Regulation fatigue: tackling the burden of regulatory compliance for asset management

A study by Alpha FMC
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Foreword

The volume and complexity of regulations impacting the investment management industry in recent years is unprecedented. Furthermore, it is having a significant impact on the bottom line, as wave after wave of regulatory requirements crash against the bows of asset management firms.

Our qualitative and quantitative polling of major asset management houses, representing a combined £6trn AUM, indicates that most managers consider that they are well set up to manage the regulatory agenda. However, it is also unequivocal that regulation and its evolving landscape will continue to be a major challenge for the industry. This is driven by the high level of uncertainty regarding the scale and direction of developments - particularly in relation to the major challenges posed by onerous reporting obligations, the opacity of the regulation coming from policy makers and the seemingly perpetual onslaught of regulation asset managers are being forced cope with.

Managers are fatigued by the cost and scale of regulatory compliance and often frustrated by the overlapping and, on occasion, conflicting requirements of different regulations. There is also a degree of scepticism amongst some managers as to whether the regulations will ever meet their goals. Despite this, and perhaps surprisingly, a sizeable minority identified areas where further regulation would be beneficial to assist in the orderly conduct of the market. Either way, one thing is for certain; the end of regulatory innovation is not yet in sight.

It will be interesting to see how opinions evolve. In the meantime, I hope that you find the contents of this study instructive as a snapshot of sentiment and strategy regarding regulatory challenges facing the asset management industry.

Euan Fraser, CEO, Alpha FMC

Executive Summary

- 78% of respondents expect to spend more in budgetary terms on regulation in 2015 than they did last year, rising to 89% in terms of time devoted to the issue

- Overspend on AIFMD regulatory compliance was an issue, with almost two thirds of respondents (63%) spending more than initially budgeted last year

- MiFID II, EMIR and Solvency II are currently the regulations causing greatest concern for asset managers

- Half of the firms polled have created a function specifically dedicated to ensuring the implementation of regulatory change. This function typically either reports to the COO or directly to the CEO

- 70% of respondents consider their regulatory arrangements to be effective, with the remainder – who consider their provisions moderately effective – citing the challenges involved in moving from analysis to implementation mode and their ability to manage multiple interrelated streams of work in parallel as the key constraining factors

- The majority cite volume of regulation, reporting obligations and uncertainty about the content of new rules as their chief concerns when addressing the regulatory agenda

- Respondents expect to, on average, spend between 21% and 30% of their change budgets on regulatory projects this year

- A majority of firms – 80% - currently do not have a central regulatory reporting team, however the majority of managers surveyed are aiming to create such a central team in the near future. The inter-related nature of regulations is seen as a key challenge.

An Expensive Business: Impressions of the Current Regulatory Climate

Since the financial crisis, regulation has never been far from the top of the agenda for asset managers. Our study of 10 prominent asset managers active in the UK market, with collective Assets Under Management (AUM) of £6trn, indicates that the shoulder is still very much to the wheel. 78% of respondents expect to spend more in budgetary terms on regulation in 2015 than they did last year, rising to 89% in terms of time devoted to the issue.

These are not the views of a tail of latecomers to the issue. Our group of respondents provides a representative spectrum of asset managers ranging in AUM from £750 million to £2 trillion and encompassing some of the largest global names, as well as firms more readily associated with the UK.

As we will see, uncertainty remains a key challenge for managers as they negotiate the new rules and this is no more visible than in the investment they require. Last year, a third of the managers in our sample spent more than they expected to on regulation.

This is not a simple question of poor planning or lack of an appropriate level of expenditure: for Foreign Account Tax Compliance Act (FATCA), 90% of respondents spent what they expected to, falling to 43% for European Market Infrastructure Regulation (EMIR) - for which 30% of respondents spent more than expected. The proportions switch for the Alternative Investment Fund Managers Directive (AIFMD) however, with almost two thirds of respondents - 60% - spending more than initially budgeted.

A Dedicated Regulatory Change Function?

Managers have developed governance procedures to ensure the process runs smoothly. Exactly half of the firms we polled has created a function specifically dedicated to governing and delivering regulatory change. All of those firms that had not established a dedicated function have set clear responsibilities for staff performing other roles within the business, mostly reporting to the CEO or COO. 70% of respondents consider their arrangements to be effective, with the remainder – who consider their provisions moderately effective – citing moving from analysis to implementation mode and their ability to manage multiple interrelated streams of work in parallel as the key challenges.

What are asset managers most worried about? Looking ahead, most of our respondents cite volume of regulation, reporting obligations and uncertainty about the content of new rules as their chief concerns. In terms of specific regulatory concerns, EMIR, Solvency II and in particular MiFID II are deemed to be the most concerning.

Duncan Spencer, Director, Alpha FMC, comments: *"MiFID II is squarely positioned as the regulatory directive of primary concern for managers over the coming years. Interestingly, concerns around EMIR also persist – with Solvency II is also high up the list of concerns, with asset managers under pressure as a consequence of demands for data from insurance clients looking to fulfil their regulatory obligations."*

Implementation: Progress So Far

There is a broad spread of projected regulatory spend but, on average, respondents typically expect to spend between 21% and 30% of their change budgets on regulatory projects this coming year.

A variety of systems have been introduced to address regulatory reporting, from off-the-shelf products developed by third parties through to bespoke solutions developed in-house. Perhaps unsurprisingly, firms that have invested in the latter are more satisfied with how these systems operate, however there is clearly a significant initial and ongoing outlay attached to developing an in-house capability.

One area in which we expect to see change is in the arrangements for regulatory reporting. 80% of firms that took part in our study currently meet their regulatory reporting obligations through multiple functions. Anecdotally however, almost all firms in the group are looking to create a centralised regulatory reporting function. We expect the balance to shift in favour of the centralised approach within the next year as managers drive towards greater efficiency, transparency and accountability in this complex space.

Bo Lantorp, Director, Alpha FMC, observes: *"Regulatory reporting is a real headache for managers, as a consequence of overlapping requirements and a lack of consistent data standards for an ever increasing portfolio of reports. To date, responsibility for regulatory reporting has typically been spread across multiple function areas and on top of other core responsibilities. Knitting the different elements together and having clear lines of accountability and responsibility for reports can therefore also be a challenge. Speaking to our clients, we are hearing a consistent message that centralising regulatory reporting is seen as a key next step."*

Challenges

Firms have changed - or are in the process of changing - the way they are organised to meet regulatory requirements, and anticipate significant ongoing expenditure both in terms of money and time. This is not simply a "hump" for them to get over before continuing as usual; an extensive and relentless regulatory pipeline persists, which is reflected in expectations for increased investment in regulation in the coming years.

Accurate budgeting for regulatory initiatives is a challenge. As the experience of many asset managers in relation to AIFMD and EMIR underlines, regulatory guidelines and timescales are subject to change – often at the very last minute. However, given the mandatory nature of regulatory compliance, our study participants indicated that securing the necessary funding to deliver regulatory change is typically not an issue; the work simply has to be done.

What our study also showed is that asset managers are concerned that some of the new rules may not have the long-term results intended by the regulators. In particular, they have voiced concerns about the EU Financial Transaction Tax (FTT) and EU Transparency Directive, which they predict will achieve only low coverage of objectives over the medium to long-term due to the risk of European countries not implementing the regulation in the same way. They are similarly concerned about PRIIPS.

Much of the impact is being felt in Compliance, IT and Operational functions, but study participants feel that the impact to client-facing functions such as Distribution, Marketing and Product may not yet have been fully assessed.

There is a feeling that asset managers are perhaps underestimating the impact in these areas as a consequence of organisational responsibility for regulation typically siting in support functions.

Duncan Spencer, Director, Alpha FMC, adds: "*Since the global financial crisis, regulation has been consistently one of the highest cost categories from a change perspective. In addition, determining the 'true' cost of regulation to the business – for example, as a consequence of expanding compliance functions, the need for increased headcount in operational areas and explicit or implicit increases in outsourcing fees – is high on the agenda for many managers, but is unfortunately not something that is easily quantifiable."*

Bottom-Up Perspective

The challenges identified by the asset managers in our sample group do not relate exclusively to implementation. Respondents highlighted that some regulations are inconsistent and could act against each other, introducing uncertainty and inefficiencies to the market.

In particular, they are concerned about the co-action of PRIIPS and UCITS which may necessitate the re-working of already implemented changes. UCITS also carries conflicts with other regulations, AIFMD and MiFID II, in terms of remuneration rules.

There is also scepticism from some managers about the likelihood that regulations will achieve the goals intended. This could be seen, perhaps cynically, as a general reluctance to accept the need for regulation in certain areas – or to engage in the organisational change and financial expenditure this makes necessary.

But this interpretation ignores the sizeable investments of time and money firms have already expended, with further investment expected going forward.

Additionally, a third of respondents believed that greater regulatory scrutiny would be beneficial, with the following areas highlighted:

- Ensuring that investor interests are fully taken into account on the failure or resolution of a central clearing counterparty
- Underlying market structural issues not covered by current or planned regulation, particularly in relation to liquidity concerns in fixed income markets
- Delivering greater standardisation and data quality approaches across regulations and value chain participants
- Greater scrutiny of commissions paid for sales, whether internally or externally.

These suggestions which, if acted on, would entail even more implementation work for the industry, indicate a willingness by industry participants to achieve an effective and efficient regulatory environment which delivers fair treatment for investors.

Bo Lantorp opines: *“When we engage with clients on regulation, even those people dedicated to regulatory compliance, we typically find that there is not a clear or consistent understanding of what each regulation is actually driving at. There is also scepticism as to the extent to which the regulatory agenda is being considered ‘in the round’ by policy makers, as a coherent and integrated approach across regulatory initiatives and jurisdictions is not always evident. Confidence in the ability of regulations to be effective in the short term is therefore pretty low; the expectation seems to be that ongoing refinement over time will be required if objectives are to be met.”*

Conclusion

The investment management industry is taking its responsibility to comply with the raft of regulation coming its way very seriously. It is committing significant time and resource to assessing and adopting the new standards, but asset managers are subject to headwinds not of their own making.

These are principally driven by a lack of clarity, as well as the sheer volume of regulation and instances of inconsistency between regulations. This is leading some asset managers to hold back from committing resources to regulations that are not yet fully formed.

The respondents to Alpha FMC's survey on regulation included some of the biggest managers of UK assets, many of them among the most-well known investment management names in the world. Their views on 12 key pieces of upcoming regulation provide a valuable insight into how the industry is adapting to its new supervisory landscape.

As with any wholesale change in a well-established market, there are sticking points. As regulators continue to assess the new rules, our study delivers two requests from the businesses they are regulating: clarify the true objectives of all regulation, and consider regulation in the round - rather than as a collection of initiatives to be regarded in individual siloes.