

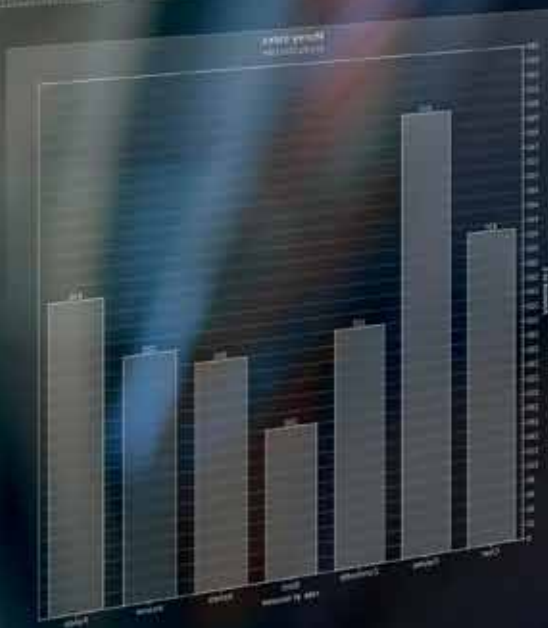
Deloitte.



Europe's fund expenses at a crossroads

The benefits of mutualizing
the cost of distribution

Business Index



Executive Summary

This study analyzes investment funds' expenses with the purpose of identifying key cost drivers and potential areas for cost reduction. It is based on a sample of 400 funds managed by 60 promoters established across 6 domiciles: 2 European cross-border domiciles (Luxembourg and Ireland), 3 European domestic domiciles (France, UK and Germany), and the United States. Our data was complemented with information received from market participants who contributed to the development of this report.

First, we argue that enhanced cost transparency and investor awareness should encourage asset managers to become more efficient and to provide better control of expenses charged to investors. We explore two areas of potential cost reduction:

- Cross-border distribution: domiciles such as Luxembourg and Ireland, as de facto cross-border product servicers, must handle the requirements of multiple target markets in which their funds are distributed. These requirements include tax reporting, documentation filings, currency share class hedging, KIID production, fund maintenance and setup, local agent and audit fees.
- Supply chain management: fund distribution is a cumbersome process, which can vary significantly from one domicile to another in terms of efficiency. The process includes order management, cash processing, Know-Your-Client procedures, distributor due diligence, reconciliations, data dissemination and document management.

Our first section of the report confirms that specialized cross-border domiciles are more cost-efficient than other European domiciles when it comes to multiple market distribution. Process efficiency, critical mass, and experience achieved over the years play a major role in reaching multiple markets while keeping costs under control. On the basis of the data we reviewed, we believe that there is limited potential for further cost reduction in this area in specialized cross border platforms.

On the contrary, the second part of the report identifies significant cost saving opportunities by mutualizing parts of the distribution supply chain:

- The mutualization of know-your-client (KYC) activities appears as a major innovative step compared with the current industry model. It would simplify the "many to many" model of KYC interactions between transfer agents and distributors/investors, enabling a reduction of compliance cost while increasing the speed of client acceptance procedures.
- Under a mutualized cash processing environment, each market player would process one payment per value date and per currency, independently from the number of counterparties with which it deals. This is precisely what DTCC provides in the U.S. fund market, and it could be achieved via the introduction and operation of a central cash compensation account.
- If all orders were processed via an automated, central ordering system, manual processing time would almost disappear, and bilateral interface maintenance and technology requirements would be significantly reduced.
- Significant streamlining would be achieved if a solution was developed to capture transfers, pre-match counterparties' instructions, and provide a single-leg automated instruction to transfer agents. Corporate actions and dividends would also benefit from cost savings via the elimination of paper confirmations and the reduced amount of time required to book these events.
- Finally, if all of the above were achieved, the industry would significantly reduce the cost of reconciliations, the number of error corrections, and the reliance on client support.

Combined, these above items currently cost around €1.3 billion per year. This total could be reduced by 70 percent to €376 million per year under a mutualized approach.

Introduction

The combined effect of cost mutualization, fee transparency and tightened inducement rules will eventually trigger the long-awaited alignment of European fund expenses with their U.S. peers

The global investment fund industry is much larger today than it has ever been. Its European component more than doubled in size over the past ten years, with total assets under management surpassing the €10 trillion mark in the course of 2015.¹ Against the background of the deepest global recession since World War II, a major political crisis, and an unprecedented number of regulatory initiatives, such a strong and sustained growth emphasizes the attractiveness of investment funds and the success of the UCITS brand.

Despite these impressive achievements, the industry will still have many challenges to overcome in order to secure and strengthen its growth. This report originates from the observation that three trends will directly impact the future success of our investment fund model:

- The strong expansion of non-European fund domiciles, as their share of global GDP and financial wealth significantly increased over the last 10 years. The development of passports and trade agreements within these emerging regions represents both a challenge and an opportunity for the European fund industry.
- The financial requirements of an ageing population and the need to provide cost efficient pension solutions via well-governed, diversified and risk managed collective investment schemes
- The public demand for increased investor protection and systemic stability of the financial system, with a potential growing role for non-bank financial solutions and intermediaries

In light of these opportunities, this report argues that the European fund industry should both control product expense and limit the cost of distribution. While the former will help unlock the investment potential of European savings (41 percent of European household wealth is still held in cash accounts), the latter will improve the competitiveness of investment funds against other financial instruments. In their constant aim to improve processing efficiency, market players should assess the opportunity to mutualize elements of the distribution supply chain, hence reducing costs against the highly efficient nature of other, more mature, asset classes.

In the general context of enhanced investor protection, the review of the Markets in Financial Instruments Directive (MiFID II) will drive a significant reduction in European expense ratios, domestic and cross-border alike. The combined effect of cost mutualization, fee transparency and tightened inducement rules will eventually trigger the long-awaited alignment of European fund expenses with their U.S. peers.

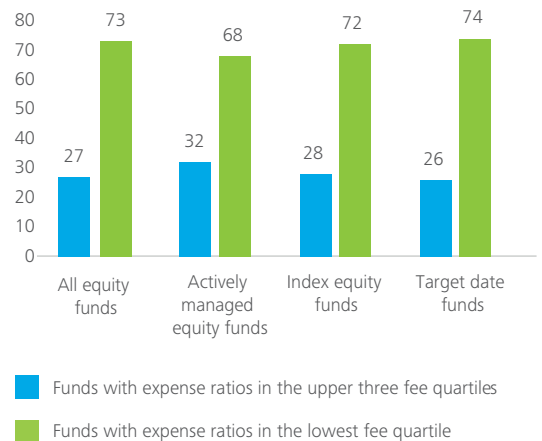
1. Fund fees in Europe and U.S.

Fund investors and fee levels

One of the major decision criteria for investors besides product performance is undoubtedly the cost of an investment solution. Whether it is in the form of front-end loads or management fees, charges incurred by investors can be significant. In a post-crisis environment, transparency and comparability directly threaten uncompetitive charging structures. A robust and disciplined pricing strategy should therefore be a priority for fund promoters.

A correlation between investor preferences and the level of fund expenses has been evidenced in the U.S., where assets tend to converge toward funds with low expense ratios.

US mutual fund assets are concentrated in lower-cost funds (% of assets, 2014)



Source: Investment Company Institute (2014)

Beyond the natural preference of investors towards cost-efficient solutions, it is a combination of market- and regulatory-driven dynamics that will eventually influence the pricing policy of European funds.

01/ **Passive products**
Strong competition from passive investment schemes (e.g., ETFs, Smart Beta Funds)

02/ **Competition**
Fierce competition between asset management firms and increased awareness from investors about product fee structures

03/ **Transparency**
Increased transparency in a post-crisis environment

04/ **Inducements**
Ban of inducements in Europe post MIFID II

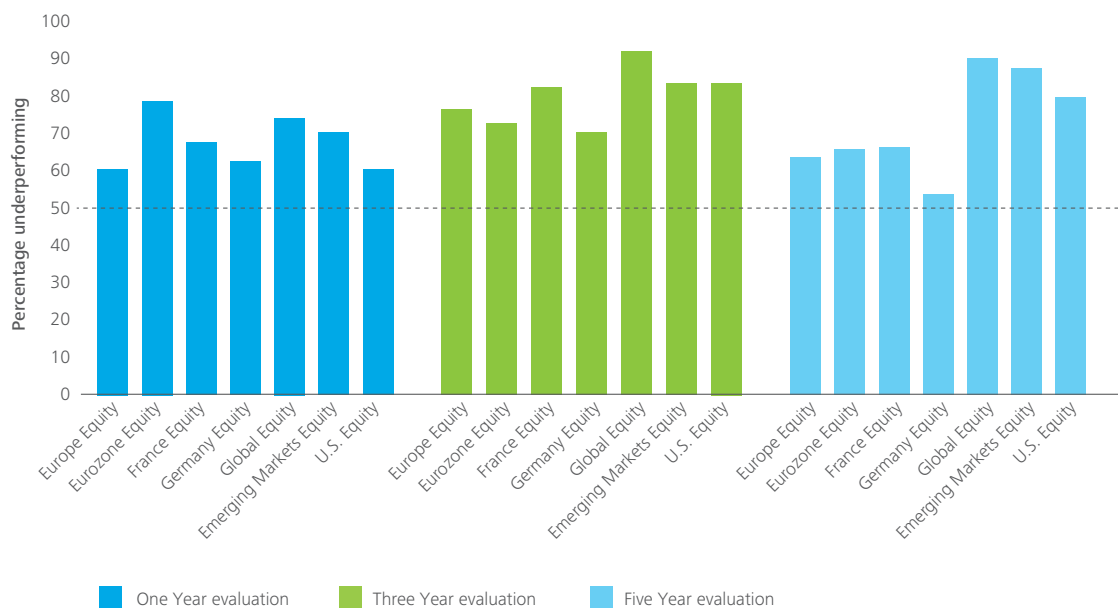
01 *Passive products*

Actively managed funds face increasing competition from their passive substitutes. The trading flexibility of exchange-traded funds (ETF) and their lower cost directly call into question the supposed benefit of an expensive investment selection process. According to research conducted by the INSEAD in 2014 the difference between actively and passively managed schemes for comparable investment strategies reached approximately 80 bps of the annual management fee in Europe.

Actively managed funds face increasing competition from their passive substitutes

This pricing differential becomes particularly difficult to justify when more than 50 percent of actively managed U.S. funds fail to consistently outperform equivalent passive strategies.

Percentage of actively managed US mutual funds underperforming their benchmark (2014)



Source: Morningstar (2014)

02 *A competitive Asset Management landscape*

Despite a constant and robust growth in net sales, actively managed funds charged 10 bps less in 2012 than they did in 2002. Over the same period, passive strategies grew significantly more than active ones while reducing annual management fees to a far greater extent than active managers (see chart on right page), with a price reduction of up to 47 bps in the UK.

A commonly accepted interpretation of these figures holds that passive funds managed to increase their market share in such a short timeframe thanks to an aggressive pricing policy. In response to this trend, recent studies highlight that active managers are reacting by further decreasing their fees and reviewing their investment processes and pricing strategies.

In this context, it is worth noting that the ability to reduce charges incurred by an investor is largely enabled by ETFs' highly efficient "creation/redemption" mechanism and the way they gain exposure to the market while being shielded from trading fees. Actively managed funds are by nature condemned to pay trading spreads and commissions each time an investor enters the fund, hence the more limited extent of their cost reduction potential.

Despite the differences inherent to actively and passively managed funds, other factors may enable active asset managers to review their pricing structure:

Internal

- Asset managers significantly improved the granularity of fund expenses breakdown and the quality of

internal management information systems.

- Some asset managers are adopting enhanced accounting systems using activity-based costing as an essential complement to fixed total expense ratios.

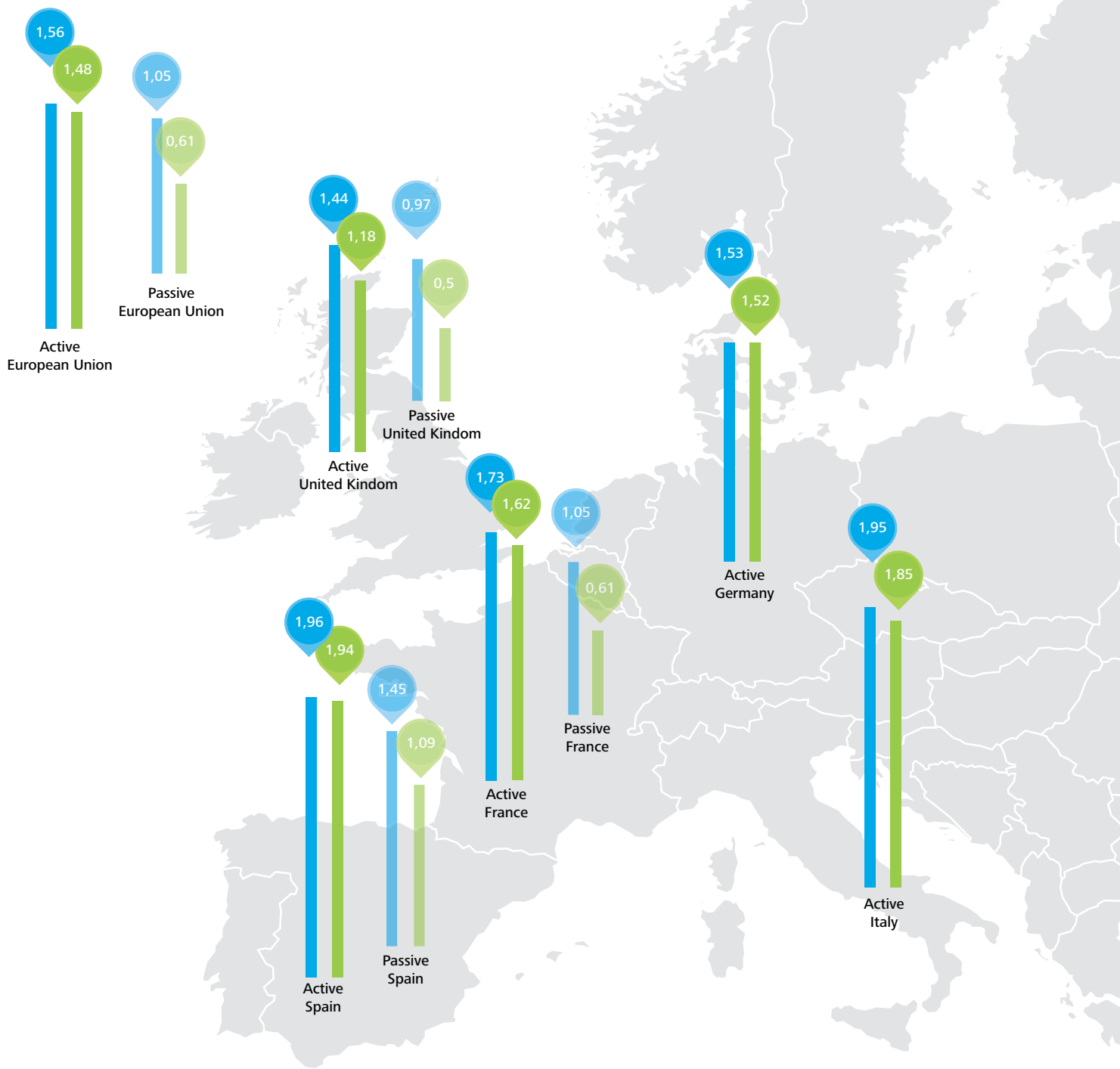
By significantly improving the quality of the analytical accounting figures and their regular monitoring, asset managers gain a more granular understanding of their product revenue margin. This understanding can in turn lead to a more flexible charging structure that is able to quickly adapt to investor sentiment.

External

- Both asset managers and their intermediaries/distributors leverage fund processing solutions currently available on the market, including automated messaging protocols, electronic data dissemination links, dealing platforms and aggregators, etc.
- Asset managers closely monitor and regularly review the performance of their outsourcing service providers in line with constantly evolving distribution setup and regulatory requirements.

These factors help to reduce asset managers' cost base, which provides more room to review pricing policies.

Evolution of management fees of actively and passively managed funds (%)



■ 2002 Management fees ■ 2012 Management fees

Source: Insead OEE data services (2014)

03 *Increased transparency in a post-crisis environment*

The financial crisis of 2009-2012 triggered a wave of new regulatory requirements. Investor protection is one of the foremost goals of this legislative effort. The legislation's focus on greater transparency aims to restore the confidence of investors toward financial services.

Within the fund industry, both UCITS and AIFMD frameworks impose strict investor protection requirements, be it via mandatory diversification of assets, independent depositary bank, or strict licensing requirements. From a cost transparency perspective, after the adoption of the UCITS KIID, additional requirements were introduced in the MiFID II package and the PRIIPS KID. The combined objective of these regulatory initiatives is to improve the content of investor information on costs and charges and to facilitate direct comparison between financial instruments:

- UCITS KIID: obligation to disclose ongoing charges, among several other standardized and comparable key characteristics for investment funds
- MiFID II
 - Detailed ex-ante and ex-post investor disclosure on the financial instruments, on the investment services and on the ancillary services provided to the client
 - Explicit requirement on financial instruments to have a coherent cost structure charged to the investor as part of the product governance arrangements
- PRIIPS KID²: extension of the UCITS KIID for all types of investment products (including insurance-linked products)

Transparency, direct comparability, and an explicit duty not to provide misleading information to investors intuitively create an incentive to control fund charging structures.



² The PRIIPS regulation will enter into force on 1st January 2017

04 *Tightening of inducement rules in the EU*

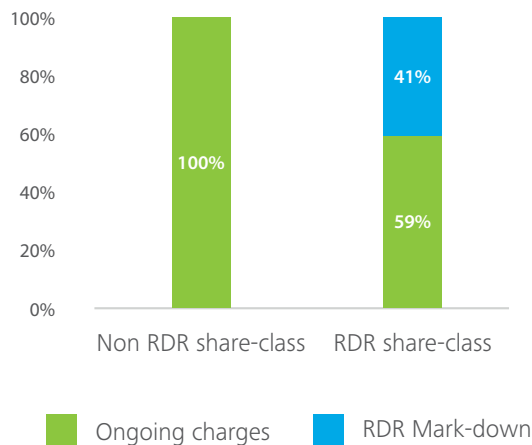
Inducements have long been a cornerstone of European fund distribution: they reflect the basic principle that intermediary networks must be built and remunerated in order to reach the final investors. The cost of these complex distribution networks has always been borne by customers via the annual management fees embedded in the fund charging structure. In parallel, a remuneration was rebated to the distributors for the service provided, usually making up a substantial part of the ongoing charges of the fund (up to 80 percent for actively managed equity funds).

In an attempt to protect the independence of the advice given to end customers and to promote cost transparency, some EU countries, immediately followed by the EU as a whole, decided to create regulations targeting inducements. From January 2017, distributors of investment funds will be either forced to:

- Forward the full amount of these payments to end investors or
- Renounce to receiving this remuneration from fund promoters or
- Renounce to their “independent” status and inform end investors on the amounts perceived from fund promoters

The new inducement regime will significantly impact the charging structure of investment funds, for the benefit of end investor. Research conducted on RDR³ share-classes in the UK shows an average difference of 41 percent in the ongoing charges between so-called “clean” share classes and non-RDR share classes. The inducement pay-out percentage traditionally varies significantly by asset class and investment strategy.

Mark-down of ongoing charges due to RDR



Source: Deloitte analysis

Whereas RDR imposes a ban on all commissions paid to advisers by anyone other than the client, MiFID II opts for a partial ban on independent advisers and discretionary portfolio management. The effect on the fund charging structure should, however, be fairly similar, i.e., a reduction equivalent to the current level of remuneration paid to intermediaries.

The new inducement regime will significantly impact the charging structure of investment funds, for the benefit of end investor

3 RDR: Retail Distribution Review – a law targeting the ban of trailer fees in the UK fund retail market in 2012

Cross-border distribution and the fund's ongoing charges

In light of this growing pressure on costs charged to investors, we assessed the average fee levels of European versus U.S. domiciled funds across a sample of 400 comparable funds representing over \$500bn.⁴

Not surprisingly, it is immediately apparent that U.S. domestic funds are significantly cheaper than their European peers, including when we compare funds that are similar in terms of size and investment strategy (i.e., no effect from economies of scale). The cost differential between the 2 "regions" can reach 30 bps for certain investment strategies.

The most intuitive explanation links the difference to the different distribution footprint: the widespread use of cross-border distribution in Europe has no equivalent in the U.S. market, where funds are almost exclusively distributed domestically. Any direct comparison between the two domiciles must therefore take into account the cross-border factor.

Based on the information received from market players, and considering the structure of a fund's ongoing charges, we identified a common set of cost items that can be directly attributed to multiple market distribution. These items can be summarized as follows:

Investor transparency and disclosure:

- Production, translation and dissemination of legally required documentation (e.g. KIID, factsheets, prospectus, annual reports)
- NAV publication in various distribution markets

Operations and accounting:

- Compliance and monitoring activities related to foreign markets
- Accounting in different standards (e.g., Lux GAAP, IFRS)
- Administration and hedging of share classes in foreign currencies
- Increased complexity of audit review due to increased control perimeter (e.g., multiple collection accounts)

Regulatory requirements:

- Fund registration fees
- Tax figures computation, filing and reporting (e.g., Germany)
- Legal fees (e.g., legal opinions for foreign markets)

Assuming that Luxembourg funds are distributed, on average, in 7 foreign countries⁵, we modelled the different cost components and drivers and have estimated the total cost of multiple-market distribution to be in the region of 2.3 bps. This cost is mainly composed of the following two items:

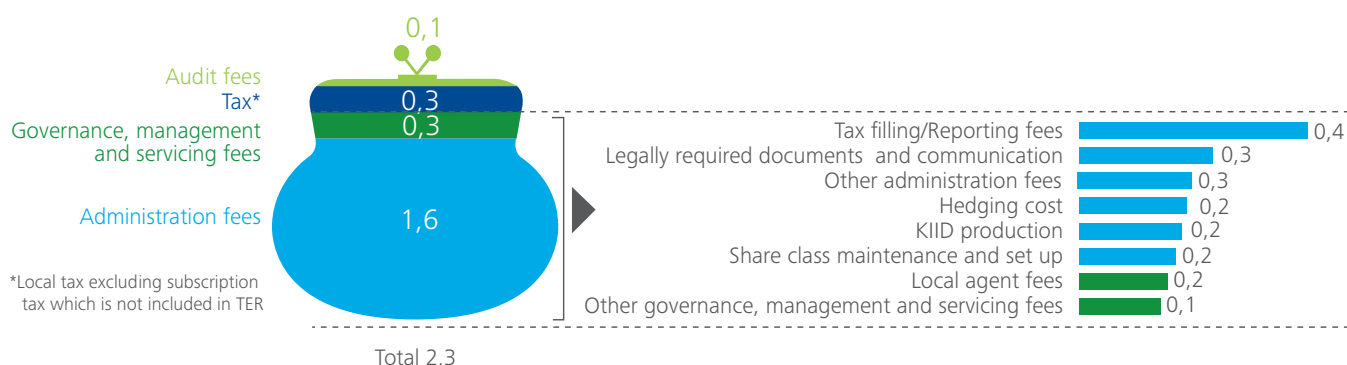
- Activities carried out within the fund administration (68 percent)
- Activities carried out within central administration (14 percent)

⁴ Our data covers UK, US, GER, FRA

⁵ Source: Fundsquare country registration data

A detailed breakdown of these costs can be found in the diagram below:

Breakdown of cross-border distribution impact per cost category (bps)



When performing the same exercise for France, Germany and UK domiciled funds, the total cross-border components of their ongoing charges ranged between 8 and 12 bps even if the number of distribution countries is below the average of cross-border platforms.

These findings clearly suggest that processing efficiency, critical mass, and experience developed in cross-border domiciles allow global asset managers to reach multiple markets in a cost-efficient way. It is therefore not in this area that cross-border domiciles should seek further cost reduction, as the potential savings would not be material, and these domiciles are already competitive against other European fund centres.

Conclusion and outlook

Facing a cost-sensitive, well-informed, and protected investor, fund managers must continuously reduce their cost charging structure. While U.S. funds are significantly cheaper than European ones, the first part of our analysis observes that cross-border domiciles (i.e., Luxembourg and Ireland) appear to be more efficient from a cost perspective than other European domiciles (i.e., France, Germany and the UK) when it comes to multiple market distribution.

Since further cost savings can hardly be generated in this area, we now turn to the activities associated with the distribution supply chain, i.e., the steps required in order for a fund to be distributed across a network of intermediaries.

In our attempt to identify how the competitiveness of the fund industry can be improved, the second part of our report analyzes how the steps required for distributing funds could be streamlined. While it is widely acknowledged that the U.S. achieves a high degree of operational efficiency and cost mutualization across the distribution supply chain, Europe is often perceived as inefficient due to a fragmented distribution and servicing landscape and low levels of processing standardization.

The second part of our report investigates this perception and simulates the impact of a fully streamlined operational infrastructure on fund processing costs with a focus on the Luxembourg market.

2. Cost mutualization and fund distribution

Fund distribution activities are known for their cumbersome requirements, especially when compared to other financial instruments. While their intrinsic, primary market nature is inherently complex, investors increasingly compare investment solutions and de facto place funds in competition against other asset classes.

Funds distributed exclusively in their home market usually leverage the existence of established financial infrastructure.⁶ These typically include central securities depositories (CSD) and central repositories capable of storing static data, dynamic data, and sometimes even fund documentation. A unique set of regulatory obligations further reduces distribution complexities. Nevertheless, their limited distribution footprint prevents them from achieving the size and scale required to generate cost efficiencies. Specific share classes—with higher expense ratios to cover for the additional distribution costs—are usually launched whenever they are distributed in a foreign country.

By contrast, international funds distributed across multiple domiciles do not benefit from a single infrastructure. A mixture of bilateral links, aggregator platforms, and processing service providers prevail, while documents and data dissemination are channelled through multiple information distributors or resellers. Local notifications must meet various national constraints, including language translation and specific tax reporting duties. Far from being a disadvantage, this operational flexibility supports the growth of these international funds. The setup of distribution networks across multiple countries was achieved in a relatively short timeframe, with immediate benefits from economies of scale.

In order to seize the full benefits of these potential economies of scale, the second part of this study aims at substantiating and quantifying the benefits of streamlining distribution activities. Our primary objective is to design a fully streamlined industry model and highlight the differences with current industry practices. We then try to quantify the cost savings generated by the target model and highlight the model's benefits for both distributors and fund promoters.

A mixture of bilateral links, aggregator platforms, and processing service providers prevail, while documents and data dissemination are channelled through multiple information distributors or resellers

⁶ This is mainly observed in France and Germany. Other domestic fund domiciles (e.g. UK) have not fully leveraged the technical infrastructure in place for other financial instruments.

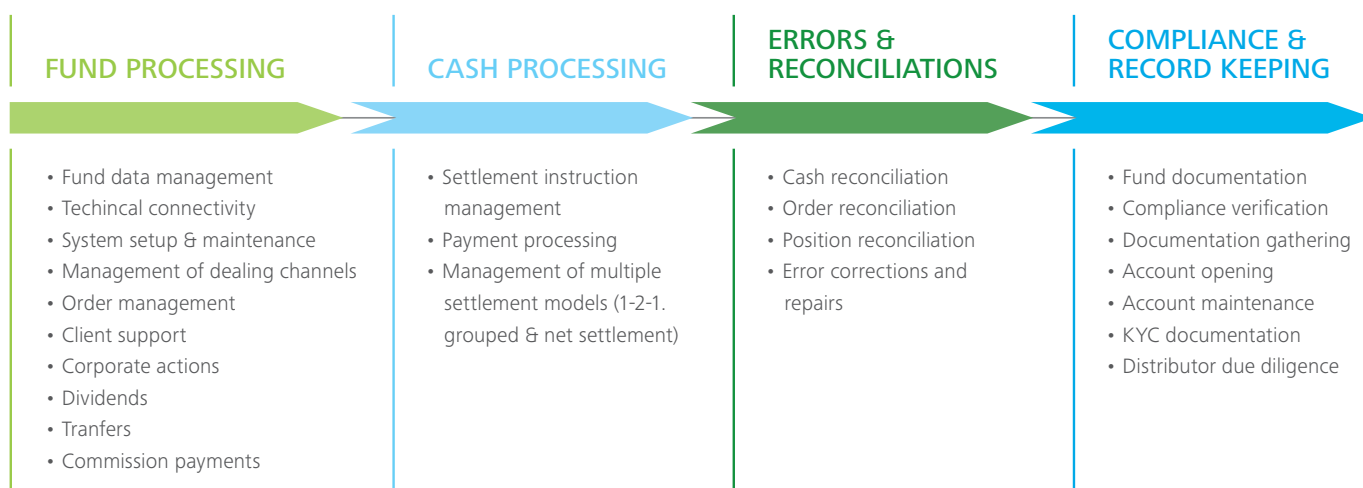
The following four critical statements emerge from our analysis:

- 1. Orders:** over the past decade, the industry made significant efforts to automate order flows. The results of these efforts are very positive with an overall industry level of “straight through processing – STP” in Luxembourg increasing from 47 percent to 77 percent in the last 8 years. However, despite these efforts, the remaining number of manual orders still represents a significant cost for the industry. Our study also argues that replacing bilateral STP links by a central order management system would generate further cost savings.
- 2. Transfers, reinvestments:** statistics on order automation do not account for other fund processing activities which, as opposed to order management, are predominantly handled on a manual basis. This mainly includes transfers, dividends and corporate actions processing.

- 3. Payments:** the predominant practice, except for leading and most mature market players, of executing one payment per order and per counterparty, despite being highly automated, has the effect of driving volume and cost up. Netting per currency across counterparties and transaction types would significantly reduce these costs.
- 4. KYC & due diligence:** regulation has tightened requirements around KYC and distributor due diligence. The current model where each management company requires the same information and performs the same checks on each distributor may have reached its own limits.

Approach & assumptions

Our analysis is based on a cost modelling of distribution activities, including both a distributor and a product manager value chain. The individual components of each value chain link were broken down into processes, for which we estimated a cost based on assumptions and hypotheses discussed with market participants.



We estimate the total annual processing cost of fund distribution in Luxembourg at €1.3 billion

The main cost driver supporting our cost model is the number of annual transactions processed by Luxembourg-domiciled funds. We applied the following approach to derive this figure with two “reference points”:

- We collected information from transfer agents representing ~55 percent of the Luxembourg fund asset base, and we extrapolated the total figure for the Luxembourg market, taking into account the market share of each player in terms of assets.
- We collected the total cash value of subscriptions and redemptions⁷ and divided this by the average order size per distribution segment.

Based on this approach, our estimate for the total number of transactions for the Luxembourg market in 2014 is 28 million.

The second most important driver in our cost modelling is the automation rate. Our assumption combines the information collected from transfer agents with information regularly published by industry associations and standard messaging infrastructures.⁸ Based on this approach we applied the following figures:

- 60 percent of the total order volume is currently handled via ISO standards (SWIFT)
- 17 percent of the total order volume is currently handled via proprietary FTP formats
- 23 percent of the total order volume is currently handled manually, mainly through fax orders

Several other assumptions and parameters were used in our model such as the total employee cost per day, processing time for a manual transaction, volume of transfers, error and repair rates, level of automation for cash payments, cost of a cash payment, average number of interfaces maintained by transfer agents, number of significant transfer agents, number of large distributors, etc. These assumptions were combined with factual data such as the number of Luxembourg funds, number of sub-funds, number of share classes, number of management companies, etc.

Industry benefits

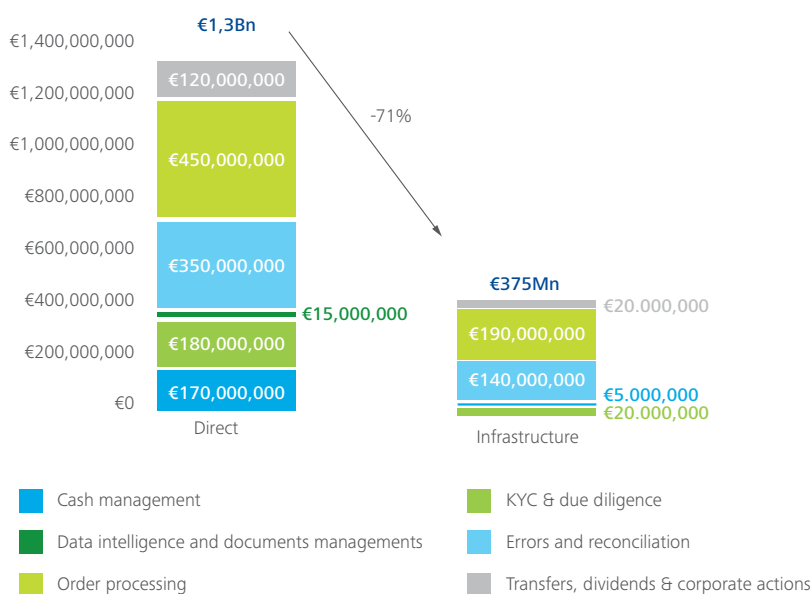
We estimate the total annual processing cost of fund distribution in Luxembourg at €1.3 billion. Taking an aggressive approach to size the total possible savings at the level of the whole market (i.e., assuming all inefficiencies could be overcome and converted into a fully streamlined model), we have estimated a split of costs and savings as follows:

⁷ CSSF statistical reporting

⁸ EFAMA – SWIFT FPS Report, Mid 2014

| Processing costs | Current (€Mn per year) | Future (€Mn per year) | Δ (in percentage) |
|---|------------------------|-----------------------|-------------------|
| Orders (fund processing) | 450 | 190 | -58% |
| Transfers, corporate actions, dividends (fund processing) | 120 | 20 | -83% |
| Cash processing | 170 | 5 | -97% |
| KYC & due diligence | 180 | 20 | -89% |
| Data & documents dissemination | 15 | 1 | -93% |
| Errors & reconciliations | 355 | 140 | -61% |
| Total | 1290 | 376 | -70% |

Split of savings generated through a streamlined distribution supply chain (overall)



If all streamlining efficiencies were achieved, the Luxembourg industry could save up to 70 percent of its total distribution costs. This represents €900 million of annual savings, which could materialize mainly across 4 areas presented below.

Tackle the “residual” portion of manual orders and reduce the cost of bilateral connections

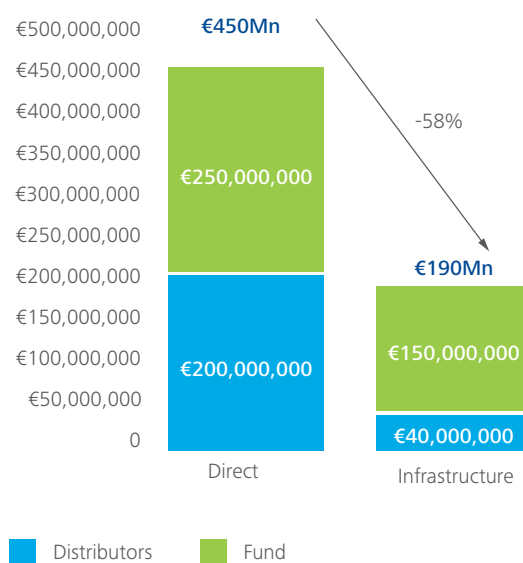
When factored into the estimated market size of 28 million trades, and applying the above rates of automation, the cost of processing orders in the current industry model amounts to €450 million.

This amount can be split in two sub-categories:

- Order routing, booking and confirmation of manual orders: despite the increase in automation rates, this item still represents 80 percent of order processing cost (€365 million), mainly due to the processing time spent by transfer agents and distributors and the resulting amount of fees charged to the funds.
- The maintenance of automated bilateral connections via ISO standards (SWIFT) or proprietary FTP formats represents 18 percent of the order processing cost (€80 million). This reflects the cost of maintaining multiple bilateral connections (i.e., updates and releases), the cost of parameterizing share classes correctly, the cost of SWIFT / FTP terminals, and the cost of SWIFT messaging.

Under the assumption that all orders are processed via an automated, central ordering system, manual processing time would almost disappear, and interface maintenance and technology requirements would be significantly lower. The effect of such mutualization would reduce the total cost of processing orders to €190 million, i.e., a 58 percent cost saving.⁹

Split of savings generated through streamlined order processing



It must be stressed that the number of orders and automation rates quoted above strictly refer to instructions arriving at the level of transfer agents. The aggregation approach of local transfer agents, large distributors, fund platforms and financial supermarkets compensates for an even greater volume of non-STP upstream orders. Short of any official statistics, these orders are not captured in our cost model. However, the predominant view during our interviews was that a majority of these orders are sent manually to the local agent appointed by the fund.

Increase automation beyond order management

Several other processing activities contribute to the cost of fund distribution. Among the most prominent ones, the annual cost of transfers, dividends, and corporate actions processing equals €120 million.

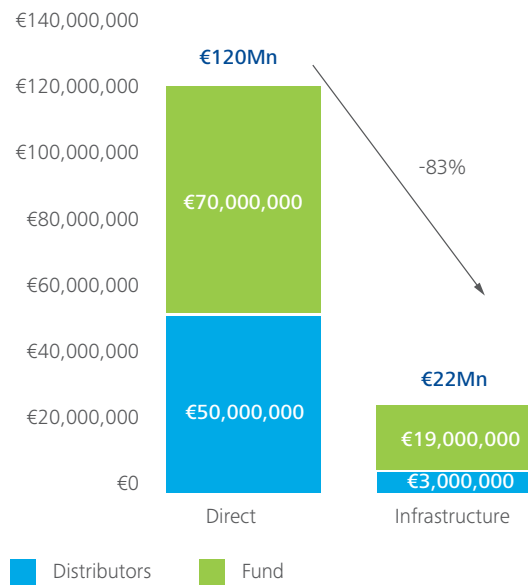
Today, stock transfers represent 10 percent of subscriptions' and redemptions' volumes. Automation rates typically encountered at transfer agents and distributors are well below the ones observed for traditional orders with an STP rate as low as 10 percent. Processing times per transfer reflect the complexity of matching both counterparties' instructions, which leads to multiple chasings and investigations.

Not surprisingly, the manual and bilateral processing of transfers between distributors and transfer agents, estimated at €95 million per year, constitutes by far the biggest portion of these processing costs. The remainder, equally distributed between corporate actions and dividends processing, mainly results from the manual booking of notifications and corporate actions events.

Significant streamlining efficiencies would be achieved if a solution was developed to capture transfers, pre-match counterparties' instructions and provide a single-leg automated instruction to transfer agents. Corporate actions and dividends would also benefit from cost savings via the elimination of paper confirmations and the reduced amount of time required to book these events.

If all the above streamlining efficiencies were implemented, the industry could save up to 83% of this cost component. This represents €97 million that would benefit both distributors and funds.

Split of savings generated through transfers, dividends and corporate actions

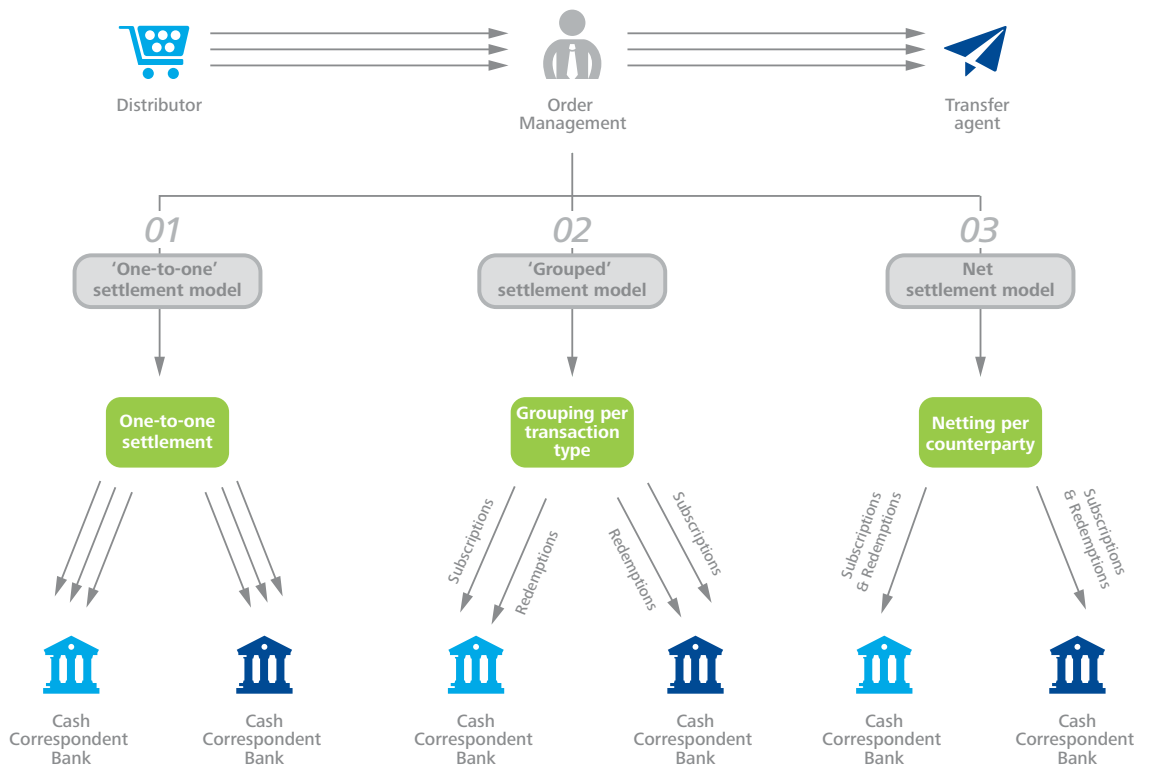


Cash netting with a central compensation account is the way to achieve the highest rate of payment compression

Under the current industry model, market players adopt three approaches to settle fund transactions:

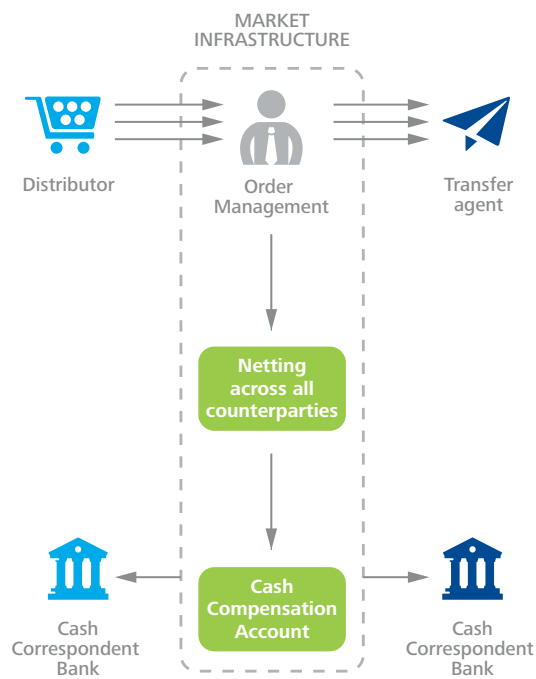
- Each order sent to the transfer agent leads to a corresponding payment (in the “one-to-one” settlement model). Approximately 60 percent of total payments follow this model.

- Orders sent to the transfer agent are bundled per transaction type (subscription vs. redemptions), per currency and per value date. An estimated 30 percent of total payments follow this model.
- Orders sent to the transfer agent are netted per currency and per value date, leading to one payment per currency, per day, and per counterparty. The remaining 10 percent of total payments follow this model.



Although the second and third models reduce the number of settlement instructions, they remain “counterparty-driven.” In an ideal world, each market player would process one payment per value date and per currency, independent of the number of counterparties with which it deals. This is precisely what the NSCC infrastructure provides in the U.S. market, and it could be achieved via the introduction of a central cash compensation account.

Net settlement model via central cash compensation account





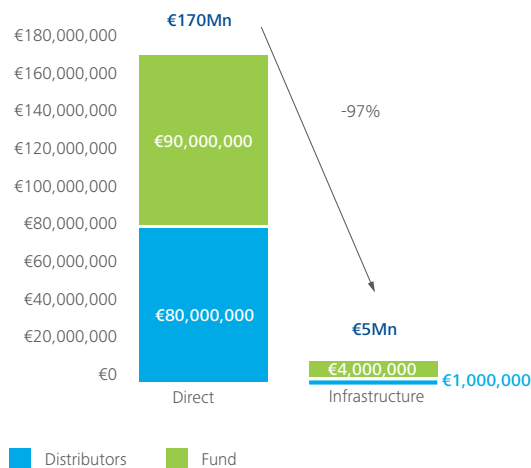
Considering the cost of SWIFT messages used to issuing and receiving payments, fund settlement processing in Luxembourg costs €160 million per year. Following the effect of volume compression, via the use of a central cash compensation account, the same activity would cost €3.5 million to the industry. These savings assume that all payments settled in the main currencies—EUR, USD, CHF, JPY and GBP—would be eligible for the central cash netting service. A residual number of payments for settlement denominated in other currencies would still have to be performed on a bilateral basis.

Mutualize KYC and distributor due diligence procedures

The financial sector witnessed increasing international and local regulatory pressure for anti-money laundering (AML) and know-your-client (KYC) measures and controls. Increasing on-site visits from most national regulators reflect the higher level of public scrutiny and expectations around the controls and procedures to be implemented by all professionals and the willingness of the asset management industry to be a role model within the financial industry.

Against this background, fund distribution is performed increasingly within a global landscape, aggressively targeting new (emerging) markets. Cross-border fund promoters target distributors across multiple countries. In turn, distributors develop open architecture strategies that lead them to set up agreements with multiple fund promoters. This interconnected environment inevitably leads multiple fund promoters to request KYC documents from the same distributors. The same inefficiency occurs when fund promoters need to perform due diligence on a distributor.

Split of savings generated through centralized cash management





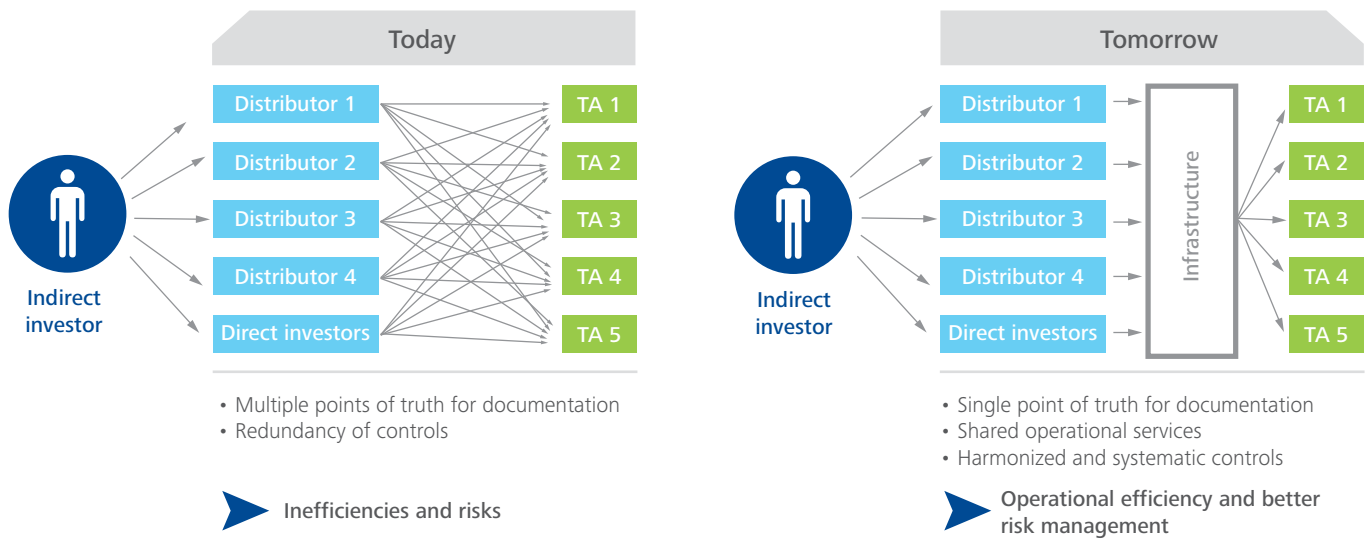
Today's industry model therefore involves a significant amount of duplicate requests received by distributors from all the fund promoters with whom they are involved. A mutualized approach, whereby a single request of documents could be shared across fund promoters, would be highly beneficial to both distributors and to the fund industry. A similar approach could be adopted for due diligence procedures, whereby a single due diligence and its observations could be used by the fund promoters' community.

The benefits of setting up a mutualized approach to KYC and distributor due diligence are intuitive:

- Have a single point of access for up-to-date and verified KYC documentations, reducing the processing costs at industry level
- Minimize operational costs while increasing the quality and consistency of controls
- Shorten time-to-market to onboard new counterparties (account opening process)
- Make a single request for documents towards the distributor, instead of individual requests per fund promoter
- Maintain focus on core business activities and get rid of non-core activities, particularly in the case of management companies and distributors

The financial sector witnessed increasing international and local regulatory pressure for anti-money laundering (AML) and know-your-client (KYC) measures and controls

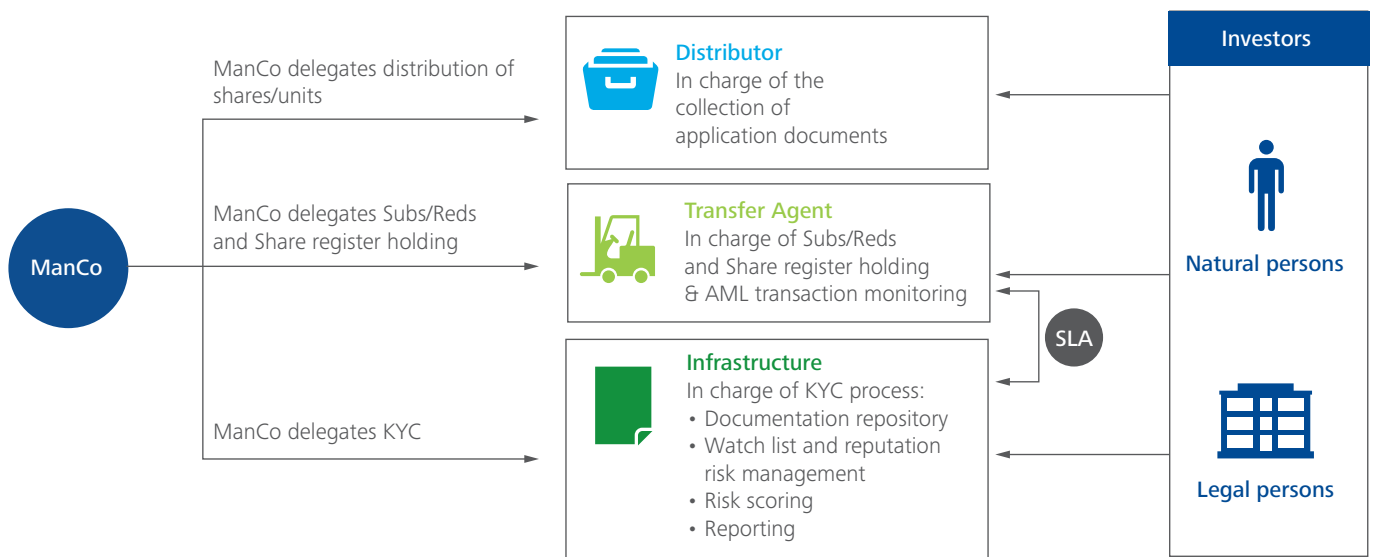




Contrary to the previous savings categories, KYC responsibilities cannot be outsourced so simply. Under the current regulatory regime, the fund management company and the transfer agent are deemed responsible for correctly fulfilling this requirement. Such an innovative model of centralized KYC therefore requires a strong willingness from market players to enter into robust contractual agreements.

One possible approach would consist in the appointment of the provider of KYC and due diligence services by the management company. The execution of controls would be outsourced to the provider under the joint responsibility of the management company and the transfer agent. A delegation agreement must therefore be formalized between the provider and the management company, and a robust contractual framework should enable the transfer agent to keep control and comfort while decreasing operational workload.

Contrary to the previous savings categories, KYC responsibilities cannot be outsourced so simply.



Acceptance of this set up from the national regulator and the financial intelligence unit (FIU)⁹ would be an additional step in the process, as the provider would have the obligation to obtain authorization and to report suspicious business relationships.

Ultimately, this approach would enable market players to focus their efforts on the development of key differentiating offerings while relying on a trusted counterparty for daily KYC activities. It would rationalize the current “many-to-many” model of KYC processes between transfer agents and distributors/investors, enabling a reduction of compliance cost and increasing the willingness to accept new business relationships.

While several activities would remain under the remit of management companies and transfer agents (e.g., client acceptance, account opening, transaction monitoring, etc.), the following services could fall under the scope of a KYC mutualized solution:

Documentation repository

- Collection, archiving and maintenance (e.g., expired identity documents, authorized signatures) of KYC documentation
- Identification, verification services, and ongoing monitoring
- Flexible data acquisition process (parameters, lists)
- Counterparty unique identification
- Centralized access to enrichment databases and business intelligence capabilities
- Compliance with data privacy legal requirements and data protection standards

Watch list and reputation risk management

- Screening against sanction, PEP and blacklist checking
- Reputation risk through bad press monitoring
- Ad-hoc updates of watch lists
- Filter settings parameterization features, case management, and reporting

⁹ National agency responsible for receiving, processing, analyzing and disseminating information relating to suspect financial transactions to enforcement agencies and foreign FIU's

Alert management

- Alert management based on decision trees and agreed upon procedures
- Complementary investigations if needed (ad hoc)

Risk scoring

- Scoring platform:
 - Risk scoring service supporting
 - Individual parameterization set (risk weights). Alternatively, standard parameterization should be provided
 - Individual acceptance matrix to categorize counterparties (new or existing)
 - Delivery and maintaining risk scores by counterparty
- Due diligence on intermediaries

Reporting

- Internal management reporting
- Files for regulatory reporting / declarations (national competent authority, financial intelligence unit)

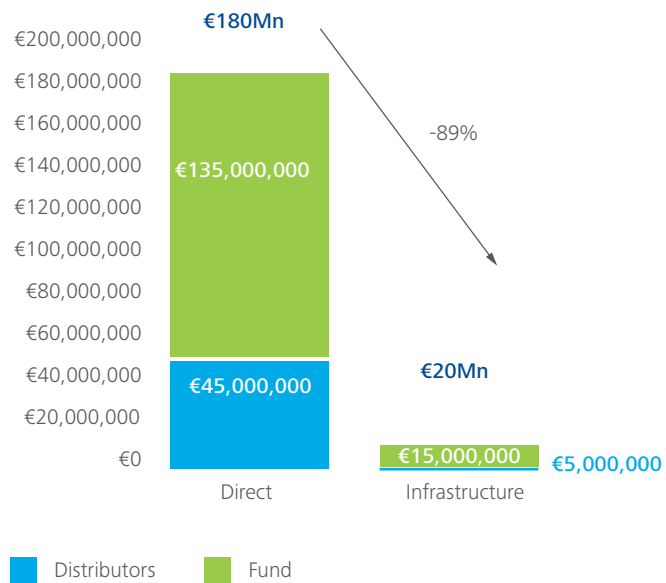
Archiving:

- Conversion and electronic archiving of KYC documentations

Considering the average number of shareholders per management company, the ratio of distributors requiring an enhanced due diligence, the effort required to complete a due diligence, and the KYC processing requirements, we estimate the total KYC cost of fund distribution in Luxembourg at €180 million per year.

Under a mutualized solution, even without assuming a higher level of processing efficiency, the mere replacement of the “many-to-many” scenario by a central provision of KYC services would translate into an overall cost of €20 million per year, i.e., a 70 percent decrease from the current situation.

Split of savings generated through centralized compliance functions



Conclusion

Finally, the fund industry should reflect on the opportunity to mutualize KYC and distributor due diligence activities

In line with the overall ambition to contain fund expenses, Luxembourg fund promoters should consider 4 immediate actions to save up to an impressive €900 million within the industry:

- Automate the residual portion of manual orders and review the opportunity to maintain bilateral STP links against the adoption of a central ordering system
- Push automation and process mutualization beyond orders to include highly manual processes such as transfers, corporate actions, and dividend processing
- Limit the number of payments by netting settlement flows through a central cash compensation account

In addition to the significant cost savings previously presented, the above three actions would substantially reduce the cost of reconciliations, the number of error corrections, and the reliance on client support. Combined, these items currently cost €355 million per year. With these actions, this cost would be reduced by 60% to €140 million per year under a mutualized approach.

Finally, the fund industry should reflect on the opportunity to mutualize KYC and distributor due diligence activities. Even if the ultimate responsibility of these checks should remain with management companies and transfer agents, this report demonstrates that mutualizing them would generate significant savings: up to €160 million per year.

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