Leaning in to a year of change and innovation

The EY outlook for Asset Management in 2018

EY

Building a better working world

Can compliance help you compete?

EY's global financial services team can help you navigate regulation and create competitive advantage.

The better the question. The better the answer.
The better the world works.

Friends,

As we move into a new financial year, the outlook for Wealth & Asset management globally is strong. Currently, we are estimating conservative growth in asset under management (AuM) at 4-5% per annum over the next 3-5 years, exceeding world GDP.

This is being driven by an increasing need for long term savings due to changes in demographics, more financial responsibility on the individual and the increasing rise of the middle class in emerging markets. There is also a need for asset management during accumulation and decumulation life phases and we see asset owners continuing to diversify assets in the search for yield.

There are challenges to this growth. At national level we are seeing more sovereign wealth funds withdrawing assets. As governments continue to attempt to transfer more financial responsibility onto both employers and the individual, a challenge is appearing on the horizon in that younger generations are less likely to save and less likely to trust financial institutions than their parents.

There are also structural shifts in the industry resulting in pressure on fees, meaning that our projected increase in AuM is unlikely to result in corresponding revenue growth for managers. Value for money of active management continues to be questioned by stakeholders, with investors tiring of high cost active which have not performed. Significant fee compression continues and price is a significant component in net new asset flows. That combined with market volatility and a low interest rate environment does not help asset performance.

These structural changes are resulting in an acceleration of passives and a new breed of alternatives. Indeed if we look at the last year in review, passive inflows accounted for a staggering 80% of net new flows, a trend we expect to continue. Regulation continues to drive growth in passive, encouraging fee transparency, often via ETFs. On the other side, clients are increasingly searching for additional sources of income and uncorrelated returns. Asset managers are enhancing the diversity of alternative products, looking at real estate, private debt, private equity and alternative credit.

In this publication, we'll be introducing our Wealth & Asset Management team in Dublin and giving you our thoughts on the big topics on the horizon for 2018, from regulatory changes to digital transformation.

It's an exciting time to be part of this industry!

Warmest regards,

Lisa Kealy

Sector Leader, Wealth & Asset Management

Regulated Funds

Passive ETFs on track to exceed active funds by 2027

Exchange Traded Funds are uniquely placed to benefit from the shift to passive and will reach $7.6t globally by the end of 2020, according to EY's Global ETF Survey 2017: Reshaping around the investor. This growth will be underpinned by growing knowledge of ETFs and their uses, adoption by a widening investor base and these funds' key attributes of low cost, transparency and liquidity.

As the industry grows in size and influence, the competition to attract inflows will heat up, and more promoters will enter the market. The report focuses on the importance of getting the investor experience right in order to capitalize on the industry's huge potential. For ETF promoters looking for sustained success, this means, refining investor journeys, reducing investor costs and maintaining product quality in the face of regulatory change.

Market trends are extremely favourable for the growth of the ETF industry; from the increasing allocations to self-directed retirement saving, to a broader shift into passive investments, we have now reached a critical point of development.

How investors use ETFs

The ETF market will be transformed by both current and new investors. The survey suggests that 15 to 25% of ETF inflows over the next three years will come from new investors – a potential inflow of $250b. Investors typically first turn to ETFs for selected exposures they cannot access elsewhere, but then become more comfortable using them as the building blocks of portfolio construction, for liquidity management and for factor based investing.

Institutional investors, who will continue to dominate ETF inflows, use them for a variety of different purposes. Pension funds will use ETFs for liquidity management while wealth managers will look for core exposure through active portfolios. Certain hedge funds will use leveraged and inverse ETFs to execute high-conviction long or short positions.

The ETF industry needs to do more to understand and anticipate the long-term needs of different investment groups, addressing their concerns and developing teams that speak to their unique challenges.

Product innovation

The shift to passive will bring more and more assets into Exchange Traded Fundss, and while the majority of inflows is likely to be captured by core passive products, smart beta products including single and multi-factor ETFs will also benefit. That means that the range of ETFs will continue to expand.

Fixed income products will drive growth over the medium term, growing to over $1.6 trillion by 2020, from $0.7 trillion today. These come from a lower base than equity ETF products, both in absolute terms and relative to the mutual fund industry and the wider fixed income markets.

Promoters will need to look to technological advances in constructing new products that meet investor needs, and this may enable ETFs to push further into the smart beta and active world. By 2020, we see the smart beta ETF world doubling in size, while the active ETF world will increase four-fold.

Innovations in product construction will take many forms, including exposure to a variety of themes and factors, greater access to high yield and emerging market debt, and using advances in AI to create new active investment strategies.

ETF providers will need to anticipate investor needs, incorporate larger trends in regulation and technology, take advantage of long-term opportunities and focus on educating investors.

Reducing Investor Costs

ETF fees continue to fall, reaching on average 27 basis points last year. While the report contends that "zero-fee" ETFs will not become the norm, 72% of people interviewed expect fees to fall further. Pressure on fees will spread from traditional passive ETFs into smart beta products. Becoming a low-cost provider is a prerequisite to survival.

Beyond top-line fees, firms are future-proofing operating models by looking to reduce all costs of ownership. Nearly half of respondents (43%) feel there is insufficient competition between index providers. As a result, certain promoters have started to or are looking at the option to self-index. Propping up returns for ETFs through stock lending programs and focusing on best execution will also bring down the overall cost of ownership for investors.

Responding intelligently to regulation

Research respondents expect regulatory changes to change the way ETFs are distributed. ETFs should, in aggregate, benefit from regulatory changes, such as the Department of Labor Fiduciary Rule and MiFID II that promote the transparency that investors need. Regulatory focus on value for money also plays into the hands of ETFs, as a low cost product.

As the regulatory landscape continues to evolve, there is growing scrutiny of the industry's potential contribution to systemic risk. Awareness of how taxation can affect product performance is also growing. The industry feels that specific regulation may be positive for the industry, as an enhanced regulatory framework for ETFs would be positively viewed by investors.

The industry needs to develop a comprehensive view of regulatory threats and be willing to modify products that underperform as a result. A combination of local understanding and global insights can help investors understand the overall regulatory environment and how this will impact investor journeys.

Author
Kieran Daly
Director | Asset Management

EU Money Market Fund Regulation

Money Market Funds (MMFs) represent over 20% of all Irish domiciled funds with Net Assets of over €465 billion.

The proposal for a European regulation on MMFs was published in September 2013 with the goal of making MMFs more stable and less vulnerable to market turbulence. The final compromise text on the EU's Money Market Fund Regulation (MMFR) was approved by the European Parliament in April 2017. Following its publication in the EU's Official Journal on 30 June 2017, the regulation becomes effective from 21 July 2018. Existing MMFs can avail of a transition period and have until 21 January 2019 to comply.

Under the regulation, all MMFs must be established as either; (i) Public Debt CNAV MMF, (ii) Low Volatility NAV (LVNAV) MMF or (iii) Variable NAV (VNAV) MMF, with particular rules applying to each in relation to liquidity thresholds, asset eligibility and the permissibility of using a constant NAV. Other areas impacted by MMFR include internal credit quality assessments, stress testing and regulatory reporting requirements, each of which have been addressed in the final report on MMFR released by the European Securities and Markets Authority (ESMA) on 13 November 2017.

ESMA's final report follows a consultation paper released in May 2017 seeking feedback from industry participants. The report contains technical advice in relation to "Liquidity and credit quality requirements applicable to assets received under a reverse repurchase agreement", "Criteria for validation of the credit quality assessment methodologies" and for "quantifying the credit risk of an issuer". ESMA has also provided guidelines on Stress Testing Scenarios which establish principal-based common reference parameters which must be observed when conducting the stress testing required under MMFR as well as common reference stress test scenarios which must be conducted. In relation to regulatory reporting, ESMA includes draft technical implementing standards (ITS) on a reporting template which have been "greatly simplified" following feedback on the template included in the consultation paper.

Author
Kieran Daly
Director | Asset Management

Brexit

In 2018, Dublin may see an influx of funds as a result the dismantling of the UK market and more front office capability. In Ireland, we need to set ourselves up as the distribution centre of Europe. Part of this will focus on the Brexit opportunity.

As Brexit negotiations progress, EY will be keeping a close eye on the impact for our asset management clients, particularly with regard to any proposed transitional arrangements after Britain leaves the EU in March 2019 and how the end of passporting rights will impact UK funds managers, and major American, Swiss and Asian funds that previously reached the European market through London.

Our legacy relationship with the UK is perhaps one of the strongest in Europe, with significant cultural commonalities, not least the English language. We have a young and well-educated pool of talent with financial services experience, and as we've seen with the technology industry, we also have the ability to draw top quality talent from around the world to Ireland.

Different financial centres in Europe have different strengths, and Brexit will undoubtedly mean more fragmentation of the industry in Europe. It is clear from our experience that financial institutions are planning towards are "hard" Brexit, but while London is a difficult location to replicate, Ireland is already punching above its weight with high-calibre financial services organisations.

Author
Cormac Kelly
Brexit Leader | Advisory

Visit **eyfs.ie/brexit** for our insights and commentary

Fintech, Artificial Intelligence and Robotics

It is crucial for Ireland to begin positioning ourselves up as the FinTech centre of Europe. We need to collaborate and innovate, driving automation through the asset management industry, aiding smarter analysis and efficiency and effectiveness of process. Asset servicers also need to continue to build their middle office capabilities taking account of the challenges for asset managers including increased regulatory burdens, and increased cost efficiencies.

Simultaneously, hedge funds using artificial intelligence (AI) are now outperforming those that are not, and the difference between the two is growing greater in recent years, suggesting AI funds are improving their algorithms. In Ireland, we need to set ourselves at the heart beat of this industry to help our clients grow in an increasingly competitive environment.

We're beginning to see real movement in the fields of robotics and automation. With Robotic Process Automation (RPA), the virtual software BOT can be taught how to do time consuming and tedious administrative work.

BOT performs the activities of its human predecessor much faster, while also improving job satisfaction by allowing teams to focus their efforts on higher-value activities like true tax planning, analysis, minimisation of tax leakage and maximisation of investor returns.

Most organisations want to do a proof of concept or pilot project first. This might begin with a conversation with their IT department or other groups internally who may already be exploring these technologies, and lead to a mini-assessment on where the client should apply RPA first.

Our team in Dublin recently designed an automated BOT in-house to automate a large part of the Fin 48 process – which was a huge success.

The new process is real example of how automation can improve our working experience, harness efficiencies and delivery a quality product.

Author
Lisa Kealy
Sector Leader | Wealth & Asset Management

BEPS and tax matters for asset managers

EY FS Tax in Dublin has seen an increase in engagement with asset management clients in relation to best practice regarding the governance/oversight of investment funds, including the minimisation of tax leakage and maximisation of returns to investors.

Investment funds have specific tax issues that need to be understood and monitored in order to ensure that the funds product range remains tax efficient, that there is no unnecessary tax leakage, and that the funds themselves comply with the various tax filing and reporting obligations required of them across multiple jurisdictions.

Additionally, the international tax changes arising from the OECD BEPS project will transform the global tax environment, affecting companies with international operations.

The BEPS Action Plan recognised that enhancing transparency for Tax Administrations by providing them with adequate information to assess high-level transfer pricing and other BEPS-related risks is a crucial aspect for tackling the BEPS problem.

In this regard, Country by Country Reporting, i.e., CbCR (included in BEPS Action 13) increases transparency around the tax affairs of multinational group by requiring them to provide information to Tax Authorities regarding the global allocation of income, taxes paid, and certain indicators of the location of economic activity among the tax jurisdictions where the business operates.

Non-compliance with tax obligations could result in Tax Audits being undertaken by Tax Authorities, and where warranted - the potential for publication of tax default.

Also, investors have become far more tax aware – therefore, overall - reputational risk is a serious concern for asset management clients.

By allowing a fund range to have one tax adviser to co-ordinate all tax advice - across multiple jurisdictions - relevant to the fund range itself, the investments and the investors, is an effective method to ensure that tax risk and tax related reputational risk is managed effectively.

Author
Sinead Colreavy
Director | Tax

Multilateral agreement

The Multilateral Treaty is a far-reaching initiative in international tax that should be considered for all new fund structures and in reviewing current structures. It is imperative that fund managers can demonstrate that a fund was not established in a particular jurisdiction for tax purposed. This is known as the Principal Purposes Test (PPT).

Ireland is chosen as the location for funds, and in particular for ETFs, for many reasons including the ability to avail of EU passporting rights, strong recognition of the country as an asset management centre, and significant infrastructural supports. The benefits of the tax treaty network are considered but typically this is a by-product of establishing in Ireland and not a principal purpose.

Treaty benefits could be denied to an fund where they have not met the PPT, so fund managers must ensure that set up documentation refers to all benefits of locating in Ireland, and not only the tax benefits.

Certain regulatory, tax and accounting challenges must inspire more innovative solutions. Asset managers must continue to find ways to keep their products competitive, and ensuring an index tracking fund is fully invested and minimises tracking error is vital to being competitive.

We are working with industry to determine how to incorporate the changes required to comply with the regulation.

Author
Donal O'Sullivan
Partner | Tax

Customer Tax Transparency

Global tax transparency rules are complicated and constantly evolving. The volume of local legislation, the speed at which it is changing and the risks and consequences of non-compliance all continue to accelerate. There are multiple operational challenges associated with implementing and running a successful Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standard (CRS) compliance program, particularly against a backdrop of imperfect customer data and significant business change. We find that directors and accountable executives are usually concerned that they have a lack of visibility over the quality of their compliance.

As competent authorities start to assess the reported data and the compliance of reporting financial institutions, many organizations are seeking an external review of their Automatic Exchange of Information compliance programs as part of a control framework. These reviews can help to assess the quality of compliance and identify any gaps that may need remediation or opportunities for operational improvement. Indeed in Ireland, there has been an increase in the number of Financial Institutions conducting pre-audit assessments in preparation to remediate any gaps in compliance programs as the Irish tax authorities have signalled commencing their formal FATCA/CRS audits.

There is a fresh focus on tax technology solutions given the scale of data volumes to be processed, complexity of data sourcing/transformation processes within the overall operational tax function and the fact that data requirements for FATCA and CRS are highly prescriptive and vary from country to country. Creative solutions to address this challenge are vital.

Author
Amanda Murphy
Director | Tax

Meet the team


Our Wealth and Asset Management practice in Dublin is led by Lisa Kealy, and is home to more than 230 professionals providing audit and other assurance services.

Leaders: Aidan Tiernan, Gareth Harman, Sheldon D'Souza, Vincent Bergin, Lisa Kealy, Donal O'Sullivan, Fergus McNally

Lisa Kealy specialises in both regulated and alternative investment funds and her client base includes Irish and offshore investment funds, asset management companies, administrators and treasury operations. Lisa advises clients on many aspects of accounting, regulatory, market, industry and operational matters.
Lisa is the EY's Asset Management Exchange Traded Fund (ETF) leader for EMEIA**.**
T| +353 1 2212 848 - **E|** lisa.kealy@ie.ey.com

Donal O'Sullivan is a tax partner in the Business Tax Advisory section of EY's Financial Services Organisation. In addition to providing Irish tax consulting services, he has more than 20 years' experience in international tax structuring and is a recognised expert on taxation issues in the asset management and insurance industry for both the domestic and overseas markets.
T| +353 1 2212 455 - **E|** ldonal.osullivan@ie.ey.com

Fergus McNally is an Assurance Partner in EY's Financial Services Organisation, whose clients include many of Europe's largest hedge fund managers and asset servicers' whom he advises on structuring, regulation, valuation issues, accounting and disclosure. Fergus has also worked with alternative funds in the design and set-up of operating and governance structures.
T| +353 1 2212 599 - **E|** lfergus.mcnally@ie.ey.com

Vincent Bergin is an Assurance Partner in the Audit Services team of EY's Financial Services Organisation. Vincent is closely involved with the firm's advisory services, particularly the structuring of fund and securitisation vehicles, and compliance with regulatory provisions. Vincent has provided services to the funds industry for more than 22 years, specialising in structuring services to hedge funds, securitisation vehicles and non-retail banks and compliance with regulatory provisions.
T| +353 1 2212 599 - **E|** lfergus.mcnally@ie.ey.com

Aidan Tiernan is an audit partner in EY's Financial Services Office. He specialises in asset management, and his clients include Irish regulated funds, offshore funds and fund service providers. Aidan has also advised a number of fund administrators on the establishment of their Irish operators.

As a member of the EY's EMEIA and Global Regulated Funds Steering Groups, Aidan focuses on the impact of regulatory developments including UCITS IV, UCITS V and AIFMD.
T| +353 1 2212 581 - **E|** gareth.harman@ie.ey.com

Gareth Harman is an Audit Partner in EY's Financial Services Organisation. He is the audit partner to a range of clients including Irish regulated funds, offshore hedge funds, funds management and administration companies, and special purpose vehicles. Gareth has extensive experience of investment funds across a variety of investment strategies and international jurisdictions, and he has extensive experience of investment funds reporting under International Financial Reporting Standards (IFRS) and US GAAP.
T| +353 1 2212 581 - **E|** gareth.harman@ie.ey.com

Sheldon D'Souza is an Associate Partner in EY's Financial Services Organisation with more than 18 years' assurance experience. Sheldon's client-base is primarily Irish regulated funds, offshore hedge funds and asset management companies. Sheldon advises many of Europe's largest Hedge Fund Managers on fund structuring, regulation, valuation issues and reporting. He has also assisted clients in developing solutions for various technical areas such as ASC 740, SEC Custody Rule and Alternative Investment Fund Managers Directive (AIFMD).
T| +353 1 2212 581 - **E|** gareth.harman@ie.ey.com

EY | Assurance | Tax | Transactions | Advisory

43934.indd 10/17. Artwork by the BSC (Ireland)

ED None

ey.com