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CFO | EDITION



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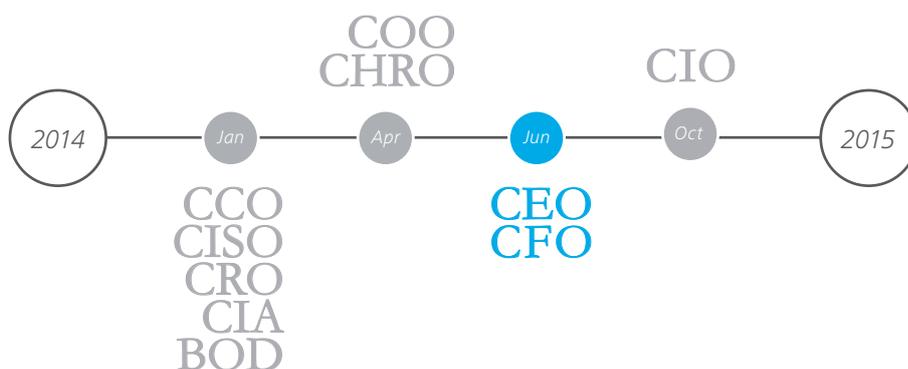
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Foreword



Dear readers and friends,

We would like to welcome you to the fifth edition of Deloitte's magazine covering the main hot topics on the market, with a focus on the Financial Services Industry. It is very satisfying for the whole team involved in creating this magazine to see how it has grown! A lot has changed since the first edition was published a year ago. The concept behind our magazine has shifted and the profile of our contributors has changed, becoming increasingly international so as to offer you insightful contributions from all around the world.

Inside is therefore gaining an increasing number of readers and we are happy to receive your feedback showing you share our belief that we are lucky to live in such times. The publication of each new issue is becoming a well-known milestone. The new issue – dedicated to Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) – coincides with the Horizon Conference held in Luxembourg. This is not a coincidence, as Luxembourg can be regarded as the perfect example of the need for renewal in the financial sector in the wake of the crisis. The Horizon Conference has also become a key date in the Luxembourg calendar and the themes we cover in this issue will nurture and extend your reflections.

We are indeed living through a period of major change, with the Financial Services industry in particular experiencing real challenges. Our aim is to help you identify the main areas of risk and to bring certain topics to your attention. In this context, many observers see this as a seriously challenging and harsh period. This is true, but we also want to show you that it is above all an era full of opportunities. Those able to take advantage of today's uncertainties will be successful tomorrow.

This is why our experts wish to share their views and thoughts with you. Some are totally new. Others you may already be aware of, but deserve to be remembered or highlighted.

We hope you enjoy this edition and look forward to hearing from you.

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Editorial

This new edition of *Inside* is dedicated to the roles played by CEOs and CFOs in today's world and draws our attention to some of the current hot topics that have a significant impact on all organisations.

This issue focuses on the financial services industry: retail banking, private banking and the investment management industry are all at a crossroads in their history as the financial crisis has challenged them to reinvent the way they do business.

The previous issues of *Inside* underlined the operational complexities derived from the speed of change within our business and regulatory environments. Today, our focus will shift to what this means for CEOs and CFOs and how to develop and implement a strategic vision while taking into account this new paradigm.

The articles included in this edition of *Inside* reflect a wide variety of viewpoints from senior industry professionals. These esteemed contributors include for instance Dominique Senequier, CEO of Ardian, who sheds light on current trends in the private equity industry, as well as Bansi Nagji and Geoffrey Tuff, leaders of the Dublin Innovation Practice of Monitor Deloitte, who share their thoughts on innovation. Their interview illustrates that being innovative is a must for continued success in today's world and one of the key takeaways from this issue.

This edition also covers other exciting topics such as the current rebound in M&A markets and how an effective post-merger integration strategy is critical to ensure that these transactions deliver on their promises. Finally, we also address some of the recent regulatory changes in the financial industry as well as some of the innovative responses we have seen.

We hope you will enjoy reading this issue and gain many insights from it.



A handwritten signature in black ink, appearing to read 'B. Collette', enclosed in a circular flourish.

Benjamin Collette

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A handwritten signature in black ink, appearing to read 'P. Masset', with a long horizontal flourish extending to the right.

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Q&A with Dominique Senequier, Chief Executive Officer of Ardian

Dominique Senequier joined the AXA group in 1996 and founded AXA Private Equity. Having grown to an investment company that manages or advises US\$46 billion of assets, the company became Ardian in 2013.

Today, the company comprises more than 320 employees based in 10 offices across the world. Dominique Senequier is currently a non-executive member of the Board of Compagnie Industriali Riunite, the Italian conglomerate. She is vice-president of the Supervisory Board of Hermes International. In 2012, she was made a Chevalier of the Legion of Honour (*Chevalier de la Légion d'Honneur*) by the French Government. She began her career working for the French Insurance Commission, before joining GAN, where she worked in reinsurance, international development and private equity.

Q: What does the independence of the company change?

We have always been independent in spirit and now we are independent in fact. When the moment came for us to claim our independence, we seized the opportunity to show our true character — our boldness, our determination to succeed and the entrepreneurial spirit that drives us forward.

The spin-off created a powerful, new, premium investment company with a strong international reach and network. There are no significant changes of strategy planned. The hallmark of this significant development is one of continuity, with management remaining in control of all operational and investment decisions and our teams holding 52% of the share capital. The company will build on the success of the last 18 years, capturing new opportunities and embracing broader horizons. Investors can expect the same level of service and investment performance, continued commitment to a culture of responsible investing and the long-term perspective of our employees whose interests are now very well aligned with those of our LPs.

Q: What is the outlook for the private equity business?

The macroeconomic situation in Europe is improving. Investors now have greater confidence in the region, leading to an increased exposure to this market. This has provided our direct activities with a more favourable environment. The markets remain competitive but we continue to find excellent opportunities to back ambitious management teams with compelling strategies to expand their companies. As confidence returns to the global economy, we are ready to work with our portfolio companies to take advantage of improving conditions. In our fund of funds business, the market continues to produce many opportunities as banks move to comply with new regulations on proprietary trading and pension funds seek to rebalance down their private equity portfolios.

Access to alternative sources of yield has become increasingly important for investors who must service long-term liabilities that are often linked to inflation, such as payments to pension fund beneficiaries. This trend has helped to make asset classes such as infrastructure and private debt increasingly important for some clients.



Dominique Senequier
Chief Executive Officer
Ardian



Benjamin Lam
Partner - Private Equity & Real Estate Leader
Deloitte

Q: What are the new expectations of LPs?

Of course, a high level of performance remains one of their main expectations, as risk free returns are historically low, but the economic crisis has strengthened the need for transparency. Nowadays, we need to provide a more tailored service to each of our LPs. It is not simply enough to visit clients once or twice a year; we need to have a different sort of relationship with them so they can monitor their investments. We also see an increasing number of investors who want to know more about our policies on Environmental, Social and Governance issues. Our commitment is to integrate ESG into the overall investment process.

The other critical element concerns fundraising, as investors are looking for co-investment opportunities. This model allows major investors to deploy investments at a lower cost as there are no management fees, while maintaining flexibility in building their portfolio. It also allows us to build deeper relationships with our investors and to work together during the transaction process.

Q: What is the impact of the AIFM?

I began my career as Insurance Commissioner, so I am convinced of the benefits of regulation. Ardian's teams have anticipated these changes and we have hired people to bolster our compliance department in our offices worldwide. In a nutshell, there will be no change for our business but there will be more work. However, the impact of the AIFM might be heavier and more difficult to deal with for smaller asset managers.

Q: How do you feel, leading one of the global leading private equity companies?

This is a great achievement and an important responsibility. Together, we are now the owners of this new company. More than 260 of us are now shareholders; from the youngest recruits to the original team that joined me to build one of Europe's leading private investment companies from scratch. We are all entrepreneurs now. Our challenge is to fulfil our purpose every day; to create enduring value and superior returns responsibly and in such a way that shared outcomes lead to shared success.

Q: How do you see the role of Luxembourg in respect of AIFMD and as a platform/hub for private equity investments?

Three years after opening our office in Luxembourg, we now have five people fully dedicated to local funds and companies. We see Luxembourg as an attractive place and a major hub for private equity investments thanks to its broad range of fund vehicles, a business friendly environment as well as well-trained lawyers, advisers, auditors and bankers who help find solutions.





Bansi Nagji
Leader
Monitor Deloitte



Geoff Tuff
Leader
Doblin Innovation Practice
Monitor Deloitte

Adding innovation to the CFO's agenda

When a group of CFOs at Deloitte's CFO Vision Conference last fall were asked whether anyone in the audience had grown tired of hearing about innovation, several people raised their hands.

Geoff Tuff

"For some CFOs, the term innovation has become meaningless and has been applied to just about anything that can justify budgets in a company," says Geoff Tuff, Deloitte Consulting LLP, who leads Doblin, the innovation practice of Monitor Deloitte. "Moreover, according to Doblin research, 95% of innovation attempts, on average, do not return their capital," he adds. Little wonder some CFOs are sceptical of innovation.

"Yet CFOs are the people who can bring discipline and analytical thinking to the innovation process, which are needed for success," says Mr. Tuff. Below he and Bansi Nagji, principal of Deloitte Consulting LLP and leader of Monitor Deloitte, discuss why CFOs should play a larger role in setting and managing an organisation's innovation agenda and the value they can bring.

The two veteran thought leaders on innovation are co-authors of *Managing Your Innovation Portfolio*, published in Harvard Business Review, and have contributed to other major business publications.

Q: Many companies use the '70/20/10 rule', described in your 2012 Harvard Business Review article, to set their innovation strategy. What is the rule, and how can CFOs apply it?

Geoff Tuff

Before describing the rule, I think it is important to ask, 'What is innovation?' Innovation is creating new value, new to our market or to the world and value is defined as economic value for an organisation's customers and the organisation itself. Innovation does not have to be high cost and it certainly does not have to be high risk.

The 70/20/10 rule is a basic guideline which stipulates that, for the average organisation, 70% spent on innovation initiatives should be focused on an organisation's core business, 20% on adjacent opportunities and 10% on projects that could be transformational for the organisation and perhaps the market more broadly. The right percentages for any given company will vary depending on the industry and the organisation, including how mature it is and its strategic and risk profiles. The economic return expected of the organisation is also a critical element in setting those ratios. So innovating at the core or adjacent businesses can be much more important to some companies than others, and such businesses would minimise their focus on transformational projects.

In each of those three levels of innovation, it is the domain of the CFO to help customise a target portfolio of innovation projects, taking into consideration the company's objectives, risk appetite and cost constraints. And the finance department may be best at applying the objective data to test the range of what those innovation targets might be.

Q: Shouldn't CFOs incorporate innovation strategies into their forecasting and planning, and, if so, be more involved in strategy development?

Bansi Nagji

This is where the CFO's perspective is important to the whole innovation strategy-setting process. Most companies are not yet operating at a level where CFOs are playing a substantive role in setting an innovation agenda, but that is changing. More than 50% of the large company CFOs at the conference mentioned earlier confirmed they are being asked by their CEOs to play a key role in evaluating, financing and driving innovation in their companies. Of the remaining CFOs, 36% confirmed that their CEO expects them to support and enable the execution of innovation decisions.

If CFOs are going to incorporate innovation strategies and their expected results into forecasts at any point in time, they are also going to have to take into account the commitment they have made to shareholders already, the company's risk profile and how the innovation strategy will influence finance's objectives. At the same time, they need to exercise a less constrained perspective about certain types of innovation within their portfolio and how they can be funded, given the company's market share or growth objectives within the industry. The challenge that a lot of companies run into is balancing the need to manage risk in the short term while pursuing growth for the long term, and CFOs can play a valuable role here.

Q: Are there leading practices to measure and monitor the pipeline of innovation-driven ideas and compare their benefits to the organisation?

Geoff Tuff

As companies think about applying metrics to innovation initiatives, it is important to apply traditional external economic metrics, such as sales, revenue increase or market share change, to the right situations. Traditional metrics are generally appropriate for an innovation programme that is connected to the core business. As the innovation project gets further away from the core business, other types of metrics, typically non-economic internal metrics, should be considered. An example of an innovation metric to measure innovations far from the core business is learning—the degree to which a CFO or an executive team is willing to fund an initiative purely for the purpose of learning something. It does not matter if the initiative succeeds or fails, and it does not matter if the investment has a market impact for the company. Rather, if leadership can learn something critical from the initiative, that in itself can justify continuing to focus on the project or funding it. Once the project gets closer to launch, CFOs and others will be able to layer in more traditional measures, such as market testing and piloting.

Q: Some companies are able to innovate in ways that customers respond to well. How do those companies get to the point of understanding their customers and then innovating around them?

Bansi Nagji

The big mind-set shift in thinking about innovation is dealing with adjacent and transformational issues. That requires delving into the world of what is currently not known. One of our suggestions for executives, particularly with transformational innovation, is not to spend a lot of time asking customers why they do or do not want a product or service. Instead they should be thinking about how customers use a product or service, how they could incorporate it into their everyday lives. And then you can start to imagine how customers could substitute one, two or sometimes three other products that currently exist in the world with a product that currently does not exist.

Q: Is there a role for the CFO in this exercise?

Geoff Tuff

What the CFO can do very well here is engage in the discussion of the business model and what constraints may exist. That also includes false constraints that can be overcome in terms of changes to the business model, such as different ways to deliver services or products to customers that currently are not being used but that are possible. It is rare to have CFOs involved in conversations about what a company can change in order to serve customers better, but CFOs need to make themselves part of this discussion even though it is not the type of meeting they are typically invited to.

CFOs are the ones who can ensure that the core business does not get fundamentally hurt as innovation teams start to play with different business models

Geoff Tuff

Bansi Nagji

Many CFOs do not get enough exposure to the world of understanding customers. Yet, they will need to be much more facile with understanding customers and what drives their behaviour, as well as understanding non-customers and why they are not behaving in certain ways—all of which can have a financial impact. In general, when you see an executive team that includes the Chief Marketing Officer (CMO) and the CFO, you will tend to find CMOs switching off when the CFO is presenting and vice versa. However, it is an opportunity for CFOs to both learn more and weigh in.

Q: What can CFOs do to participate more in their organisations' discussions and decisions on innovation?

Geoff Tuff

If anyone in the organisation understands what drives the economics of the business, it is the CFO. The opportunity we see for CFOs is not so much playing the role of sceptic but rather the voice of reason, keeper of the data-rooted business model. A CFO can engage with the innovation teams as the person who says 'yes' on a number of occasions because he or she can logically relate innovation to the key drivers of the business and how some ideas outside of the core business may be worth pursuing. But CFOs are also needed to make sure that there are guard rails in place to protect the core business and that people do not cross them. CFOs are the ones who can ensure that the core business does not get fundamentally hurt as innovation teams start to play with different business models.

Bansi Nagji

CFOs should understand where their organisation's innovation efforts are and where they stand. Are they moving as planned and meeting milestones or have they stalled? Many companies would not be able to answer these questions and it is the job of the CFO to know the answer.

CFOs can also help align portfolio choices with agreed-upon innovation initiatives and ensure the portfolio is appropriately resourced so that requests for more funding do not come in at the last second. Using their analytical skills and tools, they can create a smart metric system and valuation methodology that reflects the mix of the innovation ambitions, and they can help keep their organisations focused on fewer, bolder initiatives versus a larger number of disjointed innovation projects.

In my opinion, CFOs should become a strategic partner to other functions and get out of the business of being the person who says no, leaving innovation to R&D, strategy and operations. When they participate in innovation, they have the opportunity to instil discipline while serving as a catalyst for change. Innovation is fundamental to the strategic direction of a company, and it is logical that the CFO should play a larger role in the process.



Related Resources

- *Managing Your Innovation Portfolio*, Harvard Business Review, May 2012
- *CFOs to Play a Larger Role in Their Organizations' Innovation Process*
- *Ten Types of Innovation: The Discipline of Building Breakthroughs*
- *Realigning Your Organization's Portfolio for Growth*

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Questions? Write to Deloitte CFO Journal Editor

CFO insights

Realigning your portfolio for growth

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Portfolio realignment as part of a broader business transformation can be a complex, gut-wrenching, time-consuming process. In a slow-growth environment, however, CFOs looking to unlock additional shareholder value may also find it a business imperative.

In fact, the possibility is being examined—and embraced—by many finance chiefs in the current environment. In the Q1 2014 *CFO Signals*[™] survey, more than 20% of large company CFOs say they expect a substantial merger or acquisition in the next year, more than 15% expect a substantial divestiture and about 14% expect to discontinue operation of a business unit.¹

Whether their efforts lead to an ‘advantaged portfolio’—one that is strategically sound, value-creating and resilient—is not guaranteed, of course. Undertaking such a realignment can obviously help companies identify new assets to help them achieve growth and others to target for divestiture. But by approaching the realignment process holistically and rigorously, companies can also create a portfolio that delivers sustainable growth and better utilises future investments.²

¹ *CFO Signals*, Q1 2014, March 2014; *Deloitte CFO Programme*, Deloitte LLP
² *Portfolio Realignment: A Business Imperative*, Deloitte Development LLC 2013



There is no one way to go about the process, however. While companies are increasingly using divestitures to realign their portfolios (see sidebar, 'Shedding for growth', page 3), that tactic alone is not enough to build value. And in this issue of CFO Insights, we will examine the steps companies need to take to build an advantaged portfolio and discuss how CFOs can foster the process.

Four steps to realignment

There are several reasons why portfolio realignment is becoming a business imperative. For one, some companies that did not retool their portfolios prior to the recession have been unwilling or unable to dispose of their value-destroying businesses. Consequently, these companies may now be finding their growth and profitability hampered by overly complex operations, uneven performance and the need for fundamental improvements in business quality.

Other companies that sold underperforming assets during the recession to raise cash ineffectively utilised the resulting proceeds. Today these organisations may be discovering that they are not well positioned to take advantage of changing economic and credit conditions. Finally, some companies view portfolio realignment as part of a broader, ongoing revitalisation process of adding new assets and shedding old ones to address globalisation and value migration, or to align with a fresh corporate vision.

By approaching the realignment process holistically and rigorously, companies can also create a portfolio that delivers sustainable growth and better utilises future investments

Whatever the driver, there are four major steps to creating an advantaged portfolio:

1. Analyse/disaggregate the portfolio and dispose of value-destroying businesses

Improving the core of the organisation begins by assessing the present and future position of each business and then defining its appropriate role. When disaggregated, many corporate portfolios exhibit a surprisingly wide range of contributions to shareholder value. And equipped with that information, a company can develop a picture of how individual business units are creating or destroying value and better determine its investment solutions going forward (see Figure 1).

In fact, this first step is an important part of a self-funding approach—one that generates cash for reinvestment—by increasing investment potential among core portfolio businesses. After all, some business units may consume a large amount of corporate assets while making little or no contribution to overall value. One possible indicator: these underperforming assets often perform poorly when measured by Return On Capital (ROC), which correlates highly to shareholder value and is central to many capital-intensive industries, such as manufacturing, energy and consumer products.

Case in point: a ROC analysis of a chemical company's business portfolio identified a business unit that was destroying enterprise value despite the fact that it generated 28% of the company's EBITDA. The ROC analysis suggested that as much as US\$7.70 per share in value was lost due to owning the business. Although selling off the business unit dropped EBITDA by 30% and required a book loss at the time of sale, the parent company's share price rose approximately US\$7 per share when the deal closed. The value increase was nearly identical to the estimated value lost by holding the business.

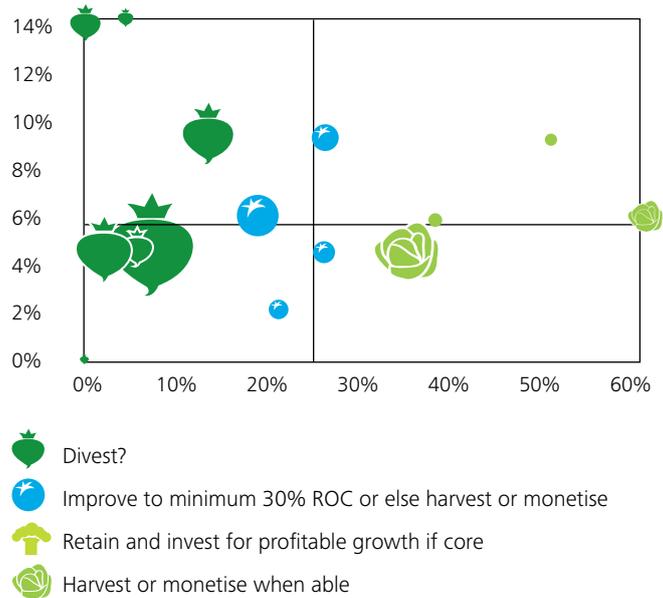
CFOs should address both the strategy and the structure of each business to help identify drivers and destroyers of value, structural costs and growth opportunities by asking the following questions:

- Where is the 'magic' made in the business? What does the business do that is different and creates value and profit?
- How does the business strategy create value? Is the strategy clearly articulated and understood?
- Which assets, customers, markets and products create value?
- Are the company's sources of growth and innovation engines clearly defined?
- How should business units be redefined to work with strategic and transaction planning?
- Which businesses are currently creating or destroying value?

Companies should resist the urge to move directly to high-growth opportunities without first removing existing impediments to success, either by divesting, shrinking, or not growing businesses with low returns. Assessing whether an underperforming business can or should be fixed requires careful thought. A changing competitive landscape, maturing markets, or large, outdated assets in the wrong part of the world can make transformation a difficult task that consumes precious management time and resources that could be better focused elsewhere.

Figure 1: Portfolio segmentation

Revenue growth



Source: *Portfolio realignment: A business imperative*, Deloitte Development LLC 2013



Shedding for growth

Corporate divestitures are increasingly being driven by companies' strategies to focus more on growth and shed non-core, low-growth assets, and less on financing needs, according to Deloitte's 2013 Divestiture Survey Report.³

Among the findings, 81% of surveyed executives indicated that pruning their businesses of non-core assets was one of the two most important reasons for divesting, up from 68% in 2010, the last year the survey was conducted. Meanwhile, 37% of respondents cited financing needs as one of the two most important reasons to divest, down from 46% in 2010.

According to Andrew Wilson, U.S. leader of merger and acquisition seller services for Deloitte & Touche LLP, the need to raise capital appears to have become less important in driving divestiture deals as the economic recovery has strengthened corporate balance sheets.

As a result, divesting is becoming an important tool for implementing corporate strategic goals and making a statement in the marketplace.

"Using divestitures to advance corporate strategy demands more than getting the traditional deal execution tasks

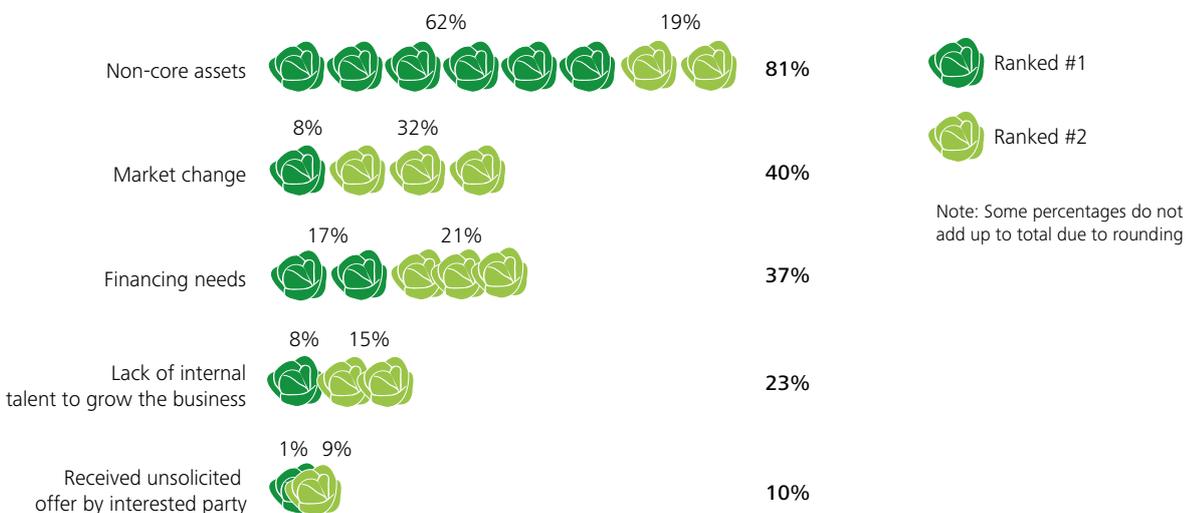
done properly," he adds. "Having a clear communication strategy for disseminating divestiture plans to stakeholder groups and maintaining strong employee morale during the process also are critical, in addition to the financial analysis required to prepare a deal for market."

One cautionary note: the survey found that only 43% of respondents indicated that their companies evaluate individual business units at least annually to determine whether they should be divested. Slightly more (45%) consider divestiture only when there are performance or strategic issues. *"The lack of routine evaluation may cause some companies to miss opportunities or rush distressed units onto market without adequately preparing for sale,"* says Ellen Clark, managing director at Deloitte Corporate Finance LLP. More frequent evaluations not only can help

in identifying opportunities, but they also can help prepare for any board inquiries or evaluations.

The survey reflected the views of executives who have been involved in divestitures, at companies ranging from less than US\$500 million in revenue to multi-billion-dollar global enterprises. More than three-quarters of respondents were from U.S.-based companies, 60% public and the remainder private.

Most important reasons for divesting a business



Source: Deloitte's 2013 Divestiture Survey Report, Deloitte Development LLC 2013

2. Structurally improve the profitability of other established businesses.

The next step for the organisation is to make the remaining assets more accretive to value by improving returns or generating profitable growth.

Structural improvements that CFOs can look to in order to drive increased returns and improve profitable growth within an individual business unit include: supply chain or operational improvements; customer and channel enhancements; product and value proposition innovation; new business models (for example, value-priced total customer solutions); asset-light restructuring; and geographic expansion.

3. Grow new businesses through internal development and/or M&A to support long-term vitality and align with company strategy.

The direction and goals of new business growth should be focused on the previously mentioned portfolio analysis questions as they pertain to organic growth opportunities. Creating an advantaged portfolio requires as much discipline when growing businesses as it does when evaluating divestiture candidates. After all, growth solely for the sake of growth consumes critical cash and corporate management attention and can lead to value destruction rather than value enhancement.

This same lens should be employed when examining M&A opportunities. A useful tactic to help screen M&A candidates is to evaluate them against designated criteria, such as geographic location, innovation and management oversight needs. These factors may help executives gauge the relative risk and corporate focus required to manage the investment as compared with other opportunities.

4. Evaluate/reevaluate the new portfolio's fit with advantaged portfolio criteria.

Finally, a realigned portfolio, including any new businesses, should be regularly evaluated to determine its fit with advantaged portfolio criteria. To help assess whether a portfolio remains 'advantaged', CFOs should ask whether the portfolio as a whole meets the following criteria:

- Is it strategically sound? In particular, is it weighted toward competitive advantage? Does it carry an optimal innovation mix? Is it configured to create synergy?
- Is it value-creating? That is, does it maximise 'intrinsic' value? Are we the best owners of the portfolio and each of its components? Are there capital market-driven reasons why we need to alter the portfolio?
- Is it resilient? Does it effectively weigh feasibility and risk? Will it be robust across future scenarios? Does it create optionality in the face of near-term uncertainties?

According to Andrew Wilson, U.S. leader of merger and acquisition seller services for Deloitte & Touche LLP, the need to raise capital appears to have become less important

Holistic, transformational, iterative

For CFOs looking to embark on successful portfolio realignment, the following elements need to be embraced:

- Holistic, top-down approach. Such an approach, which includes enlisting strong executive leadership, is essential, since asset ownership issues—as well as elements of corporate strategy—are involved
- Dispassionate data analysis. There should be no sacred cows or so-called lemonade stands (small assets). Preconceptions, personal history and bias can impede success
- Transformational, not incremental, change. Portfolio realignment is not only about cleaning up assets, it should also be driven by an enterprise-wide strategy for growth and renewal
- Leveraging informed estimates. Precision is not always possible in making the decisions necessary to retool a portfolio. Expect multiple iterations to get the data both 'right' and representative

Without a doubt, portfolio realignment takes time and patience. Shedding businesses that management has spent years, even decades, nurturing can be a painful process. Moreover, there is always a cost involved in acquiring or divesting. Companies may also have to overcome resistance to selling businesses that are low growth/low return because they may still reduce total net income/EBITDA.

Still, given the correlation to increased share price, finance chiefs need to consider cleaning up their companies' portfolios to get rid of underperformers and value destroyers. And by approaching the process holistically and rigorously, they can help construct a portfolio of businesses that supports the company's strategic vision and creates sustained shareholder value.

The survey reflected the views of executives who have been involved in divestitures, at companies ranging from less than US\$500 million in revenue to multi-billion-dollar global enterprises





From private banking to wealth management Challenges and opportunities

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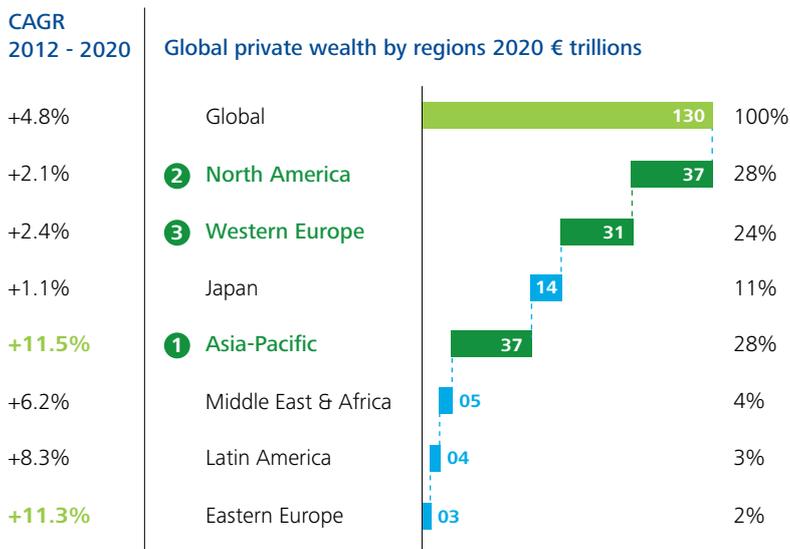
The recent financial crisis has led to a global movement in the U.S., Europe and elsewhere towards new and enhanced regulations as well as increased tax transparency pressure aimed at protecting both the banking system and clients. The impacts of this global movement are being felt across the entire banking industry.

These changes are pushing all those in the industry to adapt their business model in order to survive in an ever changing environment. In particular, private banks must rethink their vision as well as their business model, service offering, client segmentation and operational model while coping with constant profitability pressures.

Changes in the wealth management landscape¹
Europe and the U.S. will remain the largest financial centres in 2020

In 2012, global financial wealth grew by 8.2% to reach a total of €102.9 trillion.

North America, Western Europe and Japan remain the three main profit pools for private banking, though emerging countries such as those in the Asia-Pacific region are gaining ground over developed countries and this trend is expected to continue in the coming years.



The light green CAGR figures represent the two highest expected growth rates.

¹ Dark blue CAGR figures represent the two highest expected growth rates

According to the latest economic forecasts, the Asia-Pacific region will account for over 80% of global growth through 2020 (with growth mainly deriving from the creation of new wealth). China, India and Russia are projected to become the largest generators of wealth in the Asia-Pacific region, while the U.S. will remain the largest wealth market globally.

Western Europe will remain a key location for the geographical footprint in wealth management

Within the global wealth management landscape, Europe is performing well with an increase of 10% in Assets under Management (AuM) in 2012 and is reporting relatively good results when compared to other regions of the world. In terms of revenues, Europe is still a more lucrative market in general with more than 76 bps or gross revenues on assets as compared to 70 bps in emerging countries which are much more competitive and price sensitive. It is also a more efficient market with an average cost-income ratio of 65% compared to 80% in the U.S.

Targeting emerging countries such as those in the Asia Pacific region is not a must but a reality

The regional increase in AuM in 2012 was mainly driven by strong market performance combined with an increase in net new assets.

Once more, emerging regions such as Asia-Pacific or Latin America score well in both categories (performance and new assets). This trend emphasises the potential advantages for private wealth institutions to build presence in these regions and the need for European players to make a choice concerning what strategy should be adopted in order to acquire new assets:

- Either they should focus on **maximising 'performance of existing wealth'** in developed countries by optimising their value proposition to gain market shares and/or by focusing on cost efficiency
- And/or they should focus on the **'new wealth creation'** in emerging countries by taking a market share of the wealth growth in these regions

The main focus of wealth management institutions is currently Asia, and even European institutions, which are busy maximising the performance of existing wealth, complement their core strategy with a 'deployment strategy' in emerging countries to ensure the continuity of their business. Nevertheless, this re-orientation is a complex challenge and a long-term commitment for wealth managers who will have to adapt their service offering to meet local needs if they want to gain market shares in the region.

The HNW² and UHNW³ client segments are set to grow in the coming years and remain the most attractive segment in the long run

Globally, the number of millionaire households (HNWI) grew by 10% to reach about 13.8 million in 2012. Although, the number of HNWIs decreased slightly in the United States and Japan, the positive global growth has been supported by the increasing numbers of HNWIs in emerging countries (15% increase in 2012), especially in China where many households crossed the millionaire threshold to reach 1.3 million in 2012.

However, in order to rapidly gain market shares and capture additional margins, wealth managers can also consider targeting the mass affluent client segment by proposing a diversified yet standardised and industrialised service offering

² HNW: High Net Worth – individuals with over €1 million in assets

³ UHNW: Ultra High Net Worth – individuals with over €10 million in assets

North America still has the largest number of millionaire households (5.8 million), followed by Japan (1.5 thousand) and China (1.3 thousand) which should continue to grow in the coming years supporting the major shift in the country breakdown of HNWI's.

The same trend can be seen in the number of Ultra High Net Worth Individuals (UHNWI) which increased by 7% in 2012, with North America still having the largest number (3 million). When looking at the share of wealth by household segment, UHNW households will experience the strongest growth (more than 8%) in the coming years, especially in emerging countries. Ultra high net worth households should have €12.5 trillion by 2020.

It is interesting to note that different business models targeting the same or different client segments co-exist: typically, wealth management players (be they banks or wealth managers) are serving UHNW clients while universal banks are also targeting the HNW segment.

However, in order to rapidly gain market shares and capture additional margins, wealth managers can also consider targeting the mass affluent client segment by proposing a diversified yet standardised and industrialised service offering.

This strategic choice can only be a short-term decision since targeting mass affluent clients will lead to relatively slow growth in AuM. On the other hand, focusing on the UHNW and HNW segments represents a long-term choice for private banking players who will need to adapt their services to satisfy their HNW and UHNW clients in a very competitive and changing market: more value for money, looking at the overall service versus focusing on performance, increased technical awareness and expectations, etc.

Luxembourg as a competitive marketplace

Luxembourg is a European cross-border hub for wealth management

The European reach of the Luxembourg wealth management industry combined with the European passport allows institutions to serve clients in the entire European Union out of Luxembourg. The status of Luxembourg as a European cross-border hub is one of its major advantages and a key location factor in the global wealth management landscape. Luxembourg continues to position itself as a global specialist in the financial industry.

Luxembourg benefits from many macroeconomic advantages compared to other European countries as well as a favourable tax and regulatory environment allowing the creation of a sophisticated onshore service value proposition.

Key location factors of Luxembourg

- Strong expertise in wealth management and availability of experienced workforce
- Stable and sound economic (AAA rating for the country), political, social and fiscal environment, especially compared to other European countries
- Dynamic economic environment
- Low debt
- Low inflation rate
- Reactivity and proactive involvement of the government in the strategic development of the country's main financial industries
- Strong investor/data confidentiality and protection policy while fully respecting international tax information exchange requirements (i.e. focus on data discretion and protection and not on data secrecy)
- Multi-cultural, polyglot and skilled labour force
- Low unemployment rate

Typical clients in Luxembourg

Luxembourg, like all other major financial centres, is subject to global challenges and pressures on revenues, and mainly attracts clients and assets from neighbouring European countries.

The typical private banking client in Luxembourg is a continental European who earned his wealth through entrepreneurship or inheritance and requires advisory services (80% of mandates). Clients in Luxembourg originate from the entire European Union with the majority coming from neighbouring countries like Belgium, France and Germany.

In recent years a shift from mainly mass affluent clients to HNWIs and UHNWIs has been observed, leading to a consolidation of the client base (in terms of the number of clients, not in terms of assets).

Players

Private banking in Luxembourg, representing around 6% of the international private banking market, is currently composed mostly of **three types of institutions**:

1. Private banks representing over three quarters of the private wealth market in Luxembourg
2. Wealth management companies representing just under a quarter of the market share
3. Family offices entering the market with a current market share of around 5%

The emergence of some new categories of business, such as family offices, is driving Luxembourg to adapt its wealth management services in response to new client segments and operating models.

While AuM are expected to grow, profitability remains under pressure

A combination of poor market performance, shifting client preferences and increasing regulatory requirements is keeping the industry's cost base under pressure. Wealth management institutions have to deal with several challenges impacting both their cost and revenue baselines:

Pressure on cost baseline

The pressure to remain competitive is higher for existing players as they have to rethink their current business and operating models in light of multiple market evolutions and macro trends. The costs of transforming legacy activities and platforms and of managing the changes within the organisation are generally extremely high. Here are some examples of challenges impacting the cost baselines of wealth management institutions:

The regulatory pressure is accelerating with global and local initiatives seeking transparency, customer protection, prevention of financial crime, market stability and tax compliance. To face this ever changing regulatory landscape, wealth management operators are spending more on projects to ensure compliance with the new requirements by the deadlines imposed, to develop the right competencies to face these challenges and to adapt or launch new compliant products and services.

IT costs are also increasing. Having a modern, state-of-the-art and agile IT platform is now a must, especially owing to competition and the need for data management, distribution models (e-private banking, mobile banking) and new services (tax reporting, tax reclaims, etc.) required by the new regulations as well as by clients themselves. Players have to challenge their existing IT architecture to align it with their operational model which is evolving towards more hub-and-spoke activities, centres of excellence and the offshoring of some operations, etc., while keeping the related costs (total cost of ownership of the IT systems) as low as possible.

Wealth management institutions have to deal with several challenges impacting both their cost and revenue baselines

New client targets are appearing and becoming increasingly important (clients from new markets, especially from emerging countries; the new generation of HNWI and UHNWIs). To attract these new clients and meet their needs, proximity and local knowledge are required, which means higher operating costs than for 'historical' local or regional private banking clients.

The 'traditional' approach linking wealth band segments and service offering is evolving towards a more granular segmentation, pricing strategy and packaging. New value-added services are now expected by certain categories of clients, such as tax reporting, tax relief and tax reclaims, online and consolidated reporting, asset structuring, reporting performance and performance attribution or even the opportunity to invest in collectible asset classes (e.g. wine, art).

New private banking clients are more knowledgeable and have higher expectations. Wealth managers will have to adapt their business models to serve this category of clients. As a result, they will mainly have to invest in training programmes and hire new talent able to connect with and understand this new generation, and able to better profile them. Upskilling and training private bankers as well as developing a network of experts are prerequisites to meeting the expectations of the new client segments. For example, relationship managers will have to develop the right skills and competencies to provide wealth structuring advice, present new products and services and act as the central access point to an internal and external network of expertise.



Pressure on revenue baseline

The banking industry and its clients are seeking transparency with tax information exchange agreements between countries, tax amnesty for repatriation and double taxation treaties. These new market trends have numerous consequences and are calling into question the competitive advantages of some pure offshore and non-transparent tax private banks compared to local banking partners in home countries.

Furthermore, clients are increasingly 'self-guided', risk averse and price sensitive. By having access to multiple sources of information (internet, social media, e-private banking, mobile banking and their relationships managers) and benefiting from the advantages of transparency requirements aimed at protecting them, clients can

benchmark the offerings between players in terms of breadth, depth and quality of services as well as pricing. As a result, clients can also exert **pressure on banks' pricing structures**.

Private banks in western Europe have been constantly reducing their average fees in the last few years. Historically, wealth managers and private banks could generate north of 100 bps of assets under management. Today, overall fees amount to an average of 75 bps and are expected to decrease steadily to reach about 50 bps. Although the fee level does vary significantly depending on the risk profile and asset classes used by clients, the downward pressure and the extent of this pressure is a good indication of how much banks and wealth managers are suffering from revenue decreases.



In this context, private banks have launched strategic initiatives to protect or increase revenues as well as transformation programmes to streamline their cost base. Private banks that aspire to become or remain leaders are adapting their offering and delivery models and carefully choosing both the markets and customer segments they wish to serve. Most of our clients, in all tiers of the private banking and wealth management industry, have launched strategic initiatives aimed at:

- Defining a target-appropriate geographical footprint (geographical footprint optimisation)
- Defining proper product and service range and coverage
- Defining appropriate and best communication channels
- Defining new pricing models
- Upgrading staff skillsets

In parallel to these strategic growth and top-line initiatives, private banks have transformed and optimised their current operating and technical model so as to equip

themselves with an agile, flexible and cost-efficient model. But there is still a long way to go to achieve full efficiency or target cost levels and we are observing new models being contemplated such as the outsourcing or pooling of some operations, something that, in private banking, was still taboo not so long ago.

In this context, market players are focusing on transformation programmes aimed at:

- Addressing compliance requirements in an efficient manner
- Aligning IT and operational models
- Outsourcing costs (BPO/ITO, etc.)
- Performing efficiency and 'lean' reviews
- Considering an exit strategy and identifying the most likely category of buyers



Sustainable model for the future

Business Process Outsourcing

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To develop a sustainable model for the future, wealth management institutions have to rethink the way they operate – Business Process Outsourcing is one of the choices to make for a sustainable business.

The wealth management industry is currently facing a set of fundamental changes and challenges. Today, wealth management institutions across geographies have to cope with increasing tax transparency impacting the Return On Assets (ROA); the acceleration of regulatory pressure (FATCA, EMIR, MiFID II, etc.); new markets and client types requiring new competencies, services and channels; new technologies and legacy technologies (e.g. complex application landscapes and obsolete systems that will need to be replaced).

These developments are putting considerable pressure on wealth management institutions, and demand important strategic decisions. Existing players will have to accept these changes, adapt to them and develop a consistent approach for the future to create a sustainable model in order to remain competitive.

Several levers can be used by wealth management institutions to review and adapt their business and operating models, which are closely interlinked.

Business Process Outsourcing—outsourcing of operations and IT—is one of the key strategic levers many wealth management institutions are currently considering or have already used to fundamentally transform their operating models. Business Process Outsourcing (BPO) is about strategic impact not only cost reduction—it allows wealth management institutions to concentrate on their core business and to significantly increase efficiency by sharing operational and IT costs.

In this article we will look at the wealth management institutions in Luxembourg that should consider Business Process Outsourcing as a solution and discuss the various options they have, describe the current supply situation and sketch the market outlook. We will then suggest some principles for executives to consider when discussing Business Process Outsourcing.

To develop a sustainable business and remain competitive, these institutions need to outsource the majority of their operations and IT to a business process outsourcing provider



Wealth management institutions in Luxembourg are increasingly considering Business Process Outsourcing as a solution to transform their operating models—depending on their strategy and size, wealth management institutions should opt for a selective or full outsourcing approach.

Over the last years, most wealth management institutions in Luxembourg have been in ‘wait and watch’ mode as regards business process outsourcing. This time of ‘wait and watch’ is ending as institutions will soon have to act to adapt to changes and meet market challenges.

The awareness of wealth management institutions in terms of the opportunities Business Process Outsourcing began to grow about a year ago. Small as well as medium to large wealth management institutions are currently actively discussing their potential business process outsourcing options.

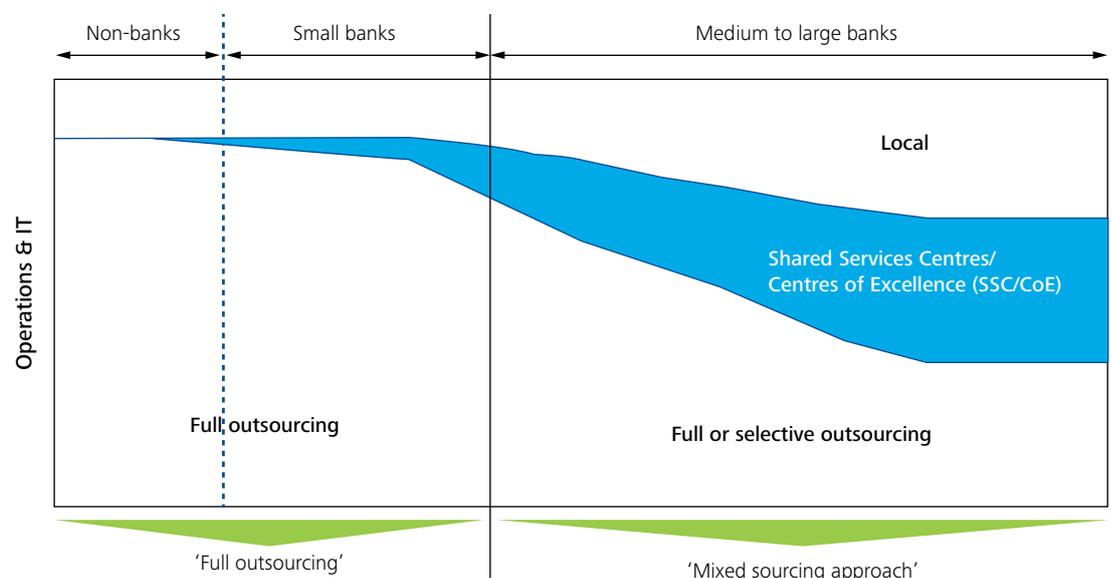
Depending on their strategic objectives and size, wealth management institutions may consider either a full

outsourcing solution or a mixed sourcing approach.

Wealth management institutions that can be classified as ‘small banks’ do not have the critical size to run operations and IT efficiently in-house and often operate on obsolete and expensive platforms requiring upgrade or replacement.

To develop a sustainable business and remain competitive, these institutions need to outsource the majority of their operations and IT to a business process outsourcing provider. This will allow them to concentrate on their core activities, i.e. client fronting, financial management, etc. and to manage costs efficiently.

Figure 1: Sourcing approach based on the size of the wealth management institution



Medium and large wealth management institutions should ideally select a mixed sourcing approach to transform their operating models, i.e. a combination of:

- Selective outsourcing for commoditised functions
- The creation of SSCs/CoEs¹ for the whole group, either centralised in one location or distributed across borders
- Keeping business-specific and differentiating services in-house

To select the right sourcing approach, executives will have to identify and assess their capabilities to transform

internally versus a business process outsourcing option taking into account market changes, such as new regulatory requirements and internal challenges, such as legacy technologies and group capabilities.

According to a Deloitte market review, about 30% of the wealth management institutions in Luxembourg, irrespective of size, will need to outsource some or the majority of their operations and IT to a BPO service provider over the next years.



¹ Centre of Excellence (CoE): entity providing leadership, best practices, research, support and knowledge, e.g. architecture, business intelligence
Shared Service Centre (SSC): entity responsible for the execution and handling of specific operational tasks, e.g. a development centre

Business Process Outsourcing offerings for wealth management in Luxembourg are somewhat limited at present, but the market is on the move

On the supply side, the business process outsourcing solutions currently offered in Luxembourg remain very limited, with only a few players providing BPO services for wealth management institutions. In this respect, Luxembourg is lagging behind other countries, such as Switzerland in terms of the maturity of offerings for the wealth management industry.

However, the market is on the move. International players have recognised the increasing need for wealth management BPO solutions in Luxembourg. Some service providers are actively working on concrete plans to replicate their service model—already proven in countries such as Switzerland and Belgium—on the Luxembourg market.

We expect two main types of players to enter the market in the short term:

1. BPO providers with a service offering in another geography will probably establish operations in Luxembourg through a joint venture with local wealth management institutions
2. Wealth management institutions already serving members of the group and/or third parties in other geographies are likely to extend their service offering to Luxembourg by leveraging existing capabilities abroad and by using the capabilities of the local subsidiary/branch

In the first case there is a clear first-mover advantage for wealth management institutions. Within the joint venture, the wealth management institution can influence the set-up of the service offering and limit the social impact as in general the entire staff will be taken over.

In the future, there will be a heterogeneous service provider market in Luxembourg. We have analysed the potential service providers and their offerings and noticed important differences. The main differences arise in the following areas:

- Depth and maturity of the service offering
- Experience and scale of the provider
- Transition and transformation approach for client on-boarding
- Pricing model—full variable pricing models based on different criteria versus mixed pricing models
- IT systems and infrastructure—in-house versus package solutions
- HR takeover—portion of the staff taken over by the service provider

Luxembourg is lagging behind other countries, such as Switzerland in terms of the maturity of offerings for the wealth management industry

Food for thought—there is no ‘one size fits all’ approach

There is no ‘one size fits all’ approach to Business Process Outsourcing in wealth management. For wealth management executives who are considering BPO for their transformation towards a sustainable model, it is essential to:

- Choose the right operating model by analysing the right areas and asking the right questions
- Identify the right BPO service provider and assess the feasibility of the project

Choose the right operating model by analysing the right areas and asking the right questions—five areas should be analysed at executive level requiring a constant arbitrage between impact and control

- 1. Strategic impact**—identification of strategic objectives, key drivers and the scope of the outsourcing
Some key questions: What are the primary strategic objectives and key drivers for considering BPO? Which functions are really business specific? Which capabilities should be considered as differentiating? Which capabilities should be streamlined? For which functions should control be kept in-house?
- 2. Business impact**—analysis of the impacts of BPO on the business model
Some key questions: Will the outsourcing better support our business? Will we gain flexibility?

3. Financial impact—outsourcing is not only cost reduction—assessment of expected revenues and costs linked to BPO

Some key questions: What are the expected IT and labour cost reductions? Is the outsourcing allowing us to increase revenues, e.g. by increasing reactivity for the implementation of new products? Is there a business case?

4. Feasibility—analysis of the service provider market, Human Resources, regulatory and legal constraints, etc.
Some key questions: Which vendors should be considered? Do their service offerings have the required maturity? What is their approach to taking over HR?

5. Business and operational risks—identification and evaluation of risks attached to BPO
Some key questions: What are the transitional, operational and financial risks? Is there a reputational risk? What is the risk of losing control?

Identify the right BPO service provider and assess the feasibility of the project—Based on the definition of the operating model, the right service provider has to be identified through a detailed RFP process to ensure that the selected service provider meets the requirements and to ensure the success of the business process outsourcing project.





M&A and restructuring trends in the Swiss private banking industry

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Traditional M&A activity in the Swiss private banking market will continue to be constrained by sector uncertainties: we therefore expect consolidation to increasingly occur via ‘asset deals’, often in combination with bank liquidations.



Despite significant sector pressure on Swiss private banks to consolidate, few traditional M&A transactions have taken place recently. The most recent initiatives suggest that ‘asset transactions’, where an acquirer purchases portions of the seller’s client assets—rather than an entire legal entity—seem to have become the ‘new normal’. Small and large banks alike are increasingly using this route to dispose of selected activities that no longer form part of their core business, or in certain cases, to exit the Swiss market. Such transactions, where a selection of the assets are acquired, reduce the potential legacy risks arising from regulatory or fiscal issues and entail a more straightforward integration process, easing the uncertainties currently faced by sector participants and improving value creation potential for sellers.

Although consolidation has not occurred on the scale many experts had anticipated, it is likely to continue over the short to medium term at an increased pace, but taking a different shape.

Sector uncertainties continue to have a significant impact

The profitability of Swiss banks active in wealth management is coming under strong pressure as a result of diminished organic growth, margin erosion and an increase in operating costs relating to regulation and the implementation of fiscal compliance programmes.

The rapid pace and number of regulatory changes affecting the sector has generated major uncertainty, especially regarding the ability of a number of banks to absorb the price of cross-border fiscal programmes. In particular, the considerable fines that Swiss banks may have to pay as a result of the agreement between Switzerland and the U.S. Department of Justice could significantly impact the equity base of a number of banks, with some potentially requiring recapitalisation or being forced to exit the market. Moreover, the lack of clarity regarding potential future agreements with European countries such as France and Germany, as well as the impact of MiFID II, significantly reduces operational and financial visibility for many market players.

These factors, along with the 'regulatory tsunami', discourage banks from acquiring a legal entity that may bring significant legacy risks. The constrained profitability in the sector is also reducing the number of transactions, as purchasers are not willing to restructure an acquired entity, while sellers are generally unwilling to fund the required restructuring costs. We therefore expect that most of the traditional banking transactions currently ongoing via a 'share deal' will be significantly delayed or fail. Until the regulatory environment is clarified, we believe that few traditional M&A transactions will take place.

Asset deals: the new normal for banking M&A

One of the main consequences that we observe in M&A activity is the increased appetite for 'asset deals' rather than 'share deals'. Under an 'asset deal', a potential purchaser acquires selected business assets (for example parts of the client book and employees) rather than an entire bank or legal entity, thus reducing the risk of taking on historical liabilities. In addition, this structure allows for greater control of the ultimate transaction price, as the price for asset deals is generally based on the client assets transferred to the acquirer.

Many transactions that took place in 2013 point to the popularity of asset deals: the acquisition by *Union Bancaire Privée* (UBP) of Lloyds International Private

Banking business was structured like this. UBP also acquired a book of clients from *Banco Santander (Suisse)* in a similar way. Bank Frey sold its non U.S. client book to *Banque Heritage* in 2013, ahead of its announcement that it was going to cease its private banking activities. In June last year, the Eastern European and *LatAm* client books of Hyposwiss Private Bank Zurich AG were sold respectively to Falcon Private Bank and *Banque Privée Esprito Santo SA*. LLB opted to exit its presence in Lugano by selling its client assets to PKB and then liquidating the remaining legal entity. Julius Bär's acquisition of Bank of America Merrill Lynch's HNW private client business was also structured largely as a series of asset deals.

These transactions are of strategic and financial relevance to potential acquirers, as they represent an efficient and profitable way to increase critical mass and assets under management, which is challenging to achieve organically in today's low-growth and intensely competitive market environment. We observe that the prices paid for client assets generally range from one to two years of revenues for fiscally declared clients. Such prices would be difficult to achieve through a 'share deal', which currently remain priced at or below book value.

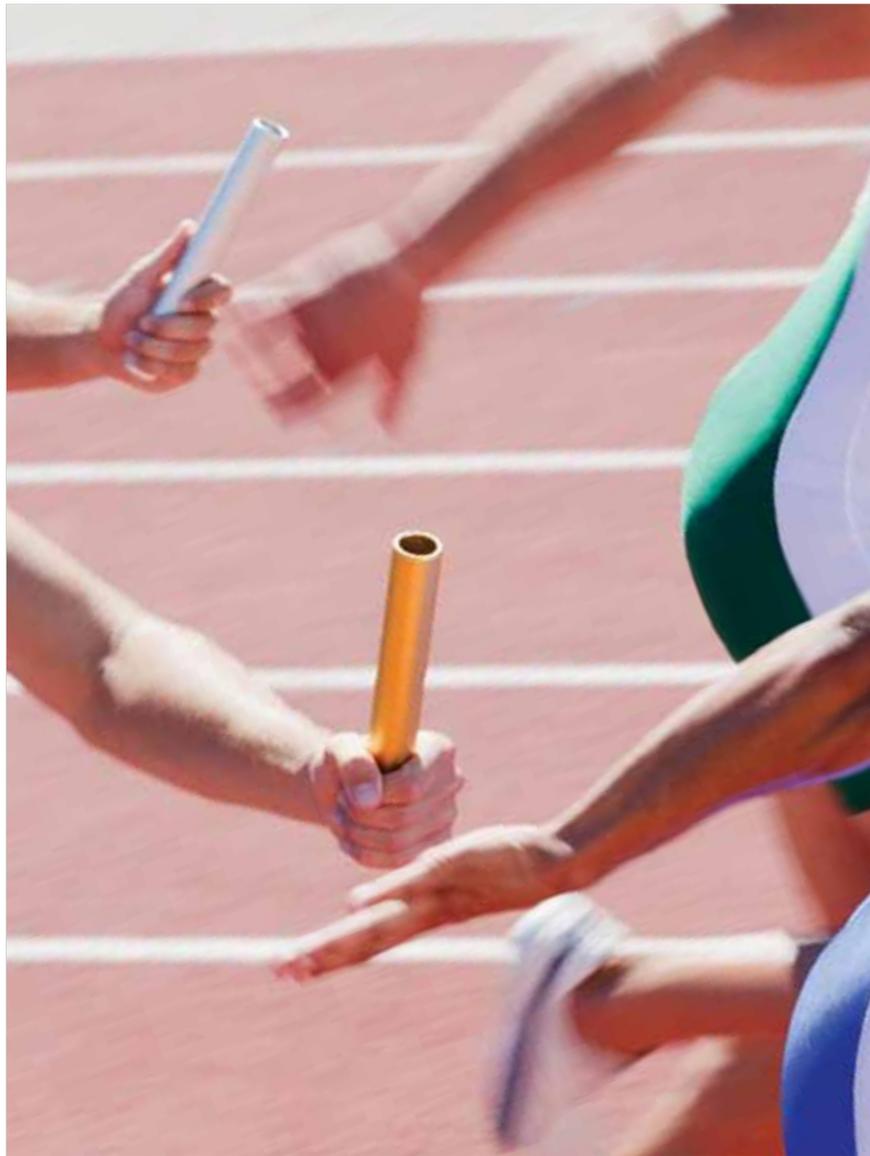
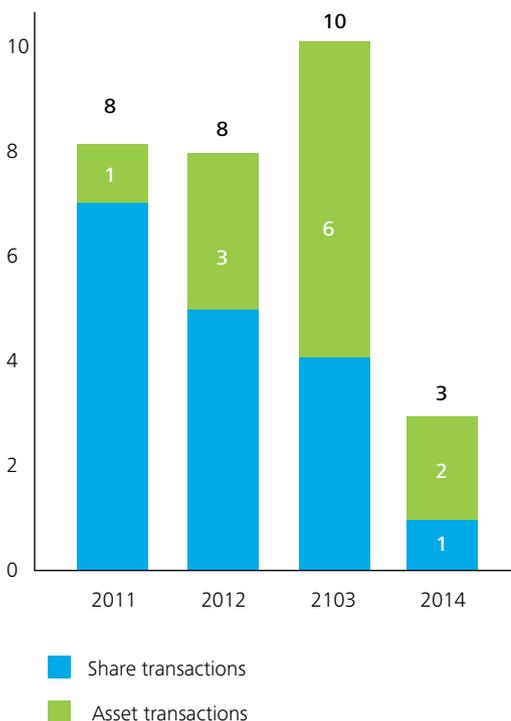
The constrained profitability in the sector is also reducing the number of transactions, as purchasers are not willing to restructure an acquired entity, while sellers are generally unwilling to fund the required restructuring costs

A resulting factor—bank liquidations

Going by the asset deals that have taken place, we anticipate that in most cases the legal entity left behind after an asset transaction will opt for run-down and liquidation. Today, there are large numbers of banks being sold in Switzerland. In most cases, at least initially, a sale of the whole bank is being attempted. We expect that several share deals will fail and that the seller will choose to go down the asset deal route followed by a liquidation for a result to be achieved.

A bank can opt for a voluntary liquidation, in which case the approval of the regulator (FINMA) is required. The main challenge of a banking liquidation is to maintain conformity with the regulator until the process is finalised. Efficiently managed, a voluntary liquidation process can be completed in approximately 18 months. Wegelin, which was the first banking institution to liquidate itself in Switzerland after the imposition of U.S. penalties, accomplished this in less than 18 months. Depending on the level of complexity, the process can take longer. Again, one of the main challenges is the management of the U.S. fiscal risk exposure the bank is facing.

Number of asset transactions versus share transactions in Swiss private banking







Outsourcing trends and risk implications

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One might be forgiven for thinking that anything that could be said, learnt or considered about outsourcing has already been said, learnt or considered one hundred times over. Outsourcing in all manner of domains has been with us for some time now, nowhere more so than in the realm of the financial industry.

The 'third party administrator', the global custodian, the 'value-added' service provider, the call centre and the whole battery of service offerings are familiar and recognised parts of the market infrastructure, and have been tried and tested over the years. And yet, something that should by now be a standard process still has the power to surprise, to confound, to challenge, or to put it bluntly, to go horribly wrong.

The logic for outsourcing is impeccable and frequently repeated, encompassing specialisation, economies of scale, critical mass, the cost of investment, a focus on core business, global reach and many, many other factors. After a certain hiatus following the financial crisis, when most actors in the markets were more preoccupied with achieving stability and focus rather than undergoing

change, activity is once again picking up in the sector. Institutions that hitherto held firm to the 'in-house' only concept are in some cases looking for potential outsource service providers; institutions that have already outsourced are reviewing their partner relationships and matching them to expectations; and service providers, still reeling under the costs of investments they have needed to make to keep pace with regulatory change, are once again on the quest for new clients.

It would therefore seem opportune to reflect for a moment on the whole experience of outsourcing, its successes, pitfalls and 'dos and don'ts', and to try to understand why a subject that is so familiar can prove so complex and often so challenging.

If business models were truly able to readily accommodate such a range, either the whole outsourcing sector would be a place of joy and happiness or the whole industry would be beating a path to a single provider

The process starts with the decision to outsource, or to consider outsourcing. Even in cases where an institution that has already outsourced decides to review its relationship with the service provider and its model, that first premise is still valid, because somewhere along the line in the process of revalidation or questioning, there should be a return to first principles: why was the decision to outsource originally taken? Have the goals that were set then been met? Have those goals changed, is there a new dynamic in the equation, and is there a better service proposition than the one currently to hand?

It may come as something of a surprise, but the problems that can bedevil outsourcing often commence at this initial stage. For the starting point must always be a clear

and precise idea of what the objective is. There are no such things as bad objectives, or wrong objectives. If the ultimate goal is simply one of saving money, that in itself is an objective. Risk arises when that rationale or that objective is not fully understood or shared, or more importantly, accepted. There can of course be many reasons to consider outsourcing: savings on the cost of system upgrades or new systems, time to market, the scope of investment strategies or cross-border development. All are valid. Problems may arise in the first case where political correctness or the 'sub-conscious selling pitch' starts to affect how the objective is articulated, and secondly, where consensus is achieved through parallel but not necessarily converging visions.



Executive committees and boards frequently seem to have issues with accepting cost as a major driver. At the back of the collective consciousness there often lurks a feeling that the decision to outsource will not necessarily be a popular one, that in some way it may appear disloyal to staff who will be impacted, and subconsciously the 'selling' process has begun. This can be a cardinal error, because if cost is the driver, by allowing it to be obscured by the fluffier elements that may well have a role in 'selling' the process at a later stage, the criteria used for the appraisal, the decision and how the project is run may also be clouded. If, however, the major impetus is another factor—extending global reach for example, acquiring more varied language skills in distribution support or extending the product range—then the whole process of evaluation is different, as are the ultimate selection criteria. As a blunt example, if cost is the object, the ideal partner is a lean, mean processing machine; if client facing is paramount, then the appropriate service provider will need a strong client service focus and culture. Asking for one and looking for the other will almost always ultimately result in disappointment. There are service providers who can score highly at both ends of this scale, but they are rare, and if the ultimate aim is to find a 'five-legged sheep' (to borrow the beautifully evocative French expression), then before embarking on the quest one should be prepared for a long and arduous search. If business models were truly able to readily accommodate such a range, either the whole outsourcing sector would be a place of joy and happiness or the whole industry would be beating a path to a single provider.

Do

- Ensure that outsourcing positively responds to at least one of the firm's five main strategic issues (profitability, geographical coverage, etc.)
- Consider the impact on the service delivered to the client—and the client's reactions
- Will the firm's key differentiators be preserved?
- Remember that something must be left on the table for all parties

Don't

- Lose sight of the business impacts of a single strategic objective
- Sacrifice clarity for consensus
- Underestimate the task being undertaken

Transparency and direct communication is essential in overcoming that hurdle, which means in turn it should not be a benchmarking exercise—there are consultants for that!

Equally, in coming to a decision to outsource, agreement is essential. And, at the risk of upsetting more consensual cultures, agreement is not the same thing as consensus. There may well be collateral advantages that allow differing visions to converge, a cost-based initial logic may well offer possibilities for more efficient data models, a global footprint, time-zone leverage and so forth, but these will remain add-ons and should not be confused with the primary objective. Conversely, if they are important in themselves, then that needs to be articulated and accepted as such. An excellent way of creating future problems is for this to be buried in consensus. Different stakeholders in the decision-making process will have different objectives—the world seen from the perspective of business development or client relationships is very different to that seen through the eyes of the CFO. It is not unknown for a board or an executive committee to arrive at an agreement on outsourcing based on each stakeholder accepting that in his or her case there are sufficient advantages to be had, without that agreement extending to what the primary drivers should be.

The first prerequisite is that the criteria are understood and agreed. They may be multiple, but in that case it should be remembered that the greater the number of criteria, the less likely it is that a single service offering will satisfy all of them.

first instance it tended to favour confidentiality, as no-one had an incentive for it to be disclosed, but above all it focused minds admirably on collective responsibility. It would indeed be far-fetched, if sometimes tempting, to suggest that there is any more than a fleeting similarity between the decision-making process of an executive committee or board and the blood-soaked anarchy of bygone Caledonia. Nevertheless, there is much to be said for things that are written down in simple words. Provided the pitfall of political correctness is avoided and once again the need to 'sell' the decision internally does not begin to obfuscate the true objective, something in itself which is not necessarily a simple exercise in larger entities with mandatory staff delegate participation in governance, a clear, minuted statement of the agreed objectives both clarifies intent without equivocation and serves as a useful point of reference throughout the selection process and for progress review over subsequent years in the new configuration.

Having taken the basic decision to outsource, the next question to be answered is "*now what do we do?*" and in general the reply is "*issue an RFP*". There are cases where a strong connection already exists with a service provider, which may be a related company, for example. In circumstances where there is a natural affinity and the conditions proposed are in line with the statement of intent and tick all the right boxes, such a short cut may have advantages. One should also be aware of the inherent disadvantages. It is an almost universal experience that very few 'in-house' clients feel themselves to be fairly treated by the in-house service provider. Sometimes this is solely a matter of perception; sometimes it is more than that. It is also difficult as an in-house client to obtain the keenest pricing within a set series of parameters, as the relationship is often confused by shared resources—profits generated in a shared dealing room or execution facility, etc. Thus, in some respects, the short cut may not necessarily be the only solution, especially in an environment where pricing, even internal pricing, of all aspects of fund charges is coming increasingly under scrutiny. However, when looking elsewhere, it is often difficult to convince potential bidders that their offer is invited for serious consideration and not merely as a benchmarking exercise. Transparency and direct communication is essential in overcoming that hurdle, which means in turn it should not be a benchmarking exercise—there are consultants for that!

The section of the RFP concerning fund accounting alone ran to over a thousand questions. When the mounds of paper came back with detailed answers, some in whole paragraphs, the institution in question was left scratching its collective head as to what to do with all the data

In the tumultuous late Middle Ages and Renaissance in Scotland, when rebellious lords or other dissenters plotted to assassinate a rival, the practice was to draw up a written bond to which the conspirators would sign their names. This apparently suicidal process, should the plot be discovered, did have certain advantages. In the



The RFP is where the first step-difference in the process arises; in the majority of cases the RFP on the 'buy' side (the outsourcer) is a new experience. For the service provider, it is closer to a sales exercise. The scope for misunderstanding between the two is rich indeed.

It is essential that—before the RFP is drafted—the outsourcing party defines exactly what it needs to know, what the key drivers are (back to the written statement of intent) and how, at least in the broadest terms, the whole project will be structured. As an illustration, there was one case in which a highly consensual approach was taken across several locations, with all stakeholders having their say in what should go into the RFP, including several levels of in-house staff. It was felt that not only would this give the necessary level of detail to be able to formulate a judgement, but would also increase the 'buy-in' on the part of the staff who would be part of the outsourcing deal. The section of the RFP concerning fund accounting alone ran to over a thousand questions. When the mounds of paper came back with detailed answers, some in whole paragraphs, the institution in question was left scratching its collective head as to what to do with all the data. It eventually came up with the idea of using graduated 'smilies' on a scale of 1-5—which was quickly reduced to 1-3, as it was impossible to agree the nuances between just two positive or two negative results, as an expedient aimed at achieving a meaningful result before early retirement began to kick in as an additional factor. The case is extreme, but it is a good illustration of the over enthusiasm that is sometimes allowed to cloud the issue. Typically, the institution will have one or two people who may have been involved in an RFP in a former life, although it is rare to have someone who has actually run an RFP. Collectively the 'project team' will spend hours agonising over the subtleties of a few questions that it believes to be important, and leave whole swathes in such general terms that the possible replies are almost too numerous to contemplate, or too vague to use, such as "Do you do this?"—to which the inevitable answer is—"yes".

Do

- Ask the right questions in the RFP Will the RFP give you insight into the alignment of strategy and values?
- Assess compatibility in terms of corporate culture
- Ensure that all of the firm's relevant departments are involved in reviewing the RFP answers
- Ensure that the RFP is reviewed by employees/consultants with good market knowledge
- Due diligence, due diligence, due diligence

Don't

- Limit the RFP questions to technical issues and pricing considerations
- Limit the RFP review to a restricted number of people within the firm
- Skip the due diligence process, as this is a unique opportunity to assess outsourcer values
- Forget that the service provider is in 'sales mode'

On the sell side, this RFP will be one of many; in a lot of cases, replies will be a 'cut and paste' of those used previously to answer similar questions (for innocent entertainment it is always amusing to scan an RFP response to see if anyone has been careless enough to leave in a former client name!) and the risk that a response is given that answers a question other than the one that was intended is significant. Moreover, each service provider has its own approach to answering RFPs. Some are very slick, commercially oriented and well organised, leveraging RFP databases and other such tools. The risk with this approach is that the operational departments of the service provider may not even see the RFP—or will probably see it without having enough time to go through it in detail, and may be consulted by the RFP team on a couple of difficult questions taken out of context. A slick RFP is no guarantee of a slick operational process.

A key question to ask in RFP review meetings is: *"How exactly has the RFP been handled?"*. The response may not be 100% accurate but the way in which the service provider responds to that question will be indicative of its corporate culture.

The potential pitfalls are numerous. In all outsourcings there comes a moment when the frustrated institution decides to go back to the RFP to see how the service provider replied to a specific point with the intention of resolving a difference 'by force'. Forget it. If an outsourcing project has reached that stage it is time to get both parties together for a heart-to-heart before relationships are permanently damaged.

The important points to be remembered are that an RFP is a tool and nothing more: it requires skill and experience to interpret it accurately, including knowing how to look beyond it and understanding which service providers have good processes but less flashy RFP responses and vice versa; realising that no two RFPs are alike; accepting that at this stage in the process the RFP constitutes a selling exercise for the service provider, and looking very closely at the executive summary, which is often the most important part of the RFP as it should allow the institution to gauge the service provider's commitment to this particular deal.

There is no right or wrong way to go about this process. It is, however, time-consuming and fraught with risk for the institution to seek to start the process from scratch when there are consultants available who can not only guide them in building a solid approach and process, but also bring experience and insight that can in the long run prove invaluable. At the same time the RFP is not a poisoned chalice to be dumped on the consultant and left well alone. The key to success is to remain involved in the process, but to recognise value and experience and to remember why a third party has been retained to help with the exercise. And the RFP is no substitute for and, at the end of the day is much less important than, due diligence.

It will probably come as no surprise, given these reflections on the theory and practice of an RFP, that it is only the first step on a long and complex path.

The key to success is to remain involved in the process, but to recognise value and experience and to remember why a third party has been retained to help with the exercise

There remains the evaluation of the responses, the selection of a short list, due diligence on potential service providers, project planning for lift-out or transfer, contract negotiations, setting up KPIs and service reviews, establishing a vendor management function—to name just some of the things that are high up on the ‘to do’ list once the mammoth task of the RFP has been completed. In the face of this complexity, it is hardly surprising that most outsourcers turn to external professionals for assistance.

What is perhaps a little more difficult to understand is the use that outsourcers sometimes make of the professional help that they retain. There are several levels where a professional may be of assistance. Few institutions that embark on an outsourcing project have the luxury of a permanent PMO and project team, and consultants may be a useful source of qualified and experienced staff in such roles. Yet to stop there is to deprive oneself of the real value-added expertise that an experienced consultant with practical hands-on experience can bring to the whole process. It can make the difference between success and a very pale version of success, or even a result that feels and leaves an aftertaste that seems very similar to failure.

This can be demonstrated in many facets of an outsourcing initiative. Due diligence is a good example. In some cases, to perform any sort of due diligence

before a short list has been drawn up may seem an unnecessary use of time and resources, especially where—for relationship reasons—the initial list of bidders invited is extensive. However, given the difficulties inherent in the RFP process (as discussed above), a degree of flexibility might sometimes avoid missing the most appropriate service provider. Another example is in the due diligence itself. Contrast the following: example one is a due diligence exercise that consisted of sitting in the service provider’s boardroom looking at a PowerPoint presentation and a repetitive chant of ‘yes we can’—an exaggeration (but not by much). Example two, considered to be more thorough, involved a visit to the operational floors. Unfortunately—either by accident or design—the start of the floor visit had been so delayed that the day’s activity had in effect already been completed, and the ‘in depth’ visit became a walking version of the PowerPoint scenario in the first example, but without the presentation and with scenic stops at various unlikely corners of a rapidly emptying office. Example three saw the relevant team from the outsourcing institution follow the NAV process from start to finish (including to the enjoyment of the visitors and the embarrassment of the service provider identifying an error in the process!). It does not take much thought to see which due diligence version was beneficial; the planning and orchestration was the work of a consultant, but one with a strong business background.

Key challenges

1. The decision process—confirm that outsourcing meets the strategic objectives

2. Selecting the right service provider

3. Transition and implementation

4. BAU—KPIs and vendor management



When it comes to evaluating the financial proposals, many institutions, beyond a simple number crunching exercise to apply quoted rates to known volumes for which they use their consultants, disappear into a huddle to make their final decision. Clearly, that decision is theirs and theirs alone. However, an experienced consultant may be able to guide them through the evaluation exercise. When something seems too good to be true, it usually is; but a low offer, especially where the key RFP criteria are a mix of cost savings and bespoke functionality, can make sense. A service provider may be looking to strengthen its credentials and client list; it may wish to acquire a specific geographic footprint, or it may be seeking diversification away from concentration in a specific segment. The skill required in judging such a proposal is the ability to weigh up just how far the service provider is going to achieve that aim, how relevant that aim may be tomorrow when the heat of the competition for today's RFP has faded, and how likely it is to influence ongoing relations. It is also essential to remember that for a successful deal, there has to be something on the table for both parties.

A suitably empowered consultant has a key role to play in pointing out to an outsourcer when the decision makers are being unreasonable. The service providers know their business; they have proven operating models and demonstrable results. At times when they are unwilling to accommodate a request there can be very good reasons for it. Facilitating this dialogue—and avoiding the dreaded recourse to the RFP—is an important task for the consultant. But to achieve this effectively, the terms of reference and the scope of the consultancy engagement should be as clearly agreed and defined from the outset as the objectives of the outsourcing itself.

Do

- Recruit a project team with extensive experience in outsourcing in the same industry
- Adopt a collaborative approach with the outsourcer—this will strengthen the relationship and facilitate successful management of the transition
- Engage with clients from the outset—a successful transition is pointless if you have lost all your clients in the process

Don't

- Underestimate change management activity, especially HR issues in the event of a lift-out
- Make assumptions about client reactions
- Go back to the RFP every time you hit a problem—it is too late for that and you will only sour relations
- Ignore any danger signal, however small
- Cut corners or fudge difficulties
- Forget that if things go wrong, there are only losers

The purpose of this article is not to seek to provide the definitive A to Z of outsourcing—that would require a book, and still be incomplete. What it has attempted to do is give a flavour of the complexities, the variable geometry and the challenges that outsourcing poses. It has concentrated on the initial phases to illustrate just how early on in a process key issues are faced—and how mistakes may be made.

But after this initial phase the challenges go on and on. They encompass the successful and appropriate handling of staff lift-outs, TUPE regulations and the more subtle but equally important psychological and motivational change that will inevitably impact the staff lifted out as they make the transition. In many cases, experience challenges conventional wisdom, for example on the merits of trying to keep an out-lifted team together for a protracted period after the transition. In order to determine the success of the outsourcing endeavour, the outsourcer will require adequate and appropriate KPIs and reporting; the art is to get the balance right between meaningful and useful information, and creating a cottage industry through unrealistic demands.

So what conclusions may be drawn from this brief review? In a nutshell they may be summarised as: know, define and agree on the objectives of the strategy. Retain control but be prepared to listen to advice and implement that advice. Build a robust plan with adequate resourcing throughout the project lifecycle and start with the control framework, KPIs and reporting design sooner rather than later.

Outsourcing is neither a black art nor an occult science. It does however have its arcane byways that require experience and expertise to be navigated successfully.

That experience and expertise cannot be found in a book—it has to be acquired the hard way, on the ground.

Do

- Identify the right KPIs to accurately assess the outsourcer's service quality and business profitability
- Build open and informal communication channels as well as formal ones
- Organise regular service reviews with the outsourcer

Don't

- Ask for so much information you will be overwhelmed
- Ask for information you have no clear idea how to use—just because 'it might be useful'
- Forget that now the hard part starts!

A service provider may be looking to strengthen its credentials and client list; it may wish to acquire a specific geographic footprint, or it may be seeking diversification away from concentration in a specific segment



Setting up a banking institution in Luxembourg

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The European banking industry is currently undergoing major changes involving further regulatory requirements such as enhanced liquidity and risk management and greater tax transparency.

In addition, the European Commission has proposed a Single Supervisory Mechanism for banks led by the European Central Bank (ECB) in order to strengthen the Economic and Monetary Union. The move towards an integrated 'banking union' includes elements such as a single rulebook, common deposit protection and a single bank resolution mechanism.

This has had consequences for the Luxembourg market. Over the last year for instance, private banks have been busy adapting their business model in order to try to renew their client base and comply with the automatic exchange of information on EU residents' savings income, which is due to be applied as of 2015.

In this more stringent regulatory context, it is expected that a number of banks may be forced to close their doors in the coming years. Nevertheless, within an environment of European Union harmonisation, Luxembourg is well placed to attract new banks to its territory. Indeed, it is still attractive for banks to establish themselves in Europe and Luxembourg remains a central place to capitalise on 500 million European customers.

However, the rationale for attracting banks is changing. While the country may attract fewer private banks, we will review the reasons why it is still interesting to set up in Europe, and particularly in Luxembourg. We will do this by exploring two case studies: Chinese banks aiming at the commercial banking market and Shari'ah-compliant banks targeting the retail and commercial banking market.

Luxembourg presents outstanding opportunities thanks to its highly skilled, multilingual and multicultural workforce, its stable political environment, its dynamic legal and regulatory framework and its extensive expertise and full range of diversified and innovative financial services

Current trends

In this rough environment, over the last year, the number of banks increased from 141 banks in January 2013 to 149 at the end of March 2014¹. Most of these banking institutions located in Luxembourg are subsidiaries or branches of foreign groups and only five of them are locally headquartered entities.

We read about new banks being created almost every month in the press. As surprising as it may seem, it is not unexpected as the rationale behind opening these banks has changed. Banks are taking advantage of the opportunities to serve Europe, which are driven by external and foreign factors such as trying to serve the unbanked (e.g. Islamic retail banking), to develop trade in Europe (e.g. Russian and Chinese banks) or forward integrating into financial services (e.g. online service providers).

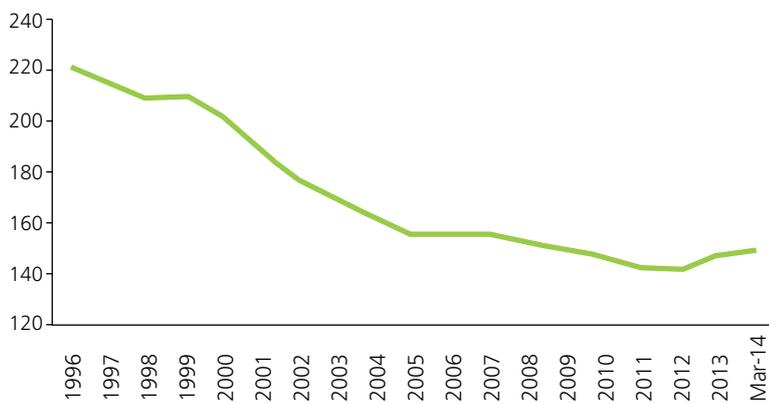
Luxembourg is one of the leading destinations for financial services providers thanks to its global hub status, its constant innovation and business culture

Luxembourg is one of the leading destinations for financial services providers thanks to its global hub status, its constant innovation and business culture. The financial market place in Luxembourg has a high degree of synergy and diversification, appealing to a wide range of investors, including international entrepreneurs and corporations.

Located at the very heart of Europe and benefitting from a AAA rating, Luxembourg is a unique gateway to access the European market. Luxembourg's success can be attributed to a series of positive, long-term government policies aimed at developing a business-friendly environment and diversifying the country's economy. Luxembourg offers these banks the opportunity to take advantage of the full banking license which does not require various application files to perform universal banking activities.

In this context, Luxembourg presents outstanding opportunities thanks to its highly skilled, multilingual and multicultural workforce, its stable political environment, its dynamic legal and regulatory framework and its extensive expertise and full range of diversified and innovative financial services.

Evolution of the number of banks



Source: CSSF

¹ Source: www.cssf.lu/en/statistics/banks/

Setting up banking operations in Luxembourg

Banking in Luxembourg may be carried out either by establishing a branch or a subsidiary of a foreign credit institution. Several foreign credit institutions operate in Luxembourg as both a branch and a subsidiary to take advantage of the benefits that accrue from combining the two structures.

The standard procedure when applying for a banking licence is to submit an application file to the Ministry of Finance, which will seek advice from the CSSF.

Upon receipt, the CSSF will examine the application file and may address additional queries to the applicant in case clarifications are required. In terms of timing, the whole process takes roughly six months, but this might vary depending on the complexity of the credit institution and the quality of the application file.

The authorisation procedure is described in part 1 of the amended law of 5 April 1993. In consideration of the complexity of the procedure, credit institutions usually request the assistance of advisory firms.

Indeed, before setting-up a bank in Luxembourg, one may potentially wish to consider implementing an alternative lighter legal structure such as an investment fund or a Professional of the Financial Sector (PFS).

Once it has been confirmed that a bank is the most relevant structure to be set up, a market opportunity assessment should be carried out focusing on the strategic market entry perspective. The objective is to provide an overview of the opportunities on the market and the resources required to serve it. Subsequently, a business case should be developed focusing on the bank's business and operating model.

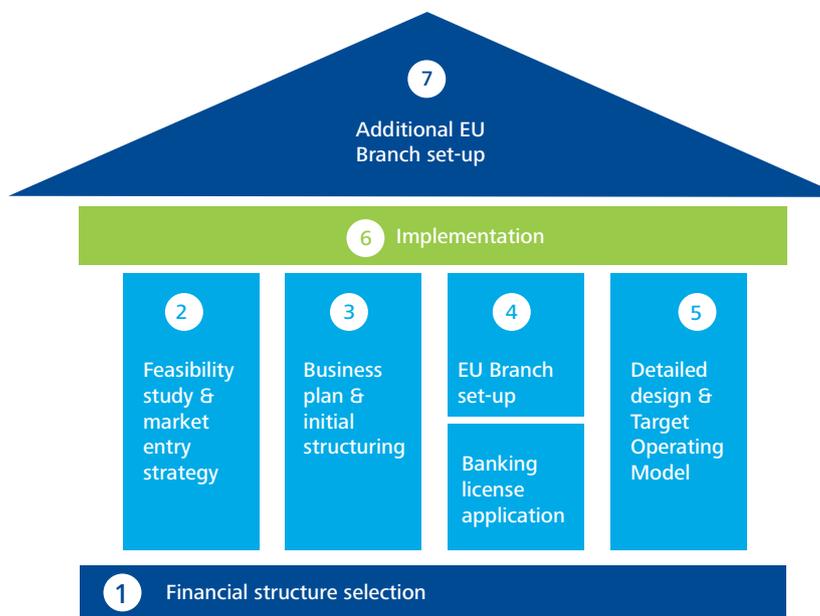
A detailed business plan of the bank's activities should then be finalised. In parallel, the drafting of the entity's statutes, the selection of the premises and the definition of the governance should be initiated.

These documents will then help with the completion of the banking license application file to be submitted to the CSSF in Luxembourg before approval from the Minister of Finance. The application file will depend on the type of entity to set up, which will be either a branch or a subsidiary.

Once the license has been granted by the Minister of Finance, the promoters should finalise the target operating model of the bank before launching the implementation phase.

Finally, when the form of subsidiary has been chosen and is operating in Luxembourg, it may consider opening branches in other EU countries by notifying the CSSF of their ambitions and starting to draft the relevant documentation, including a programme of operations.

Steps to set up a bank in Luxembourg



Case studies

Chinese banks

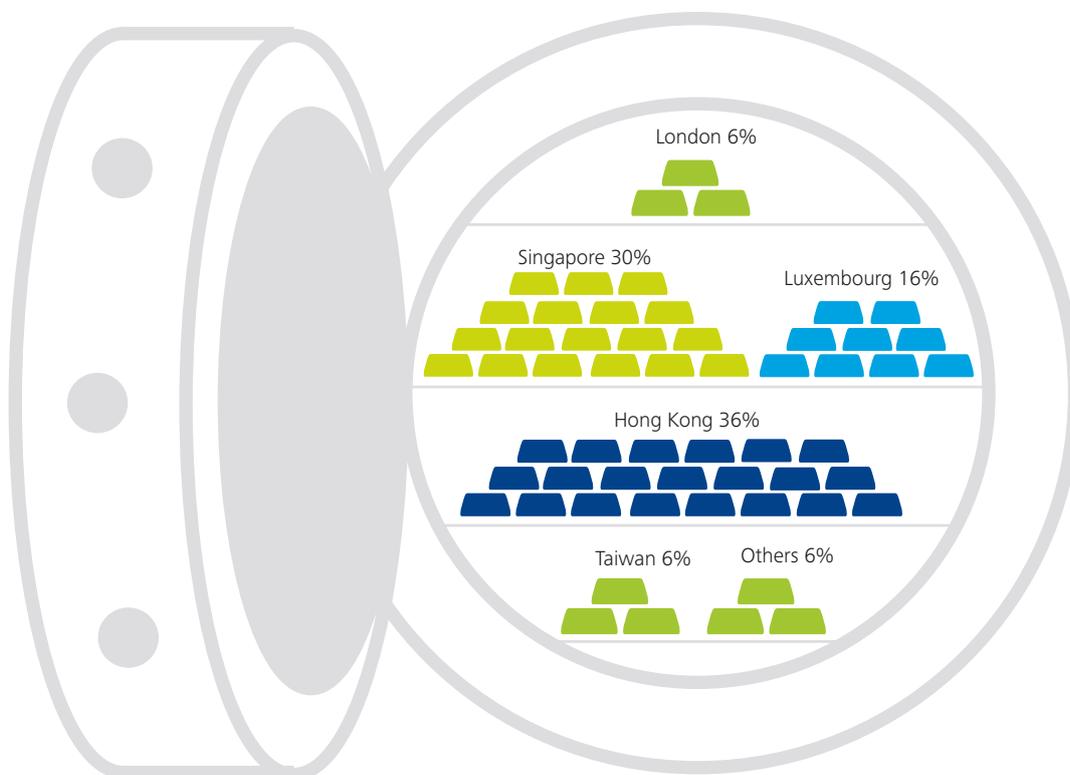
One key area of diversification for the country is to address the needs of Chinese banks eager to enter the EU single market. The most recent and notable example is that of China Construction Bank (CCB), ranked in the top five among listed banks in the world in terms of market capitalisation, which set up both a branch and a subsidiary in Luxembourg in October 2013.

Luxembourg is currently hosting the European headquarters of three of the largest Chinese banks, including Bank of China (BoC), Industrial and Commercial Bank of China (ICBC) and, as previously mentioned, CCB. Dialogues are ongoing with other Chinese financial institutions envisaging setting up a presence in Luxembourg in order to penetrate the European market.

Moreover, Luxembourg has been classified as the centre for international RenMinBi (RMB) business in the eurozone, as it is the largest pool of RMB deposits and funds as well as the leading centre for RMB-denominated bonds and cross-border RMB business in the eurozone. In this respect, the Luxembourg Stock Exchange is leading the international eurobond listings and possesses one of the largest numbers of RMB listed bonds and volumes in Europe.

In addition, the growth of Asian trade and investments in the EU gives rise to trade finance and corporate loan opportunities. Strong economic growth in China allows local banks to look for alternative investment opportunities to diversify their source of income by expanding and setting foot in EU-markets.

Breakdown of worldwide RMB-denominated bonds listings by exchange (Feb 2014)



Islamic banking?

Although five Islamic banking institutions have been set up in England, no such bank is currently fully operating in continental Europe yet. However, the potential customer base amounts to around 20 million Muslims living in the European Union, in addition to customers potentially attracted by a new and ethical way of banking. Indeed, it is estimated that around 20 million Muslims live in continental Europe and this number is expected to grow rapidly. The European market presents vast potential for Islamic banking as 60% of Muslims are under the age of 30—the group considered as the most active consumer of financial services (Housby, 2011). Furthermore, the savings rate of European Muslims is considered to be relatively high. As of today, however, no full-fledged Shari'ah-compliant bank has been established in continental Europe.

While we have been experiencing growing interest from Middle Eastern and Asian firms for setting up Islamic banks in Luxembourg, one may wonder why such a small country in the middle of Europe, with only around 12,000 Muslim residents, may be the location of choice for such endeavours.

First of all, the Luxembourg government is encouraging such initiatives and Luxembourg is already the domicile for numerous Islamic investment funds. It is making sure that the regulatory environment addresses the specific requirements of Islamic finance. In addition, the local banking industry is mature and unlike in some other European countries, Luxembourg's regulatory authorities may grant a 'universal banking license' allowing financial institutions to carry out activities such as private,

corporate or retail banking. Since Luxembourg is a member of the European Union, once a bank receives the license to conduct operations, it is allowed to perform banking activities in the 27 other member states without having to go through another full license application process. Banks may therefore decide to develop activities outside of Luxembourg on a purely cross-border basis or by establishing a branch in the target country, taking advantage of the 'European passport'. For instance, an Islamic retail bank licensed in Luxembourg may decide to open a branch in Paris in order to offer retail banking services to local Shari'ah-sensitive customers.

Therefore, establishing a presence in Luxembourg and obtaining the universal banking license opens access to an untapped market of 20 million Muslims residing in Europe, in addition to the many non-Muslim customers interested in the ethical values of Islamic banking.

Dialogues are ongoing with other Chinese financial institutions envisaging setting up a presence in Luxembourg in order to penetrate the European market

Impact of regulations

Banks in Luxembourg have to comply with the amended law of 5 April 1993, which is supplemented by various national regulations and circulars issued by the CSSF.

Since January 2014, the law is also impacted by the introduction of the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV). The CRR/CRD IV package implements the new global standards on financial institutions' capital (Basel III agreement) in the EU legal framework. This new framework impacts financial institutions in several ways:

- **Corporate governance:** by imposing additional requirements on the composition of the boards of directors, their functioning and their role in risk oversight and strategy in order to improve the effectiveness of risk oversight by boards
- **Liquidity arrangements:** by setting out a new fully-fledged prudential framework for liquidity risk, mirroring the existing pillar I and pillar II approaches for capital requirements
- **Capital requirements:** by requiring more stringent capital requirements through the calculation of credit risk

In addition, the SSM will be introduced in the eurozone. As a consequence, Luxembourg banks shall deal with the new SSM, empowering the ECB with the supervision of banks operating in the eurozone. This will be directly applicable to banks with the following characteristics:

- The bank's assets exceed €30 billion. This criterion is to ensure that the largest banks in the SSM countries are supervised directly by the ECB
- The bank's assets exceed €5 billion and account for 20% of the GDP of the Member State in which it is located. Due to the 20% of GDP requirement, this criterion only applies to SSM countries with a GDP of less than €150 billion (e.g. Luxembourg)

Finally, with effect from 4 November 2014, the issuance of a banking licence in Luxembourg by the CSSF will require the co-decision from the ECB in the form of a second opinion. Since this co-decision will require a collegial agreement among some of Europe's largest countries, setting up new banking institutions may entail more time and effort.

Setting up a bank in Luxembourg offers many advantages. The banking license application process is relatively lengthy but straightforward

Conclusion

Setting up a bank in Luxembourg offers many advantages. The banking license application process is relatively lengthy but straightforward. The timeframe for acquiring a license may vary depending on the complexity of the project but also on the approach taken by the promoters.

Although interactions with the local regulator are encouraged throughout the process, it is paramount to select the relevant structure at the outset, bearing in mind the opportunities for entering the EU single market centrally from Luxembourg thanks to the 'passport' and the 'free provision of services' regulations.

This is particularly interesting for non-European banks and the Luxembourg government is particularly keen to develop the presence of Chinese banks and Shari'ah-compliant financial institutions on its territory.

Finally, the recent regulatory developments have impacted the European banking landscape. In particular, the upcoming single supervisory mechanism will empower the European Central Bank to review and potentially overrule national recommendations of the CSSF. This may have some influence on the authorisation process as new procedures may be imposed by the SSM.



How to maximise value creation during the M&A process?

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It is commonly acknowledged that mergers and acquisitions can be effective tools in the execution of a corporate strategy seeking to maximise value for shareholders.

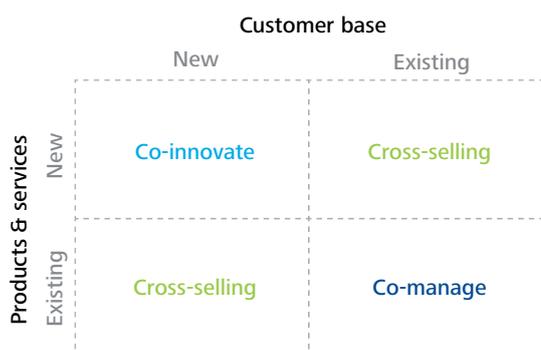
That being said, this route is not without pitfalls and careful thought must be given to the planning of both the execution and the post-deal integration phases.

The integration risks are often not fully understood or fully scoped at the time the deal is signed. Similarly, integration risks are rarely seen as a high priority at that stage.

From the point of view of the acquirer's shareholders, a transaction can lead to value creation through three main avenues:

- Target is acquired at a lower price than its intrinsic value
- Improvement of the target's operating and financial performance on a stand-alone basis post-acquisition
- Realisation of synergies between the acquirer and the target, assuming that the value associated with these synergies is not transferred by the buyer to the seller via the transaction price

This article will focus on the third source of value creation, namely the value generated through the realisation of synergies between the two parties.



What are the different types of synergies?

Synergies occur when the value and performance of two companies exceed the sum of the separate individual parts.

Broadly defined, synergies can be placed into two categories:

1. Operational synergies

These synergies are generated via improvements in the sales or production cycle of the combined entity which could not be made on a stand-alone basis.

Operational synergies can be considered depending on where their impact can be found on the income statement. To simplify, depending on where their impact is shown, synergies can either be revenue or cost synergies.

a) Revenues synergies

Top-line synergies support the revenue generation of the combined group and can be classified in three broad categories as described below:

- A co-manage strategy can be implemented when two competitors merge in a given segment, thereby gaining a greater market share and pricing power vis-à-vis an existing client base buying existing products
- A cross-selling strategy can be adopted when the acquirer is able to sell its products to the target's client base and vice-versa
- When the synergies relate to the new product/service and customer base, we talk about co-innovation. This principle increases top-line synergies through the use of each company's resources to create new services and look for a new customer base. It is also important in co-innovation to review and adapt the product value chain to better address client needs

b) Cost synergies

Cost synergies are generated whenever the combined revenues of the merged entities can be supported by a cost base that is lower than the sum of the cost bases of both entities. This reduction in cost base can result from better purchasing terms leading to lower cost of goods sold, reduction in headcount, improved utilisation ratio of existing infrastructure, etc.

In addition, combining different managerial skills can also lead to operational synergies which can become apparent either at the revenue or cost level.

The origin of synergies will vary greatly from industry to industry and will often shape the nature of a transaction. By definition, industries that are more mature will tend to consolidate for cost-related synergies, while less mature industries still experiencing growth will often see transactions that seek to implement revenue-related synergies. For obvious reasons, the most promising transactions are those where both revenue and cost synergies can be expected.

2. Financial and investment-related synergies

While not as widely advertised as operational synergies, financial synergies can also be a significant source of value creation.

These synergies will arise in several situations, such as:

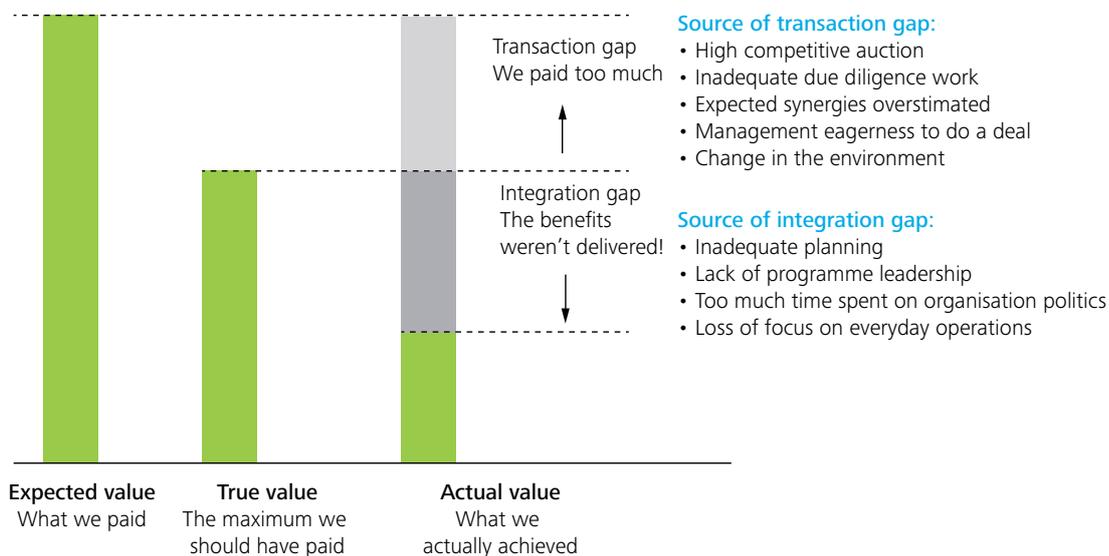
- When the combined entity’s cost of funding is more attractive than the weighted-average cost of each entity’s capital on a stand-alone basis

- When the combination leads to better overall capital allocation (e.g. merger of a company with excess capital with a company offering significant investment opportunities)
- When the combination leads to a lower tax base overall (e.g. one company with losses carried forward merging with another with a significant taxable base)
- When the combination leads to the avoidance of redundant investments

What are the challenges associated with implementing synergies?

The first challenge posed by synergies is their initial quantification. While cost synergies and some financial synergies can to some extent be fairly accurately quantified, the number achieved can differ considerably from the initial assessment. The challenge is even more significant when it comes to revenue-related synergies, as their actual size depends on several factors including the reaction both from the potential market and from the competition.

The second challenge relates to the inability to unleash the inherent potential of a merger. While the initial quantification might have been accurate, management will be faced with a significant challenge if a post-merger integration plan has not been precisely put in place during the closing stages of the transaction process.



Some principles to maximise the realisation of synergies

While there is no magic recipe in this field, some basic principles can be followed to facilitate the integration process between two companies and maximise the probability of seeing the expected synergies materialise.

1. Thorough prior due diligence

Operating and financial synergies should be carefully identified, quantified and validated by both management teams during the transaction. This stream should be a critical part of the due diligence process and sourced by people equipped with a suitable skill set as well as offering an independent view of the size and likelihood of realisation.

2. An opportunity to be creative

A significant transaction can be an opportunity to re-think the overall operating model. While some measures might have been considered unfeasible on a stand-alone basis, the benefits arising from the transaction could provide an opportunity to reassess some of them. For example, the possibility of outsourcing a shared services centre could be investigated for some part of the business to limit the investment and focus on the core business.

3. Formalise and empower

Integration objectives should be clearly stated from the start of the life of the combined entity. This can be done via a 'first 100 day plan' for instance, which should also include the identification and recognition of cultural differences. In addition, such measures should be championed by strong leaders within both organisations. By allocating some of your best resources to run this programme, you will empower your staff, facilitate the change process and maximise the probability of getting value earlier in the process.

4. Be equipped

The nomination of an integration director or an integration core team can be of effective support to the leaders in charge of delivering the synergies. Their task will be to ensure the consistency of the integration plan as a whole, as well as promoting alignment at the senior level in both organisations. This core team will put a formal programme management structure in place, which will implement a robust planning and programme management process.

5. Communicate, communicate, communicate!

The importance of effective and frequent communication to facilitate change and maximise buy-in cannot be underestimated. Much of the communication plan needs to be defined pre-deal. Hearts and minds are won and lost within the first few weeks of transaction completion.

6. Progressing at the right pace

While moving quickly to facilitate the integration of two organisations can sometimes be the right way to proceed, careful thought should be given to: (i) ensuring all the necessary information has been shared between the parties before moving towards the integration phase, (ii) leaving sufficient time for a structural solution to be put in place rather than a quick fix which will soon have to be revisited, (iii) providing sufficient lead-time to ensure proper buy-in from all the parties involved.

Conclusion

Many M&A transactions fail to realise the synergies that are often highlighted when a transaction is first announced. After a company has developed its M&A strategy and executed the deal, the bottom line comes down to successful integration. Management's ability to integrate two organisations into an effective and streamlined operation is where transactions ultimately succeed—or fail—to deliver the much-anticipated synergies. A successful integration begins with a plan that will enable those synergies to start taking effect on day one.

While some of the principles mentioned above are nothing but common sense, they may get lost in the day-to-day reality of the challenges that mergers can bring about.

Defining an implementation programme as well as a governance framework during the closing stages of a transaction negotiation are two simple, yet critical steps that senior management should consider in order to maximise the probability of seeing synergies materialise.

Intelligent concentration of technology as a prerequisite for strategic differentiation

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Many Swiss banks have yet to move their core banking platform to the next generation. They now face the challenge of not missing the boat on digitalisation, which is essential to remaining competitive in today's banking world. Meanwhile, banks that have already migrated to a standard platform feel trapped by their past technology decisions.



Both groups of banks are trying to repair and add to their current technologies, which are often inadequate. Usually under immense time pressure and lacking top-down decisions, these banks are attempting to review the dependencies, coherence and strategy compliance of their technology decisions.

Recent Deloitte surveys conducted with Swiss banking executives paint a clear picture: strategically speaking, all Swiss banks have the same objective for their domestic market, i.e. that differentiation and strategic advantages should be achieved via client interaction. This ambition is driven more than ever by the technological capabilities of banks, but the survey shows the IT priorities of Swiss banks are effectively opposed to this objective. The majority of IT investments – according to Swiss banking CIOs – should go towards compliance, maintenance of current systems and back-office optimisation. The expansion of additional technologies often occurs randomly and is uncoordinated. Promotional initiatives and social media are for the most part coordinated by Marketing; CRM and data analytics by sales; and e-banking overhauls and mobile solutions are often managed solely by IT. The fact that social media goes hand in hand with mobile solutions, data analytics, CRM and e-banking is often ignored, as is the fact that all technological programmes need to follow the same strategy.

IT Transformation paralyses business strategy

Too few banks use questionnaires to predict and ascertain the level of service customers really want to receive. Until now the future was always too distant, but nowadays all Swiss banks should know that the clock of technological development is ticking faster, especially with regards to customer channels and data analysis. Technological innovation, which until five years ago was reserved for large banks, can now be implemented at relatively low cost even for smaller domestic banks. However, the IT architecture of banks is often not flexible enough to implement the changes required by their business strategy. The only way to escape the constraint of IT architecture is firstly to determine what form future client interaction will take and what the requirements are. Only then will a bank be able to determine its IT strategy and IT capabilities. This requires a coherent IT infrastructure providing data through any channel that is linked with a cross application-aligned IT strategy. However, establishing this basis seems to be an insurmountable and unfinanceable hurdle for most banks.

Better coordination of technology projects leads to a drastic fall in IT costs

Studies have shown that IT costs within banks can be reduced by up to 30% to 40% if management is able to keep constant control over the strategic fit, to improve the coordination of technology investments, to leverage functional synergies and to apply the optimal order of implementation. Many Swiss banks would be able to radically increase their power and ability to innovate by applying these principles, allowing them to take a step towards the next technological generation. In addition, coordinating bank-wide initiatives would ensure the correct data availability required for analytics activities.

Next Best Action can be ascertained via analytical models

After more than 20 years of trying, it is finally possible for a bank to use available customer data to ascertain the 'next best action'. This will be a prerequisite when dealing with customers in the future, with banks that are able to interact with their customers via their preferred channels – at an acceptable price – being able to make a real difference for their clientele. This will constitute a competitive advantage until other banks catch up. Deloitte has developed a method that identifies the 'next best action' for each customer through a retail or corporate banking growth engine.

Technological innovation means that banks can move closer to customers via an optimal combination of digital and physical channels, allowing for a bespoke level of interaction



Decentralisation and shared services mean that intelligent concentration of technology is no longer a contradiction in terms

Deloitte is convinced that Switzerland will keep its banking landscape, with more than 3,000 branches, for the long term. However, face-to-face contact with customers will become more important in the future, facilitating the increased success of decentralised banking models.

Virtual shared services, together with central service centres, allow cost and know-how synergies to be captured, optimising the employee base and guaranteeing decentralisation and physical proximity with customers.

Internally-implemented social banking collates knowledge and provides it to the client adviser, but also to the compliance manager and other support functions.

External social banking enables a push-pull interaction between the bank, client adviser and customer, across all channels and at any time. Technological innovation means that banks can move closer to customers via an optimal combination of digital and physical channels, allowing for a bespoke level of interaction.

Implementation mistakes can be avoided

Never has it been so important to coordinate initiatives and projects from a process, sales channel, core banking platform, CRM and data management perspective in order to create a single programme. The competitiveness of banks will eventually depend on this coordination. Current regulatory pressure means that retail and private banks cannot afford to make mistakes in their sales strategy. A successful modern sales function is 100% reliant on technology, but IT strategy must still follow business strategy and not vice versa. Banks that put their IT strategy first will lose out in the long run.

Seven prerequisites to maintaining a competitive edge via technological concentration

1. Take time to think at least five years ahead in terms of customer strategy, despite high regulatory pressure
2. Create a clear unique selling proposition for your bank
3. Determine a sales strategy and develop an approach for each support channel
4. Adjust or re-engineer required business processes
5. Create a coherent IT strategy in terms of core banking, platform transformation, channel integration (e-banking, mobile, web), CRM and data analytics
6. Identify technological scenarios for implementing the above strategies and closing the gaps
7. Fine-tune cost cutting and investment programmes whilst ensuring a strategic fit



Profit increase via improved service and sales effectiveness

Increased front office efficiency

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The front office has less and less time to service customers due to the ever increasing volume of administrative and compliance tasks. How can front office efficiency be improved?

Regulatory changes in cross-border banking and customer protection and a shift in customer behaviour, combined with increased competition with other financial hubs are causing Swiss banks to face new challenges. They also have increasing implications for relationship managers' schedules. New laws and compliance policies increase the administrative costs of customer acquisition and service. According to a Deloitte study, the time allocated directly to customer interaction has decreased from around 70% to 50% over the last five years. The main reason for this decline is the rising compliance and administrative workload involved, especially when serving foreign customers. The introduction of additional customer protection laws (e.g. the MiFID II regulation) will further intensify this trend. The resulting additional effort, together with a falling customer interaction time, leads to a reduced profit margin. This means that productivity and customer orientation become the focus of attention. With respect to a clear value proposition and service offerings, wealth managers have to determine which customers they should serve actively and which to serve only passively. This is the only way they will be able to lift margins back up to a pre-crisis level. Successful

customer focus management therefore consists of three components: customer orientation, customer interaction, and (customer) organisation. However, according to a recent survey of wealth management CEOs, the customer interaction component is the most important differentiation factor. The differentiation itself can be further clustered into three areas: capacity, effectiveness and efficiency.

An increase in capacity can be accomplished with the establishment of the correct IT solution. It connects customer relationship management, portfolio management and monitoring as well as reporting. In addition, the deployment of integrated technologies enables relationship managers to provide more targeted investment advice and, with regards to MiFID II, investment advice that is best suited to the customer. Together with the automation of administrative and compliance processes, it is essential to utilise relationship managers' remaining time as effectively as possible. Firstly, wealth managers should focus on the most attractive customers. In this context, attractiveness is defined according to several factors, such as total revenue, new



investment potential and price enforceability. Secondly, it is important that target customers come from geographic markets offering attractive profit and growth potential. Thirdly, each relationship manager should only focus on a few attractive target markets. Markets that are not considered a priority should be managed either passively or not at all. This geographic and customer focus increases the effectiveness of the front office significantly, and therefore contributes to an improvement in the cost-revenue ratio.

Another lever to raise productivity is an efficiency increase during customer interactions. This can be achieved with significantly lower effort when customers are consulted based on their risk profile. At the same time, relationship managers need to be supported by tailored IT solutions that allow capturing and cross-selling of potentials. When reshaping customer interaction, it is important for employees to implement the intended improvements successfully and this can be achieved through the adaptation of the compensation model. According to a Deloitte study, the compensation structure and performance measurement are the leading mechanisms.

Several Swiss banks have already adapted their compensation structures or are currently preparing to do so. Plans to update performance measurements, however, have not progressed at the same rate. Nevertheless, measurement indicators increasingly shift away from pure revenue and AUM considerations towards profitability indicators.

Initiatives from individual banks have shown that the pre-tax profit margin can be increased by up to 20% through an improvement in service and sales effectiveness. However, not all banks have accepted that challenge yet. Nevertheless, regulatory pressure and increasing competition make it difficult to exclude the front office from effectiveness improvement initiatives.

With respect to a clear value proposition and service offerings, wealth managers have to determine which customers they should serve actively and which to serve only passively



Towards transparency and freedom of choice An unbundled pricing model for retail banks

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Retail banking is currently facing many challenges driven by regulations and increasing customer expectations. The financial crisis has heavily damaged the reputation of the banking sector, and both customers and regulators are now more cautious about the banks' approach to transparency and protecting customer interests.

The new regulations requiring ring-fencing of individual and business customer deposits from any investment activities, increased risk assessment and monitoring measures and minimum capital requirements are driving banks' costs beyond the levels seen to date. In addition, customers are seeking greater transparency in terms of products, pricing and accessibility (e.g. mobile channels, flexibility of customer service).

The above factors have a major impact on bank profits, and thus a more careful analysis of revenue streams is required. Changing the product and service pricing model is one of the alternatives and finding the right solution can prove to be a challenge.

Seeking a new pricing model for retail banks

In recent years, trends in pricing have mainly focused on bundled offerings and relationship pricing, aimed at creating packages of products at a particular price and targeting specific customer segments. This article presents one of the possible alternatives, i.e. a focus on an unbundled approach rather than packaging products together. This model was recently evaluated by the Deloitte Centre for Financial Services via a retail bank survey and its findings have been summarised in a report called 'Shifting retail bank pricing models: managing the transition to unbundled services'¹. The survey was conducted online among 4,271 U.S. retail bank customers

who had a personal checking account. The concepts presented below derive from this study and have been adapted to our local market characteristics.

At this point, it is important to note that this approach should not be considered as the new ultimate pricing strategy that will replace all the current methods: it is one of the available options and, as mentioned in the following paragraphs, principles or lessons learned from other approaches remain valid in this case.

The shift to the unbundled service pricing model

The trend towards offering customers freedom of choice and control over the price they pay for a service or product is not a new phenomenon. Many of us experience it when buying a plane ticket with a low-cost airline and deciding on the amount of luggage, priority boarding, extra legroom or even the snacks and drinks we want to purchase. Each of these services is given a certain price and the customer can decide which to buy.

This unbundled pricing model has advantages for both the customer and the retailer: by having a choice of items, the customer receives a service or product fulfilling his requirements and retains control over the price, while the retailer can relate the price to the cost of each item without charging the customer for extras he does not need.

¹ <http://dupress.com/articles/shifting-retail-bank-pricing-models-managing-the-transition-to-unbundled-services>

The 'pay-per-use' model is becoming increasingly common in a number of business sectors, such as hospitality, catering or media (e.g. newspapers in print or digital format), as well as air transport. The asset servicing industry adopted a similar pricing model as products and services became more sophisticated. This approach balanced out revenues, which are not only asset based but also more service usage driven. The move in this direction is particularly relevant for retail banking.

Applying the unbundled pricing model in a retail bank is a major divergence from the current integrated approach, where the majority of services are offered once a periodic flat fee is paid. In this model, the customer gets access to the majority of services in unlimited quantities for the corresponding flat fee, while in the unbundled one, the customer pays only for the services he uses. The unbundled model offers advantages for both the bank and the customer. Banks can charge a price corresponding to the value of their services, while customers gain transparency, the possibility of choosing only the options they require and control over the price. **The unbundled pricing model could be considered as an alternative path to increasing fees, and therefore, bank revenues.** At present, the rise in periodic flat fees often generates customer resentment and negative publicity. In addition, periodic flat fees can be perceived as lacking transparency and being difficult to understand. A majority of customers say that they would switch banks following even a modest increase in their monthly fees².

Service profiles in the unbundled model

In the previous example of the flight ticket, the airline company applies differentiated pricing: there is a price for the flight and for each service used. This differentiated pricing of previously integrated services represents one of the major challenges in the shift to an unbundled model. **To define an effective pricing model, banks have to thoroughly understand the drivers of customer needs and their ability to meet these needs by providing the required service.**

In order to set a framework for the unbundled model, the products and services typically included in retail bank packages could be classified according to two aspects: the perceived value added and the cost of servicing. The first aspect, the **perceived value added**, is a qualitative assessment used to capture how essential the service is in the overall package. This criterion could be defined as

the distance from the core, where a high distance service could be considered as a value-added service or a luxury³. The second aspect, **the cost of servicing**, corresponds to the cost to the retailer of providing the services. Low-cost services would be, for instance, electronic payment services, while higher-cost services would include financial advice provided by the teller or any other activities requiring manual tasks from an employee.

When classifying the services according to these two aspects, we have identified four categories: **core services, convenience services, benefits and value-added services** (Figure 1).

The **core services** are the essential products or services such as current accounts, debit cards and ATM withdrawals. These services form part of the basic package provided to all customers and are often offered for free and in unlimited quantities. They could be sustainably offered to customers without fees or limits, depending on the customer's needs (and the segmentation), as services requiring more expensive processing used to be excluded from this category.

The **convenience services** are close to the core services in terms of customer needs, but the costs of servicing are higher. These services could therefore be offered to the customer for a small flat fee and in a limited quantity. The usage of convenience services beyond a defined threshold specific to each bank would trigger a per-transaction fee. This classification of services allows the bank to charge fees to high-volume users without requiring any subsidies from low-volume customers. Typical examples of services in this category would be access to the teller or call centre and paper checks processing.

The **benefits** are services with more value added, and thus improve the customer experience. However, they are not perceived as essential by customers and their servicing costs are not considered high. Given this last criterion, they could be free for certain customers, and for non-qualifying customers wishing to access these services, a small fee could be charged. For instance, international wire transfers could be provided free of charge to a particular segment of customers (such as the high-end customer segment with a higher average balance) and offered at a small fee to the mass segment or high-frequency users.

² Deloitte Centre for Financial Services: 2012 retail bank pricing survey

³ An example could be the car, i.e. getting from A to B is the core service, while air conditioning or a navigation system are the additional services

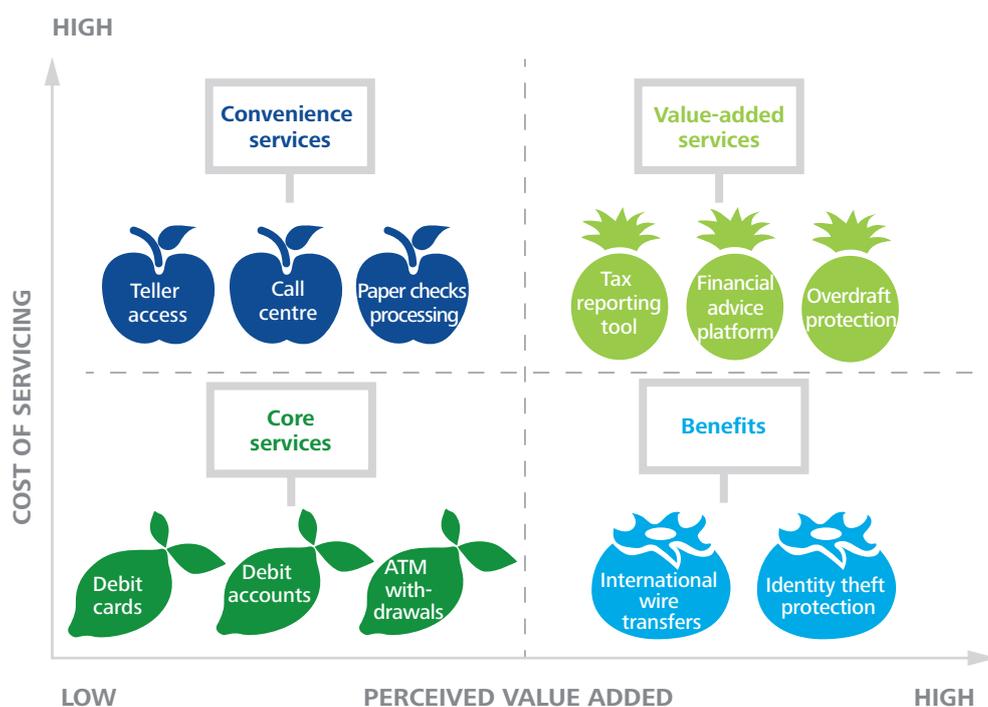
The **value-added services** are at the other end of the spectrum to the core services. These services are believed to significantly improve the customer experience, but their costs of servicing are also higher than other essential products. This classification of services allows the bank to maintain specific services in their offering that would be mainly subsidised by customers who specifically seek these products. For example, a financial advice platform or specific tax tool could be included in this category. As for the other service segments, the composition of this category depends on the target customer segments and their specific needs.

The principle of applying differentiated pricing depending on service categories is being used by asset service providers, who—apart from the asset-related thresholds—also apply different prices to core and value-added services. As mentioned above, this approach was triggered by the proliferation and complexity of products and services offered to their customers.

The impact of a classification of this nature and the related pricing on different customer segments should be carefully analysed based on each bank’s customer base. Nevertheless, as a general rule, one can expect that customers who mostly use core services (such as online account management or ATM withdrawals) would pay lower fees and would no longer subsidise the services with greater value added used by higher-frequency users or high-end customers. The trend in global retail banking towards web/mobile banking confirm this tendency, as the core services delivered through these channels are provided free of charge and balanced by fees earned on value-added services.

As described in the next chapter, the benefits of such pricing should be clearly communicated to customers.

Figure 1: Illustration of possible service segmentation



Source: Adapted based on Deloitte Centre for Financial Services: 'Shifting retail bank pricing models: managing the transition to unbundled services'

The essential principles in a repricing implementation

Whatever the industry, shifting the pricing model has always been a sensitive initiative. Over the years, banks have tried to change their fee structure several times, but many have failed to achieve a complete and efficient deployment. In many cases, the failure did not stem from the strategic decision, but rather from the implementation. Moreover, fee changes are usually drivers of negative perceptions among customers.

For all these reasons, certain elements should be carefully considered, especially when shifting to the unbundled model:

- **Knowing your customer**—adopting a customer-centric approach to thoroughly understanding the customer's needs and perceptions is more important than ever. The first objectives would be to classify the services offered in accordance with the two aspects identified above. The new pricing strategy can then be based on a complete understanding of customer preferences and behaviours. In this case, clear customer segmentation could be considered a good starting point.

The second objective would be to set precise usage thresholds for fees per service, in a similar way to the asset servicing industry, where it is common practice. This step is crucial in the structure described here and will depend on the individual characteristics of the bank's customer base. For instance, the survey conducted by Deloitte showed that 20% of users account for more than 50% of total usage across a wide range of products and services. Consequently, customer analytics should be considered a key element in the implementation process.

- **An opportunity to refocus on target customer segments**—pricing changes can potentially alter or modify the characteristics of the customer current base. New fee grids could not only change the customer's perception but may also materially affect product usage and hence result in a switch in customer behaviour. As a consequence, a new pricing strategy could be leveraged to refine customer segmentation and allow the bank to refocus on its long-run strategic objectives.
- **Tailored communication to specific customer segments**—communicating value and keeping a high level of transparency are essential when shifting to unbundled pricing. Without customer buy-in, all efforts to change the pricing would be to no avail. Although the themes of transparency and fairness are likely to be central in communication to all groups, messages should be tailored to specific customer groups to secure their support. Furthermore, changes in distribution channels and the increasing digitalisation of communication could be leveraged to ensure efficient communication.
- **Understand your ability to service the customer's needs**—in order to classify the products and services along the cost of servicing axis, the bank needs to have a clear and exhaustive view of their current product offering. Pricing changes could also be an opportunity to streamline the offering. A simplified offering could limit pricing complexity and facilitate customer understanding.

An analysis of these elements together with a classification of services should allow the bank to categorise its service offering per customer segment as illustrated below (Figure 2).

Figure 2: Illustration of possible service segmentation for two client segments

	Debit account	Debit cards	Regular credit cards	International wire transfers	Gold credit cards	Financial advice platform	Specific tax reporting tool
MASS SEGMENT		 Core services	 Convenience services	 Benefits		 Value-added services	
Fees		None	Small flat fee	Small fee		High fee level	
Threshold		None	Low	High		High	
Main distribution channel		Alternative	Alternative	Alternative		Alternative & traditional	
Usage rate							
	Debit account	Debit cards	Regular credit cards	International wire transfers	Gold credit cards	Financial advice platform	Specific tax reporting tool
HIGH-END SEGMENT		 Core services		 Benefits	 Convenience services		 Value-added services
Fees		None		Small fee	Small flat fee		High fee level
Threshold		None		High	Average		Low
Main distribution channel		Alternative		Alternative	Alternative		Alternative & traditional
Usage rate							

Source: Deloitte analysis

Over the years, banks have tried to change their fee structure several times, but many have failed to achieve a complete and efficient deployment



Repricing implementation—specific topics

As mentioned above, the implementation phase is critical for this type of initiative and dozens of key points and challenges could be highlighted.

The areas to focus on when shifting to a new pricing model mainly concern: simplification of the product offering, adoption of a customer-centric approach and changes in the distribution channels. In view of the breadth and the complexity of each area, this article only provides a high-level description of those topics.

Simplification of the product offering

Currently bank customers want choice and diversity in the product offering. However, such variety implies maintaining a complex product portfolio that can eat into profits. For instance, this broad product offering involves cumbersome front office tasks. This complexity not only negatively affects customer perception but also drives the servicing costs up. This is also the case for the middle and back office, which have to struggle with the complexity of maintaining such product portfolios. Complex product portfolios that push revenues down and costs up can often be explained by the following:

- **A product-centric view**—traditional product offerings tend to focus on the product, valuing the success of individual products rather than viewing it at the customer or relationship level
- **No product lifecycle**—banks tend to launch new products without discontinuing the old ones. As a result, a significant portion of the product portfolio comprises legacy products
- **The complexity of banking products**—banking products may have hundreds of variations, and the complexity can be further increased by hundreds of specifications and characteristics

When facing a situation of this nature, the complexity of the product portfolio could be reduced by:

- Trimming the current portfolio by removing redundant, underperforming products, or even products that are misaligned with the bank's current strategy
- Reviewing the organisational and operating models of correspondent departments ensuring that all bank departments involved in product management (from development to monitoring) are in the scope of the analysis
- Aligning products with the current strategy and objectives, but more importantly, with customer preferences

Streamlining the product portfolio requires adopting a customer-centric approach, beginning with the definition of customer segmentation and targeting. This last element also plays a central role when shifting to a new pricing model.

Understanding customer needs

The customer-centric approach requires a deep understanding of what customers need, want and expect. It is crucial therefore for a retail bank to perform a comprehensive analysis of its customer base and invest in collecting and managing the data. Advanced analytics need to be deployed in order to obtain an enhanced view of customer behaviour, thereby allowing for accurate segmentation.

A recent survey of retail banking executives performed by *The Economist*⁴ identified the urgency of "improving client segmentation and considering its impact on product design and distribution" as the second-highest priority in the years to 2020. It shows that banks' management acknowledge the importance of segmentation and the need to adapt the approach to customer data. Consequently, it involves not only financial and personal data collection but also data interpretation allowing for identification of customer behaviour. Managing information has become as important for retail banks as money inflows, and data management is significantly affecting banks' market share.

Traditionally customers are segmented according to lifecycle principles such as age, stage of professional life and income. However, these methods will not be sufficient given fast-forward changes in customer behaviour, where technology plays a central role. In response to changing demographics and customer preferences, the bank of the future needs to focus on mobile services and applications to increase customer convenience and loyalty. While developing these innovative solutions, it is essential to cater for the less tech savvy customer as well.

Banks may therefore apply customer segmentation, combining the traditional lifecycle and revenue-driven approach with a focus on the following groups:

- Traditionalists, for whom a personal relationship is imperative
- Techies, which represent an increasing number of customers embracing the use of efficient and uninterrupted ways of connecting with banking services

A clear shift in the source of retail bank growth can be observed, where product innovation and the creation of more complex offerings, as well as the ability to quickly adapt to changing customer behaviour, will generate growth.

At present, the rise in periodic flat fees often generates customer resentment and negative publicity

⁴ *The Economist Intelligence Unit: Future factors: How regulation, client expectations and technology are transforming retail banking*

Distribution and the emergence of alternative channels

In a similar way to customer segmentation, the ongoing evolution of technology is impacting the role of distribution channels. The traditional operating model built on bricks and mortar is rapidly shifting towards an online model. Mobile banking is no longer an extension of the traditional channels (branch, ATM, call centre, web banking), it is becoming a major tool for the customer to perform various operations and interact with the bank. Each distribution channel has a distinctive role, yet overall integration is required to allow the customer to navigate through them with ease.

Consumers expect more services, at a lower price and with 24/7 access. The alternative distribution channels, including social media, are now meeting these requirements—especially in terms of transactional business focused on the lower-value customer. The role of a branch is now concentrating more on offering

customers financial advice, rather than performing simple banking operations. Worldwide trends show the drive towards a lean branch structure, with fewer, smaller branches. Low-cost branches—and increasingly, virtual branches—where customers use a combination of online tools to manage their accounts and consult their account manager via a web communicator are on the rise. These changes allow for more direct customer targeting on a larger scale, as well as significant cost efficiencies when compared to traditional branch or direct sales focused distribution. Banks should continue their efforts to offer a multi-channel experience, with a view to moving towards full-fledged mobile banking in the near future.

These factors will have a significant impact on the bank's pricing strategy and product development, allowing for the creation of a more competitive offering delivered directly to the customer at an attractive price.



Conclusions: pricing strategy—a central piece of the global strategy puzzle

Pricing plays a central role in customer satisfaction and profitability. This is especially true in the current financial situation, where retail banks have to cope with cost pressure, changing customer expectations and increasingly stringent regulatory requirements. Furthermore, retail banks have again begun to implement strategic moves in order to reposition for profit and growth opportunities, in this very competitive market space. The strong drive towards digital banking and transformation of this channel into a sustainable revenue stream with more products/services being offered via online and mobile tools is one of the trends. In that context, pricing is a key lever that could be used alongside other initiatives in order to retain existing customers and attract new ones.

Several approaches can be adopted to redefine the pricing model, ranging from dynamic pricing to relationship pricing via the unbundled model described above.

Nevertheless, in all cases, shifting from one pricing model to another is likely to mean embarking on a long path full of challenges. An in-depth analysis of the bank's product offering, customer base and distribution channels is required in order to determine the expected benefits and how best to tackle any potential issues.

Finally, and more importantly, pricing strategy should be part of an overall/global corporate strategy. As mentioned above, the implementation of a new pricing model requires strong interaction with other strategic areas of focus. Thus, pricing should not be tackled in isolation, but form an integral part of the bank's global strategy—after its impact on other business areas has been analysed. At the end of the process, as with other strategic initiatives, pricing must be aligned with the organisational model and corporate values, in order to ensure that business objectives are achieved.

A clear shift in the source of retail bank growth can be observed, where product innovation and the creation of more complex offerings, as well as the ability to quickly adapt to changing customer behaviour, will generate growth





Joining the dots of the new regulatory framework for a better understanding of the new securities infrastructure landscape

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The harmonisation of the European asset servicing landscape has been one of the major objectives of the financial authorities for more than ten years.

In the wake of the market turmoil of 2008, a battery of regulatory measures and market events has been shaping the future European market infrastructure. Among the key aspects of this transformation, we will focus on the market infrastructure and post-trade-related aspects, and factors relating to collateral.

The Financial Collateral Arrangements Directive (FCD) and Settlement Finality Directive (SFD) are two of the regulatory responses to the major increase in cross-border financial flows in a highly fragmented European market. Welcomed by the market, these directives have proven to be a step in the right direction, but there is still room for improvement. The use of collateral has continued to increase, leading the industry to call for an extension to the list of assets eligible for use as collateral with the European Central Bank. On 13 June 2013, the European Central Bank announced greater flexibility in terms of assets accepted as collateral (e.g. asset-backed securities). Furthermore, the need for High-Quality Liquid

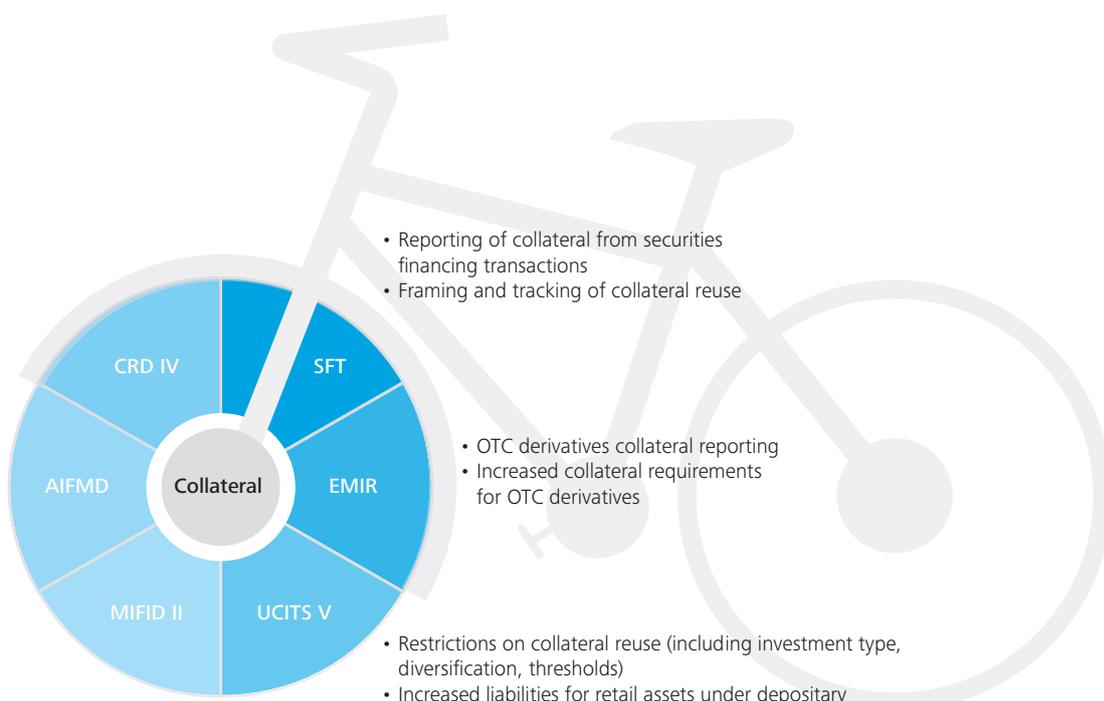
Assets (HQLA) for bank liquidity buffers as per the CRD IV definition drove market players to a scramble for the 'most wanted' assets (e.g. debt of G20 countries), which resulted in the collateral market drying up due to a lack of definition of HQLA Level 1 (extremely HQLA) and Level 2. We are therefore seeing a profound change in market practices and methods in an environment in which infrastructure is also transforming collateral management in Europe.

The challenge facing the sector mainly consists of achieving proper understanding and implementation of the various regulations, all of which are aimed at improving market efficiency and investor protection, but with a different rationale, objective and timetable in each case, making it difficult to adopt a holistic approach to creating the optimal operating model for the future. Our subject, collateral management, will be impacted by, for example, EMIR, MiFIR, the ESMA guidelines on UCITS and AIFMD.

- Increased capital requirements
- Increase HQLA collateral needed to manage liquidity buffer

- Depository liabilities for assets held
- Obligation and constraints on prime brokers with access to collateral pool

- Increased technology in trading and reporting infrastructure



Against a backdrop of profitability pressure and cost cutting, asset servicing organisations do not have much choice other than to chase one regulatory hot topic after another, ensuring they are compliant as soon as the regulation enters into force. Nonetheless, it remains vital for the medium/long-term strategy of post-trade providers to maintain a holistic view of the target operating model of the European post-trade industry.

We regularly observe that the opportunity to step back from the wave of new regulations and take the time to have a global view of the final destination is a must that unfortunately few institutions can afford. Despite the obvious need to adopt a staggered implementation timetable in parallel with the regulators' timetable, it is reasonable to believe that the winners will be the financial institutions that succeed in adapting their operating model using a holistic strategic approach in terms of asset servicing.

The evolving regulatory framework is having a profound effect on the asset servicing sector and impacting the entire value chain from the initial trade to post-trade and custodian services. Below we focus on AIFMD, EMIR, the Central Security Depository Regulation (CSDR) and the future Target 2 Securities (T2S) platform, which will not only transform the depository's role, responsibilities and operating model in terms of collateral management, but also reshape the whole European custody landscape.

First, you need to learn the rules of the game, then you have to play the right cards

What are the main transformations?

T2S—a level playing field for collateral management

In a nutshell, the European T2S platform will facilitate the consolidation of pockets pool of collateral into a large EU pool of collateral. It will provide greater harmonisation at the European level for securities collateral and settlement activities. This is a new strategic factor that depositories will need to take into account when considering their future EU custody network.

Where it was a clear 'must have' to appoint at least one sub-custodian in each country in which a bank was operating accounts, T2S will make it possible to appoint one counterparty (a global custodian/CSD) as the main means of access to the other European CSDs. This new open architecture will create opportunities in the provision of collateral management services.

T2S will create a level playing field for European market infrastructure and stimulate competition among industry players. In terms of collateral management, this market event, which will centralise all local market access, based on a single hub, represents a major opportunity for asset servicing firms to build a pan-European and international open architecture via its European T2S hub, almost a one-stop-shop for collateral management without changing the physical allocation of the assets used as collateral.

From OTC to a regulated market place—how to manage collateral

Besides the aim of EU regulators and the market to harmonise the post-trade infrastructure, another key objective is to shift derivatives transactions from over-the-counter trading to a regulated market infrastructure.

The European Market Infrastructure Regulation (EMIR) is aimed at organising the derivatives markets respectively for trading and clearing on recognised regulated platforms such as Organised Trading Facilities (OTFs) and Central CounterParties (CCPs). As a result, the market estimates that approximately 80% of financial derivatives products (it is expected that IRS and CDS will be subject to the CCP model), which are currently traded OTC will become subject to a streamlined trading environment.

The intention is that OTFs and CCPs will reduce risk and enhance transparency in relation to these transactions. CCPs act as the sole counterparty for market participants, thereby minimising the risk of derivatives counterparties defaulting.

EMIR will impose requirements in terms of reporting, risk mitigation and collateral management. One result will be that participants will have to provide collateral under margin requirements (initial and variable margin) in order to access the CCP. Although the definition is not yet available, the technical standard for non-centrally cleared transactions is likely to impose additional requirements for collateral exchange. In both cases, whether centrally cleared or not, collateral will need to be segregated with no (or limited) opportunities for rehypothecation or reuse.

Securities financing—the other collateral issue

Among the proposals regarding shadow banking, the EU issued a proposal aiming to regulate securities financing transactions in order to *“dampen risks and pro-cyclical incentives associated with securities financing transactions such as repos and securities lending that may exacerbate funding strains in times of market stress”*. According to the Financial Stability Board, regulators will apply similar rules to EMIR for the repo and lending market, but in addition to mandatory reporting of transactions to trade repositories, rehypothecation will be restricted under specific conditions.

This will probably lead to the rise of repo marketplaces (such as Eurex or LCH RepoClear) with a centrally cleared model, as well as tri-party repo and lending transactions.

Asset servicing firms seeking the optimal T2S, CSD and CCP operating model will be well advised to adapt their collateral management capabilities in parallel to their infrastructure connectivity. In addition to timely trade confirmation, portfolio reconciliation or dispute resolution, managing collateral will become more than a competitive advantage in this context of asset centralisation and collateral pools. Mark-to-market valuation, eligibility assessments or assistance to set up the client’s intragroup exemption criteria will be essential to lock in asset manager clients looking for a post-trade one-stop-shop. Some players are preparing to set up operations along the lines of Clearstream’s global liquidity hub or the BNP Paribas Securities Services intraday liquidity facilities.





The safekeeping of collateral will also change under the new regulations. EMIR and AIFMD both impose requirements in terms of appropriate safekeeping of financial assets used as collateral. The general principle consists of the obligation for a depositary to hold all financial assets (i.e. including collateral) within its sub-custody network. As a result, keeping financial assets in custody generates an obligation of results for the depositary, meaning that it will need to return any loss of financial asset collateral without undue delay. This strict liability for the depositary generates additional custody risk for the depositary bank. It will be vital to define a sound collateral safekeeping strategy in order to be in a position to mitigate the risk of financial losses on the financial assets held within the sub-custody network.

Depositaries shall be aware that legal title transfer of financial collateral given by their AIFs will remove the obligation to maintain the assets within its sub-custody network and hence the strict liability in terms of assets. On the other hand, financial collateral received by the fund with title transfer will become an asset to be kept within the network, with full liability in the event of the loss of the asset.

As an illustrative example, when financial asset collateral belonging to the investment fund is held with a prime broker or a counterparty of the fund, the depositary faces major challenges. If the depositary bank appoints a counterparty holding financial assets of the fund as a sub-custodian, which is the direction the market currently tends to take, the depositary will need to keep safe these financial assets with the same standard and care as in its traditional network. Considering that prime brokers do not use the same network as the depositaries, it will be a major challenge for depositaries to prove due care and diligence in terms of the safekeeping of financial assets given as collateral without title transfer. For example, we can mention the obligation for the depositary to monitor the pre-agreed rehypothecation limits when the fund's long assets are fully given as collateral to the prime broker, which reuses these assets based on complex indebtedness calculations for which any further segregation and asset allocation reporting on their street side becomes a major challenge.

In addition, appropriate segregation of the collateral is also one of the key issues that arises when dealing with a clearing member who wishes to access a CCP. The counterparty may either choose to have **omnibus or individual segregation of** records and accounts for direct and indirect clients. As a result, reconciliation and day-to-day administration of the collateral will be made more complex by this potential dichotomy of segregation between two counterparties.

Central Securities Depository (CSD)—the place to be?

The question of liability and segregation of collateral may take on a different meaning when being considered in relation to a Securities Settlement System (SSS). The SSS concept is the current regulatory definition of the CSD and ICSD market infrastructure. The AIFMD (and this will probably be the case for the forthcoming UCITS V and VI) has provided a specific status for the asset in safekeeping under the SSS regime.

As per the directive, safekeeping in a SSS is not considered a delegation of custody function. Therefore, when assets are deposited with a SSS, the depository can consider adopting a risk-based due diligence approach (as opposed to full-fledged due diligence). This is less obvious when the SSS further sub-delegates the safekeeping of these financial assets to a non-SSS institution. In this latter case, a full-fledged due diligence could be considered. In the case of a full SSS safekeeping chain, the requirements for asset segregation as set out in AIFMD would not apply.

In the event of a loss of financial instruments to be held in custody occurring at the level of a full SSS safekeeping chain, the normal liability regime of the depository (i.e. obligation to return lost financial instruments except in certain circumstances) applies as a matter of principle. However, the depository may allege that the loss at the level of a full SSS safekeeping chain is an external event beyond its control and equivalent to an obligation of means in terms of safekeeping.

Under EMIR, Central CounterParties (CCPs) are required to hold collateral assets posted as margin or default fund contributions at a SSS level, where possible.

The main rationale for these considerations relates to the fact that market infrastructures such as CSDs as well as CCPs and organised trading facilities are subject to a specific regulatory framework (EMIR, CSD, MiFIR) in addition to national legislation, EU and global standards (such as the ESCB/CESR and CPSS/IOSCO recommendations for SSSs), making an obligation for a depository to return lost financial assets or even settlement risks in general rather unlikely.

CSDs will also be subject to their own specific legislation (CSDR), which is being prepared by the Commission. The regulation will provide the CSD with a European passport and harmonise a common T+2 settlement cycle in Europe, while imposing dematerialisation for securities issuance. The CSDR is key to preparing the CSDs ahead of the introduction of the T2S platform.

Regulations must be understood as a full set, not independently

The major global custodians have understood these new regulatory and market dynamics. Bank of New York Mellon set up a new CSD early this year, and has signed the T2S Framework Agreement. J.P. Morgan has also chosen to enter the CSD arena under a partnership agreement with the London Stock Exchange (Monte Titoli post-trade infrastructure), with a new CSD to be established in Luxembourg.

The ability to centrally manage and use collateral divided up into multiple location pools is probably one of the major challenges financial institutions will have to address in the coming years.

The combination of custodian collateral services, together with CSDs and integrated CCP market infrastructures, could constitute a strategic approach to addressing the collateral management challenge.

Is the new securities target model really that easy to define?

Obviously—and unfortunately—not. The trend towards market infrastructure consolidation is clearly there and will gather pace in the next few years. The custody business is also being reshaped in line with the different market and regulatory trends. The development of collateral transformation (upgrade to a higher quality) is the best illustration, in addition to collateral and liquidity outsourcing offerings.

More competition and globalisation will also impact the number of EU sub-custodians. On the other hand, there are a series of financial, regulatory, tax and operational challenges, such as day-to-day asset administration (e.g. corporate actions, tax reporting) that will still require dedicated local and sub-custodian expertise that not all CSDs can directly provide.

Joining the dots...

What will the securities business look like in the next three years? As we have seen, several regulatory and market considerations are driving the new framework, and the current business environment will be different as the EU market becomes much more integrated.

The efficiency of collateral management will be particularly crucial in the coming years, and will require new business approaches and services. Estimates point to the demand for collateral increasing by US\$4-5 trillion in the next few years as a result of the new regulatory framework. Combined with the reduction of the European Central Bank's liquidity injections (such as ECB LTROs), we will consequently see the cost of collateral increasing, and therefore, the cost of funding. Furthermore, financial institutions will face a dilemma when allocating collateral among OTC derivatives, liquidity and regulatory collateral.

To address this dilemma, financial institutions should carry out an impact assessment of current and future collateral organisation and solutions and evaluate their capacity to meet the new requirements, as well as taking advantage of a central and holistic view of their needs and assets in terms of collateral. This will result in prioritising collateral allocation, and optimising the global pools.

Leveraging the new European post-trade environment and defining the future strategic business model of its custody network is also a strategic topic on the 'to do list' of EU financial institutions. As we have seen, this exercise is closely related and must be carried out while bearing in mind the collateral management framework.

All participants in the post-trade value chain are currently facing the question of their future business model in the new European environment. The answer to the question is far from being trivial, as it will probably drive the business operations of these participants for the next decade. We are already seeing strategic changes, including alliances between CSDs and global custodians.

It appears that major global custodians are starting to position themselves (via a CSD infrastructure) as an integrated approach for asset servicing at European level. Most other financial institutions that operate in asset servicing now have a unique opportunity to take advantage of this new landscape, while anticipating the new regulatory requirements (collateral margin), achieving business operational efficiencies and developing new business opportunities. In order to achieve this strategic objective, joining the dots of the regulatory framework is probably the right approach...

Conclusion:

- The European market infrastructure will dramatically change in the next few years following the introduction of a new regulatory (EMIR, AIFMD, CSDR, etc.) and market framework (T2S)
- The new post-trade landscape will move from a collection of 25 domestic markets into a common European level playing field for settlement and collateral management
- HQLA is increasingly requested, as collateral assets will impact both derivatives and funding costs
- Efficient collateral management will be required to anticipate and meet the future margin requirements as envisaged by the new regulations
- There will be new opportunities to access the different European domestic markets from one main counterparty (a CSD or global custodian) under the new T2S environment
- This potential centralisation may also offer the opportunity to develop a central and consolidated view of collateral capability and needs
- Global custodians are positioning themselves more and more (via the CSD infrastructure) as one-stop asset servicing providers with direct access to T2S (and EU domestic markets) and global collateral management services
- Financial institutions have the unique opportunity to revisit their current asset servicing business model to anticipate the new regulatory framework and take advantage of the new European market infrastructure landscape



MiFID II

From a compliance to a business challenge

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Why MiFID II?

When the first Markets in Financial Instruments Directive (MiFID I) package entered into force in 2007, the European legislator did not expect the text to be applied as it is today. For instance, requirements on inducements and their full transparency for the customer have been interpreted and implemented differently by the industry.

Moreover, innovation, market and technological developments (e.g. high frequency trading), and growing complexity in financial instruments have outpaced current MiFID provisions.

As a response, Europe has proposed and recently voted on a recast of the package, comprising a directive (MiFID II) and a regulation (MiFIR), collectively known as MiFID II. The new package runs to more than 700 pages, to which detailed standards based on the ESMA guidelines will be added.

What is new with MiFID II?

Unsurprisingly, most of the provisions contained in MiFID are strengthened in MiFID II, for example: an enlarged scope of products and activities, a revised marketing and targeting process, more comprehensive client profiling, a broader definition of complex instruments, more detailed client reports and new pre- and post-trade reporting. All of these changes will bring further transformation to the banking and asset management industries, which must be compliant by the end of 2016, the expected implementation date.

Out of the whole MiFID package, a single article has sent shockwaves throughout the industry: article 24, which prohibits the common practice of retrocessions (inducements) for discretionary asset management and 'independent' advice. Article 24 creates a huge difference between MiFID I and MiFID II: while the first generated compliance costs, the second puts significant revenue at risk. In other words, MiFID I was mainly a compliance matter for the financial industry, but MiFID II poses challenges for your revenue and thus your strategy and business model.

By end-2016, all 28 EU member states will be on a level playing field, unless certain countries go for more stringent rules (gold plating). In the meantime, national regulators throughout Europe have already taken tough measures to either ban retrocessions or strictly limit them. A number of countries, including the United Kingdom, Italy, Netherlands and Germany, already have requirements that go beyond MiFID II.

One of the most notorious changes to legislation is the United Kingdom's Retail Distribution Review (RDR), which came into effect on 31 December 2012. In particular, it bans commissions received by financial advisors from fund managers on all new products (including insurance products). After more than a year under the RDR regime, the effects are clearly visible: a number of institutions have withdrawn their advisory services from the mass market, believing that this offer would become unprofitable without retrocessions.

Insurance products scoped out

Despite the request of many stakeholders, including EFAMA, the MiFID rules on distribution (including inducements) will not apply to insurance products. Although insurance products will be covered by a different directive (IMD II), the latter has been considerably delayed. The asset management industry is of the opinion that this creates a clear risk for a non-level playing field, where insurance products will benefit from more flexible distribution rules until IMD II addresses the issue.

Consequences and challenges for distribution

The impact of MiFID II on distribution models in Europe will vary from one model to another and from one country to another. There will be losers, but also winners.

Discretionary asset management

Discretionary asset management (DAM), i.e. the management of client assets under a mandate allowing the manager to buy and sell securities on behalf of clients without explicit client consent for each transaction, will be directly impacted by MiFID II.

Banning inducements in DAM may remove a significant portion of the asset manager's revenue. In particular, retrocessions received from third-party funds will disappear. This may lead the asset manager to:

- Increase DAM fees transparently charged to clients, as far as the client agrees to pay them
- Increase the minimum portfolio size to make DAM services economically viable, thereby excluding many investors from accessing affordable advice
- Promote in-house funds, since buying third-party funds would not provide any advantage
- Encourage clients to shift to non-independent advisory, where inducements are not banned

Proprietary distribution

In principle, banks and asset managers with integrated distribution networks can be considered 'non-independent' because they tend to favour the sale of in-house products. However, such networks may also provide access to third-party funds, giving a veneer of independence.

Large banks and asset managers may, as far as possible, combine non-independent and independent advice inside their own distribution network, applying different remuneration models depending on the situation: (i) non-independent advice organised more or less as it is today, and (ii) independent advice with a strict ban on inducements and a revised remuneration model (developed later in this article).

This 'hybrid profile' scenario would have the advantage for banks of leaving the door open to retrocessions for all non-independent advice. However, banks would have to deal with increased operational complexity, since distribution models and the related remuneration of each service would depend on whether this particular service is provided on an independent basis or not.

Independent financial advisors

Independent Financial Advisors (IFA) are individuals or small- or medium-sized companies that do not belong to banking or insurance groups. Consequently, they do not have access to an internal distribution network.

IFAs are generally remunerated by commissions received from third-party product providers. Their remuneration will therefore be directly impacted by MiFID II. The change will mean:

- IFAs will have to be paid by investors for the advice they provide, instead of receiving remuneration from product providers. They will need to demonstrate to their clients that their advice is of added value and worth the fee. Lessons can be learned from the recent experiences in the United Kingdom and the Netherlands, and by looking at models in the United States where similar rules exist

- Tough times for IFAs unable to revise their remuneration model and offset the loss of retrocessions.
- Assessing how legacy assets will be affected during the transposition period
- Simplification of the product offering, where standardised/straightforward products will be preferred by investors because they are easy to understand and have lower management fees

Private bankers

In a similar way to IFAs, private bankers will see their revenue decrease, since retrocessions often constitute a considerable portion of their remuneration.

The potential impacts may be comparable to those of IFAs. However, private bankers will generally be able to increase the advisory fees charged to clients, and so be less vulnerable than IFAs to the changes introduced by MiFID II.

Distribution platforms

Distribution platforms primarily offer a wide range of funds to buyers (e.g. sub-distributor, client advisor). Acting as an intermediary between the management company and the buyer, these platforms mainly receive remuneration in the form of retrocessions from management companies, which will be banned under MiFID II.

In order to survive, distribution platforms will need to revise their contracts and means of remuneration. In fact, their commission for enabling distributors to select funds according to the risk profile of clients is justified, however it is received (e.g. fees paid by investors instead of retrocession from the management company), and should be reconsidered.

The diversification of revenue sources will be necessary. Asset platforms can provide other ancillary services that can be charged for separately, such as investment advice (e.g. fund screening and selection, provision of factsheets), transaction management, risk reporting and other types of reporting, and analytical services. Going beyond a pure model of operating as a logistical hub, platforms will broaden their revenue sources and re-establish their position on the market.

Innovation, market and technological developments (e.g. high frequency trading), and growing complexity in financial instruments have outpaced current MiFID provisions



Towards a revolution of business models?

To be independent or not—that is the first question

Since article 24 of MiFID II gives advisors the option to adopt independent status, there is a decision to be made.

Opting for the status of independent advisor will be a strong commitment to giving up all kinds of retrocessions and advising on a wide range of financial instruments.

An open question remains as to how much clients will value the independence of their advisor and how much they will be willing to pay at the “*point of advice*” to benefit from independent advice.

You would have thought that when it comes to advice, clients would always value independence. However, current practice shows that most of the advice we follow every day is free or cheap, but biased. When you search for ‘best investment fund’ on Google, your first hit will be a paid ad. Similarly, when you ask your travel agent to recommend the best hotels in Spain, for example, he may recommend his preferred partners, which will remunerate the agency for sending clients to their hotel. Even your insurance broker will probably start with the products he most wants to sell.

Does this mean that we do not value independent advice? One answer to this question may be that the greater the wealth of a client, the greater his ability and desire to pay for real independent advice. This would mean that, on one hand, pure private bankers serving the HNWI segment would claim independence and increase advisory fees, while on the other hand, the mass market would be served by non-independent advisors guiding them through in-house products or third-party products with generous retrocessions.

It should be noted that the definition of ‘independent advisor’ is to be clarified by ESMA, as part of the technical standards it will be working on over the next two years.

New fee structures

Various fees are paid by the client to its bank and/or financial advisor. Some fees are straightforward and very transparent (e.g. account opening/closing fees, account maintenance fees, transaction fees, custody fees, advisory fees), some are less so (trailer fees, performance fees, finder’s fees, soft commissions and other types of inducements).

The objective of MiFID II is to shine a light on or ban most of the non-transparent fees listed above. The challenge for the sector will be to adequately re-evaluate its fee structure and find innovative and cost-effective solutions. As experience in the United Kingdom and the Netherlands has shown, new fee structures may include hourly rates, a percentage of funds invested and annual flat fees.

The main question sector players will have is: what additional costs will the customer be willing to pay, especially in times of economic crisis, low gross returns, mistrust in the financial sector and often an uncertain investment horizon? The task will be to measure the perceived value of advice and effectively market this service along with other ancillary services from which clients can benefit. Substantial investment in the revision of contracts and schedules, as well as staff training, will be needed before informing clients of the new arrangements.

Increased use of technology as a response to lower fees

One solution may be to provide an asset management service that is highly computerised, where the algorithm defines portfolio allocation on the basis of a profile completed online, in a similar way to ‘wrap’ programmes. This would, admittedly, be less attractive than a discussion in a cosy living room, but may be more attractive for wealthy European clients in the retail rather than the (U) HNWI category.

Platforms such as Skype, Paypal, Amazon, Booking.com and many others have already revolutionised their respective industries and captured millions of clients. They have quickly proven to be efficient and cost effective. Will financial advisory become the new development area for platforms? For sure, those that can implement innovative solutions to target the mass market will win.

It is clear that many retail clients are now choosing not to pay for financial advice, instead opting to either use online platforms or go direct. This is a concern, not only for the advisors losing clients and assets under management, but also for regulators if they see that the number of retail clients investing directly without prior advice is growing. Furthermore, this could create unintended consequences such as poor tax planning, inappropriate liquidity and uninformed purchasing of products with high cancellation fees.

Changes in the product offering

A review of the service offering, business models and pricing may also be accompanied by changes in the product offering. Since the level of retrocessions will no longer be a differentiating factor, the focus of advisors will, more than ever, be drawn to the brand, product performance and costs.

Passively managed investment products may receive more attention. While they were disregarded by certain advisors because the products did not generate sufficient income to pay retrocessions, such products may now appeal to customers who object to paying advisory fees.

New share classes have emerged, as investment managers have had to develop clean share classes that strip out commission and platform fees. Despite the increased complexity introduced by the existence of multiple share classes, each with its own remuneration scheme, this method has the advantage of offering MiFID-compliant solutions for each type of service and client.

Conclusion

The times of hefty commissions or inducements being charged—directly or indirectly—to clients have definitely gone. The whole industry needs to question its current model. We expect small advisors or portfolio managers serving the mass affluent and making a living from opaque retrocessions to be the most impacted.

High-margin and complex products may be penalised by increased transparency requirements (including when IMD II is implemented), whereas simple, low-load, passively managed funds might become more appealing to investors because of their low-cost structure. The emergence of clean share classes has come as a MiFID II-compliant response to the ban of inducements, leading to increased complexity in operations.

While MiFID I was mainly a compliance matter for private banking, MiFID II calls into question strategies and business models. Although MiFID II will not be implemented before the end of 2016, the major implications are known and require action. Since changing a business model may take years, investment firms need to address these implications now.

An effective response to MiFID II may create new opportunities for the smartest firms to enhance their market position.





Optimisation under regulatory constraints

KPIs and dashboard

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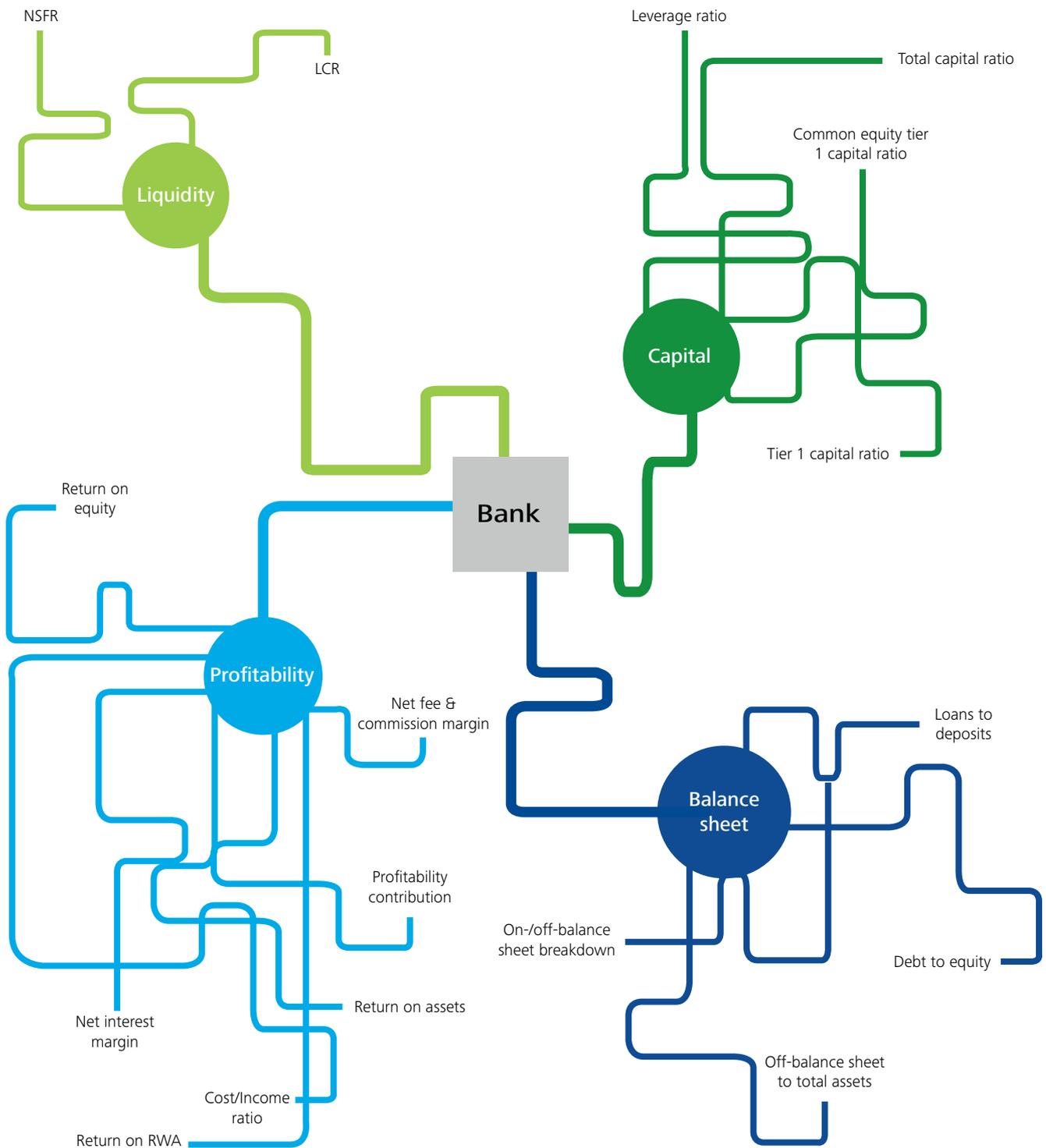
Why is Basel III a turning point for the banking industry?

The recent wave of new regulation (including CRR/CRD IV, EU mortgage directives, MIFID II, etc.) is considerably changing the rules of the game for the banking industry.

Basel III alone forces banks to manage additional regulatory ratios in parallel, which are highly interconnected — and this of course also impacts balance sheet and profitability ratios. The new requirements for capital and liquidity in particular will force banks to rethink their business strategy.

Gaining the right insights into this complex system (i.e. the interaction between balance sheet, capital, liquidity and profitability) will be a key success factor in this new era, and a major requirement for dashboards used by senior management.

In order to ensure profitability from a business perspective, the balance sheet needs to be optimised, taking into account all regulatory constraints.



Balance sheet optimisation

The first step in this optimisation process is to understand the economic and regulatory features of the bank's balance products.

However, this can only be properly assessed if all direct and indirect income/expense items and opportunity costs (including funding, capital and liquidity buffer costs) are accurately allocated and factored in.

In order to enable our clients to analyse the various aspects of products/product categories, we have developed an intuitive and powerful approach that identifies the contribution of individual products to profitability, capital and liquidity requirements.

Once these contributions are known, a quantitative optimisation algorithm can be applied. Alternatively, this can also be achieved via an iterative process of integrated scenario analysis.

Dashboards and integrated scenario analysis

Of course, banks already use dashboards to summarise the main regulatory ratios and KPIs that senior management receive on a regular basis. Most of the time however, these are 'static' collections of numbers and ratios on a piece of paper and cannot easily be analysed in further detail.

Banks have also built tools to conduct sensitivity analyses and isolated 'what if' scenarios for capital or liquidity ratios. However, we rarely see the **simultaneous** impact of a specific scenario on the overall system of KPIs and KRIs being modelled and made available to senior management.

While grasping these complicated and manifold interactions is already not straightforward for risk managers who deal with this on a daily basis, we think it is even more challenging for senior management who – based on such static dashboards – is supposed to anticipate the impact of tactical/strategic decisions on their key KPIs and KRIs.

We know that banks have all the information (somewhere) to perform such integrated analyses, but such data is usually stored in different systems or database silos that cannot communicate with each other and have been designed for regulatory reporting rather than for internal management purposes. In such an environment, it is typically not a simple task to establish a direct link between specific balance sheet items and their impact on the RWA or LCR calculation, for example.

We are convinced that in this increasingly complex environment, senior management needs to be equipped with the right tools to enable him to look at their institution from a combined balance sheet, profitability, capital and liquidity perspective. Ideally, such dashboards should:

- Facilitate understanding of connections between the balance sheet and KPIs/KRIs
- Provide easy access to the underlying data if needed
- Allow simulation and evaluation of strategic options
- Provide for integrated analysis of products/product types
- Provide appealing, relevant and interactive visualisation

This means that dashboards will have to migrate to dedicated and interactive software tools that allow the impact of business decisions on the overall system of KPIs and KRIs to be anticipated.

Equipped with such tools, senior management will then also be better prepared for discussions with the different business and controlling units when adjusting and optimising the balance sheet according to the constraints of Basel III, for example.



In order to ensure profitability from a business perspective, the balance sheet needs to be optimised, taking into account all regulatory constraints

CFO insights

Dashboards and key performance indicators as the link between strategy and execution

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To ensure business growth and contribute to profitability, CFOs have to expand their areas of intervention. Traditionally, CFOs have provided businesses with different types of performance reporting, be it through financial dashboards, balanced scorecards, closing consolidations and reporting, key performance indicators, enterprise planning, budgeting or forecasting.

Today, additional functions are demanded from CFOs to assist businesses in monitoring and improving performance. Product margin monitoring, client profitability monitoring, risk measurement and control as well as measuring and monitoring process efficiency improvements are examples of where CFOs are increasingly assisting businesses. Dashboards and key performance indicators are essential elements for driving businesses to execute the organisation's vision and strategy and provide management with a constant pulse of the company's performance.

Can your business rely on the finance function to drive the monitoring of financial and operational performance?

CFOs as trusted strategic advisers and sources of management information

Information is knowledge and knowledge is power. Organisations' finance functions have the unique ability to provide financial and operational information to businesses. The quality of the information is defined by four characteristics; the first being transparency. Information should be simplified and easy to understand. It should represent the true picture of performance and should therefore also be accurate. A third characteristic is



timeliness, where information is provided rapidly following period completion and near real-time information is available to investors. A final characteristic is predictability, where continuous planning provides management and investors with the data needed to react to changes in the business environment.

In today's economy, CFOs become trusted strategic advisers as businesses turn to finance functions for several needs which traditionally would not have been featured in the management's decision-making mechanism. We note the following:

- CFOs take charge of the risk management strategy via the production and maintenance of consolidated dashboards and linking accounting and risk information due to increased group finance and risk alignment
- CFOs are key in product margin monitoring to ensure proper consideration and evaluation of profit/cost ratios per product and that the margin is aligned with the firm's cost structure during the product lifecycle
- CFOs intervene in assessing client profitability (net capital inflow) and produce analyses and reporting on profitability as well as the solvency level at the beginning and throughout the business relationship
- CFOs are deeply involved in assessing process efficiency, as they can provide data and analyses, which render the assessment of operational cost/margin ratios possible. They can also work alongside the COO to identify a possible lack of optimisation within the organisation
- CFOs take a lead in communication processes, both internally and externally, with the production of three key elements of improved quality and at a higher frequency: reporting, dash-boarding and budgeting

Dashboards are synthetic documents that provide operational staff and managers with sufficient and reliable data necessary for activity monitoring. Dashboards display financial and non-financial performance indicators and facilitate enhanced steering of the organisation's key activities. They allow an organisation to:

Plan and target

- Clear links between strategic planning, budgeting and management reporting are created
- Top-down guidance is provided throughout the organisation
- Finance can engage with operations at the appropriate level in order to plan and budget
- Planning and budgeting is completed using standardised and common approaches across the organisation

Measure and evaluate

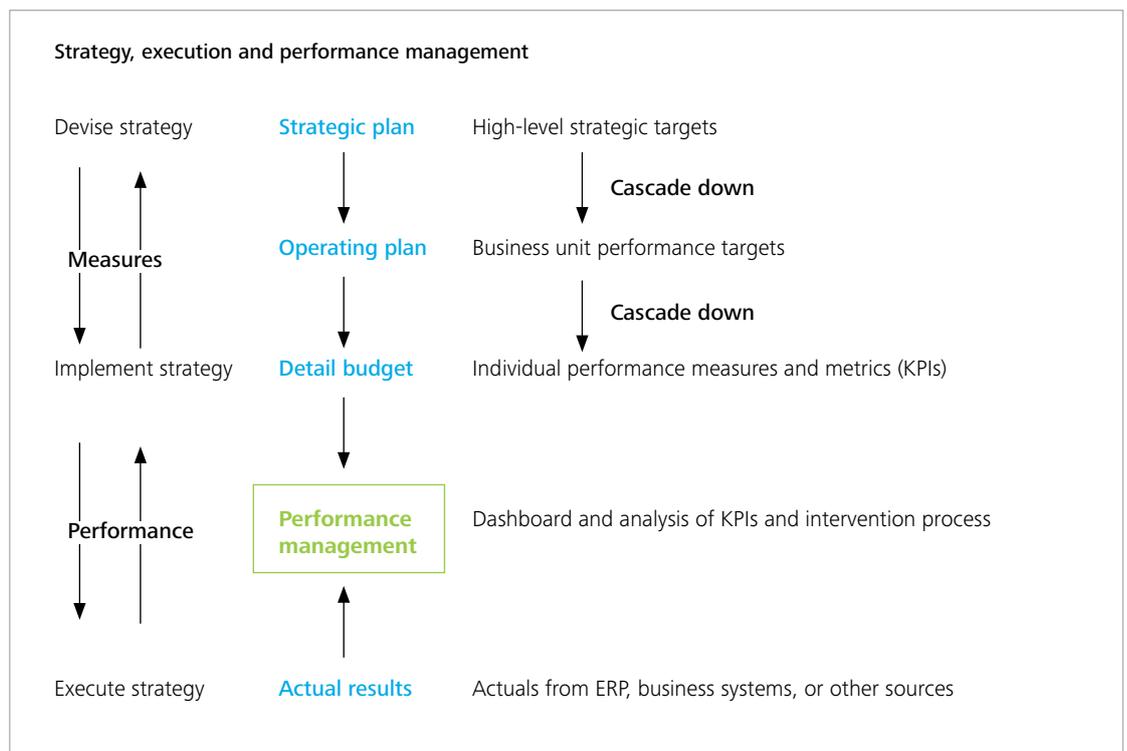
- Management at all levels can understand how the business is performing
- Management reporting is created using organisation-wide standard processes, enabling the creation of 'one version of the truth'

- Financial reporting is created using standard organisation-wide processes that are controlled and reduce the likelihood of external reporting errors
- Management uses its time to focus on analysing results and not manipulating reports and data

Intervene and realign

- Allows management to take corrective action
- Allows management to update forecasts based on market and economic conditions
- Information acquired in these processes is used to update the strategy and next year's plan and budget, thus facilitating the continuous process

The picture below demonstrates how the finance function can align and cascade the KPIs down throughout the organisation.



Dashboards and key performance indicators are built around strategic objectives. They link strategic targets with operational performance targets and allow performance measures and metrics to be identified to monitor the organisation's performance and react to changes in the business and economic environment. Therefore, dashboards and KPIs drive the implementation of the organisation's strategy and assist management in monitoring the execution of the strategy against the actual results.

In today's economy, CFOs become trusted strategic advisers as businesses turn to finance functions for several needs which traditionally would not have been featured in the management's decision-making mechanism





The forces at work in the Trust & Corporate Services sector and their impact on M&A activity

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Historically, the Trust & Corporate Services sector (T&CS) has been somewhat fragmented. However, in recent years, the sector has undergone a wave of consolidation, first at the local level and subsequently at the regional or global level. The purpose of this article is to outline the reasons underpinning these developments, and to provide some insight into what the future might hold for the sector.

From a highly fragmented market to the rise of local champions

The T&CS space has historically been populated by small and local operators. With barriers to entry relatively low and demand for services offered high, the opportunity for individuals with the right skill set and entrepreneurial flair to launch a thriving business was significant.

Throughout the 1990s and 2000s, Luxembourg saw several success stories based almost exclusively on a local presence.

Over the years, some M&A activity has appeared to be driven in part by: (i) the desire for a number of the earlier entrepreneurs to exit their business and monetise their life's work, (ii) the opportunity to reap synergies and economies of scale on the operating side, and (iii) the opportunity to gain size and be recognised as a credible operator by large institutional clients.

The result has been the creation of a small number of local champions, followed by a long tail of small and medium-sized operators.

As these local champions become increasingly important, smaller operators have been faced with increasing pressure to either turn consolidator or sell to a competitor.

2008: a game changer for the industry

The 2008 crisis has had a significant impact on the industry, both from the demand side and from a regulatory standpoint.

A new regulatory paradigm

The public deficits that followed the crisis have led many governments to seek new ways to balance budgets and collect additional revenues. Several media articles have increased calls from the public for governments to clamp down on tax optimisation by multinationals, and for a fair allocation of the tax burden between private and corporate citizens, including: 'The Great Corporate Tax Dodge' (Bloomberg), 'But Nobody Pays That' (The New York Times), 'Secrets of Tax Avoiders' (The Times) and 'Tax Gap' (The Guardian). These are just a few examples of the increased media attention on the tax affairs of corporations.

It was against this backdrop that in July 2013 the OECD launched an action plan on base erosion and profit shifting (BEPS) in order to equip governments with a multilateral instrument to amend bilateral tax treaties and prevent double non-taxation. While the consequences of this move are not yet fully known, it could have a significant impact on some of the structures implemented by T&CS service providers. It may be necessary to operate in a more integrated fashion at an international level as well as increase reporting requirements.



In parallel to this situation, the number of new regulations affecting the financial sector has significantly increased in recent years, thereby adding several layers of complexity to the sector.

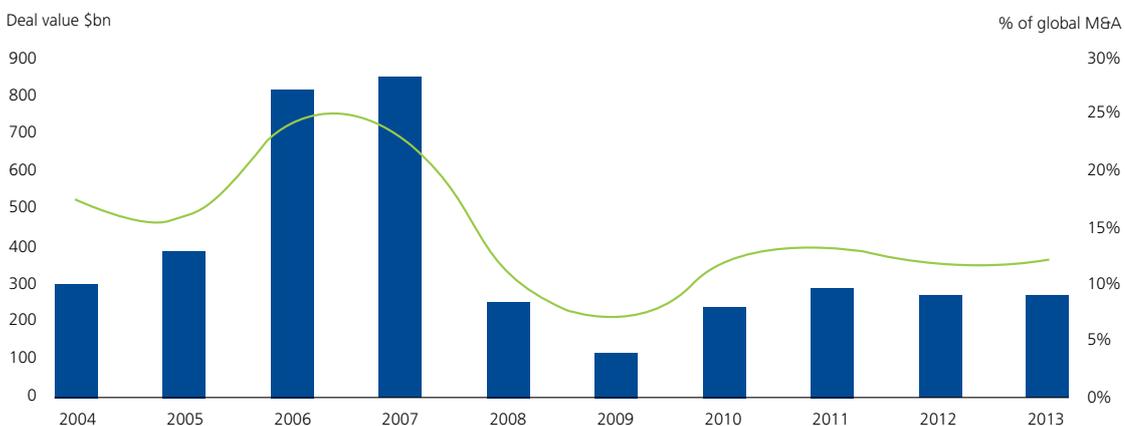
Regulatory pipeline	Regulatory change	Opportunity/risk factor
Alternative Investment Fund Managers Directive (AIFMD)	Increase in transparency requirements	Increased information sharing on account information between jurisdictions
UCITS V		
EU Savings Directive	Change to substantiation requirements	Modification to substantiation requirements to prove 'Ultimate beneficiary' resides domestically
FATCA		
Limitations of Benefits Provisions in tax treaties	Transfer pricing assessment	Enhanced assessment of transfer pricing practices across legal entities
Dodd-Frank		
HIRE Act	Fund compliance	Increased compliance, disclosure and reporting requirements
Bipartisan Tax Fairness and Simplification Act		
Stop Tax Haven Abuse Act	Revision of bilateral tax treaties	Changes to key terms affecting economic incentive and/or operational requirement
Controlled Foreign Companies & Excluded Territories exemption		
The Offshore Funds (Tax amendment) regulations 2011	Revision to participation exemption	Changes to key terms affecting economic incentive and/or operational requirement
Proposed FSA ban on unregulated collective investment schemes	Tax harmonisation	Harmonisation of tax code across jurisdictions, reducing incentive for cross-border solutions

While some of these new regulations represent an opportunity for T&CS operators to offer their clients additional services, this will mainly benefit operators that have reached a sufficient scale to have the in-house capabilities to provide these services.

In summary, while historically the T&CS sector was characterised by relatively low barriers to entry, the recent changes in the regulatory environment have contributed to raising these barriers. They have also led to increasing differentiation between operators in terms of their size; while larger operators will be able to leverage the opportunities offered by the new environment, the smaller ones might struggle to keep up.

A market which has yet to fully recover

The second major impact of the recession was on T&CS clients. Transaction volumes for private equity funds, which represent a significant portion of T&CS business, have yet to rebound to pre-crisis levels, as shown in the chart below.



However, according to private equity data provider Preqin¹, private equity fundraising for 2013 totalled US\$431 billion, up 13% from 2012. Preqin also reported that the previous high point for private equity funds raised was in 2008, with a total of US\$688 billion.

¹ Source: Preqin press release, 6 January 2014

From local to regional and global

In this context, a second wave of corporate activity has taken place in the T&CS sector whereby local champions have begun to enter new geographies. While in some cases this has occurred via greenfield operations, acquisitions have proven to be a widely used approach to achieve immediate critical mass in a new market.

In addition, some of the local champions have acquired private equity shareholders, drawn to the sector by attractive margins and historically good visibility on revenues. The arrival of these professional investors has added financial and managerial capabilities to the local champions in their endeavour to expand their footprint through acquisitions.

This wave of international consolidation is underpinned by three major factors:

1. The need to diversify event risk related to a single jurisdiction
2. The need for large clients to be served by professionals across all jurisdictions in which they operate
3. The ability for multi-jurisdiction operators to spread central corporate functions across a wider base, as well as develop centres of excellence for dedicated services within the network

This context has provided an opportunity for local operators to participate in the ongoing consolidation phase in a different way, which combines the need to join a larger platform with the willingness to monetise part of their assets, while retaining some degree of relative autonomy within a larger group.

As a result, the M&A market has remained active, as demonstrated by the large number of transactions that have occurred in recent months.

Date	Buyer/Bidder	Target
Mar-14	Hawksford	Janus Corporate Solutions Pte
Feb-14	Electra Partners	Ogier Fiduciary
Dec-13	Sanne	State Street Bank & Trust Company
Nov-13	JTC Group	Ardel Trust Company
Jul-13	First Names Group	Temmes
Jun-13	Intertrust	ATC
Apr-13	First Names Group	Basel International Limited
Apr-13	Silverfleet Capital Partners	IPES
Dec-12	Blackstone	Intertrust
Nov-12	Maitland & Co	Admiral Administration Ltd.
Oct-12	Inflexion Private Equity	Sanne Group
Sep-12	SGG	FACTS
Jun-12	Orangefield Trust	ICS Trust (Asia) Limited
May-12	Vistra	HTGroup
Mar-12	CBPE Capital LLP	JTC Group
Mar-12	Intertrust	Walkers Global
Mar-12	AnaCap	IFG

Source: MergerMarket and press releases

Conclusion

The factors that have driven the industry to consolidate in recent years are still very much present today. At a local level, the increased complexity and rising cost of doing business, as well as the desire of some entrepreneurs to monetise what is usually their main asset, continues to drive deal flow.

At regional and global levels, the need to diversify risk away from overexposure to any particular geography and the increasing requirement of clients to be served on a global basis is adding fuel to the consolidation fire.

Against this backdrop, the limited rebound in corporate activity since the highs of 2005-2007 and increased scrutiny of international tax structuring have impacted on the speed and multiples at which deals get done.

The number of new regulations affecting the financial sector has significantly increased in recent years, thereby adding several layers of complexity to the sector





Improving international tax rules Stop or try again?

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In recent decades, innovation, new technologies and globalisation have changed the way businesses are run. International trade has grown sharply. Many consider that international tax rules are not up to date with the realities of doing business in a globalised world. They are creating new challenges for national tax authorities all around the world.

As stated by Pascal Saint-Amans¹: *"It is a watershed moment for international tax policy. The debate over tax evasion by the wealthy and tax avoidance by multinational corporations has never before grabbed so many headlines² or caused so much anger"³.*

While the current hot tax topics emerged for governments over a decade ago⁴, there has been political support for international tax coordination as from the end of 2000s.

Indeed, the financial and economic crisis has forced governments to struggle over the question of public and social spending, as well as to increase taxes and protect their tax base.

This article focuses on two main aspects of international tax coordination between governments: the increase in tax transparency and the update of international tax rules and consequences for taxpayers.

¹ Director of the Centre for Tax Policy and Administration at the Organisation for Economic Co-operation and Development (OECD)

² The media has scrutinised many 'tax affairs' all over the world. Recent tax events in many countries are one way or another in the spotlight of the international media

³ 'Bringing International Tax Rules Into the 21st Century', Pascal Saint-Amans, article published on the website of the Huffington Post on 17 September 2013

⁴ For illustrative purposes, the OECD report 'Harmful Tax Competition: an Emerging Global Issue', 1998



Towards more tax transparency...

Since 2009, tax transparency has become widespread through the exchange of information. There are three different methods for exchanging information:

- **On demand:** a government may ask another government to provide information on a case-by-case basis
- **Automatic:** governments will automatically exchange the information agreed upon (e.g. income, frequency, format)
- **Spontaneous:** without prior request, a government must forward to another government information of which it has knowledge under a number of circumstances

In April 2009, the G20 declared that *"the era of bank secrecy was over"*⁵. Since then, the OECD standard of an exchange of information on demand has been implemented by many governments⁶.

Currently more than 60 countries have signed the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters, as amended in 2010 (over 20 countries signed during 2013)⁷.

Furthermore, cooperation for the automatic exchange of information is expanding both at international and European levels⁸ and is becoming the new norm when it comes to exchanging information between governments.

In this respect, the drafting of a new OECD standard on the automatic exchange of financial account information is under way. Under this OECD standard, governments will automatically exchange information obtained from their banks and financial institutions on an annual basis. The OECD is expected to deliver detailed commentaries on the new standard in September 2014.

⁵ 'Tax is all about trust', Pascal Saint-Amans, release published on the OECD website

⁶ This is the case of Luxembourg, which negotiates double tax treaties including this OECD standard

⁷ On 29 May 2013, Luxembourg signed this multilateral tax convention

⁸ At the European level, the action being taken relates to the European Directives on Administrative Cooperation and Savings

As stated by Angel Gurría⁹: *“The commitment by so many countries and jurisdictions to implement the OECD’s global standard on the basis of a specific and ambitious timetable is good news for everyone who wants to see a fair and transparent international tax system. The rapidity with which the new norms are being developed and agreed shows that the political momentum for reform is now overwhelming.”* And he added: *“Adopting the new global standard is not just a question of establishing cooperation between states; it is also about restoring the trust of citizens in government”¹⁰.*

On the basis of this trend toward global coordination among governments through the various forms of information exchange, national authorities will collect a huge amount of data on their taxpayers.

The exchange of information will generate significant reporting costs for financial institutions, taxpayers and

governments. Nevertheless, the expectation is that governments will be able to assess taxes in a more straightforward manner and collect them with greater efficiency.

International agreements implementing the different methods of exchanging information always indicate that this international cooperation will respect the fundamental rights of taxpayers.

However, there is always the fear that this will not be necessarily the case in practice (e.g. fishing expedition issues, guarantees and information on taxpayers facing an exchange of information request).

Based on what has been accomplished so far, we are not sure that a proper balance between the need to exchange information between governments and the need to provide safeguards for taxpayers has been found.

In April 2009, the G20 declared that *“the era of bank secrecy was over”*. Since then, the OECD standard of an exchange of information on demand has been implemented by many governments

⁹ OECD Secretary-General

¹⁰ *“Tax: OECD’s Gurría welcomes international progress towards automatic exchange of information”, release published on the OECD website, 24 March 2014*

...and a revamp of international tax rules...

On an international level, the OECD has the political clout¹¹ to introduce measures in connection with base erosion and profit shifting (commonly known as BEPS).

But what is BEPS? It refers to aggressive “tax planning strategies that exploit gaps and mismatches in tax rules to make profits ‘disappear’ for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid”¹².

For governments, the aim of the BEPS initiative is to redefine the boundaries of what is considered acceptable and legitimate for cross-border transactions.

As recently stated by Pascal Saint-Amans, “What multinationals are doing is legal, and if it is legal but you do not like the outcome what you need to do is change the rules¹³.”

Indeed, “the OECD has been providing solutions to tackle aggressive tax planning for years. The debate over BEPS has now reached the highest political levels in many OECD and non-OECD countries. The OECD does not see BEPS as a problem created by one or more specific companies. Apart from some cases of egregious abuses, the issue lies with the tax rules themselves. Business cannot be faulted for using the rules that governments have put in place. It is therefore governments’ responsibility to revise the rules or introduce new rules”¹⁴.

The key issue is how to define ‘aggressive tax planning’. To the best of our knowledge, there is no definition currently available. However, public opinion could agree with a kind of common public understanding of which situations would come under this notion. One could effectively have the feeling that something is wrong in certain situations, such as stateless income, double exemption, etc.

In July 2013, the OECD published its action plan on BEPS. This action plan sets forth the work that the OECD will do in 15 areas of international tax law and practice¹⁵. According to the OECD, these measures will result in “fundamental changes to the international tax standards and are based on three core principles: coherence, substance and transparency”¹⁶.

The draft propositions currently on the table suggest that this is about more than simply combating “aggressive tax planning”.

One example relates to BEPS Action 6 “The granting of treaty benefits in inappropriate circumstances”. The OECD action plan identifies treaty abuse, in particular treaty shopping, which is viewed as one of the most important issues. The OECD released a discussion draft on 14 March 2014 on this subject, which is currently under discussion.

In a nutshell, the draft proposals on BEPS Action 6 are as follows:

- Limitation on benefits clause: a specific anti-abuse rule is proposed based on the limitation on benefit provision already included in many U.S. tax treaties. The rule is designed to limit treaty benefits to companies and individuals (not-for-profit organisations, pension funds and government bodies) with sufficient presence in the relevant country. The rule operates based on the legal nature, and general activities of residents of a treaty country
- General purpose rule: in addition to the limitation on benefits clause, the discussion draft proposes a broadly drafted general purpose rule aimed at removing treaty benefits from income where one of the main purposes of the arrangements or transaction was to obtain treaty benefits

One of the concerns with these wide-ranging proposals is the degree of uncertainty that will exist in applying them. Indeed, the general purpose rule will be very difficult to define and apply. This uncertainty will create practical issues for businesses seeking to understand whether the benefits of a treaty will apply to their transactions.

On a European level, the European Commission has pledged to support the BEPS initiative. The European Commission already provides recommendations to tackle aggressive tax planning. In this respect, it has proposed new provisions for the Parent-Subsidiaries Directive to limit double non-taxation situations in Europe. The European Commission’s proposal would also oblige member states to adopt a more comprehensive, common anti-abuse rule adapted to the specifics of the Parent-Subsidiaries Directive. Nevertheless, the proposed amendment has a broader scope and creates uncertainty.

...but the proposals should not create uncertainty about tax rules

At the present time, although we do not know the outcome of the BEPS initiative (on which there have been many articles and discussions), we do know that the international tax rules will change.

Lawmakers should keep in mind that international tax rules are here to enhance international transactions and not to create unnecessary or disproportionate obstacles.

The rationale of international tax rules is to remove obstacles to the development of economic transactions and provide certainty to taxpayers in cross-border situations¹⁷. In order to achieve this, international tax rules should be clear, transparent and workable for taxpayers, as well as easy to administer for national tax authorities. Compliance costs to taxpayers should also be as low as possible.

The current proposals give the impression that the overloaded 'weapons' being prepared might prove to be an issue for international business and global transactions. To increase their respective tax revenues, governments could change the international tax rules in connection with the fight against tax evasion. However, such changes cannot restrict the exercise of fundamental freedoms of taxpayers, such as the freedom to conduct a business, unless the restrictions are justified, proportionate and well balanced.

The changes to international tax rules could be viewed as a creation of barriers and a return to state protectionism motivated purely by budget concerns (for which taxpayers are not necessarily responsible), as opposed to adequately fighting obvious abusive situations effectively on an international level.



The exchange of information will generate significant reporting costs for financial institutions, taxpayers and governments

¹¹ The BEPS project is being driven by key OECD member countries (including France, Germany, the United Kingdom and United States) and is strongly endorsed by the G8 and G20

¹² Frequently Asked Questions on BEPS published on the OECD website

¹³ Pascal Saint-Amans speech during the G20 finance ministers meeting in Sydney, 23 February 2014

¹⁴ Frequently Asked Questions on BEPS published on the OECD website: <http://www.oecd.org/ctp/beps-frequentlyaskedquestions.html>

¹⁵ The 15 areas include tax challenges of the digital economy; hybrid mismatch arrangements; controlled foreign corporation rules; deductibility of interest and other financial payments; harmful tax practices; treaty abuse; artificial avoidance of permanent establishment status; transfer pricing for intangibles; transfer pricing for risks and capital; transfer pricing for other high-risk transactions; analysis of data on BEPS and actions addressing it; disclosure of aggressive tax planning arrangements; transfer pricing documentation; effectiveness of treaty dispute mechanisms; and development of a multilateral instrument for amending bilateral tax treaties

¹⁶ According to the OECD, the expected outcomes could be:

- Changes in double tax treaties and possible development of a multilateral tax instrument. The OECD has already developed a multilateral tax instrument through the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters (please refer below to developments in connection with exchanges of information).
- Recommendations on the design of domestic rules
- Changes in transfer pricing guidelines and recommendations

¹⁷ 'Model Tax Convention on Income and on Capital', full version (as it read on 22 July 2010), page 12 (introduction section)

Executive compensation

The call for a change in mindset and practices

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Executive compensation is firmly on the social, political and regulatory agenda today. The level of executive pay has been constantly rising for decades, particularly in comparison with the average workers' pay.

There is a debate over whether such high executive pay is justified by the skills and results of business leaders¹ or a socially unacceptable phenomenon² that should be controlled. Moreover, there is a question mark over whether typical remuneration package components such as share options are effective in encouraging long-term decisions³. Furthermore, the economic crisis and government bailout were a strong catalyst in this debate and led governments and regulators to act under the social pressure⁴.

This raises a number of questions, but three are particularly interesting: Why are executive remuneration practices at the top of the agenda? What are the trends influencing executive compensation? How do companies adapt to these trends?

What's the problem?

An executive's remuneration package typically comprises a fixed salary, together with a range of benefits in kind, a performance bonus and long-term incentives (such as shares and options). The package should be balanced between the fixed and variable parts, and in terms of payment in cash or financial instruments.

The structure of the package is at the top of the senior executive's agenda, because the package is a key factor in encouraging the expected behaviours, while adequately rewarding and recognising performance. The proposed remuneration should be sufficiently attractive, while allowing for flexibility as regards company results and individual performance.

For decades now, and even more so following the financial crisis, three main aspects of executive remuneration practices are being challenged: (1) the significant gap between top remuneration and the average worker's salary, (2) the constantly rising levels of pay, and (3) the relevance of rationales used to determine the individual components.

The gap between top remuneration and the average worker's salary—both the OECD⁵ and AFL-CIO⁶ point out that significant remuneration gaps are sources of future social and political instability. Indeed, the actual gap between top managers and employee salaries is not static and is generally on the increase (Fig. 1). For instance, in the United States, a top manager receives on average, 354 times more than the average employee. This ratio is 1:148 in Switzerland, 1:147 in Germany, 1:127 in Spain, 1:104 in France, 1:67 in Japan, 1:58 in Norway and 1:48 in Denmark. The European country with the smallest gap is Austria, with 1:36.

1 Valérie Lion (26 March 2013). *Salaire des patrons: halte aux idées reçues*. <http://lexpansion.lexpress.fr>

2 Sarah Rainsford (2011). *Spain's 'Indignants' lead international protest day*. BBC

3 *The Economist* (13/2/2014.) *Share options: The law of unintended consequence*. www.economist.com

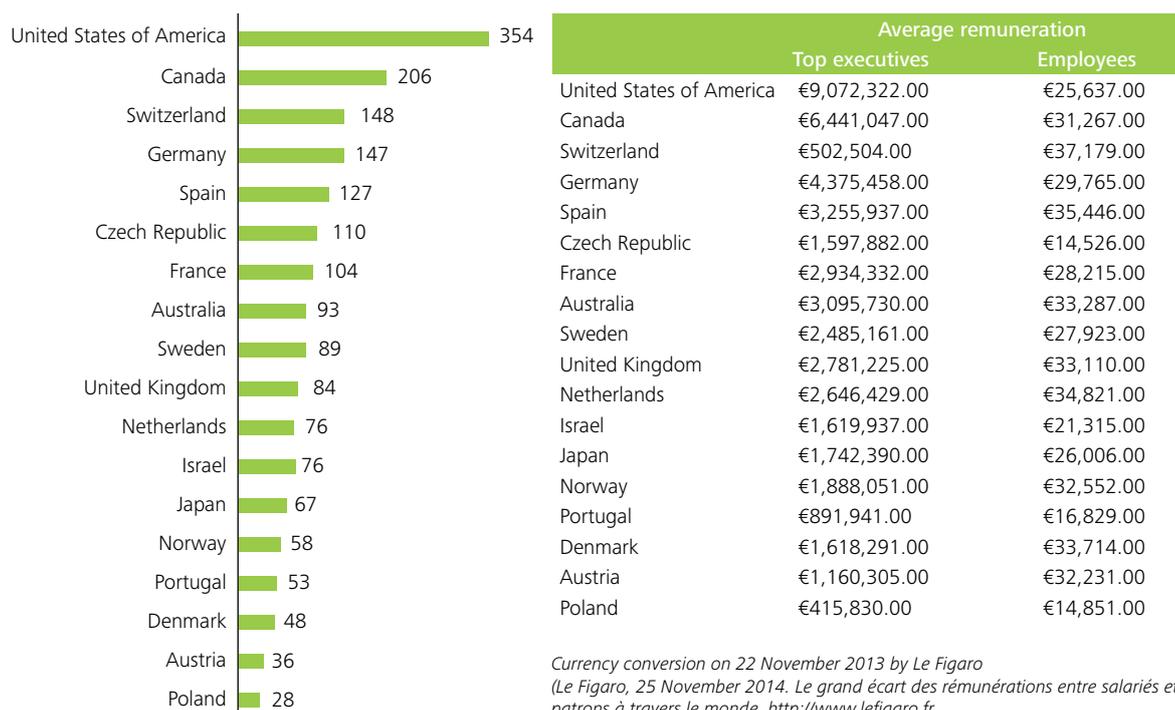
4 Jean-Jacques M'U (2012). *Nous, Indignés... occupons le monde !* ABC éditions, Paris

5 OECD (2013). *Growing risk of inequality and poverty as crisis hits the poor hardest*. <http://www.oecd.org>

6 AFL-CIO (2013). *CEO-to-Worker Pay Ratios Around the World*. <http://www.aflcio.org>



Figure 1: The salary gap between top executives and employees worldwide



Source BLS, OCDE & AFL-CIO

The increase in executive remuneration levels—in addition to the gap, top salaries are continuing to increase. For example, between 1998 and 2008, the salaries of top managers of CAC40 companies rose by 18%, while stock options and bonus components increased by more than 120% (Fig.2)⁷.

Rationales for defining remuneration levels—on the one hand, companies argue that high remuneration is necessary to ensure competitiveness on the international market for top managers. However, critics point out a disconnect between remuneration levels and results⁸, along with insufficient transparency in the criteria used to define remuneration levels. Meanwhile, citizens or employees are increasingly discomfited by levels of executive pay, especially when companies are losing money or share value⁹.

As a consequence, traditional executive remuneration practices are increasingly being questioned, and social, political and regulatory pressures are creating a significant shift in the mindset and practices applied to executive compensation.

Towards greater control and regulation

A number of initiatives and pressures coming from the supranational, governmental, corporate and social spheres are favouring greater control and regulation of executive compensation practices. This external pressure is influencing executive compensation in various ways.

Supranational regulatory initiatives—in the financial sector, the Capital Requirements Directive (CRD), introduced in the wake of the financial crisis, more control and regulation of the remuneration of material risk takers, especially executives. The key requirements

⁷ Le Nouvel Observateur/Jean Gatty (3 March 2012). Pourquoi les salaires des dirigeants du CAC 40 ont doublé en dix ans. <http://rue89.nouvelobs.com>

⁸ Valérie Lion (26 March 2013). Salaire des patrons: halte aux idées reçues. <http://l'expansion.lexpress.fr>

⁹ Louis Vergeat (3 July 2013). Classement des salaires des patrons: le top 5 de ceux qui les ont le moins mérités. <http://www.atlantico.fr>

focus on increased transparency and governance, as well as risk alignment of remuneration. Initially applied to banks and credit institutions, the scope of the regulations is being progressively expanded (this now includes the investment sector, with the AIFMD and UCITS directives). The regulations are also becoming more restrictive. As an example, CRD IV introduces the requirement for a 1:1 ratio of variable versus fixed remuneration. This requirement can only exceptionally be extended to 2:1, under certain disclosure conditions.

Government initiatives—European countries have adopted national legislation to regulate executive compensation practices. In 2013, France adopted a law introducing a 75% tax on the highest salaries¹⁰, which also banned stock options and limited bonuses. Following this trend, the Netherlands, Spain, Sweden, the United Kingdom, Italy and Germany¹¹ have limited or are going to limit the highest remuneration using a wide range of regulatory and other measures¹².

Figure 2: Top executive pay at CAC40 companies 1998-2008 (€ million)

Company	Salary of the executive committee		Number of members in the executive committee		% increase
	1998	2008	1998	2008	
Accor	3.9	8.9	12	13	120
Air Liquide	5.9	9.9	7	11	29
Alcatel	7.1	9.1	11	7	55
Alston	1.7	6.0	11	5	399
Axa	40.2	18.4	22	19	-51
BNP	6.8	3.2	23	4	20
Bouygues	8.8	15.6	15	13	91
Capgemini	7.5	20.8	15	28	110
Carrefour	4.3	7.0	9	5	129
Danone	7.4	17.5	11	11	136
Essilor	2.5	7.4	12	19	133
France Telecom	2.5	6.6	9	9	161
Lafarge	6.1	8.7	15	11	70
Lagardère	2.4	8.8	12	7	394
L'Oréal	9.9	23.8	10	13	107
LVMH	17.2	51.0	20	15	239
Pernod	3.5	13.7	10	17	202
Peugeot	5.0	9.3	14	16	75
PPR	3.1	25.4	7	12	502
Renault	3.1	7.3	7	7	135
Saint-Gobain	11.0	13.4	22	18	14
Sanofi	9.6	30.1	21	22	243
Schneider	4.2	12.1	10	16	123
Société Générale	11.2	9.1	29	16	5
STMicroelectronics	7.5	16.0	18	28	76
Total	5.5	18.0	16	28	156
Vivendi	10.2	10.1	17	6	63
				Median	120

Source: *Le Nouvel Observateur*/Jean Gatty (3 March 2012). *Pourquoi les salaires des dirigeants du CAC 40 ont doublé en dix ans.* <http://rue89.nouvelobs.com>

¹⁰ BBC (29 December 2014). *France's 75% tax rate gains approval by top court.* <http://www.bbc.com>

¹¹ There is a long-running debate in Germany (which started in 1979 with the Geßler Commission) about the position of banks, which this year led to a call for capping executive compensation at listed companies.

¹² CGA/AFP (4 March 2014). *La Suisse «inspire» le premier ministre français.* <http://www.20min.ch>

Corporate initiatives—companies are also taking measures to redefine their executive compensation frameworks and governance. For instance, Nestlé plans to adopt a new pay system for its top management in 2014, whereby the shareholders' meeting votes on its top managers' total compensation (fixed and variable) for the following year¹⁵. This represents a significant shift in power and redefines the relationship between the principal and the agent¹⁶. Theoretically, shareholders will now have considerable power in relation to the board of directors and top executive remuneration. Moreover, this should reduce high bonuses and potential abuse.

Citizen initiatives—the most representative citizen initiative is the Swiss federal initiative 'against rip-off salaries' of 2013, which was praised by the European Union¹⁷. This initiative aims to control the executive pay of companies listed on the stock market, and to increase shareholder power in the area of corporate governance. In fact, this initiative partly reflects developments in the United States, namely the Dodd-Frank Wall Street Reform Act 2010 §957, which banned brokers from voting on their clients' money, and the Stewardship Code 2010 in the United Kingdom, which placed a duty on financial intermediaries to disclose their voting policies and make use of voting power.

Whether generic or country and sector specific, all these initiatives are strongly influencing current and future executive compensation practices. How do companies cope with these key changes in practice?

Mixed results and painful implementation

Nonetheless, it would also be fair to say that citizens and governments are leaning towards accepting some of the economic arguments. Indeed, some initiatives have been shelved or their implementation postponed.

For example, the 2013 Swiss federal popular initiative '1:12' which aimed to cap salaries¹⁸ using a 1:12 ratio has been rejected. The initiative demands that the highest salary paid by a company should not exceed 12 times the amount of the lowest salary paid. The aim is to restrict the salaries of the top managers and top executives. In addition, we can also mention the abandonment in France of the idea of regulating corporate governance and top manager salaries^{19, 20}.

Although the trend is clearly towards increased control and regulation, the actual implementation of the various initiatives is proving difficult and painful, including at the political and corporate level. In fact, the regulatory initiatives do not seem to have translated into practical results so far. While the tendency is to cap variable remuneration in the financial sector, UK and U.S. bankers saw their variable remuneration levels increase by almost 50% between 2012 and 2013²¹, according to the MEP Philippe Lamberts.

Regulators are aware of these challenges, and are therefore highlighting the need for enforcement measures (e.g. MiFID) to ensure that remuneration policies adhere to transparency, investor protection and risk alignment principles—and that they also are effectively implemented. Of course, changing practices is easier said than done.

In parallel, companies are finding it difficult to understand and interpret complex and sometimes overlapping guidelines, and to agree on practical ways of implementing them. In particular, they are concerned by the related additional administrative complexity and implementation costs, as well as a loss of attractiveness on the employment market.

13 BFMTV (11 March 2014). *Salaires des dirigeants: Nestlé anticipe la limitation*. <http://www.bfmtv.com>

14 See Agency Cost Theory [Jensen, Michael C. & Meckling, William H. (1976). *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*. *Journal of Financial Economics*, 3(4): 305–360]

15 RTS (9 March 2013). *Séduite par l'initiative Minder, l'UE veut limiter les hauts salaires*. <http://www.rts.ch>

16 *By salary, the initiative means the amount of benefits in cash and in kind paid in connection with gainful employment*.

17 *Les Echos* (23 May 2014). Pierre Moscovici: "Pas de loi sur la rémunération des patrons". <http://www.lesechos.fr>

18 Denis Thomas (24 May 2013). *L'Etat renonce à encadrer le salaire des grands patrons : On a eu très peur !* <http://www.agoravox.fr>

19 *Trends.be* (14 March 2014). *Philippe Lamberts continue de faire trembler la City, ses banquiers et leurs bonus*. <http://m.trends.levif.be>

Conclusion

The pressure on high salaries is not going to ease, and we are likely to continue to see bad press. Although governments and citizens seem willing to give companies some time to find solutions, they will keep a close eye on companies' practices and actions. In this sense, businesses should be prepared to adapt and face further tightening of regulations.

Despite this pessimistic picture, there are solutions. This means anticipating forthcoming changes and being creative in terms of total rewards and employer brand to make up for lost attractiveness in terms of monetary incentives. In other words, companies need to work on their compensation, benefits, work-life balance, performance and recognition, development and cross-board career opportunities. Moreover, corporations can also use tax optimisation strategies to enhance the position of top executives.

Put simply, there is plenty of scope for overcoming the difficulties in this area and adopting an organisational strategy that will gain respectability. This new mindset requires a move from pure compliance to the inclusion of the new remuneration paradigm in the corporation's strategy.

The trend is clearly towards increased control and regulation, the actual implementation of the various initiatives is proving difficult and painful, including at the political and corporate level



Evaluating IT

A CFO's perspective

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Ask finance chiefs about their frustrations with Information Technology (IT), and you are bound to get an earful. Excessive investments made, multiple deadlines missed, little progress in Return On Investment (ROI)... We could go on.

To complicate matters, many CFOs simply do not know if Chief Information Officers (CIOs) are doing a good job. What exactly does a good IT organisation look like anyway? How should IT be evaluated? And what are the warning signs that indicate an enterprise is not prepared for the future from a technology standpoint?

The answers to these questions take on greater importance given that IT is typically the largest line item in Selling, General and Administrative expenses (SG&A). Moreover, with CIOs often reporting to CFOs, there is a growing need to effectively manage the CFO-CIO relationship.

Evaluating IT is no simple matter. It requires focus on three specific areas—communication, governance and assessment—so that an overall framework for analysing current and future IT capabilities can be established.

In this article we will discuss how steps taken in these areas can help enhance collaboration between CFOs and CIOs, identify gaps in the business support capabilities of IT, increase the focus on IT investments and strengthen the future vision of the value of IT.

Targeting communication—and miscommunication

One of the main challenges affecting finance and IT is communication. CFOs generally focus on business financials; CIOs tend to focus on business capabilities and enabling technology. CFOs often fault their CIOs for not fully aligning IT projects and spending with company strategy and value creation—a dynamic that makes getting a handle on IT priorities and technology spending particularly difficult for CFOs. CIOs can likewise be challenged by cost-cutting CFOs who may not realise how deferring spending today delays time-to-value and may limit future options. Simply put, this lack of a common point of view and communication between CFOs and



CIOs can lead to a fundamental disconnection hindering the capacity to effectively invest in IT and generate value. To address this disconnection, CFOs and CIOs should establish a common language for assessing and communicating how IT can create business value. Specifically, the conversation should focus on how IT improves business processes, such as product development and pricing, rather than just talking about a specific technology or system. And for each critical process, CFOs and CIOs should consider the value of both the 'I' and the 'T' aspects, by:

Targeting relevant information—on the 'I' side, how does information enable better process outcomes or decisions? Is the information generated by specific systems to support the process sufficiently timely, accurate, insightful and relevant to enable value creation?

Agreeing on the appropriate technology—on the 'T' side, how does the technology enable automation and reduce manual tasks to save costs? Will the technology choices enable scalability of process outputs to be dialled up or down to meet businesses demand efficiently? Will interoperability with other technologies be possible at a low cost? Is the technology reliable and low maintenance? How soon will technology obsolescence have to be addressed?

By focusing on how improvements in both 'I' and 'T' create value and mitigate risks in tangible business processes, CFOs and CIOs can establish a shared language for evaluating IT. As many CFOs typically assign performance metrics to specific business processes, those measures can become another component of the language needed to assess IT.

Establishing effective IT governance

CFOs and CIOs can help to improve the evaluation of IT by establishing broad, organisation-wide governance models for major IT spend decisions. With the appropriate stakeholders, models of this kind can lead to joint ownership and better resource allocation, commitment to, and execution of, IT projects.

One of the main challenges affecting finance and IT is communication

Effective governance models are likely to have two levels: one for IT governance of long-term strategic initiatives and the other for individual projects. The first level should address how IT will support the business in the future and enforce discipline around large-scale IT investments that position the company for competitive advantage. Responsibility for this level of IT portfolio governance should be shared between the businesses and the CIO. CFOs can help CIOs to establish effective governance systems that serve their mutual interests for effective and efficient delivery of IT capabilities to the enterprise. To judge the effectiveness of the governance system, CFOs should be guided by the following questions:

- Are you (as CFO) and other members of the C-suite involved in determining IT spending and development priorities?
- Do major IT projects have a clear ROI that is documented and measurable, and do they improve delivery of specific processes?
- Do approved IT projects help with both our long-term business and long-term IT objectives?
- Are our IT initiatives creating (or at least sustaining) competitive advantage?

A second level of governance is needed for individual projects. Such tactical IT governance allows CIOs to get

the relevant users on board for specific projects and keep them on track. Moreover, such oversight at the project level allows problems to be identified and fixed in a timely fashion. Finance can partner with IT at this level of governance.

To determine whether the governance model at the project level is effective, consider the following three questions:

1. Do the technical practitioners and business users assigned to the project have the appropriate level of expertise?
2. Are both the development methodology and control environment adequate to protect systems from errors and data issues?
3. Are regular status reports providing project progress/costs available?

In addition, while the two levels of governance should be complementary, it is essential that the CFO and CIO are clear about which projects are long-term and require portfolio review. In addition, if there are other initiatives that businesses have not sponsored, they need to be reviewed at the project level to make sure they are creating value—and shelved if not. Overall, however, there should be very few IT projects without strong business sponsorship.



Stabilising value creation

Having a common process language and robust governance in place can lay the groundwork for assessing current and future IT architectures from a business process standpoint. To make that assessment for your current environment, start by benchmarking five or ten important processes. From there, develop a heat map to show how well IT supports each of those projects, using questions that focus on both the 'I' and the 'T'.

As mentioned earlier, the first-level questions address the quality of information supporting each business process. For example: is the information timely? Is it relevant? Second-level questions target the ability of the IT to provide what the business needs now and what it will need for the future. For example: is the technology scalable? If the technology breaks down, how will it impact the business process and the organisation overall?

Equipped with a heat map of IT capabilities and vulnerabilities at the process level, CFOs and CIOs can develop a shared view of the critical gaps they need to consider fixing, as well as the way in which IT can drive the impact on the business through improved processes. Before spending money to address the gaps, finance should sit down with the process owners and the CIO to determine the business value and the cost-benefit of improving specific gaps in a business process. CFOs should ask their CIOs and process owners what it will cost to fix specific gaps as well as what it will cost if the gaps are not addressed. Opportunity cost is a critical piece of IT spending governance.

The last key governance area concerns what the future architecture should actually be. In IT, knowing what the end will look like can fend off cost overruns and major disappointments. But that future architecture often looks different to different people. Your vendors, for example, might offer the rallying cry of 'one ERP system'. On the other hand, your CIO may believe that it is too early to tell. After all, the technology required to execute your specific strategy may not be invented yet.

As CFO, you may need to determine if funding the unknown or a big-bang solution is prudent. This is especially critical given that the benefits of evolving your current architecture may be more than enough already. Often, the systems you choose to fix typically offer an added benefit: stability. And by fixing those specific gaps you may even be framing the future architecture.

If you accept the reality that there will probably be cuts and bleeds involved in IT, then an iterative improvement solution is maybe the best a company can hope for. The CIO's choices can shape the optimum scenario—a completely new architecture or one that can drive increasing stability in the organisation. It may not be radical nor world-class, but in some cases, really good may be good enough. The funding challenge for CFOs is to determine when good enough works versus the need for radical overhaul or replacement of existing systems.

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