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Financial Services

POINT OF VIEW

LIGHTS, CAMERA, ACTION!

CONDUCT IN ASSET MANAGEMENT

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EASY RIDER

Asset managers have had a relatively easy ride. At least as far as scandals are concerned, the industry has not been subjected to the vilification directed at banking, whether for mis-selling or for undermining market integrity. “We have a proud fiduciary legacy” is the prevailing motto, appealing to a golden era (perhaps imaginary) when the industry invested carefully for a modest fee.

However, clouds have been closing in on the eternal sunshine of this apparently spotless record. Quite aside from the well-worn debates over conflicts of interest in soft commissions and other inducements (for which MiFID II and other local regulation call for a change in approach), regulators have now begun to issue rather demeaning fines for misconduct. These fines – for misdemeanours such as fraudulent trade allocations (cherry-picking) or misleading retail advertisements, or neglecting to keep investors informed of changes to fund operations - are now becoming more frequent and more punitive. If you also consider the findings from the Fair and Effective Markets Review*[1] calling for the extension of the Senior Managers Regime to cover buy-side firms as well as banks: it is the wake-up call to the industry’s “big sleep”.

Firms are now responding, notably in the United Kingdom where the regulator was the first to lead the conduct agenda in the banking and insurance industries. The UK’s Financial Conduct Authority (FCA) has recently launched a market study, focused on the asset management industry, that questions whether institutional and retail investors get value for money when purchasing asset management services. There are implications not only for tighter compliance, but also for business models and overall strategy. Firms need to keep commercial aspirations a priority, whilst also being mindful of the constraints of the conduct agenda.

To understand these implications more clearly, we asked the Chairmen and CEOs of 15 leading asset managers in the UK to lend their support to their respective firm’s participation in our first conduct survey of the industry. The survey built on our extensive banking and insurance conduct experience, including our recent work with the G30 on banking conduct and culture*[2]. Our sample covered independently-owned firms, as well as firms owned by banks or insurers.

*[1] HM Treasury, Bank of England, FCA, *Fair and Effective Markets Review - final report, June 2015*

*[2] The Group of Thirty, *Banking Conduct and Culture – a call for sustained and comprehensive reform*, 2015

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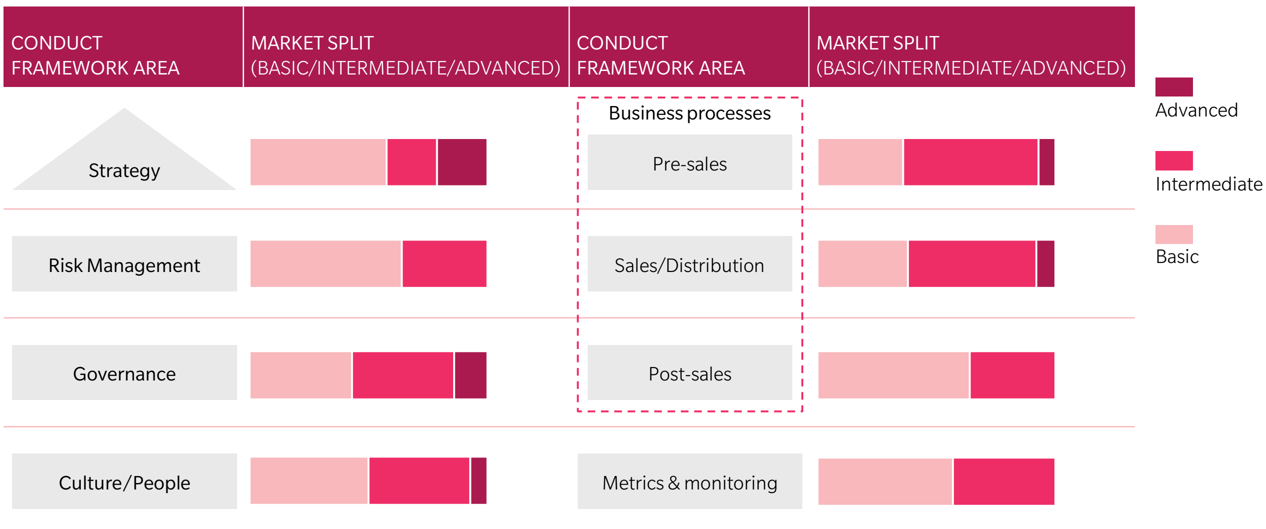
NOT THE INDEPENDENT'S DAY

We found that the asset management industry has only recently started to think systematically about conduct and to establish relevant processes and controls. Exhibit 1 provides an overview of industry-level results with reference to Oliver Wyman's conduct framework. There is a lot to be done across the board, notably in risk management (such as defining conduct tolerance and linking this to business processes), post-sales processes (such as outcome testing in the retail market) and management information, which is proving challenging everywhere.

EXHIBIT 1: INDUSTRY RESULTS OF UK ASSET MANAGEMENT CONDUCT SURVEY[*3]



*3 2015 Oliver Wyman Asset Management Conduct Survey. The benchmarking reflects asset managers' self-assessments and as such is not Oliver Wyman's assessment of each AM's conduct capabilities

The industry is in the early stages of coming to terms with a more formal conduct agenda. None of the players we surveyed had reached anywhere close to an ideal state. But we found the picture to be very different across various firm types. Those asset managers that were part of a broader banking or insurance group were typically in considerably better shape than the independent asset managers. Not a surprising result, perhaps, but the contrast was stark.

However, it is not all roses for the group-led firms. While there are some best practices and lessons to be drawn from banking experience, firms run the risk of group directives being lost in translation when cascaded to the asset management business. As a result, the drive for group consistency means that the issues specific to asset management are not given full attention.

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GROUNDHOG DAY

The asset management industry may have come late to the conduct party, but this also means it can learn from the often challenging experiences endured by banking and insurance in establishing a robust conduct framework. Indeed, it is difficult to build such a framework from scratch. We identified several key challenges in asset management which these other industries have already experienced, notably in front office engagement, culture and management information (MI).

EXHIBIT 2: CONDUCT PRIORITIES WE'VE SEEN BEFORE

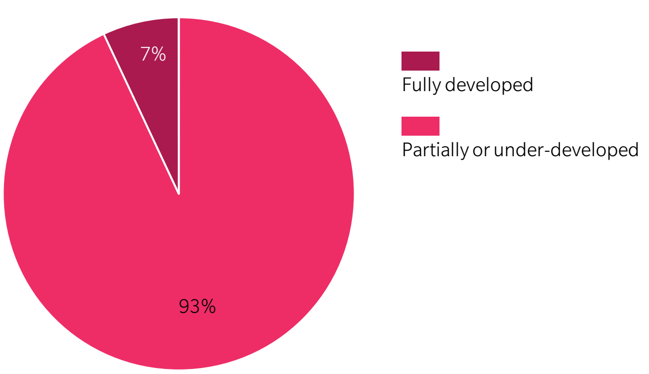
FAMILIAR CHALLENGES		KEY QUESTIONS
Front Office Engagement	• FO sees conduct provisions as "passing the test" exercises	*"How do we ensure that front office takes more ownership of conduct?"*
Culture	• Takes time to embed, and need to balance reliance on culture vs. controls • Difficult to measure	*"How do we demonstrate good culture and strike a balance between culture and controls?"*
Metrics & MI	• Legacy metrics influence MI design • Useful, actionable MI is "lost" among irrelevant metrics	*"How do we put together fit-for-purpose metrics & MI that lead to tangible actions?"*

Opportunity for shortcut by using lessons from banking and insurance

Engaging the business is of course crucial. We observed a number of different practices in this regard, including one firm that had appointed conduct champions at the executive committee level for each dimension of conduct and used this as a way to help ensure there was buy-in across the entire organisation. Indeed, leading banks and insurers have found that senior champions within each business are critical in ensuring engagement.

Meanwhile, most firms find it difficult to demonstrate good culture and/or achieve cultural consistency across a multi-national firm, and MI is generally still in the "planned" or "build" phase.

EXHIBIT 3: MATURITY OF CONDUCT REPORTING CAPABILITIES



Top management priority:
for respondents with partially developed MI, over half admitted that their board, executive and business conduct MI capabilities are only in "planned" phase

A key lesson from the banking and insurance experience has involved management information. Much time in these industries has been spent cobbling together dashboards from existing metrics, or from legacy Treating Customers Fairly (TCF) reporting, without enough attention paid to whether the output would be meaningful. This resulted in subsequent painstaking rounds of iteration, in some cases totally scrapping the initial work. Asset management firms can go from black-and-white to high-definition in one step by (a) taking time to design the right metrics, and (b) fully involving the business in this process.

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However, it is not simply a case of "rewind, repeat". Asset management has a simpler business model than banking, and both firms and regulators recognise that the implementation of the conduct agenda in asset management has to be modified.

NEW RELEASES AND FORTHCOMING ATTRACTIONS

There are a number of challenges with regard to conduct that are particular to asset management. Some of these will be difficult to tackle without a concerted effort on the part of individual firms and the industry as a whole.

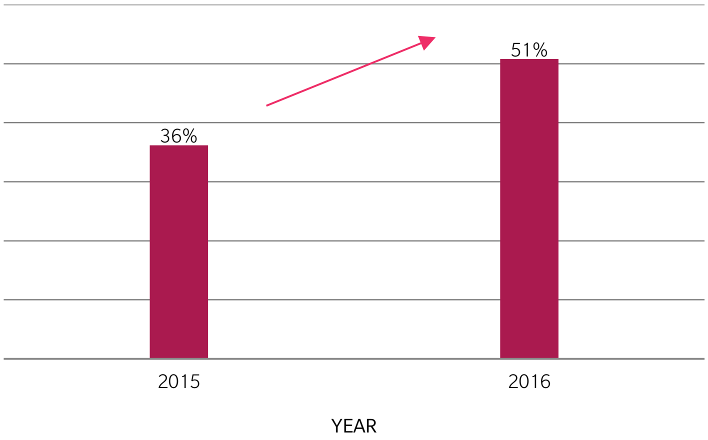
EXHIBIT 4: CONDUCT PRIORITIES SPECIFIC TO ASSET MANAGEMENT

ASSET MANAGEMENT-SPECIFIC CHALLENGES		KEY QUESTIONS	
Manufacturer vs. Distributor	• Regulatory focus emerging on collective conduct responsibility • Data sharing and collaboration challenges	*"What MI do we need and how do we get it?"*	Less clear path ahead but opportunity to shape industry
Value for money	• Early days for AMs • Requires embedding across the product lifecycle • Need to balance with commercial considerations	*"How should we embed value for money concepts and gain client confidence, without driving down profitability?"*	
Institutional conduct	• Institutional conduct framework less mature than for retail	*"What should we do differently to improve identification and management of conduct risks for institutional clients?"*	

Take, for example, the relationship between manufacturers and distributors. Firms in our survey identified a real shift in responsibility for conduct. What was mainly the preserve of distributors is expected to be much more of a shared responsibility in 2016. The shift was largely down to regulatory scrutiny on the topic and manufacturers are anxiously deliberating how they might discharge this additional responsibility.

EXHIBIT 5: STAND BY ME

Share of manufacturers' (vs. distributors') responsibility for conduct[*4]

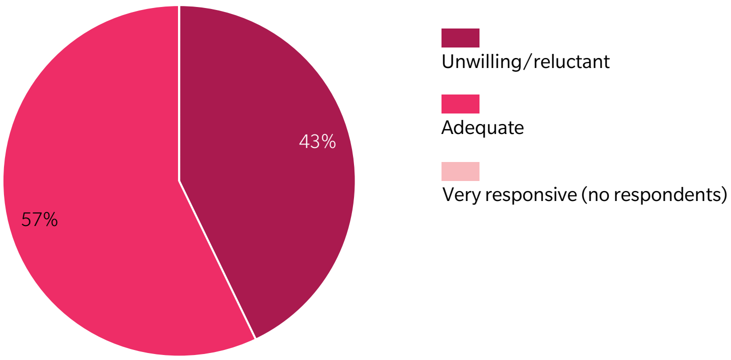


*4 Survey participants were asked to select the proportion of conduct responsibility that was borne by manufacturers (vs. distributors) for 2015, and how they expected this to evolve in 2016 (where 50% would indicate a fully shared responsibility). These percentages represent the average across participants' responses.

For instance, manufacturers are revisiting their customer segmentation criteria to incorporate a conduct lens, defining more explicit and granular criteria on suitability for each product. However, if these firms are to take responsibility for conduct, they need to know in similar detail how and to whom the product has been sold. But this is information that belongs to distributors. Obtaining it usually incurs a fee; it is not standardised across distributors; and in most cases, it is simply unavailable. Many firms in our survey responded that distributors were unwilling or reluctant to provide the information necessary for the manufacturer to discharge its responsibility for conduct.

EXHIBIT 6: GOODWILL HUNTING

Willingness of distributors to provide required conduct information to manufacturers



The solution to this puzzle is not obvious. Part of the problem is that distributors are wary of sharing information with manufacturers that may undermine their competitive position. Another consideration is that there is no common standard for exactly what information needs to be handed over to manufacturers, or how it should or should not be used. Moreover, the very large number of distributors means that bilateral solutions are seldom viable. In our view, an industry-led solution is required. Manufacturers should decide on the template or common standards required, and then work together with distributors and regulators to formalise this requirement.

If manufacturers are still stuck in the first scene in their relationship with distributors, they haven even moved past the trailer when it comes to value-for-money considerations. Many firms we surveyed did not pay heed to these considerations at all. A handful used median market pricing as a proxy, but only one or two players could provide examples of how value-for-money considerations were explicitly incorporated into their product lifecycle management, with downward fee adjustments being applied when required.

Firms should be wary here. In our view, it is only a matter of time before firms selling active and/or passive products will need to justify why seemingly interchangeable products have such different fee structures. Even if the regulatory pressure is less explicit, this could have a significant impact on the business model - another reason why conduct needs to be a board-level concern.

The final blind spot involves institutional business. Most firms are happy to report that they treat all institutional investors equally, with the same excellent standard of care. But this misses a trick: institutional investors are not all the same. And while it may be true that Assets under Management (AuM) is not a perfect proxy for level of sophistication, we were surprised that most players did not have a systematic approach for distinguishing between institutional investors for conduct purposes. If the banking experience has taught us anything, it is that conduct is not only a retail screenplay.

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NO COUNTRY FOR OLD WAYS

The UK's FCA has been the most recent thought leader in conduct regulation. Their approach has been to create attractive conditions for investors, on the basis that investors will elect to park their funds in the cleanest, fairest market.

While the FCA has more substantial resources to support its conduct mission than other regulators, it is a mistake to see this conduct focus as a curiosity limited to the UK market. The FCA's approach and commitment to asset management conduct is being watched with interest by regulators throughout the world, including in the United States, Hong Kong and South Africa.

It remains true that most regulators internationally are oriented to prudential regulation, with conduct remaining a subset of this approach. But the increased focus on the topic from international bodies (notably the Financial Stability Board (FSB)) is starting to change this reality.

Some national European regulators (such as in Switzerland, France and Germany) are taking a "wait and see" approach, only adopting best practices once these have been proven elsewhere. However, it is likely that some of the investor protection requirements in MiFID II will dovetail with the FCA's good conduct expectations, resulting in a consolidated approach to asset management conduct emerging across the European Economic Area.

In short, we expect to see conduct priorities increasing in prominence regardless of jurisdiction. The question then becomes what firms can and should be doing to get ahead of the curve.

BACK TO THE FUTURE

Asset management firms need to act now to safeguard their business by building conduct frameworks which enable weak areas to be identified and gaps to be filled. We believe they should adhere to the following agenda:

1. Urgently establish a conduct definition, strategy and framework (if this hasn't already been done).
2. Complete a diagnostic to identify gaps within these internally defined standards, ideally against a range of relevant peer practices.
3. Perform a risk identification exercise across products and processes to uncover conduct weaknesses and conflicts of interest, and define the risk tolerance for these at board level.
4. Closely analyse the culture of their business, not just looking at "tone from the top", which is necessary, but far from sufficient. Ensure effective implementation, and view the process as a journey lasting several years.
5. Develop critical conduct indicators to help identify emerging risks and be ready to answer the FCA's five questions with confidence.

Some firms have already completed some of these tasks, and have work underway for others. It is time to get the house in order. Lights, camera, action!

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