852 285 210 82  
antlau@deloitte.com.hk

## Iceland



**Gunnar Thorvardarson**  
Partner - Audit  
+354 580 3031  
gthorvardarson@deloitte.is

## India



**Rajesh Gandhi**  
Partner - Tax Leader  
+91 22 6185 4380  
rajegandhi@deloitte.com



**Bimal Modi**  
Partner - IM Leader  
+91 22 6185 5080  
bimalmodi@deloitte.com

## Indonesia



**Rosita Sinaga**  
Partner - Audit  
+62 21 2992 3100  
rsinaga@deloitte.com

## Ireland



**David Dalton**  
Partner - Consulting  
+353 140 748 01  
ddalton@deloitte.ie



**Brian Forrester**  
Partner - Audit  
+353 141 726 14  
bforrester@deloitte.ie



**Mike Hartwell**  
Partner - Audit  
+353 141 723 03  
mhartwell@deloitte.ie



**Brian Jackson**  
Partner - Audit  
+353 141 729 75  
brijackson@deloitte.ie



**Christian MacManus**  
Partner - Audit  
+353 141 785 67  
chmacmanus@deloitte.ie



**Deirdre Power**  
Partner - Tax  
+353 141 724 48  
depower@deloitte.ie

## Israel



**Ran Feldboy**  
Partner - Audit  
+972 3 6085478  
rfeldboy@deloitte.co.il

## Italy



**Marco De Ponti**  
Partner - Audit  
+390 283 322 149  
mdponti@deloitte.it



**Maurizio Ferrero**  
Partner - Audit  
+390 283 322 182  
mferrero@deloitte.it



**Paolo Gibello-Ribatto**  
Partner - Audit  
+390 283 322 226  
pgibello@deloitte.it



**Marco Miccoli**  
Partner - Audit  
+390 283 322 308  
mmiccoli@deloitte.it



**Riccardo Motta**  
Partner - Audit  
+390 283 322 323  
rmotta@deloitte.it

## Japan



**Yang Ho Kim**  
Partner - Tax  
+81 3 621 338 41  
yangho.kim@tohatsu.co.jp



**Nobuyuki Yamada**  
Partner - Audit  
+81 90 650 345 34  
nobuyuki.yamada@tohatsu.co.jp



**Ken Atobe**  
Director - Risk Advisory  
+81 80 405 691 77  
ken.atobe@tohatsu.co.jp

## Kazakhstan



**Roman Sattarov**  
Partner - Audit  
+7 7272 581340  
rsattarov@Deloitte.kz

## Luxembourg



**Eric Centi**  
Partner - Cross-Border Tax  
+352 451 452 162  
ecenti@deloitte.lu



**Pascal Denis**  
Partner - Advisory & Consulting  
+352 451 452 970  
padenis@deloitte.lu



**Laurent Fedrigo**  
Partner - Audit  
+352 451 452 023  
lafedrigo@deloitte.lu



**Nicolas Hennebert**  
Partner - Audit  
+352 451 454 911  
nhennebert@deloitte.lu



**Lou Kiesch**  
Partner - Regulatory Consulting  
+352 451 452 456  
lkiesch@deloitte.lu



**Benjamin Lam**  
Partner - Audit  
+352 451 452 429  
blam@deloitte.lu



**Simon Ramos**  
Partner - IM Advisory & Consulting  
+352 451 452 702  
siramamos@deloitte.lu



**Xavier Zaegel**  
Partner - Financial Services  
+352 451 452 748  
xzaegel@deloitte.lu

## Malaysia



**Anthony Tai**  
Executive Director - Enterprise Risk Services  
+60 3 7610 8853  
yktai@deloitte.com

## Malta



**Michael Bianchi**  
Partner - Audit  
+356 2343 2879  
mibianchi@deloitte.com.mt

## Mexico



**Ernesto Pineda**  
Partner - Financial Services  
+52 55 5080 6098  
epineda@deloittemx.com

## Monaco



**Julien Le Marrec**  
Director - Risk Advisory  
+377 97 77 27 41  
jlemarrec@deloitte.mc



**Pascal Noël**  
Director - Risk Advisory  
+377 97 77 47 37  
pasnoel@deloitte.mc

## Netherlands



**Jan-Wouter Bloos**  
Partner - Consulting  
+31 88 288 2768  
jbloos@deloitte.nl



**Bas Castelijm**  
Partner - Tax  
+38 288 6770  
BCastelijm@deloitte.nl



**Marieke van Eenennaam**  
Partner - Risk Advisory  
mvaneennaam@deloitte.nl  
+31 88 288 2500



**Remy Maarschalk**  
Partner - Audit  
+31 88 288 1962  
RMaarschalk@deloitte.nl



**Evert van der Steen**  
Partner - Enterprise Risk Services  
+31 62 078 9545  
evandersteen@deloitte.nl

## Norway



**Sverre Danielsen**  
Partner - Enterprise Risk Services  
+47 99 517 686  
sdanielsen@deloitte.no



**Henrik Woxholt**  
Partner - Audit & Advisory  
+47 23 27 90 00  
hwoxholt@deloitte.no

## Philippines



**Bonifacio Lumacang**  
Partner - Audit  
+63 2 581 9000  
blumacang@deloitte.com

## Portugal



**Maria Augusta Francisco**  
Partner - Audit  
+351 21 042 7508  
mafrancisco@deloitte.pt

## Singapore



**Ei Leen Giam**  
Partner - Global Financial  
Services Industry  
+ 65 62 163 296  
eilgiam@deloitte.com



**Ho Kok Yong**  
Partner - Global Financial  
Services Industry  
+65 621 632 60  
kho@deloitte.com



**Michael Velten**  
Partner - Tax  
+65 6531 5039  
mvelten@deloitte.com

## Slovakia



**Peter Longauer**  
Partner - Audit  
+421 2 582 49 411  
plongauer@deloitte.com

## Spain



**Rodrigo Diaz**  
Partner - Audit  
+349 144 320 21  
rodiaz@deloitte.es



**Francisco Rámirez Arbues**  
Partner - Tax  
+34 606289571  
framirezarbues@deloitte.es



**Antonio Rios Cid**  
Partner - Audit  
+349 915 141 492  
arioscid@deloitte.es



**Alberto Torija**  
Partner - Audit  
+349 143 814 91  
atorija@deloitte.es



**José María Grande Esturo**  
Partner - M&A Consulting  
+34 944 447 000  
jgrande@deloitte.es



**Ignacio García Alonso**  
Partner - Tax  
+34 67 952 180  
igarciaalonso@deloitte.es

## Switzerland



**Marcel Meyer**  
Partner - Audit  
+41 58 279 7356  
marcelmeyer@deloitte.ch



**Simona Terranova**  
Partner - Audit  
+41 58 279 8454  
sterranova@deloitte.ch



**André Kuhn**  
Director - Tax  
+41 58 279 6328  
akuhn@deloitte.ch



**Markus Weber**  
Partner - Tax  
+41 58 279 7527  
markweber@deloitte.ch

## Taiwan



**Vincent Hsu**  
Partner - Audit  
+886 2 545 9988 1436  
vhsu@deloitte.com.tw



**Olivia Kuo**  
Partner - Audit  
+886 2 25459988  
oliviakuo@deloitte.com.tw



**Jimmy S. Wu**  
Partner - Audit  
+886 2 2545 9988 7198  
jimmyswu@deloitte.com.tw

## Thailand



**Somkrit Krishnamra**  
Partner - Risk Advisory  
+66 2 676 5700  
somkrishnamra@deloitte.com

## United Kingdom



**Allee Bonnard**  
Partner - Audit  
+44 20 7303 0472  
abonnard@deloitte.co.uk



**Gavin J Bullock**  
Partner - Tax  
+44 20 7007 0663  
gbullock@deloitte.co.uk



**Jonathan Burdett**  
Partner - Risk Advisory  
+44 20 7303 2580  
jburdett@deloitte.co.uk



**Baber Din**  
Partner - Financial Services  
+44 20 7303 2878  
bdin@deloitte.co.uk



**Sheelan Shah**  
Partner - Tax  
+44 20 7007 2779  
sheelanshah@deloitte.co.uk



**Andrew McNeill**  
Partner - Consulting  
+44 20 7007 6151  
amcneill@deloitte.co.uk

## United States



**Patrick Henry**  
Vice Chairman  
National Sector Leader  
+1 212 436 4853  
phenry@deloitte.com



**Kristina Davis**  
Investment Management Leader  
Risk & Financial Advisory  
+1 617 437 2648  
kbdavis@deloitte.com



**Dave Earley**  
Partner - Tax  
Investment Management Leader  
+1 617 319 2048  
dearley@deloitte.com



**Paul Kraft**  
Partner - Audit  
US Mutual Fund and Investment  
Adviser Practice Leader  
+1 617 437 2175  
pkraft@deloitte.com



**Jagat Patel**  
Partner - Consulting  
Investment Management Leader  
+1 203 708 4028  
jagpatel@deloitte.com



**Tania Taylor**  
Partner - Audit  
Investment Management Leader  
+1 212 436 2910  
tlynn@deloitte.com

## Vietnam



**Thinkh Pham**  
Managing Partner  
+84 839100751  
thpham@deloitte.com

# Contacts



**Cary Stier**

Partner - Global Investment  
Management Leader  
+1 212 436 7371  
cstier@deloitte.com



**Vincent Gouverneur**

Partner - EMEA Investment  
Management Co-Leader  
+352 451 452 451  
vgouverneur@deloitte.lu



**Tony Gaughan**

Partner - EMEA Investment  
Management Co-Leader  
+44 20 7303 2790  
tgaughan@deloitte.co.uk



**Jennifer Qin**

Partner - Asia Pacific Investment  
Management Leader  
+86 21 61 411 998  
jqin@deloitte.com

Please do not hesitate  
to contact your relevant  
country experts listed in  
the magazine.

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