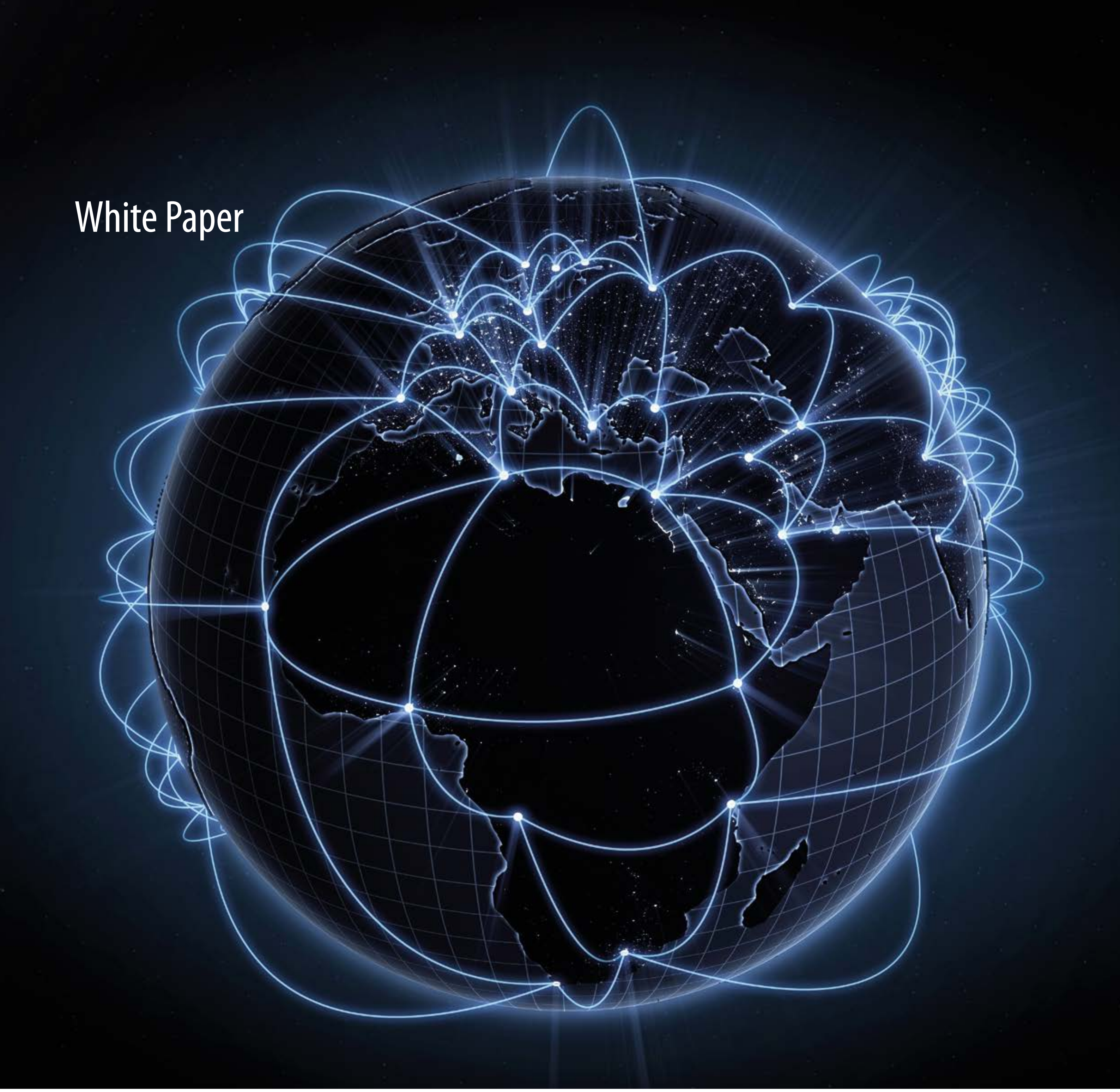
White Paper



The digital fund distribution revolution: opportunity through change

Calastone™

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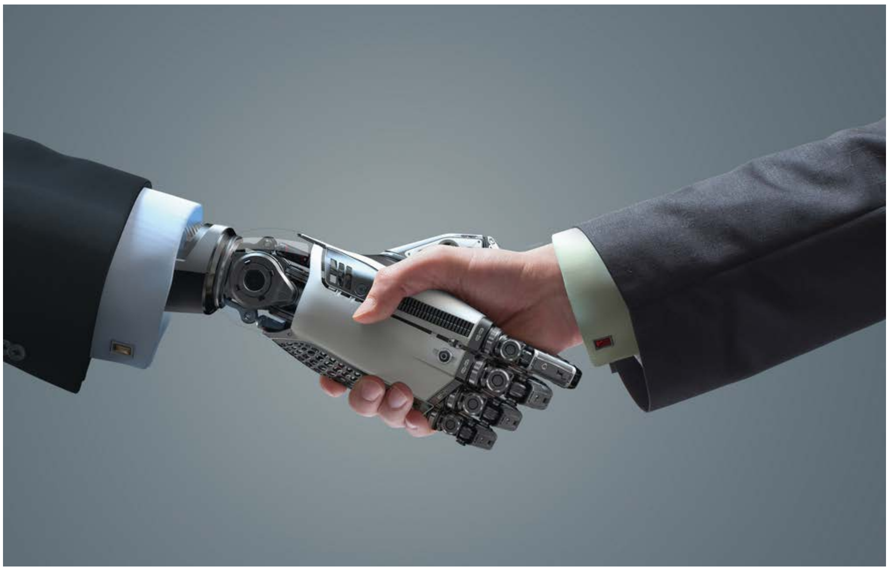
Introduction

Perhaps one of the most discussed topics for the asset management community has been the challenge of managing change, and it is one that many feel the industry has yet to fully resolve. Progress is being made, but many recognise that with the growing risk of disintermediation and market disruption, more needs to be done.

The drivers of change are becoming more diverse, ranging from the recent growth in regulatory overheads, ever evolving market environment, advances in technology through to managing the expectations and needs of the new generation of investor. Globalisation too presents its own opportunities and challenges, as fund firms seek new markets with which to expand the manufacturing of funds, and to develop new markets in which to distribute.

The funds world, from the outside, may look like a complex one – with different partners and participants including a mix of banks, private banks, insurance companies, wealth advisors, platforms, independent financial advisors (IFAs) and even asset managers themselves each playing their role in serving the investor relationship and facilitating the transactional distribution of funds.

In this paper, we examine the funds ecosystem and the drivers of change that are impacting today's fund distribution model across global markets. We also explore the role of technology such as robo-advice, transaction automation and Distributed Ledger Technology (blockchain), and how funds industry participants can leverage these to their greatest effect.



The fragmented distribution ecosystem is evolving

So how does fund distribution vary across markets? The EU – despite having a harmonised fund structure and a reasonably aligned regulatory regime in the form of UCITS and the Alternative Investment Fund Managers Directive (AIFMD) – has a number of different distribution channels across its member states. Investors in many European countries will typically acquire units in funds via a bank although platforms are gradually winning market share.

Focussing on the Scandinavian and Swiss markets for example, funds are primarily distributed through private banking networks whereas the majority of funds sold in the UK, Germany and The Netherlands are done so via either platforms or Independent Financial Advisors (IFAs). Efforts to streamline the cross-border distribution model are being pursued by the European Commission through the Capital Markets Union (CMU) programme, but, for now, Brexit seems to have stalled its progress.

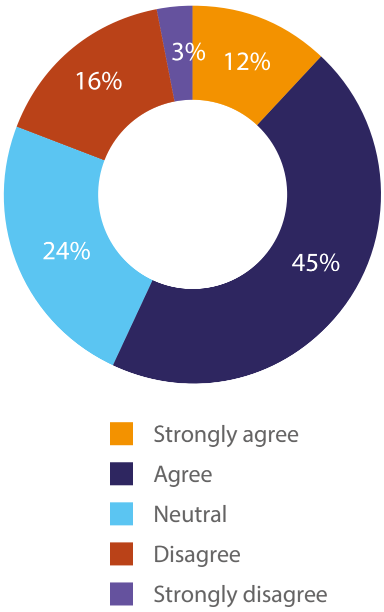
Further afield, the distribution process in Asia-Pacific similarly lacks uniformity. Banks broadly dominate retail fund distribution in Singapore and Hong Kong. Harmonisation of funds' regimes in Asia is making good progress but there are three customised initiatives in motion (the Asia Region Funds Passport (ARFP); the ASEAN Collective Investment Scheme (ASEAN CIS) and Mutual Recognition of Funds (MRF) between Hong Kong and China). Such fragmentation of the distribution ecosystem creates challenges and complexity.

There are, however, radical transformations occurring in fund distribution on a global basis. A growing trend continues in many markets to establish Direct to Consumer (D2C) businesses. Some Transfer Agents (TAs) are creating platforms and D2C propositions of their own. An **industry survey commissioned by Calastone** in 2017 found 57% of respondents believed that online D2C distribution channels such as fund platforms would take over from the traditional channels, whereas just one fifth disagreed.

Many firms are known to be seeking to recalibrate their infrastructure away from high cost legacy technology into a more flexible architecture. While D2C presents its own challenges, many recognise it could disintermediate a lot of the transitional participants sitting between fund managers and investors.0

Growing regulation: complex and costly

Fig. 1: Online, direct-to-consumer distribution channels such as fund platforms will take over from traditional channels (banks, IFAs) as the main way asset managers raise assets under management



Source: Distribution state-of-the-nation: Exploring a changing landscape for funds, Funds Europe, 2017

Regulation and legislation is challenging at a corporate implementation level. A 2016 PwC survey of chief compliance officers indicated the costs of regulation had skyrocketed, with half reporting their compliance budgets were at peak levels. Operating costs are at proportions well above the pre-crisis average, and asset managers are exploring ways in which overheads can be controlled without adversely impacting their business.

However, regulations are being enacted in many cases to achieve greater consumer protection. At a market level, this is arguably a positive if it succeeds in delivering greater consumer trust and financial proficiency.

Regulations such as the UK's Retail Distribution Review, Australia's Future of Financial Advice reforms and the EU Markets in Financial Instruments Directive II (MiFID II) put a strong emphasis on inducement bans, pricing and transparency in the funds industry. MiFID II requires fund manufacturers as well as distributors to ensure they are selling the correct products to the appropriate target market, a responsibility previously assigned solely to the distributor. This could further accentuate D2C models among asset managers.

Regulations globally are pushing for greater disclosure to end clients on pricing, and this applies to intermediaries embedded in the distribution and transaction process. As scrutiny over costs is likely to grow with enhanced transparency obligations, more fund manufacturers will look towards lower cost solutions or develop D2C products themselves. It is also likely to lead to a shift towards robo-advisors, providers of low-cost, accessible, algorithmic investment advice.

Governments globally are also increasingly legislating on matters relating to personal economic wellbeing and financial self-sufficiency. This itself potentially presents a huge opportunity for asset managers as a potential driver for future investment. My Super Rules in Australia obligate employers to contribute 9.5% of an individual's income into the Super scheme. This is creating a powerful investor base, and Deloitte projects that Australia's superannuation scheme will double from the current $2 trillion within 10 years, and eventually reach $9.5 trillion by 2035.[1] The investor pool in Australia is getting larger for asset managers.

The UK is instigating rule changes of its own. Auto-enrolment obliges employers to set up pension schemes and pay into them. Equally, major consolidation is underway in the notoriously fragmented local government pension schemes (LGPS). Other material changes include the migration to defined contribution (DC) schemes from defined benefit (DB) as the pool of retirees grows larger, and as a tool to eliminate pension fund investment risk off company balance sheets.

All of these regulatory changes are going to lead to reforms in the distribution chain in due course, and technology can play a major role in supporting participant firms to meet their own requirements in achieving this.

1 *https://www2.deloitte.com/au/en/pages/media-releases/articles/dynamics-of-9-5-trillion-australian-super-system-171115.html*

Investors look to new channels in a changing environment

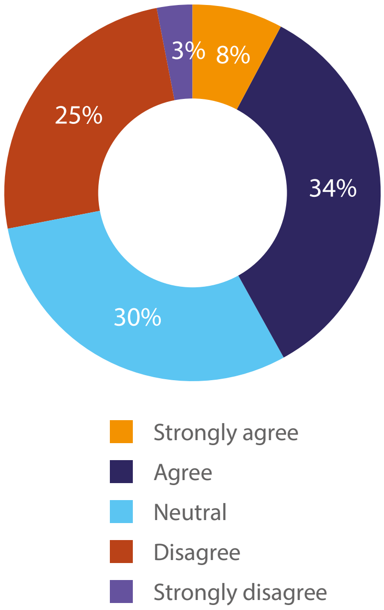
In recent years we have seen a gradual shift towards greater client centricity. In the UK IFAs, for example, are no longer remunerated by managers for selling their products, but paid by clients for providing impartial advice. Cost pressures have also prompted the industry to identify more efficient ways of targeting consumers through specialised D2C initiatives including the more recent emergence of robo-advisors.

Forty-two percent of respondents to the Calastone study said robo-advice would become the main distribution channel for raising assets from the mass retail market, whereas just 28% disagreed. Consumers have become more digitised, it is the norm now when obtaining goods and services, not exclusive to financial products, to do so online. This expectation around transactional experience is most profound for millennials, the next generation of investor. The industry is attuned to this trend and we will undoubtedly see a continued growth in the number of digital wealth channels and further evolution of robo-advisors.

According to a Legg Mason study, the majority of millennials (63%) globally said they were comfortable with robo-advice. This demographic will expect simplicity and efficiency in any transaction enabling them to subscribe and manage their investments that meet their risk and preference criteria via the channel of their choosing, whether that be mobile or online. In order to achieve such a functionally rich experience, and to support the investment returns, it is vital that the process behind such a digital point of sale is similarly efficient and digitised.

The current distribution ecosystem presents challenges in delivering a truly digital service, due in part to its inherent fragmentation. The challenge for traditional distribution channels is that amending or upgrading legacy systems or re-platforming can be a costly initiative. Recent research from consultancy firm, LangCat, suggest that re-platforming costs as much as £260 per client, meaning that project costs for larger participants range into the hundreds of millions of pounds. Even small structural changes to existing systems can carry enormous operational and regulatory risk.

Fig. 2: Robo-advisers will become the main distribution channel for raising assets from the mass retail market



Source: Distribution state-of-the-nation: Exploring a changing landscape for funds, Funds Europe, 2017

The need to deliver alpha

An asset manager exists to deliver alpha to the end investor. The macroeconomic environment does not always work in favour of achieving this, which can place further pressure on asset managers to perform. Interest rates across many markets have been extremely low, which has undermined managers' efforts to generate returns.

Active managers, in particular, have found this low yield, high volatility environment most challenging. Thirty-four per-cent of respondents to the Calastone study said poor fund performance was holding back the success of asset management businesses.

A growing trend towards passive products has emerged. Data collected by Morningstar (on behalf of *FTFM*) found passive funds grew x4.5 faster than active managers in 2016. Assets controlled by passive mutual funds increased 18% to $6.7 trillion in 2016, a significant rise from the 8% growth seen in 2015. Active funds grew at 4%, added the Morningstar data, and while they control a greater share of the assets, this gap between active firms and their passive counterparts is narrowing.

This sentiment was confirmed in the Calastone survey where 57% of respondents felt passive funds would likely overtake active managers as the core investment product for retail clients. The majority believed this would happen within two to five years. Nonetheless, just 30% felt passive products would become the main investment vehicle of choice for sophisticated investors.

A move towards digitisation will enable greater efficiency across the market.

An opportunity to generate efficiency

The funds' industry is at a critical point. When combined the challenges outlined in this paper equate to high costs in the trading and settlement of mutual funds. Calastone has played an important role in facilitating improvements around automation and straight through processing (STP), but the funds' world still arguably lags behind other segments of financial services, such as retail banking's evolution of customer channels.

Case study: Retail Banking

Retail banking, by comparison to other sectors in the financial services world, has made some significant progress in advancing technological innovation through its migration into digital banking.

Retail banks have not just enhanced the customer experience but driven their own digital disruption and in doing so have achieved important financial benefits too. There are lessons to be learnt from this that fund distributors should look to emulate. Through digitisation and channel rationalisation, retail banks have achieved a number of things.

User experience

– Over the last 15 years, in most mature financial markets, retail banks have changed the way customers interact with them by providing a choice of channels. Importantly this change has not reduced client interaction but conversely driven a more frequent – arguably more engaged banking relationship. This move by traditional banking organisations has injected disruption into their own sector

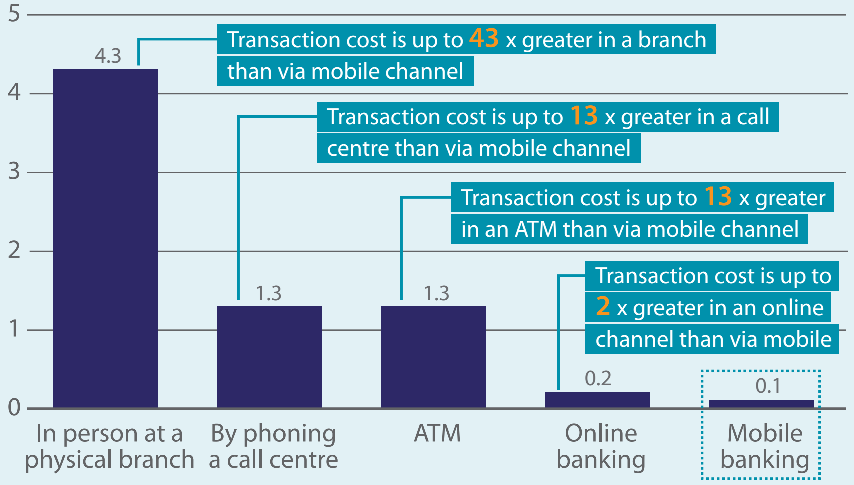
Digitisation – the increase of electronic transactions

– This move to remote channels (telephone, online, mobile) has removed paper based transactions from the financial system, improving efficiency, reducing manual processes and lowering the associated risk costs

Cost benefit

– The original driver for these wholesale channel changes was most certainly cost. The industry succeeded, and has been able to scale back infrastructure and refocus their human resources to more profitable work. Technology was a true enabler, the evolution of which is visible through the move from phone to mobile and changes to back office functionality including document digitisation and huge increases in electronic transaction processing.

Fig 3. Estimated transaction cost by channels



Source: KPMG Mobile Banking 2015 produced in collaboration with and using primary survey data supplied by UBS Evidence Lab.

For the funds industry, the opportunity remains to drive greater efficiency from the distribution ecosystem. The challenge is how to digitise the whole transaction chain, which today is so fragmented, costly and inefficient.

Ultimately, digitisation and automation will permit overheads to be reduced creating sustainability in an industry that is looking like a target for disintermediation. Studies several years ago revealed fund managers feared disruption through internet giants such as Google. Since then, the industry has moved on from seeing internet giants as the competition, but increasingly rather as partners. The Calastone study found 20% of industry participants said technology companies such as Google and Microsoft were likely to be the most useful potential partners going forward, just behind fund platforms. The funds world needs to contemplate a wholesale change to its operating model if it is to stave off competition or coexist with disruptors.

The industry is, however, moving towards greater automation in the transactional process, something which Calastone has long supported and helped implement. While distribution may not be the costliest component of asset managers' operations, its adoption of automation and integration of emerging technologies like Distributed Ledger Technology (Blockchain) could spark a chain reaction in other aspects of the funds' business. Adoption of the latter would require a total transformation of the current distribution operating model.

Technology: an enabler for a new model

By taking advantage of technology enablers such as Cloud Computing, Software as a Service (SaaS), Big Data and Distributed Ledger Technology (DLT), it is possible to envisage a future state model which addresses a number of the challenges facing the industry today.

DLT (blockchain) provides a single source of truth on an infrastructure that can be fully distributed across many participants in a market. When combined with smart contracts, or self-executing agreements based on pre-defined conditions, this creates a digitised and distributed infrastructure where all market participants agree on both the data and the outcome of running smart contracts.

Distributed Ledger Technology clearly demonstrates potential to facilitate new ways of working. Inherent challenges driven by market fragmentation must be remedied otherwise the funds industry as it exists today is at serious risk of being disintermediated. DLT (blockchain) is viewed as a remedy towards disaggregating the fragmentation across fund distribution by creating a common system or infrastructure for all parties to interoperate.

Creating a distributed market infrastructure

Calastone recognises that high frictional costs and fragmentation in the market are challenges which need to be addressed. Given its unique role in the market and experience in facilitating the efficient distribution of mutual funds globally it is in an ideal position to lay out a roadmap towards a future state model which addresses these challenges.

Since 2014 Calastone has been actively exploring how distributed ledger technology could be utilised to support the global funds community in reducing the frictional cost of trading, and in doing so address the structural and operational challenges industry participants face.

Calastone's vision is that these ambitions can be realised through migrating the entire market on a distributed market infrastructure where all participants, including the fund provider, administrator and even regulator can participate.

Through such a model, a fully linked trade lifecycle (order – settlement – payment and post trade services) become smart contracts, applied to the marketplace. Reconciliations can occur in real time as the transaction chain cannot be broken. Data transparency becomes a standardised view on the blockchain with permissions allocated to protect visibility and privacy.

APIs enable participants to interact with the ledger supporting value added services to their core business and importantly enabling each to build differentiation. Such normalisation of the market place makes it possible to change the market structure and enable new services which can be universally adopted by all participants.

In June 2017 Calastone announced the second phase of its distributed market infrastructure innovation programme. Calastone is creating a design group consisting of global market participants, spanning all aspects of the industry, who will participate in additional exploration of their distributed market model.

About Calastone

Calastone is a financial technology company. Our mission is to make markets friction-free by connecting trading partners through our global fund transaction network. With connectivity across 34 countries and territories, more than 1,200 customers are now processing domestic and cross border transactions via Calastone, benefiting from the cost and risk reduction opportunities transaction automation can offer.

Our purpose is to use smart technology solutions and industry collaboration to enable global distribution, reduce operational risk and enhance client profitability. Calastone has offices in London, Luxembourg, Hong Kong and Sydney.

In order to represent the best interests of the industry, Calastone is actively involved with the following organisations; TISA (Tax Incentives Savings Association), TEX (TISA Exchange), WMA, NICSA, ALFI, SMPG, FPG, FSC, AMPS, HKIFA, IMAS, IFA and ACSA.

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