Asset Management practice point of view

Core Team

Olwyn Alexander
Asset Management Assurance
Partner
PwC Ireland
+353 (0) 1 792 8719
olwyn.m.alexander@ie.pwc.com

Dervla McCormack
Asset Management Consulting
Partner
PwC Ireland
+353 (0) 1 792 8520
dervla.mccormack@ie.pwc.com

John Cronin
Asset Management Advisory Leader
PwC Ireland
+353 (0) 1 792 6047
john.cronin@ie.pwc.com

Olivia Sweetman
Asset Management Advisory
PwC Ireland
+353 (0) 1 792 8152
olivia.sweetman@ie.pwc.com

What does today's fund manager expect from a Fund Administrator's Business Model?

Market meltdowns and the unprecedented scandals of recent years have had a transformative effect on the hedge fund landscape of the past and its effects will reverberate far into the future. Scarred investors are now tentatively considering investment but once bitten, are now painfully "shy" and will only come back on their terms. In the new scheme of things, they hold the balance of power in the managers' value chain and the emerging breed of sophisticated, informed investors are in no way afraid to wield this power. Managers' priorities and modus operandi must change to compete and therefore so must those of the service providers that they increasingly rely on to help navigate new industry challenges as they emerge.

Background

Declining assets has meant the closure of many funds, and for those that remain, there has been a renewed focus on margins, the traditional "2 and 20" fee structures still in question. Meanwhile, the crisis has forced funds to focus on risks and deal with an increased level of scrutiny by regulators and investors. Post-Madoff, investors return to hedge funds is contingent on the presence of a robust regulatory environment characterised by greater transparency and asset safety. Many investors in erstwhile unregulated or self-administered funds are reticent to return to this historic model, forcing

funds onshore and into new operating models. A minimum expectation is for fund portfolios to be reconciled and valued by an independent third party. Even where a third party administrator exists, investors are performing rigorous due diligence on processes and models utilized. The NAV-lite practices of old, where the administrator passively verified figures produced by the manager, will no longer be acceptable.

Competition amongst managers for the favour of these investors is fierce. However, meeting their demands as well as compliance with new regulation is costly. Managers are focusing on their operating models, outsourcing non-core activities and related in-house capabilities to shed weight and costs, allowing them to focus on core competencies of portfolio selection, product development and customer relationships. The traditional role of administrator centred on back-office processing and calculating the fund net asset value, generally on a monthly basis. Emerging investor and manager expectations are challenging this role. Investors expect the fund administrator to exercise enhanced independence and operational integrity in its procedures and to provide them with timely disclosures and analytics. Managers expect administrators to provide a suite of services which allows them to outsource responsibility for essentially everything after the trade.

What are the opportunities and challenges for the fund administrator?

In Europe, emerging regulation is stimulating streamlining of managers' fund ranges and operating models as well as the use of devices such as passporting and master feeder structures to distribute funds across borders. This trend as well as ongoing consolidation in the asset management industry will fuel downstream competition in the service provider space, tipping the balance of power in the favour of the manager. It is essential that service providers are ready to service the new larger, more streamlined asset managers and funds that are emerging and broad geographical coverage may be an advantage in this respect. Administrators must align their service offerings to their clients' needs and operating models and recognize the increasing influence of the investor's expectations in the manager's value chain. Administrators must diversify their offering through investment in front-office services and expansion of current middle and back-office infrastructure. Needless to say, managers keen to pass on cost pressures will prefer service providers offering the best quality for the lowest price.

Investor Reporting

Administrators can help funds to deal with investor demands for greater transparency by providing the investor with portfolio level reporting as to performance, risk and exposure of the fund as well as the independent validation of the existence and value of the assets including FAS 157 classifications. Administrators should also be able to supply data feeds to external vendor risk reporting tools.

Daily NAVs

Investors are now looking for a more frequent view of fund valuation and performance. In response, NAV calculation is moving to a daily or even intra-day environment. Many administrators are leveraging a global platform and "follow-the-sun" pricing model to provide the most time sensitive and efficient service level. Reconciliation of holdings, cash and market values to counterparties is also moving to a daily environment as is profit and loss calculation and reporting.

Valuation

The increasing complexity of products means that the ability to process and account for complex OTC instruments is key, along with the expertise and access to data sources and models to support the valuation of such instruments. Administrators must also maintain interfaces for confirmation and reconciliation of these products.

Many administrators are being asked to price portfolios according to bespoke client pricing hierarchies, using non standard vendors and to release NAVs faster after the price snap. This is driving a focus on vendor management and more efficient, automated price validation procedures.

Investors are keen to understand whether the valuation function is independent, consistent and controlled, and emerging regulation such as the AIFMD may formalize these requirements.

Controls

Independent oversight, governance and risk management are all high on the agenda of today's savvy investor. Administrators will be under pressure to disclose the robustness of their validation processes and to attest to the strength of their internal control environment through controls reporting such as SAS 70 or SSAE 16, as issued by an independent auditor.

Increasing regulation

Managers globally are soon to be subject to a host of new regulatory requirements (e.g. AIFMD, SEC registration under the Dodd-Frank Act), compliance with which will be labour intensive, requiring a sophisticated understanding of the implementation terms. Administrators who understand and are able to respond to the requirements will be able to assist clients in meeting them and managers keen to outsource functions will look to administrators to service the operational aspects of compliance. Managers will also expect their service providers to provide them with intelligence from the countries where they have existing or wish to distribute new funds to keep them up to date with local regulatory changes, rules governing distribution and marketing practices.

Managing relationships

Most hedge funds have now moved to a multi prime brokerage and custodial relationship model in order to diversify counterparty risk. A primary requirement of any fund administrator is the systems infrastructure to consolidate all data sources by providing connectivity to all of these counterparties.

Front-Office Services

Administrators may differentiate themselves by providing access to portfolio and order management systems. Some are supporting exposure and risk analytics to help managers with pre-trade investment decisions and post-trade position management. Many are providing engines that facilitate what-if or scenario analysis, stress testing, and addressing demand for credit and market risk analysis.

Cash Management and Treasury Services

Administrators that are part of larger banking institutions have the advantage of being able to provide cash management and full-service treasury capabilities as these functions are part of their core model.

However, providing these services may not be enough. An administrator must also demonstrate that it has the wherewithal and flexibility to work with the manager in launching any new product or strategy, processing and valuing any new complex instruments and in servicing any client expectation that might arise, often servicing their needs on demand or within very tight time-frames.

So what does the future hold?

Streamlining

Service providers will need to differentiate through flexibility, responsiveness, quality, cost competitiveness and in terms of the suite of services provided. Administrators must upgrade their technology offerings in order to deliver on these requirements. Administrators could be under pressure to provide an enhanced service as part of a competitive package which does not pass on all the costs to the manager. Pressure on margins and increased competition will drive the creation of more efficient fund administration models characterized by standardisation, automation and centralized, functionalized operational processes which minimize redundancy and duplication. Service providers may need to attain critical size and be in a position to leverage a global operating platform and / or undertake significant strategic process re-engineering to implement this model. The challenge (and opportunity) for the pro-active administrator is to design the optimal operating model which meets the bespoke needs of the sophisticated manager whilst competing effectively on costs.

Emerging domiciles

Emerging European regulation allows service providers more flexibility to establish in the domicile that best suits their needs and positioning. Where managers were to date somewhat restricted to using local administrators, the removal of this restriction will give them new options and can, in the future, be expected to influence their selection of a service provider. Factors such as the tax and regulatory environment, the attitude of the authorities, the expertise and cost competitiveness of service providers and the ability to outsource processes will continue to be taken into account, so existing centres of excellence will benefit as a result of known reputation and expertise. However, new favourable jurisdictions may well emerge.

At the same time, many administrators are establishing a presence in low cost jurisdictions to which low valued-adding, labour-intensive processes may be out-sourced as part of a cost containment initiative.

Automation

The fund administration operating model of the future must be characterized by an increased awareness of operational risks and controls, flexibility, quality and speed of delivery. Automation and straight through processing will allow administrators to offer a greater level of assurance over accuracy of processing and risk mitigation, while at the same time allowing them to process higher volumes faster, reduce turn-around times and man hours. Due to the greater proportion of fixed costs in a highly automated model, more clients can be on-boarded and the business can be grown without a proportionate increase in overall costs.

Small versus large?

Small service providers have been most directly affected by the credit crisis, in some cases losing key clients. The costs associated with regulatory compliance will also have a more pronounced affect on smaller players. However, the future can be expected to see a trend towards managers exercising far greater care in selecting an administrator, where previously brand may have been relied upon. This may benefit smaller administrators offering a bespoke service characterised by technical and regulatory expertise, quality and an enhanced level of client service. This presents an opportunity for niche players.

As consolidation and streamlining in the asset managers' world continues, the larger global administrators may have the edge in the selection process given the range of services offered, and where their geographical presence and operating models best mirror those of their clients. Pressure on costs as well as strategic considerations has to date resulted in a number of high profile takeovers and mergers which may continue.

There will be opportunities for both smaller and larger players servicing different client bases. However, differentiation on quality and client service will be the common denominator amongst those that prosper, large or small.

What does all of this mean?

The following are the next steps which administrators must consider in order to review their current service offering and to plan strategically for their desired future state:

- Keep close to existing clients and seek to understand challenges and expectations of potential clients.
- Critique and benchmark your current offering to your clients' "critical-to-quality" requirements.
- Understand the needs of clients' clients and the opportunities presented by their increasing influence.
- Prepare a prioritized investment plan to deliver a service which is strategically aligned to clients' needs.
- Differentiate between value-adding versus non value-adding functions and identify opportunities to functionalize, off-shore and / or delegate secondary functions.
- Realize simple cost savings through identifying and re-engineering redundant and inefficient processes.
- Plan to support long term sustainable growth through an evaluation of the cost base, structures, processes, people, technology and the cost to service markets and customers.
- Critique your internal control and risk management framework, benchmarking to best practice guidelines.
- Consider the proactive control demonstrated to the user of an independent auditors' controls report.
- If applicable, develop an acquisition or joint venture strategy to address areas of weakness or to take advantage of opportunities, or a divesting strategy to ensure that maximum value is realised.

Outlook

Many administrators are playing a game of "wait and see", unsure what the future holds. Bolder administrators are grasping opportunities, streamlining the operating model and leveraging technology and a global platform in order to achieve a superior service level through scale. The future will see the role of the administrator become one of the most critical of fund counterparties as the administrator's infrastructure becomes enmeshed with that of its clients through the level of interaction and inter-dependence. This will simultaneously serve to raise switching costs. A strategic approach is critical and will be the ultimate differentiator between winning or losing the fund administration war on margins.

Contact:

PwC has to date partnered with a number of global and locally based service providers, large and small to optimize strategic performance and efficiency through operating model streamlining and the delivery of sustainable cost reduction programmes which align to the broader corporate strategy. If you would like any further information or an initial discussion around the implications for your business, please contact our core team.

pwc.com/ie