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CHANGES AND OPPORTUNITIES IN THE EUROPEAN CROSS-BORDER FUND DISTRIBUTION INDUSTRY

January 2018

“Opportunity is missed by most people because it is dressed in overalls and looks like work.”

Thomas Edison

Contents

Executive summary

The European investment fund industry in recent years has grown to over €15 trillion in assets today. This growth has been supported partly by general market conditions as well as the recovery of capital markets. Another key contributor has been the asset inflows generated through cross-border fund distribution, which has gained importance over the past decade.

The cross-border fund distribution model, where a fund and its management company outsource key functions such as distribution, portfolio management, or risk management to other entities that may be located in other countries, has become central to how the European asset management industry works. The model has also served as a key driver of service quality and efficiency delivered to European savers and investors.

The ability of the cross-border fund distribution model to deliver such efficiency is mainly due to the development of key cross-border hubs, such as Luxembourg and Ireland, where infrastructure of scale and key competences have developed over time in support of the industry.

In this context, several changes are ongoing in the industry, driven by regulation, re-structuring, technology, evolving social behaviors, and the development of alternative funds. These trends have the potential to significantly affect the fund industry, in particular the cross-border fund distribution model.

The first change is supervisory convergence, and the recent steps taken by European regulatory bodies toward the increased centralization of supervisory authority for funds. This trend may cause some modifications to existing cross-border delegation setups, and will require careful attention from the industry to preserve the existing sources of efficiency and keep fund costs as low as possible for investors. This is particularly important in the context of Brexit, which is adding uncertainty for delegation setups involving the UK.

Second, the manufacturing and distribution industry structure is changing, due to competition and fee pressure, but also regulations—notably MiFID II—which have altered the balance of economic interests across the fund distribution value chain. For example, recent steps observed among distributors point toward a vertical re-integration of manufacturing and distribution, which may lead to the decentralization of fund distribution activities.

Third, technological change continues to represent a key opportunity for asset managers and distributors to optimize their operations, notably through centralized data management and the digitalization and automation of activities; at the same time, significant investment is still needed to adapt to changing investor expectations and enable new digital distribution models.

Fourth, investor needs and behaviors are changing, with a growing importance of customer experience and the increased need for strong qualitative information and investor education. The generation change also brings increased investor confidence and an appetite for self-direction, which over time may contribute to the further development of new products, such as ETFs.

Last but not least, alternative funds are becoming increasingly strategic for the fund industry. With strong growth, the alternative segment is steadily developing

The ability of the cross-border fund distribution model to deliver efficiently is mainly due to the development of key cross-border hubs, such as Luxembourg and Ireland, where infrastructure of scale and key competences have developed over time in support of the industry.

into a fundamental part of the European fund distribution landscape, and players active in this space will need to count on several of the factors that have contributed to the success of the traditional cross-border fund distribution model, for example scaled-up, efficient, and digitalized infrastructure.

We can argue that, if left unchecked, some of these trends may promote a degree of deconsolidation of distribution activities in a context where clarity and investments, notably in technology and digitalization, remain critical to drive further optimization in distribution operations.

Should this happen, the efficiency of cross-border fund distribution may deteriorate, and the costs borne by investors may ultimately increase. This would not be positive for the industry, as the intrinsic complexity of the European landscape already tends to make European products more expensive compared to their global peers, which matters not only to European but also to international investors seeking cost-competitive investment solutions.

Managing distribution costs down remains critical, in particular in the context of the broader savings market in Europe. With the importance of promoting saving alternatives to public pension schemes and encouraging European investors to allocate more of their savings to productive financial assets such as investment funds, the industry will need to focus on preserving its sources of efficiency and on investing in initiatives that will continue to reduce costs and maximize investor access.

This is a challenging but exciting time for European fund distribution.

1. Overview of key messages

Context

1. The European investment fund industry has grown to over €15 trillion in recent years, in part based on the success of the cross-border fund distribution model

2. The cross-border fund distribution model promotes broader market access and efficiency while bringing benefits in terms of structural risk management of multi-party fund activity

3. The success of the cross-border fund distribution model is associated with the development of infrastructure and competence in key cross-border hubs, such as Luxembourg and Ireland

Key changes

4. Supervisory convergence and Brexit bring uncertainty, potentially leading to changes in existing fund delegation setups, and will require careful attention to maintain optimal efficiency

5. The fund industry structure is changing as a result of competition and fee pressures, as well as regulation—notably MiFID II—which may lead to further decentralization of fund activity

6. Technological change brings favorable circumstances for further optimization and transformation of existing processes, but also requires investment to adapt to new distribution models

7. Investor needs and behaviors are changing, focusing on the growing importance of customer experience and the increased need for qualitative investor information and education

8. Alternative funds are becoming increasingly strategic for the fund industry, with ongoing convergence around key competence centers

Implications for the industry

9. The industry needs to maintain open access and efficiency to maximize fund attractiveness vs. other savings avenues

10. Beyond scale, it is important for industry players to promote efficiency and investor reach by leveraging technology, and developing capabilities to adapt to evolving market needs. This can be achieved through promoting alternative ranges, innovative investment management, and advisory solutions or ETFs.

2. The growth and success of the open architecture cross-border fund distribution model

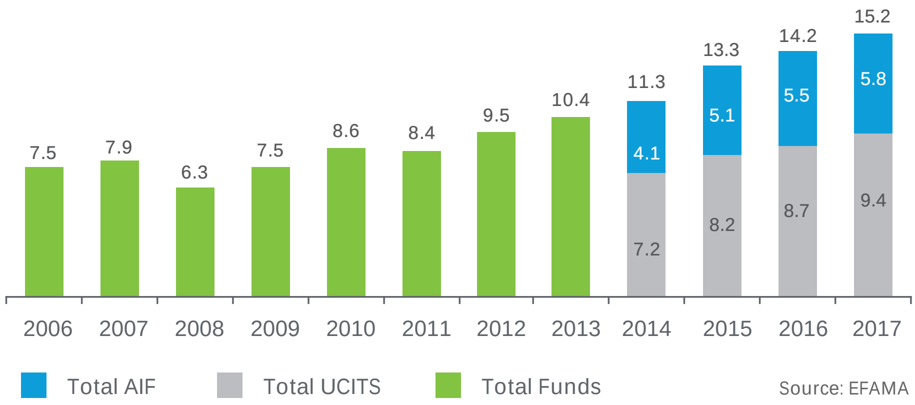
Market conditions around the globe have led to growth in both traditional and alternative fund sectors. In Europe, investment funds have risen to over €15 trillion as of Q3 2017, according to EFAMA. These net assets represent over €9 trillion in UCITS funds and nearly €6 trillion in AIFs. These assets are held in over 31,000 UCITS funds and 28,000 AIFs, respectively.

This development has been supported by the economic recovery since 2009, accompanied by the growth of capital markets in a context of accommodative monetary policies and low interest rates. While bringing special challenges such as the difficulty to produce yield in certain strategies, this recovery has provided generally favorable conditions from an asset growth perspective.

Another contributing factor to the growth of investment funds in Europe has been the development of the cross-border fund distribution model. This model of distribution based on open architecture, where a fund and its management company outsource key functions such as distribution, portfolio management, or risk management to other entities, has continued to gain importance over the past years. According to EFAMA, the share of cross-border funds in Europe has in fact risen from 34 percent of total European UCITS and AIF net assets a decade ago to 41 percent in 2016.

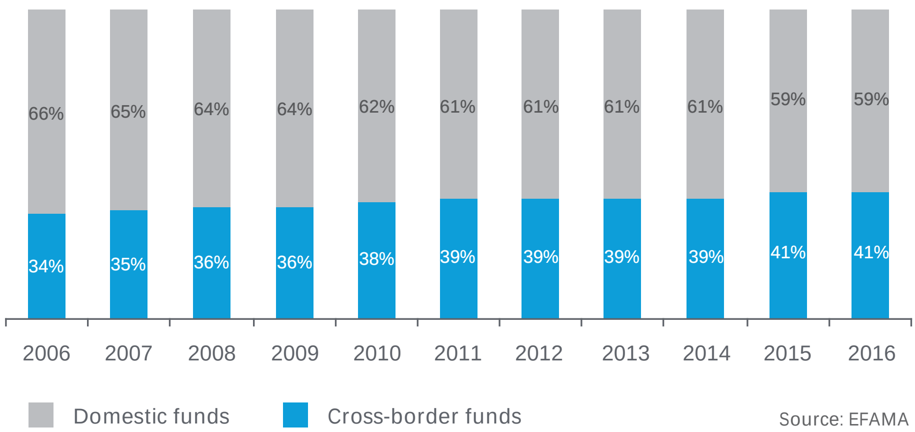
One of the drivers supporting the development of cross-border distribution is demand from non-EU geographies, such as Asia or Latin America, where well-regulated fund regimes are valued by investors for reasons such as safety and diversification. In other words, cross-border fund distribution is a key driver to export European competence globally.

Net assets of European investment funds (in trillion euros)



Source: EFAMA

Share of cross-border funds and domestic funds in total investment fund assets



Source: EFAMA

The share of cross-border funds in Europe has risen from 34 percent of total European UCITS and AIF net assets a decade ago to 41 percent in 2016.

Benefits and challenges of the cross-border fund distribution model

This open architecture model, or delegation model is central to how the European asset management industry works—and is a key driver of service quality and efficiency delivered to European savers and investors.

There are multiple benefits to the cross-border fund distribution model. First and foremost, the model helps maximize investor access to investment products. The model is designed to facilitate the broadest possible market reach for investment products by allowing funds to be distributed or marketed across multiple countries, thereby allowing investors in these locations to access these products depending on their specific needs.

Second, the model brings service quality. Delegation allows a fund manager to select the best possible investment management capabilities available on the market in support of the fund's strategy. This leads to the involvement of the best teams of portfolio managers regardless of their location, to ensure end investors ultimately have access to the highest possible service quality for portfolio management, a key variable in ensuring positive investment returns within the risk limits set by the fund.

Third, the open architecture cross-border fund distribution model is a significant driver of efficiency. Portfolio management and administration services can be delegated freely to operators with the best value to performance ratio, and over time this favors the development of an infrastructure of scale. In major cross-border hubs such as Luxembourg and Ireland, years of process optimization and the build-up of critical mass and expertise have allowed global asset managers to reach multiple markets in a more cost efficient way. A handful of fund administrators and custodians have emerged as large-scale, efficient operators in servicing funds domiciled in these jurisdictions. These players would probably not have been able to achieve the same levels of efficiency in a strictly national framework. In a recent survey of European investment funds, we estimated the cost of distribution-related activities for cross-border funds to be at least three times lower compared to the cost of these activities for nationally domiciled funds. The cross-border funds may yield as much as 5-10 basis point savings versus national funds, due to being distributed through a centralized infrastructure—a clear benefit to European investors.

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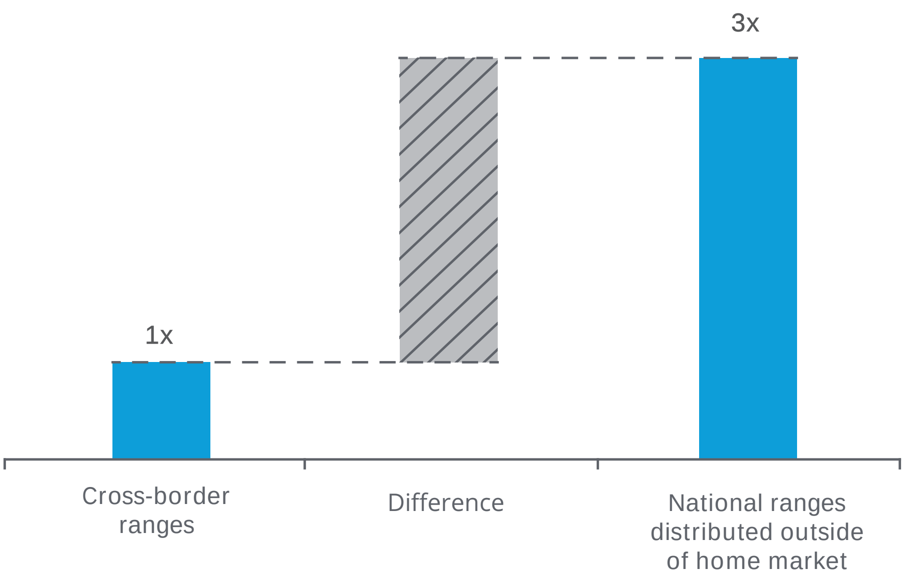
Cross-border vs. national distribution cost differential



Source: Deloitte analysis of cross-border and national fund ranges

Delegation also brings a degree of structural risk management into the fund management chain. While recent regulatory guidance may suggest a degree of skepticism on this point, the cross-border fund distribution model contributes to reducing risk, by allowing the selection of best practice competences for each management company activity, whether in-house, within the group, or through a carefully selected third party, ensuring rigorous control and oversight. Of course, management companies must have sufficient substance and competences to perform their oversight duties. As an illustration, the median number of employees per ManCo in Luxembourg is high, with over 25 people, and the mean is even higher—more than 50. These employment levels are supportive of the application of the rigorous control framework that ManCos need to put in place to fulfil their role.

That said, the model also presents certain challenges. For example, complexity is typically higher because of the need to understand and comply with numerous distribution requirements in multiple jurisdictions. Certain specific costs must also be considered, such as local administration fees or fees to local agents/representatives, which would not necessarily be required in a local-to-local setup. The model also requires robust oversight capabilities from participating operators to ensure the delivered service quality is in line with the fund's requirements. Additionally, participants need to be flexible and adapt to operating approaches and ways of working that may differ from one counterparty to another.

Benefits and challenges of cross-border fund distribution model

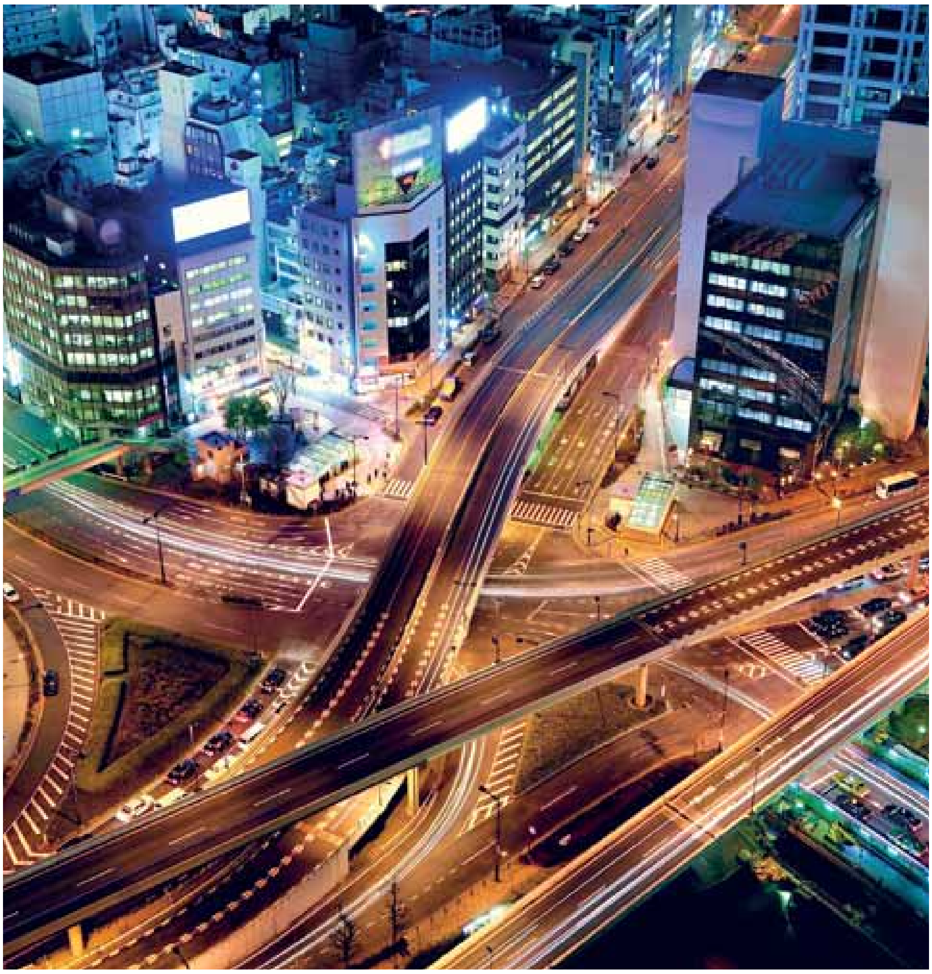
Benefits

1. Maximize investor access to multiple end markets and distribution channels
2. Most efficient approach to international distribution
3. Structural risk safeguards in delegation model

Challenges

1. Higher complexity of handling multiple jurisdictions
2. Certain additional costs vs. local-local distribution (efficiency is key)
3. Requires robust oversight capabilities and flexibility from participants

3. Key changes impacting the industry



In the context of growth and the increasing importance of cross-border fund distribution activities, a number of factors are unfolding that we expect to have significant impact on the European cross-border fund distribution industry. These factors are diverse and to some extent inter-related; they include:

- **Supervisory convergence:** Recent steps taken toward the increased centralization of supervisory authority for funds may cause some changes to existing cross-border delegation setups, and will require careful attention from the industry to preserve existing sources of efficiency and keep fund costs as low as possible for investors. This is particularly important in the context of Brexit, which is adding uncertainty for delegation setups involving the UK
- **The fund industry structure is changing:** The change comes not only as a result of competition and fee pressures but also regulations—notably MiFID II—which have altered the balance of economic interests across the fund distribution value chain. Recent steps observed among distributors point toward a vertical re-integration of manufacturing and distribution, which may lead to decentralization of fund distribution activities
- **Technological change:** Technology continues to represent a key opportunity for asset managers and distributors to optimize their operations, notably through centralized data management and digitalization and automation of activities. At the same time, significant investment is still needed to adapt to changing investor expectations and enable new digital distribution models
- **Investor needs and behaviors are changing:** There is a growing importance of customer experience and an increased need for strong qualitative information and investor education. The generation change also brings increased investor confidence and appetite for self-direction, which may contribute over time to the further development of new products, such as ETFs
- **Alternative funds are becoming increasingly strategic for the fund industry:** With strong growth, the alternative segment is steadily developing into a fundamental part of the European fund distribution landscape, and players active in this space will need to count on several factors that have contributed to the success of the traditional cross-border fund distribution model, including scale and efficency.

Supervisory convergence in post-Brexit Europe is bringing questions for the organization of cross-border distribution activities in Europe, and the industry will need to be careful to maximize continuity and maintain efficiency

In the summer of 2017, draft EC regulation and an ESMA opinion outlined principles for the European fund authority to have an increased role of in the approval and supervision of fund delegation setups. New review standards have also been introduced for the delegation of important functions to third countries, which would include the UK when it is expected to leave the EU in 2019.

This regulatory evolution brings a degree of uncertainty for existing delegation models in the European fund industry. From the standpoint of cross-border fund distribution, regulatory oversight is already centralized around the key cross-border fund distribution hubs but changes in the structure of oversight could raise additional questions for existing operating or delegation models.

Potential re-configuration of cross-border fund distribution models must be balanced with the need for efficiency

A potential implication of the model is that industry players subject to more central supervision may have to re-organize their cross-border distribution arrangements and operating setups to satisfy new regulatory expectations. Should this happen, and for example if funds change their legal domicile, the industry should and will seek to ensure that existing infrastructure and capabilities can still be used optimally, and to maintain at least the same level of service quality and operational efficiency for investors.

In addition, we have also noted potential uncertainties on the ability of a central regulator, at least in the short-term, to absorb the volumes and complexities of new fund application reviews currently handled at national level. As a result, we expect the industry to pay particular attention to the effectiveness of any new regulatory setup, to preserve the optimal time-to-market for new product developments.

For fund management companies, substance requirements may need to be adapted to new cross-border review standards, prompting the need to source potentially additional adequate resources. For delegating portfolio management to third countries, this would mean that proportional technical competences would need to be made available in the country of domicile to ensure full oversight and responsibility as per the latest regulatory requirements. The change of the UK's status to a potential "third country" would also likely require a significant re-papering of existing contractual delegation relationships.

Opportunities for more international market coverage for cross-border hubs

On the positive side, this change can be viewed as an opportunity for existing cross-border distribution hubs. In our view, asset servicers and other service providers located in cross-border distribution hubs should expand their market coverage horizons as much as possible, and extend beyond servicing local cross-border products to servicing local products in other national jurisdictions. This would effectively represent a shift from a product to a service orientation for the cross-border fund administration industry.

Regulation is changing revenue models and affecting industry structure

The last few years have brought about a historic wave of regulatory changes to the fund management industry. New regulations including MiFID, EMIR, MiFIR, MAD, PRIIPS have required (and still do require) significant attention and transformation efforts from the industry. More recently, MiFID II has occupied the regulatory agenda and its implementation is now either complete or well under way for most players.

As the effect of these regulations becomes apparent, we can now appreciate the real magnitude of the changes across the fund management industry, and how MiFID II has altered the way financial advice is delivered and how products are distributed in Europe. Players of the fund management chain are affected in substantial ways, including distributors, product manufacturers, and asset servicers.

Perhaps most significantly, the ban of inducements has created significant revenue risk and change throughout the fund distribution value chain, as distributors are no longer allowed to collect payments from third party fund providers in exchange for selling their funds to clients.

Growing competition among fund managers and distributors

A number of distributors are seeking to expand or create their own fund solutions to capture an increased portion of the value derived from fund management activity. This is increasing competition among third party asset managers and creating opportunities to develop white label fund solutions. Distributors with existing in-house operations are expected to significantly focus on these innovations in the near future. We are already seeing players who previously relied on third party product distribution who are now re-building portfolio management competences and developing own-brand offerings, potentially through a white-labelling infrastructure. One consequence for fund managers is that access to distributors is becoming more competitive.

Secondly, we are witnessing increased competition among distributors themselves, as inducement-free share classes become more and more prevalent, and distributors of third party funds are now on a level playing field with each other and are at liberty to push down advisory fees and commissions depending on their own commercial priorities.

We also observe a focus on narrower product ranges. Those same distributors of third party funds are choosing to focus on more limited and carefully selected ranges that are potentially less complex and costly to oversee, thereby putting value to clients above other criteria. For fund managers, this results again in increased competition for product manufacturers in terms of product strategy, brand, price, and performance.

Distributors now need to demonstrate “quality enhancement” to clients to justify the proportionate capture of value from distribution agreements. This brings new service opportunities; for example, fund selection capabilities and information services that may help banks to demonstrate quality enhancements, and could be provided by multiple parties in the fund value chain. New advisory solutions are also needed, to help distributors enhance their value proposition to clients and protect their economic interest.

As the effect of these regulations becomes apparent, we can now appreciate the real magnitude of the changes across the fund management industry, and how MiFID II has altered the way financial advice is delivered and how products are distributed in Europe.

Finally, with traditional distribution networks re-focusing their activities and becoming more difficult to access, asset managers will need to consider how to best promote and distribute their products, potentially by setting up their own direct-to-consumer distribution capabilities. In this context, the role of fund distribution platforms is also set to evolve, for example to develop more efficient access to traditional distributors for fund players, and to support distributors in their fund selection processes.

Continued rise in reporting and other operational requirements reinforcing the importance of scale and efficiency

Increasing suitability and appropriateness requirements coupled with increased reporting requirements have continued to make fund distribution a more complex and costly process. Across the value chain, players need to monitor and report multiple elements in terms of client suitability and client transactions on a pre- and post-trade basis. For example, MiFID II requires multiple checks and reporting of client suitability and appropriateness across the life of all conducted transactions. PRIIPS requires new enhanced client documentation, while EMIR and MiFIR require significant transaction-related reporting.

Taken together, these requirements are increasing the cost of managing distribution activities for all players involved. As distribution costs continue to increase, we expect scale to remain a differentiating factor, and consolidation among asset managers, asset servicers, and distributors to remain a strategic priority.

Technology brings both opportunities but also potential disruptions

Centralized data management and automation as key drivers of distribution efficiency

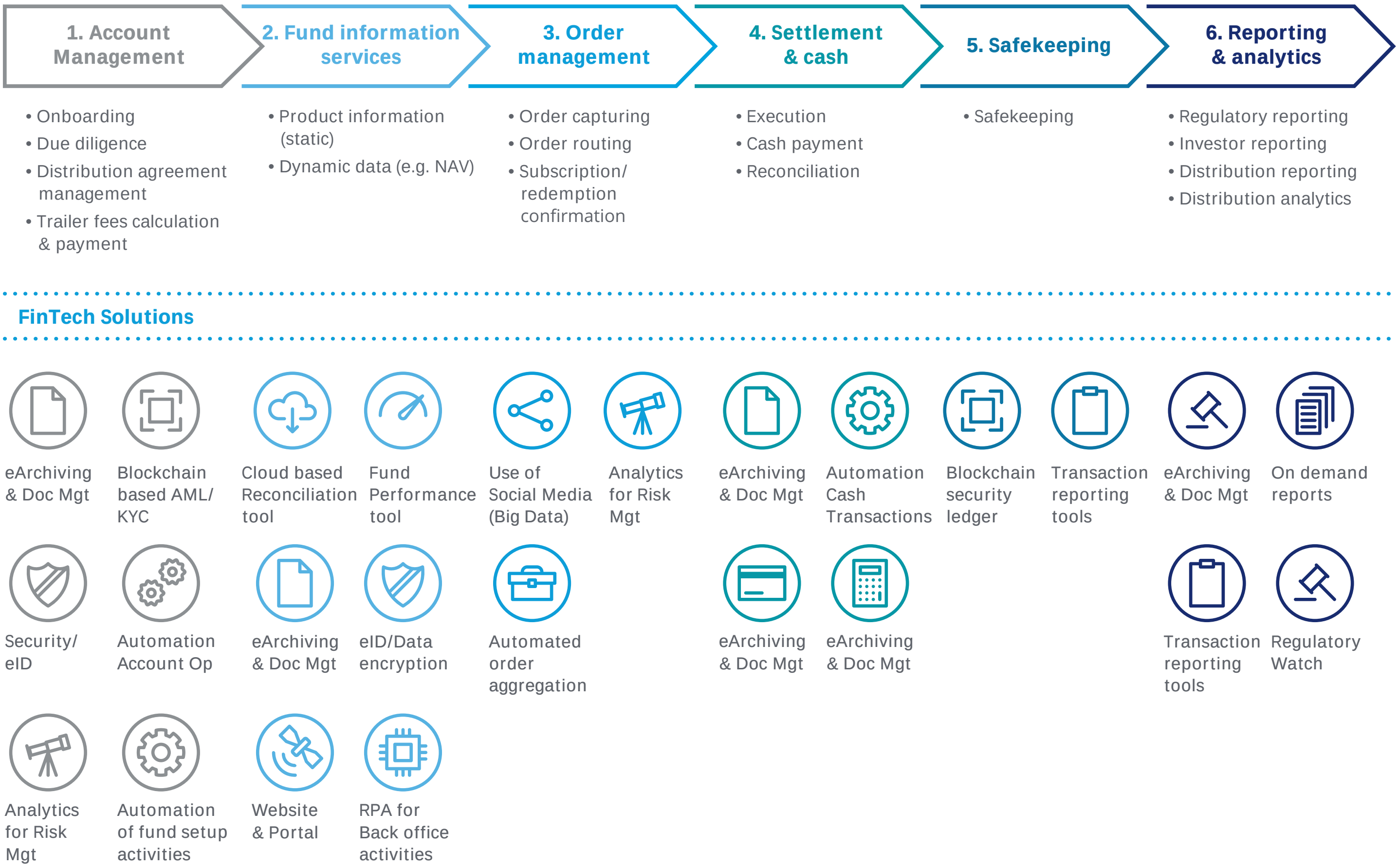
Technology will continue to play a central role in the optimization of distribution operations in the coming years, and will in fact remain one of the best ways to keep retail distribution possible at the most reasonable cost.

A number of processes already benefit from digitalization—for example, order flows have been automated to a significant extent in recent years, resulting in improvements in straight-through-processing rates and cost savings in terms of order management. In spite of these efforts however, a high number of activities remain manual and prone to error and inefficiency. For this reason, our view remains that the fund distribution industry should continue to examine its processes across the entire distribution chain, to seek out potential automation and cost savings.

In practical terms, this means increasing automation beyond order management, to optimize other drivers of fund distribution costs. Opportunities are diverse and may require in-house development or the sourcing of external technology competences, or a combination of both. By way of illustration, potential optimization areas across the fund distribution chain could include the following:

- **Order management:** optimizing treatment of corporate actions, dividends, or transfers through more centralized and automated data management
- **Account management:**
  - Optimizing due diligence processes through a centralized platform and data repository
  - Optimizing the treatment of distribution contracts and other supporting documents through the smart management of documents across the distribution chain, combining marketing, operational, legal, and compliance elements
  - Automating KYC processes, through smarter document management
- **Fund information services:** automating the maintenance of fund-related data, and optimizing reconciliation activities by improving access for all users to more centralized data sources
- **Reporting and analytics:** automating regulatory and distributor reporting activities, leveraging on centralized data sources.

Examples of technological solutions across the fund distribution value chain



A common requirement to capture many of these opportunities is the need for more centralized data management. Ensuring the alignment of multiple counterparties for the same data or providing access to the same documents in a more centralized manner, is an opportunity that we expect technology to unlock in the coming years. The potential for efficiency extends not only to simple, repetitive processes, but also to more complex and time-consuming activities, which typically require significant investment in knowledge management and expertise. For these, it is our view that smart sourcing is often a viable solution. For example, activities such as regulatory watch, prudential reporting, tax reporting, transaction reporting, and KYC/AML, can now be outsourced seamlessly to third parties, typically at a lower cost and with limited investment requirements over time compared to an in-house solution.

Beyond cost savings: improving the customer experience

Technology is an essential component of better investor education and information, which is critical for the further development of cross-border fund distribution and the general broader adoption of investment funds as a savings solution by European investors.

Despite ongoing developments in favor of transparency, opportunities still remain to communicate fund offerings and educate investors on the benefits and risks of investing in funds, in a more qualitative, interactive, and often simpler manner.

The number and complexity of funds available remains high, along with investors' need for clarity and re-assurance on the merits of financial solutions. With this in mind, strides made by direct distributors, such as online banks, brokers, and robo-advisers, may provide a reference in terms of how to position a financial offering clearly and simply.

In contrast, for most traditional asset managers, the marketing documentation most readily available to investors is often their funds' factsheet. These factsheets tend to be more static than financial information typically available through online channels (e.g., the NAV of a fund will refresh daily at best compared to a permanent live quote for ETFs).

For this reason, the fund industry should invest not only in making its marketing activities more efficient by reducing costs, but also in making its interactions with investors easier and more informative.

Re-inventing investment advice through technology

In recent years, a new form of advice has emerged with a fresh breed of asset management firms starting to gather retail assets away from incumbent players. They provide automated, algorithm-based portfolio management advice to the client without the need for human financial planners or advisers. Some firms have also pioneered tools and methodologies that generate real-time trade and investment recommendations tailored to individual investors' history and preferences. This phenomenon clearly emphasizes the shift from human-based, person-to-person advice to science-based, model-driven advice. We have witnessed the birth of "robo-advisers." Clients can access robo-advice through rich, digital user interfaces for lower fees versus traditional investment offerings, which allow for the distribution of funds directly to retail clients. These new offerings have made noticeable inroads in the US wealth management landscape, backed by the support of major players such as Vanguard and Charles Schwab. In Europe, new players are emerging but the development in volume remains modest.

The emergence of robo-advice is nevertheless an opportunity for traditional asset managers to re-think their business model and create a brand new user digital experience. Adding robo-advice capabilities to traditional business models fundamentally changes the way that products are sold. Not only is it a way to target a new type of client and generate new sales, it is also a way to obtain more detailed information about clients and therefore propose more appropriate and tailored services.

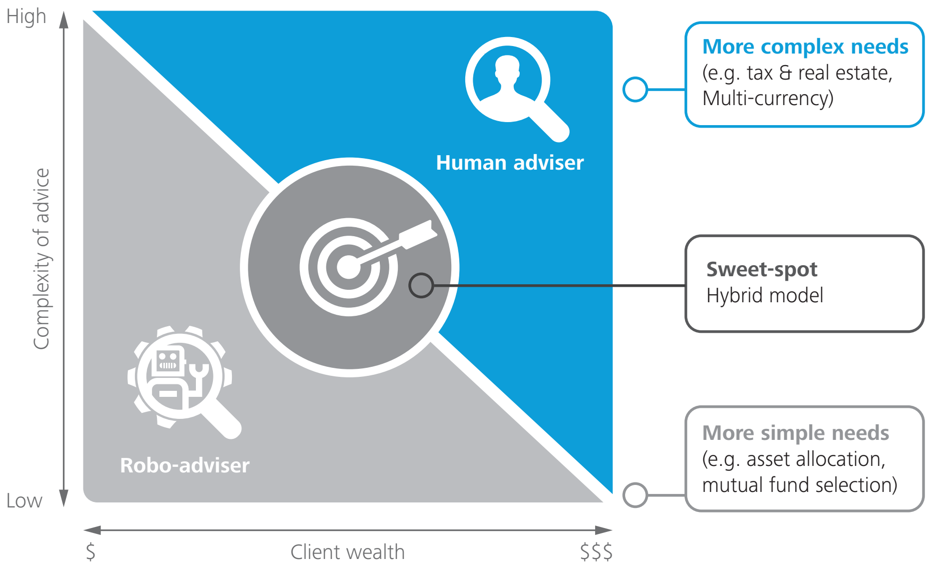
Despite ongoing developments in favor of transparency, opportunities still remain to communicate fund offerings and educate investors on the benefits and risks of investing in funds, in a more qualitative, interactive, and often simpler manner.

A common argument against algorithms is their inherent limitation in relation to human-based advice. A good example is the understanding of risk tolerance. Most robo-based services determine risk perception and financial goals based on a few questions being answered upon setting up an account, an infinitely less nuanced understanding than that created through a relationship with a human adviser.

Nevertheless, despite this only being their beginning in Europe, fund managers should react sooner rather than later, as robo-advisers present the potential for significant market disruption. However, science-based advice will not fully displace human-based advice, nor are robo-advisers likely to disintermediate financial advisers in a major way. Rather, in a not-too-distant future, science-based advice may actually draw in customers who could not previously afford a personal adviser or were not comfortable with human-based advice—thus potentially expanding the advice market. The majority of European robo-advisers will most likely be bought out by current players in the market that are keen to stay ahead of the FinTech curve. Incumbents will find it quicker and simpler to acquire an existing robo-adviser than to develop one internally. Winning advisory models will combine elements of both the science and human-based advice models into a hybrid model. The balance between the two will likely vary across investor segments based on investors' ability to pay for advice and the complexity of financial needs and financial background. Furthermore, investors are likely to continue to seek personal advice for needs that reach beyond investment (such as tax and estate planning) or involve emotional issues (like securing health care for elderly parents).

A key potential change for the industry in this dimension remains the entry of large e-commerce players, the so-called "GAFAs" with significant digital resources, as well as data and customer access that may enable the development of new direct investment propositions.

A hybrid model between human and robo-adviser will be the key to success



Evolving social behaviors and client needs are bringing an appetite for self-direction

Changing generation, evolving client needs

A new generation of investors is emerging. Generation X (born between 1960-80) and Millennials (1980-2000) are characterized by new thinking patterns, standards, and expectations that are substantially different from previous generations. Even an increasing number of Baby Boomers (1946-60) are being influenced by their younger peers. Therefore, today's financial service providers need to clearly identify and profile each generation individually. This new generation of investors thinks differently about advice compared to previous generations and expects to interact with their advisers in a different way.

In a recent Deloitte study[1], nine new "mentalities" and six potential implications for asset managers were identified. For instance, investors no longer wish to be treated as part of a segment but instead as unique individuals ("Just me") with specific goals and preferences. They expect to receive advice tailored to their unique circumstances. Likewise, they want to stay in control of their financial lives and understand the advice they receive to make important decisions themselves. They are reluctant to buy discretionary services and are increasingly comfortable conducting their own research. Due to this, asset management firms and their advisers should consider shifting to more holistic, goal-based advice and measure performance based on achieving clients' goals within agreed timeframes rather than necessarily beating market benchmarks.

1. Deloitte, How can FinTech facilitate fund distribution, 2016.

The 9 mentalities of the Re-Wired Investor are here to stay

Mentalities of the Re-Wired Investor

- Just me
- Stay in control
- Do it yourself
- Anywhere, anytime
- Digital & Personal
- Wisdom of my tribe
- Skeptical of authority
- Risk defied as downside
- Not a Second Class Investor

Implications to IM firms

Tailor-made
Investment advice and products perceived to be tailored to individuals one at a time

Multi-channel
Access to multiple channels and several advisory models at the same time

Multiple sources of advice
Not just from one adviser, but from other advisers, peers, experts, social media

Rich digital front end
Expectations formed when interacting with non-financial services; must be simple, intuitive, self-directed

Risk Management as Hedging
Downside protection and hedging more diversification

Democratization of Investments
Access to same high yields assets & strategies once available only to wealthier investors

Source: Deloitte, How can FinTech facilitate fund distribution, 2016.

Increased sensitivity to fees and appetite for self-direction may support European ETFs over time

Technological change, the growing exposure to digital technologies, and the abundance of information are driving increased financial literacy and confidence among investors, as well as increasing expectations in terms of quality of advice and information availability. Information and advice are now expected to be available at anytime and anywhere, and at low, or sometimes no cost.

With increasing transparency on fees in the wake of MiFID II, it has become easier for investors to understand and compare the fees across products. In addition, investors are increasingly seeing fees as a constraint on potential investment returns, in particular in a low interest rate environment.

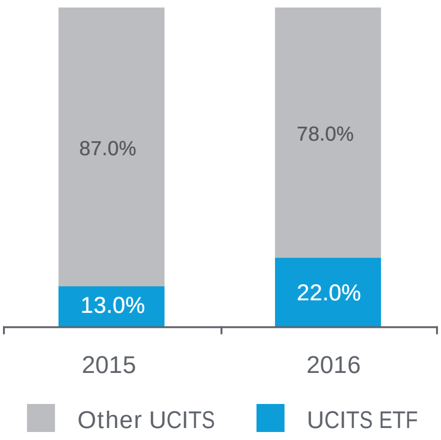
Traditional actively managed funds have regularly been subject to reviews in terms of performance after fees compared to benchmarks. In recent years, the high asset correlation environment experienced as a result of current monetary policies, where low rates drive the price of all assets up and reduce performance bias, has only added to the difficulty of driving investment performance through active management.

Passive products—in particular ETFs—continue to develop in Europe. As of 2016, European ETFs represented nearly €500 billion, up 11 percent from the year before. European ETFs represented 22 percent of UCITS net sales in 2016 compared to 13 percent the year before, indicating the growing momentum for this asset class.[2]

However, this demand is still largely driven by institutions in Europe, and the European ETF market remains less developed compared to the US market. It is estimated that over 80 percent of ETF ownership in Europe is institutional, and only around 10 percent for retail (versus 40 percent in the U.S.).[3] ETFs also represent only 6 percent of European UCITS,[4] which is below that in the US where these products represent approximately 13 percent of the investment fund market.[5]

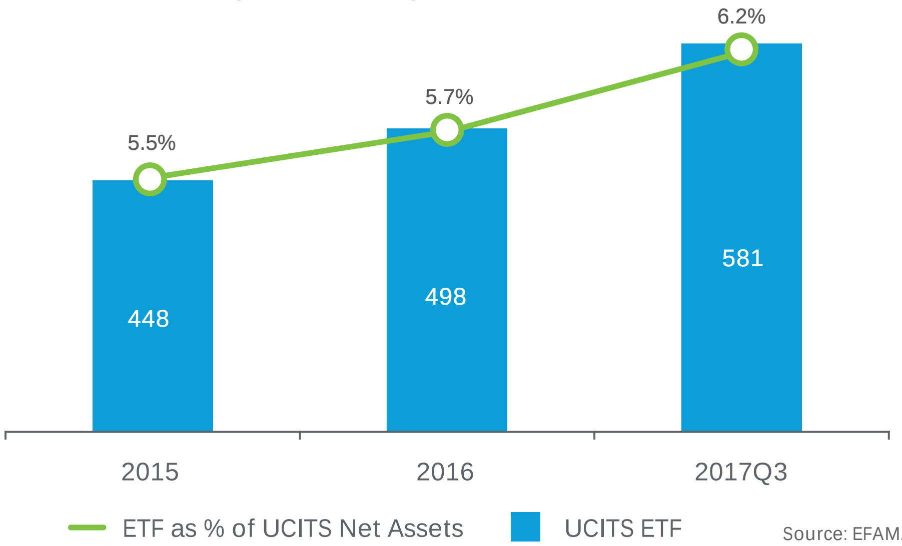
While several factors may remain constraining to the growth of ETFs in Europe (e.g., tax considerations, OTC vs. exchange trading), the evolution of retail investors' needs and the changes in industry structure following MiFID II are among the factors that are expected to support their further development.

UCITS ETF Net Sales (percent of total UCITS)



Source: EFAMA

UCITS ETF Net Assets (in billion euros)



Source: EFAMA

2. EFAMA
3. Vanguard
4. EFAMA
5. ICI

Alternative fund distribution is undergoing significant growth

Global growth and development of alternative asset classes

The alternative asset industry is worth approximately €8 trillion globally[6] and has grown at double-digit rates in the past few years, much faster than the traditional asset management space. Low rates, high liquidity, and the search for yield are among the factors driving substantial demand for private assets from both institutional and high-net-worth investors. If this trend continues as we expect, alternative assets will exceed €10 trillion before or shortly after the beginning of the next decade.

Current growth trends remain strong. For example, the PE sector raised over US$300 billion over the three first quarters of 2017, marking an increase of 18 percent compared to the same period in 2016.[7] Capital distributions reached an all-time record high of nearly US$500 billion in 2016, with almost US$1.5 trillion returned to investors since 2013.[8] Those distributions, combined with the poor performance and volatility linked to traditional asset classes, have driven increases in allocations and have attracted new investors.

This strong demand for alternative assets is driven by both institutional investors and HNWIs. A recent Deloitte survey showed that while PERE fundraising remains focused toward institutional investors (e.g., pension funds, insurance companies) with over 80 percent of funds targeting this segment, a significant portion of alternative fund distributors (55 percent) also target HNWIs and related entities such as private banks and family offices.[9]

6-8. Prequin
9. Deloitte Luxembourg PERE survey 2017
10. EFAMA

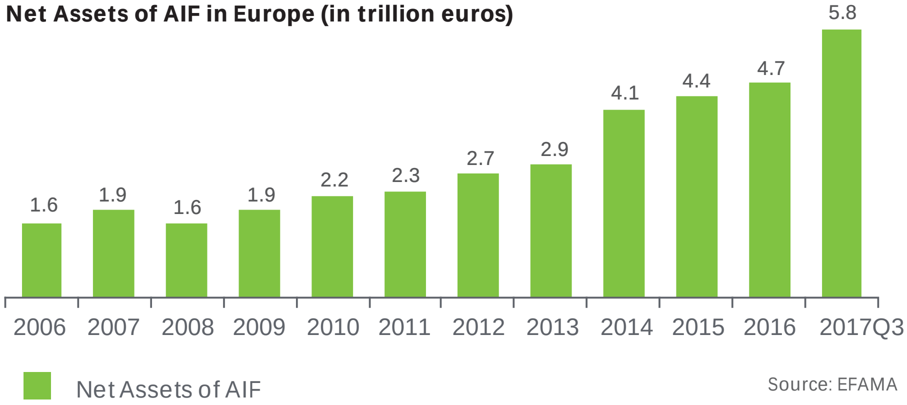
While the PERE sectors have represented the bulk of alternative asset growth in recent years, the development of private debt funds may be among the drivers of future growth. With changes in the European corporate financing landscape and the difficulty for some companies to access bank financing, fund-based solutions are expected to continue developing as an alternative source of lending. In turn, this will drive further growth for the alternative fund industry in Europe.

Certain challenges to this positive backdrop are looming. For example, the concentration of capital, whereby 10 of the largest funds that closed recently raised over 60 percent aggregate capital in the same period, and the increasing difficulties to deploy capital, might temper investor appetite. Any slowdown in the credit markets or rapid rise in interest rates could also alter prospective investment returns and mitigate interest further.

The growth of the AIF regime and increasing concentration around cross-border hubs

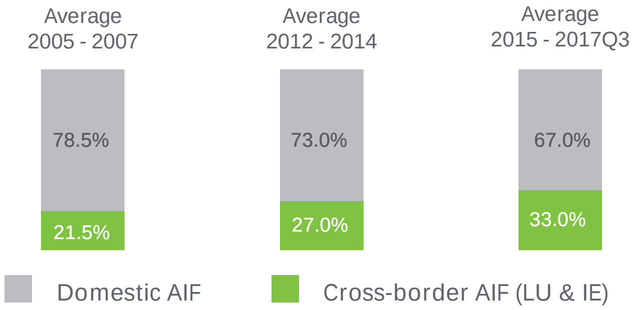
While market conditions remain positive, however, fund promotors are taking full advantage of the structuring framework introduced by AIFMD. The number of AIFs in Europe has grown to around 28,000 as of Q3 2017, supporting net assets of nearly €6 trillion compared to less than €2 trillion a decade ago.[10]

Net Assets of AIF in Europe (in trillion euros)



Source: EFAMA

Total net sales of AIF in key cross-border countries (percent of total Europe)



Source: EFAMA

Increasingly, the growth of AIF activity in Europe is concentrating on the major cross-border hubs, and developing where infrastructure and competences are available. The share of AIFs designed for cross-border marketing is likewise increasing, from less than 22 percent a decade ago to 33 percent in the past three years.[11] This is driven in part by increasing substance requirements (BEPS, supervisory convergence) requiring operators to maintain efficient fund structures, with scale and sufficient concentration of activities. Empirically we have seen a number of promotors rationalize their European fund structuring setup in favor of centralized cross-border hubs.

The uncertainty around Brexit, specifically concerning the implications in terms of third country passporting rights, is also prompting fund managers to seek long-term, reliable structuring solutions to maintain optimal access to European countries for fundraising purposes.

The development of cross-border alternative hubs

Similarly to the UCITS space, today we are witnessing the development of cross-border hubs for PERE fund managers. Luxembourg is currently among the largest of these hubs, with nearly 5,000 locally domiciled AIFs, representing approximately 17 percent of the number of total European AIFs, second only to Germany. Net assets related to AIFs totaled €0.7 trillion* as of Q3 2017,[12] and the number of authorized AIFMs domiciled in Luxembourg has exceeded 250 since the inception of the framework.[13]

The diverse range of vehicles, from unregulated to regulated products, together with the asset class expertise developed over the years within the professional community in conjunction with the local regulator, are all key factors for the success of a country as an alternative investment hub. In Luxembourg for example, new vehicles established in the past few years—mainly the RAIF and SCSp (also known as the Luxembourg Limited Partnership)—have filled a vacuum in the structuring landscape. These vehicles now provide increased structuring flexibility for fund promotors, enabling faster time-to-market under robust regulatory and investor protection standards; the number of RAIF and SCSp vehicles has increased significantly and are expected to gain prominence among other structuring tools.

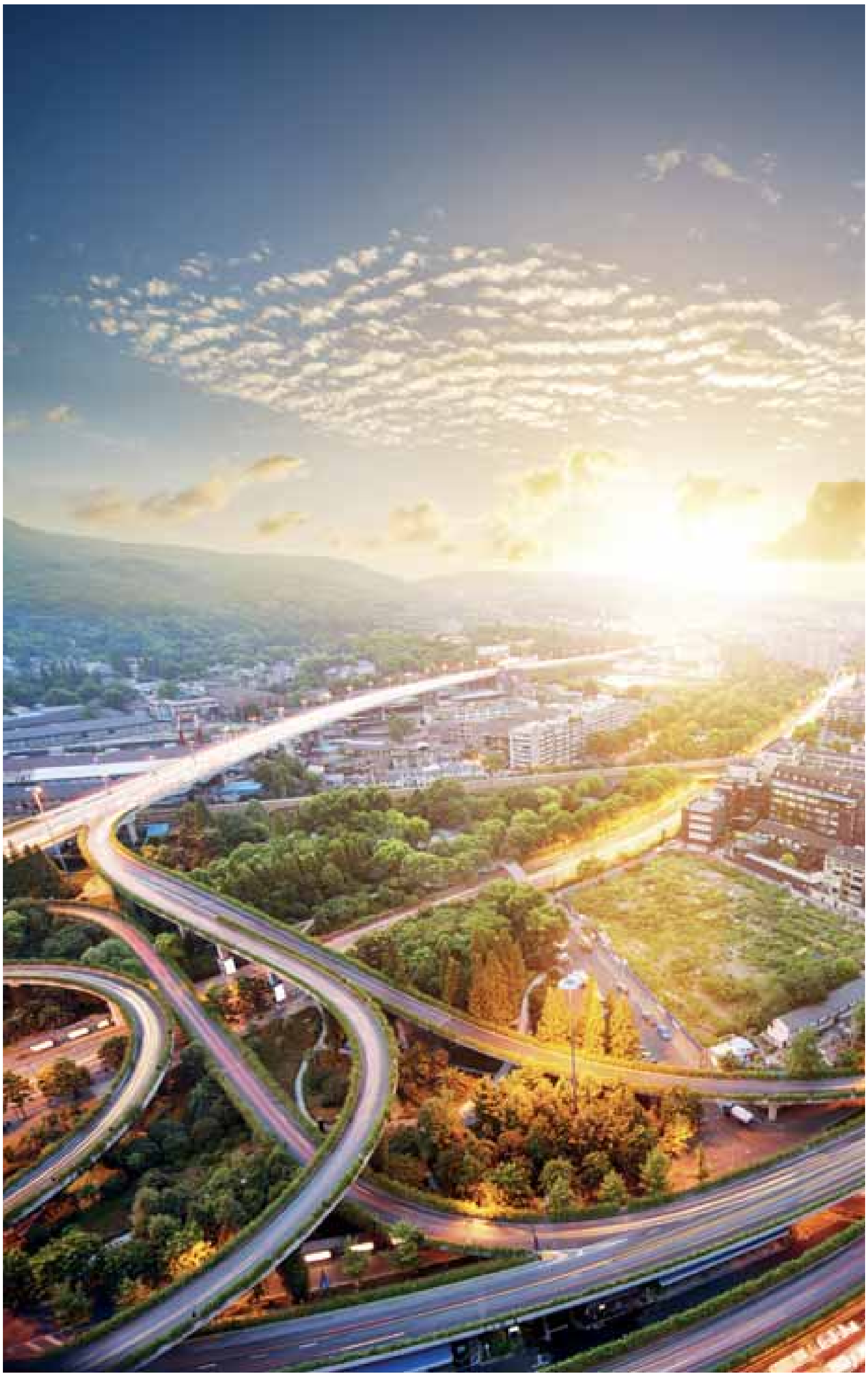
The availability of a large and efficient administration infrastructure—including fund administration, depositary bank, and reporting capabilities, coupled with supporting competences like legal, risk, and tax—also remains a key consideration for promotors and has supported this convergence.

Going forward, we expect further convergence of cross-border activity toward cross-border hubs, for multiple reasons. First, the regulatory outlook no longer justifies maintaining multiple hubs to accommodate local regulatory specificities, but instead critical mass, efficiency, and centralization are gaining importance. Our view is that at least half of the top 15 promotors will eventually establish AIFM capabilities in a cross-border hub if they have not already done so, which through network effects will drive further concentration and efficiency over time.

The uncertainty around Brexit, specifically concerning the implications in terms of third country passporting rights, is also prompting fund managers to seek long-term, reliable structuring solutions to maintain optimal access to European countries for fundraising purposes.

* These assets constitute only the visible, fully regulated portion of the alternative fund sector. In addition, there is also significant legacy or non-European business carried out by asset managers on an unregulated basis, which in fact represents the majority of the business in this sector. In addition, over 600 entities whose AIFs' assets qualify as "below-threshold" are registered as AIFMs in Luxembourg.

The evolution of AIFMD and NPPR could also amplify the development of cross-border AIF activity. Today, NPPRs are used widely by non-EU fund promoters as a lighter and cost-effective alternative to the setup of a EU domiciled AIF, thereby allowing the growth of cross-border EU distribution. Future iterations of the AIFMD may alter the distribution possibilities offered by NPPR, which could further increase the appetite for specific AIF setups, but at the same time will raise questions in terms of efficiency and cost. Given current Brexit-related uncertainties and the recent postponement of a major AIFMD revision, it is likely that such changes will not take place before 2019.



11. EFAMA
12. EFAMA
13. Deloitte analysis based on CSSF data

4. Implications for the industry

Maintaining open access

Taken together, the trends discussed in this white paper have the potential to effect substantial change on the European fund distribution industry. First, convergence of fund authorization and supervisory powers combined with the trend toward re-insourcing of fund management by distributors raises questions for existing cross-border setups. Any changes to the models currently in place would need to maintain as much efficiency as possible while ensuring the cost borne by the end investor remains as low as possible. This is particularly important, as the intrinsic complexity of European cross-border distribution already tends to make European products more expensive compared to their global peers, for example in the US.

Furthermore, recent regulatory developments including MiFID II and PRIIPS, both of which are clearly aimed at improving investor transparency and protection, may nevertheless have indirect impacts on European investors. Through changes in industry structure and the way in which distributors decide to approach their activities, these regulations may alter the balance of economic interests across the distribution value chain, which in turn may encourage a degree of de-centralization of cross-border activity, as well as potentially reduce investor choice.

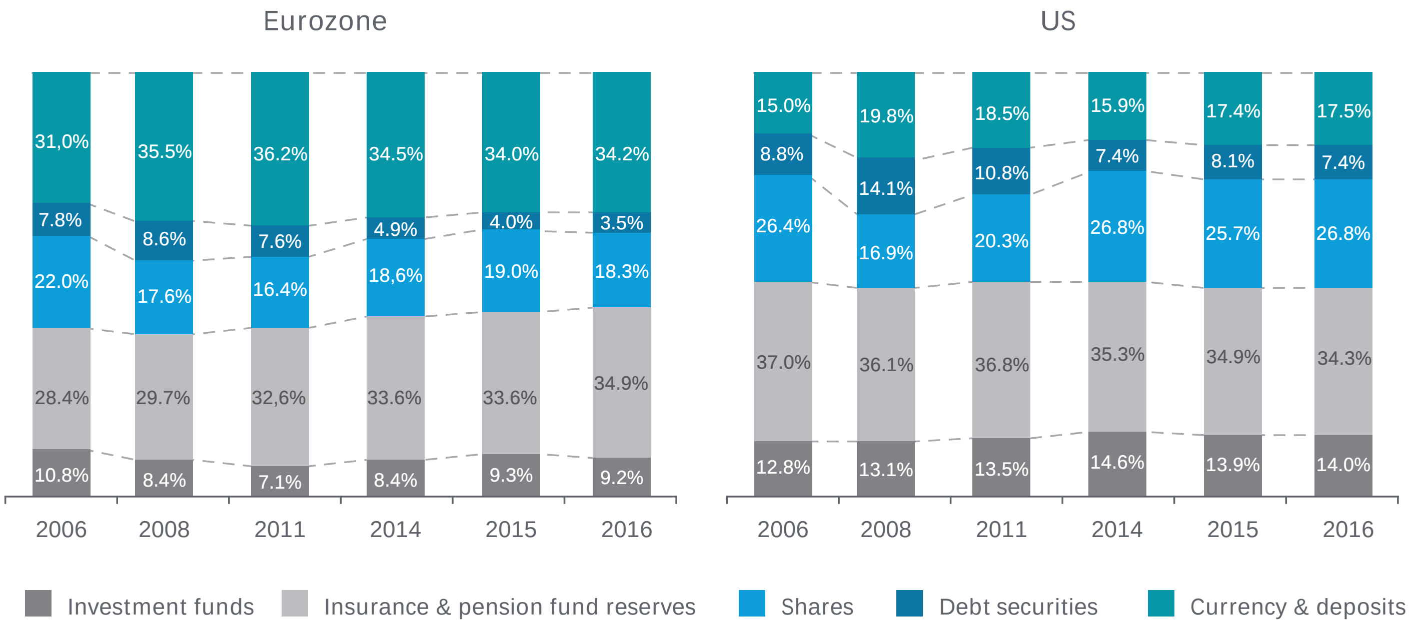
At the same time, significant investment needs to be maintained—notably in technology—to continue improving efficiency in distribution operations, for example through centralized data management and the digitalization and automation of activities, or in terms of fund compliance, legal, and marketing activities. More investment will be required from asset managers and distributors to adapt to shifting investor expectations and to enable new digital channels.
Investor needs and expectations are changing, raising the bar in terms of information requirements, user experience, and interactivity. Generational change also brings increased investor confidence and appetite for self-direction, which may have an influence on the demand for certain products over time, such as ETFs.

In addition, the growth of alternative funds raises its own questions, as the asset class has now become strategic for a growing number of players in the fund management and distribution landscape. Regulatory evolutions may have a significant impact on the development of this segment and continue encouraging convergence around major cross-border hubs. Technology investments and operational optimization will also come to the forefront, as players need to cope with continual digital evolution.

Maximizing the attractiveness of fund investments

Changes in the fund management industry are ongoing in a context where European funds remain substantially more expensive than their US equivalents, sometimes in the range of 50-100 basis points. The complexity of the European distribution landscape and the high standards of transparency and investor protection in place are key reasons for this difference. Nevertheless, these higher costs need to be managed downward, in light of the importance of further promoting savings alternatives to public pension schemes and encouraging European investors to allocate more of their savings to productive financial assets. The proportion of household financial assets in Europe remains below that of the US (9 percent versus 14 percent) while conversely the proportion of currency and deposits is much higher (34 percent versus 18 percent). Over the long-term, this lower investment in productive financial assets penalizes European savers in the perspective of retirement.

Household financial assets in Eurozone vs. US (share in percent)



Source: EFAMA

Every actor in the fund industry should put focus on increasing efficiency and facilitating investor access to funds. Achieving these objectives may require a different approach from that taken today, but it will continue to depend on maximizing scale for key activities, leveraging technology to its fullest to optimize operations, and improving investor interaction. Other objectives include the development of capabilities to adapt to ever-evolving market needs, whether through the promotion of alternative investment fund ranges, innovative fund solutions, or ETFs.

Taken together, the trends discussed in this white paper have the potential to effect substantial change on the European fund distribution industry.

5. Next steps for industry players

- **For asset managers and product manufacturers:**
  - Maximize distribution reach and efficiency through existing cross-border distribution channels
  - Maintain stability of market access in light of regulatory and supervisory convergence
  - Review product offering and distributor collaboration post-MiFID II
  - Develop new direct distribution avenues
  - Maximize efficiency of the distribution process through digitalization and smart sourcing

- **For distributors:**
  - Recapture lost revenue through product/fund provider rationalization, new fund and advisory pricing, and the integration of asset management capabilities
  - Maximize efficiency of the distribution process through digitalization and smart sourcing

- **For distribution support service providers and asset servicers:**
  - Maintain flexibility in changing delegation environment to serve fund sponsors across multiple locations
  - Adapt service offering to new regulatory requirements
  - Maximize efficiency through:
    1. Centralization and scaling up key competences
    2. Digitalization and automation of core processes

Glossary

AIF	Alternative Investment Fund
AIFMD	Alternative Investment Fund Managers Directive
AML	Anti-Money Laundering
BEPS	Base Erosion and Profit Shifting
EFAMA	European Fund and Asset Management Association
ETF	Exchange-Traded Fund
ESMA	European Securities and Market Authority
EC	European Commission
EMIR	European Market Infrastructure Regulation
FinTech	Financial technology: a line of business based on using software to provide financial services
GAFA	Acronym for "Google, Apple, Facebook, Amazon"
HNWI	High Net Worth Individual
KYC	Know-Your-Customer
ICI	Investment Company Institute
MAD	Market Abuse Directive
ManCo	Management Company
MiFID II	Markets in Financial Instruments Directive II
MiFIR	Markets in Financial Instruments Regulation
NAV	Net Asset Value
NPPR	National Private Placement Regime
OTC	Over The Counter
PE	Private Equity
PERE	Private Equity Real Estate
PRIIPS	Packaged Retail and Insurance-Based Investment Products
RAIF	Reserved Alternative Investment Fund
RPA	Robot Process Automation
SCSp	*Société en Commandite Spéciale*, a Luxembourg special limited partnership
UCITS	Undertakings for Collective Investment in Transferable Securities

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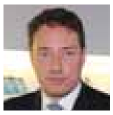

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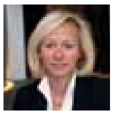

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