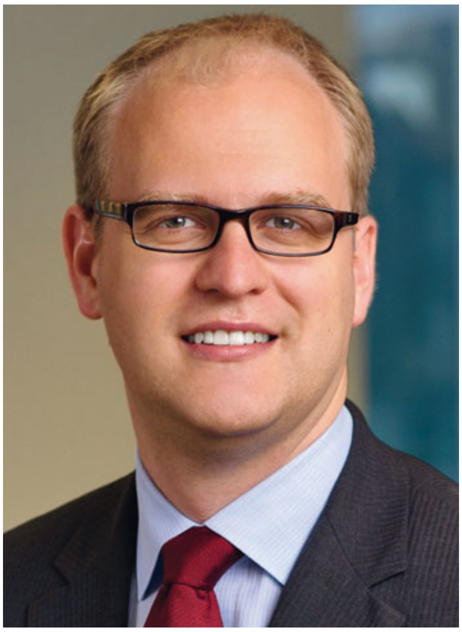
The Upside of More Regulation: A Billion-Euro Opportunity



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Cumbersome and complex, frustrating and fiddly, it's hard to find many businesses that wholeheartedly embrace increased regulation – even when they accept it's being implemented for all the right reasons. But what if regulation could be a springboard for greater profits in the same way that M&A can be?

Asset managers face more than 50 different pieces of new regulation globally, which can make it tough to plan a strategy and adapt to emerging opportunities. Most expect regulatory pressure to increase and a negative impact on their bottom line, yet almost 60% still embrace a wait-and-see approach. These players are reacting only when the level of uncertainty tied to regulatory change has been reduced.

There is another spin to this story of regulatory headaches. In one prominent example, Ucits IV, regulation could actually create € 1 billion for the industry. Individual players that maximize the opportunity could see profits rise by at least 15%. Ucits IV has been in place for a few years, yet our research suggests that asset managers have been slow to act upon its strategic implications. Indeed, regulatory change more broadly can be a platform from which to transform a business. It may even be a way to overcome resistance to change from within the organization.

Letters and numbers

The catchily named Ucits IV offers a stark example of how regulation can bring bottom-line benefits to an asset manager. When it was introduced, Ucits IV significantly reduced the constraints around managing and distributing funds across European Union countries. This enabled asset managers to focus on efficiency and effectiveness measures based on four dimensions of their operating model – yet few seized the opportunity.

1) Asset managers are now able to consolidate their presence more easily, i.e., they can operate in multiple countries through branches that are all linked to a single management company in a domicile of their choice. This lets them avoid the complexity of multiple local legal entities while preserving local distribution. Such a move can cut legal bills by up to 20% and simplify governance. European players can save up to € 200 million just from this streamlining.

2) Winning players are also centralizing investment activities in a very limited set of locations. Here they can build teams specializing in single asset classes or investment strategies. This has allowed them to enhance effectiveness and economies of scale and ultimately deliver better investment performance. There's another € 200 million to be made in profit here from new inflows attracted by the better performance. While the centralization could have been implemented even before Ucits IV, it is now easier to do.

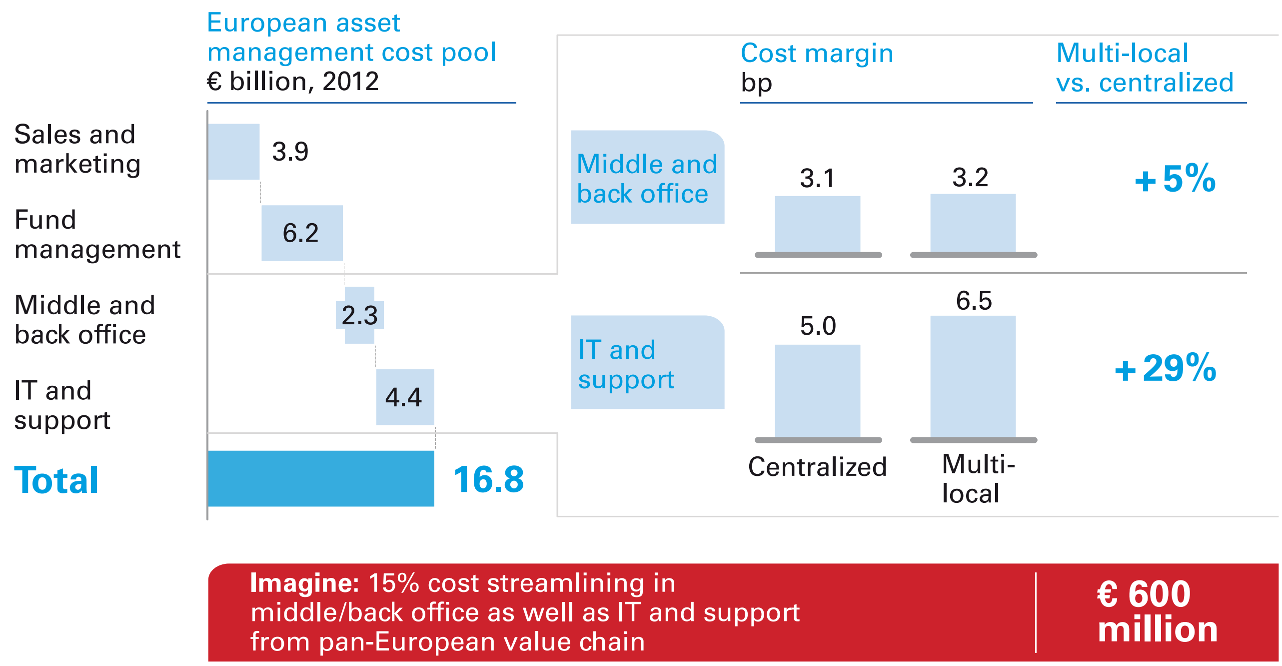
3) Operations and support functions are a major source of rationalization. Over time, they tend to be increasingly detached from the country of distribution. Based on our annual survey of asset management firms, we have assessed that centralized operations and support functions improve efficiency in operations and support by 15% (representing approximately 40% of all costs). European players can unlock € 600 million by consolidating these functions at a pan-European level (see chart).

4) The product range is the last significant area for rationalization under Ucits IV. Asset managers' product ranges have already been through several restructuring waves in earlier versions of Ucits, but there is a long way to go before full rationalization. At least 30% of the funds of large pan-European asset managers overlap significantly with each other across multiple domiciles. Master and feeder structures newly introduced by Ucits IV can now boost the next wave of product rationalization with significant benefits in investment execution and potential of further reduction of the industry cost pool.

Total the numbers up and this regulation – designed with consumers in mind – could also generate more than € 1 billion in additional profit for the industry across Europe as a whole. Some asset managers have already captured such an opportunity. A firm with assets under management of € 100 billion, for example, with a decentralized setup across more than five EU countries, could create € 30 million in additional operating profit.

To capture all the benefits does, inevitably, require tackling a number of obstacles. These can prevent players

Unlocked costs: € 6.7 billion are locked in middle and back office as well as IT and support costs



from even starting to attempt the necessary rationalization. To begin with, there is still no standard authorization process within Ucits IV that enables firms to consolidate local companies into a pan-European company with local branches. There are also internal complexity challenges, and the lack of established practices requires firms to adopt a flexible approach so they can respond quickly to regulators' requests. Finally, there are risk management issues around operating stability, client and talent retention as well as sales development that need to be addressed.

The regulatory agenda

Asset managers with a more visionary approach to regulation have broken down their response to regulation into three buckets:

1) Pursue the 'known knowns': Where the benefits of regulation are clear, leading asset managers are rigorously redesigning their operating model.

2) Master the 'known unknowns': Where it's not clear what the benefits of regulation are – or even if they exist – asset managers need to ensure their strategic planning process allows for regular reviews of regulatory developments. This should help them understand the risks and opportunities in order to make 'no-regret' moves or to position themselves to act should benefits emerge.

3) Deal with the 'unknown unknowns': To avoid being caught out, advanced asset managers monitor regulatory developments at the executive board level and are actively engaged in the debates both at the EU and the domestic level. Despite being very straightforward, most firms typically struggle even with the 'known known'. To capture the 15% performance improvement from Ucits IV, firms have to pay the same level of attention required by complex full-blown mergers.

We live in a regulatory age. The time of full liberalization is over, and initiatives like Aifmd, Mifid II (with, e.g., a ban of inducements), RDR and others are likely to be accompanied by greater judicial scrutiny. Regulatory literacy therefore becomes a skill. On a positive note, however, such literacy should not be acclaimed out of fear or force to comply. The management mantra of 'think opportunity' is as modern as ever: Despite their threatening nature, regulatory disruptions can help asset managers unlock significant value.

In the same way as a change, for example, in sales commissions can pose a threat to established distribution models and routines, the same change can open a window for a market entry or a new push into client segments (think about going 'direct' in a market where traditional distribution ties are unwinding, for instance). As a consequence, regulatory anticipation should replace regulatory reaction and become a standard building block in asset managers' continuous zest to deliver a competitive edge.

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