The coalface issues of a ‘goldilocks’ 2018

Unprecedented challenges and issues will come to the fore as 2018 unfolds as the Irish, European and global financial services industries manage in a shifting regulatory, tax, and monetary environment. In a year that starts with even the monetary base being challenged (by cryptocurrencies) regulatory changes such as MiFID II and PRIIPS come into force, to be followed by further changes later in the year. Firms will be assessing their positioning as market changes, investor and client preferences and regulatory emphasis reshape their industries. In six thought leading contributions, we look at issues across asset management and investment funds, international banking, aviation finance, international insurance as well as the EU regulatory pipeline and the global economy at the start of 2018.

Funds industry focus on efficiency and costs will sharpen in 2018

NICHOLAS BLAKE-KNOX, former Senior Legal Counsel of PIMCO’s EMEA funds business who took up the role of head of investment funds at Walkers Ireland on January 1st assesses the economics of the asset management industry and the forces that are reshaping it. He also analyses the regulatory pipeline and potential Brexit complications facing the European and Irish funds industry.

To put it mildly, 2017 was an eventful year for the asset management and investment funds industry. Yet, despite the various geopolitical and regulatory headwinds that the industry has faced throughout the year, the number of Irish authorised investment funds and the respective assets under management have increased compared to 2016, based upon the latest available data.

Although increased AUM levels have been helped in part by record equity valuations, the number of new Irish fund authorisations during the period has been encouraging. Whilst the drivers for growth in the equity markets have been well documented and the Dow and FTSE have recently hit record highs, an increasingly competitive and cost conscious market environment, coupled with a more complex regulatory landscape, are likely to contribute to choppy waters for certain asset managers in 2018.

This challenging environment has been a driver behind increased M&A activity within the industry recently as firms seek enhanced economies of scale through mergers and other partnerships (e.g. Janus/Henderson and Aberdeen/Standard Life) and this trend is likely to continue through 2018.

From an investment funds perspective, the increased focus on costs and achieving economies of scale will likely mean greater rationalisation of product as managers seek to consolidate existing structures in order to avoid the unnecessary costs of operating multiple strategies with very similar investment strategies. It may also see funds which have low AUM being closed altogether amid a greater focus on delivering efficiency and value for money.

The market shift towards low cost, passive products is likely to further intensify these efforts as the pricing point becomes the most important differentiating factor between many funds. Enhanced transparency requirements relating to costs disclosure which take effect at the beginning of 2018 are also likely to further intensify the industry focus on costs. However, in certain circumstances, the methodologies that have been proposed for transaction costs disclosures can result in values which are misleading and not reflective of actual implied transaction costs, predominately due to the lack of availability of intraday pricing for certain types of securities, such as fixed income instruments. It can be argued that misleading data puts investors in a worse position than having no data at all.

In relation to less liquid and alternative asset classes, the growth in alternative investment funds (AIFs) is likely to continue, as investors search for alpha in a low yielding environment. The markets for certain types of assets have become significantly more competitive in recent times. This has been in part due to the entry of new market participants, including more mainstream traditional asset managers seeking to meet higher target returns. However, the growth in alternative investment funds is likely to continue, particularly in the direct lending and private debt space.

With the recent, long-overdue Irish Government initiatives to reform the existing Irish limited partnership legislation, Ireland should be well placed to support an increase in less liquid private equity and private debt type fund formation when these measures have been fully implemented. Parallel funds employing dual structures involving US and Cayman funds are also a trend which is expected to continue and which enables European asset raising in a more scalable and efficient manner. Irish investment funds align very well with these types of structures.

Technology is another factor that will continue to play an increasingly important
role in the investment funds industry during 2018. The number of Fintech firms is rising exponentially and there are significant opportunities for the asset management industry to utilise the benefits of artificial intelligence in conjunction with large scale data analytics or ‘Big Data’ in the management of portfolios. Within the investment funds industry, there are opportunities to harness blockchain ledger technology, particularly in areas such as transfer agency which could facilitate new and innovative approaches to the purchase and sale of fund units and could dramatically change the global distribution model for funds. The millennial market is also one which has not yet been fully captured so new and innovative ways to make investing easier and more engaging are likely to continue through 2018.

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From a regulatory perspective, a number of key European regulations and directives which come into effect in 2018 will impact investment funds either directly or indirectly. These include the Packaged Retail Investment and Insurance-based Products Regulation (PRIIPs) and the overhaul of the existing Markets in Financial Instruments Directive (MiFID II) as well as other key regulations affecting investment funds such as the General Data Protection Regulation (GDPR) and the Benchmark Regulation. A big part of the European regulatory agenda over the last few years has been focussed on enhancing investor protection through providing increased transparency to both regulatory authorities and end investors. The implementation of MiFID II on 3 January 2018 continues to put these initiatives at the forefront.

Although Irish UCITS management companies and AIFMs are not directly subject to the provisions of MiFID II unless specific authorisations have been granted by the Central Bank of Ireland to extend their existing regulatory permissions, many are likely to be impacted indirectly if their funds are distributed in Europe and beyond using underlying distribution networks comprised of MiFID authorised firms. To continue distributing these products, the MiFID authorised distributors will require various information from the manufacturer, including detailed information regarding the costs and charges of the product (including data points which have not previously been required, such as actual and implied transaction costs figures) as well as information regarding the intended target market of the product. If the products are sold on an ‘execution only’ basis, the distributors will also require information relating to the complexity of the product in order to address appropriateness requirements under MiFID II. Irish authorised investment funds and their management companies, particularly those that have no MiFID authorised entity within their group, are therefore likely to experience increased engagement with their distributor network in 2018 as a result of MiFID II.

MiFID II also introduces new rules around the payment of inducements, such as rebates and trail fees. Under the new regime, distributors will no longer be able to retain rebates or trail fees where they hold themselves out as providing ‘independent’ advice. Only those distributors who characterise themselves as ‘non-independent’ will be able to retain such payments and, critically, may only do so when the rebates or trail fees they receive enhance the quality of service to their underlying clients (i.e. the fund investors). Although the industry is still getting to grips with these new rules, it is likely to result in further scrutiny by the distributors on the particular fee arrangements within the share classes that they sell to their clients and, consequently, put further pressure on fund manufacturers to introduce bespoke share class offerings which are tailored to the distributors’ requirements. Within the independent advisory channels, the removal of rebates will also likely lead to greater ETF sales over time, with distributors no longer incentivised to sell traditional open-ended funds amid a stronger investor appetite for passive strategies.

From an Irish regulatory perspective, the Central Bank of Ireland remains very engaged on a number of fronts as we head into 2018. It should be noted that 1st July 2018 is the deadline for full compliance by existing firms with the rules issued by the Central Bank under CP86. These rules include the streamlining of existing managerial functions to the six new prescribed managerial functions, the implementation of the Organisational Effectiveness role, the retrievability of records rule and the effective supervision requirement (i.e. the location rule).

Brexit also remains a key priority for the Central Bank of Ireland given its significance for the investment funds industry and financial services, more broadly. This year is likely to be a period when many firms that have been in the contingency planning phase move to the actual implementation phase. The impact of Brexit upon Irish investment funds and their managers very much depends on their current structure and distribution model. Factors to be considered include whether their UCITS management company or AIFM is passported into Ireland from the UK, whether they currently use a UK MiFID firm to provide portfolio management and/or distribution services to, or on behalf of, their Irish domiciled funds and whether they intend to sell their existing Irish domiciled investment funds into the UK post-Brexit.

The Central Bank has recently written to the boards of various Irish management companies and investment funds outlining its expectation for proper Brexit planning to have been conducted. In some cases, it has indicated that it expects formal plans to be submitted to them for review at different stages during the first quarter of 2018. Although not characterised as being specifically related to Brexit, the Central Bank has also recently conducted a cross-sectoral outsourcing review, requiring firms to submit details of their existing outsourcing arrangements. The outsourcing or delegation of functions, particularly portfolio management, to UK firms remains a critical matter for Irish investment funds in light of Brexit and is one which is being closely watched by the industry. Uncertainty in this area continues to be a concern for asset managers despite the opinions published by the European Securities and Markets Authority (ESMA) in 2017, which had the stated aim of ‘fostering consistency in authorisation, supervision and enforcement related to the relocation of entities, activities and functions from the United Kingdom’.

In summary, therefore, 2018 is likely to be just as eventful as 2017 was, if not more so. Hold on tight!

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