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EUROGROUP CONSULTING

Asset Management transformation:
A new paradigm in the making

By **Emmanuel DE ROBIEN**

Over the last 18 months, the newsflow in Asset Management has been encapsulating structural challenges lying ahead for the industry, let alone prepare for new regulations (e.g. MiFiD II):

- **Active funds challenges:** According to S&P Dow Jones, 99% of actively managed US equity funds sold in Europe have failed to beat the S&P 500 since 2006,
- **Switch from Active to Passive:** Since 2007, AuM in passive funds have grown by 230% globally while AuM in active funds have grown by 54%. In the US, Passive funds now account for 1/3 of mutual fund assets in the US, up from 1/4 in just 3 years,
- **Digital frenzy:** Fidelity and Charles Schwab launched their own robo-advisors (Fidelity Go and Schwab Intelligent Advisory). Blackrock has restructured its actively-managed equities fund in a move to inject more technological solutions (computer models and data science) into its active-management activity,
- **M&A deals:** Henderson buying Janus Capital in Oct 2016, Amundi buying Unicredit's Pioneer in Dec 2016, Standard Life buying Aberdeen AM in March 2017,
- **Pricing revolution:** In Oct 2017, Fidelity International has unveiled plans to drastically change its fee structure, planning to reduce management fees and introduce a performance fee instead.

The apparent fee race-to-the-bottom looks like a doom loop for asset managers unless the industry reinvents itself. The above is creating a new paradigm in the industry and we believe that the AM of the future will tick at least one of the 3 boxes below:

- **Alpha generator specialist -** Fee pressure may be more limited for products creating value for the client. This will require product innovation and technological solutions implemented at the core of the investment process (e.g. automatization, AI, alternative data),
- **Consistent passive products offer -** Growing demand for passive products needs to be addressed. Successful players will need to leverage their scale, offer liquidity and innovate in the underlying securities and asset classes being replicated, among others,
- **Shift of value towards client servicing -** The ability to offer an efficient client service will be an increasingly important differentiating factor going forward (e.g. customization of products, solutions, dedicated reporting, responsiveness, smart market insight, etc.).

One may compare the AM industry to the auto industry with large scale producers on one hand dominating the landscape, able to amortize the huge fixed cost base and in search for constant innovation, and on the other hand niche players addressing the need for specialist products. Players in the middle are being stuck and are facing potential extinction. We believe that the CEO agenda should be dominated by 3 key priorities:

- **Rethink the industrial model -** Operating and business model can't be thought over independently,
- **Embrace digital enablers -** Within the whole AM value chain, digital tools can add the most value / disruption within the investment process,
- **Consider M&A -** As far as distribution upgrade, cost base reduction and products portfolio broadening are concerned, engaging in M&A should be considered.

While the above is easier said than done, the key factors of success of the industry transformation will necessarily comprise the following:

- **Alignment between operating and business model,**
- **Secure discipline in execution,**
- **Find the right enabler.**

Corporate banking and digital disruptions:

Opportunities and challenges for incumbents

By
Pierre REBOUL

In JP Morgan's last annual letter to its shareholders, its CEO Jamie Dimon rightly insisted on the growing importance of fintechs in the banking industry, and underscored the recent actions undertaken by the firm in that respect, particularly within the CIB space. For instance, $600 million were spent by JP Morgan during FY2016 in emerging solutions, and the firm also recently partnered with disruptive players such as OnDeck Capital (SME lending) and WePay (payment technology) to provide its corporate customers with more accessible and convenient solutions.

That being said, JP Morgan is among the multiple CIB players understanding that the corporate banking sector is on the verge of profound disruption – and it is happening whether or not banks are totally ready.

While CIB institutions performed well over the last quarters (cf. Eurogroup CIB report for 9M2017, with revenues for both primary and commercial/transaction banking activities up by respectively +8% and +8.8% YoY[1]), and improved their cost structures and capitalizations (especially in Europe), recent market studies showed that the emergence of fintechs (with record levels of funding, reaching c. $8bn in 6M2017) is threatening RoE of complacent incumbents. Indeed, disruptive players tend to target mainly downstream and high value elements of the corporate banking value chain by entering their low-end/underserved markets (e.g.: SME segment), by reducing barriers to entry (e.g.: through highly adaptable platforms such as Demica being embedded into ING supply chain finance functions) and by proposing substitutes to existing solutions (e.g.: Taulia in Supply chain finance).

Established corporate banking institutions have real advantages though, with lower cost of capital (typically 50 bps or less for banks), built-in customer base and strong business networks. Comparatively, new challengers have limited brand recognition, and getting new customers is typically expensive and competitive.

As a consequence, by embracing this new digital environment, incumbents should be able to remain totally relevant, and unlock incremental value by leveraging different potential drivers on 3 main axes:

- **Revenue:** by using advanced analytics and convenient platforms to increase share of wallet, digitally enabled Relationship Managers to secure new accounts and improve customer experience, and big data to perfect pricing strategies. OnDeck Capital, for instance, uses 2,000-plus data points from more than 100 sources to accurately price its loans to corporations.
- **Cost:** by increasing automation via Robotic process automation (RPA) and chatbots to improve cost structures, by developing open APIs & Blockchain to simplify processes and reduce fixed cost base. In this regard, Barclays and BBVA have been taking leading roles in the race for blockchain adoption in trade finance.
- **Risk:** by promoting predictive risk modeling and machine learning to better segment, track and assess risk profiles and metrics (e.g.: development of the Internet of Things in Trade & Supply chain finance).

However, it can prove very challenging for incumbents to innovate from within for obvious reasons, ranging from cannibalization, complacency and/or pure capabilities. In that context, there are different strategies that allow coexistence of new streams with traditional ones, but require C-level commitment and a sound alignment between digital integration and how much money and time is

available. Large institutions, such as JP Morgan, Barclays or BAML are already active on multiple levels, with partnerships, digital labs, incubators and VC units up and running.

Finally, the fundamental and key component of success for incumbents adapting to this new environment will be the way they lead their transformation. In their recent book *"Dual Transformation" (April 2017, HBR)*, S. Anthony, C. Gilbert and M. Johnson singled out three elements for a successful dual transformation:

- **Reposition today's business** to maximize resilience (e.g.: increase competitive advantage, change value proposition, improve customer segmentation).
- **Create a separate growth engine** by identifying constrained/underserved markets, by developing business models iteratively and by strengthening the activity moving forward (e.g.: M&A, partnerships, hiring new talents).
- **Link capabilities** to leverage interrelationships between traditional and new streams, and therefore gain competitive advantage. This requires obviously C-level intervention to select interrelationships to capitalize on, to manage interfaces strategically (e.g.: by using different rules, formal exchange teams, transfer pricing) and to arbitrate proactively with a bias for new streams.

By implementing those steps, corporate banking incumbents should be able to adapt to an ever-changing digital environment, and strengthen their competitive advantage vis-à-vis new challengers. Nevertheless, they should realize that the changing structure of the industry will deliver extra value to firms choosing to collaborate with the right fintechs.

[1] Numbers are calculated using a pool of 16 banks representative of the overall market.

UK financial services industry: ongoing time-pressed Brexit negotiations and UK political instability do not bode well for the sector

By
Matthew WESTON

2017 has been an intense political year which has prompted many challenges for the EU. The ongoing Brexit process is looking bleak as political turmoil between the EU and the UK government casts gloom over hopes of securing a mutually beneficial trade agreement. The German election that took place at the end of September proved to have a very small impact on the ongoing negotiations, and on the outcome of Brexit agreement. Angela Merkel secured her 4th term as Chancellor after 12 years in power, thanks to a 32.9% victory which ensured the conservative bloc a lead position but the uneasy task of building a coalition.

To what extent does the current European political context impact Brexit's potential outcome?

The current European political context – with Emmanuel Macron's election as French president in May, the United Kingdom's mitigated snap election in June, and Angela Merkel's September victory - seems to suggest a hard Brexit is still to be expected as London and Brussels dwell over the cost to be borne by the UK for leaving the EU. Other European political and economic developments are to be continuously monitored in order to gain further insight into Brexit's potential format. In particular, next year's Italian national election could still alter the situation given its nationalist far-right party's influence.

In the event of a hard Brexit, we expect the UK financial services market ecosystem to decrease by 15 to 20% (from GBP 200bn revenue to GBP 170bn), and the corporate and investment banking (CIB) market in particular, to decrease by 30% due to its international outlook (from GBP 44bn revenue to GBP 30bn). The amount of revenue lost will highly depend on the potential loss of passporting rights for the UK and the relocation of Euro Clearing into continental Europe, an idea that is strongly supported by the ECB. There is still a great deal of uncertainty regarding these two issues, which are crucial to the UK financial services market operation. In addition, the UK financial services job market will resent a hard Brexit with a predicted decrease of FTEs by 15% – bearing in mind that financial services represent around 3% of UK jobs at present. It appears Brexit will reshuffle the current settings of financial services in the City, diminishing a little its influence in the future although not completely annihilating it. Frankfurt, Paris and Dublin are set to be the big winners of Brexit (currently ranked respectively 11rd, 26th and 30rd by GFCI 22 global financial centre ranking).

For these reasons, using our proprietary Brexit Severity Index[1] that was a Level 7 after the French Election in May 2017, we have now re-assessed the level of severity after the German Election to be a Level 8.

What actions are banks currently undertaking to counteract Brexit's negative effects?

Major global banks are already implementing contingency plans, which often entail moving staff to continental Europe while maintaining a physical presence on UK territory. These relocations represent the opportunity for European hubs to upgrade their financial services environment, by providing a finance-friendly ecosystem – lower corporate tax rates, FinTech hubs – and sometimes, specialising into a financial services stream hub – for example asset management in Luxembourg and CIB in Frankfurt.

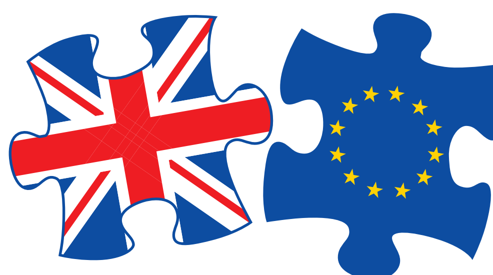
With the March 2019 deadline fast approaching and December 2017's round of negotiations ending in a last minute deal, where does the UK and the EU stand on key Brexit issues?

The first rounds of negotiations that took place during the summer resulted in little progress on Brexit talks. Clarification on four key areas – namely EU citizens' rights in the UK and Britons in continental Europe, the Northern Ireland and Republic of Ireland border, Brexit deal terms and Brexit's cost – were still awaiting when the November 2017 talks closed. December 2017 brings positive breakthroughs though, which slowly pave the way for future trade talks. This last minute deal ensures that there will be no hard border with Ireland, the rights of EU citizens in the UK and UK citizens in the EU will be protected and the cost of the divorce bill is caped between GBP 35bn to 39bn. Mid-December's two-day Summit in Brussels is expected to bring further progress to negotiations, despite a difficult political context within the UK. The British Prime Minister indeed fronts-up EU politicians with a very recent major Parliament defeat on a vote relating to the Withdrawal treaty. Still, the two-day Summit is expected to enable both parties to move forward on trade talks.

Which area of the UK financial services industry will be most impacted?

There are six UK financial services ecosystem actors surrounding Brexit (CIB, Retail Banking, Asset & Wealth Management, Insurance / Reinsurance, Stock Exchange including Clearing and Other Financial Ecosystem Services including FinTech). As stated above, the CIB actor will probably be the most impacted due to its international focus. The CIB market will become fragmented, additional capital (up to GBP 40bn) will need to be invested in new EU units (for licensing and operating reasons), and profitability and ROE will fall with both revenue decreasing and costs rising (around GBP 10-15bn structural costs) due to restructuring and services being duplicated in both new EU entities and London. Within the CIB industry, it is expected the Trade Finance and Mergers & Acquisitions areas will be the most impacted due to the uncertainty surrounding them with Brexit.

[1] Level of severity ranges from 1 = very soft to 10 = very hard. Eurogroup Consulting is currently undertaking an in-depth study on Brexit and the index comprises advanced research and statistics across a number of drivers that will impact Brexit.



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About

Tricumen provides in-depth analysis of the financial markets. It offers actionable intelligence on performance, organizational structures, business models and working practices within the sector.

Its staff draws from a global network of research partners, that mostly come from the industry and hold first-hand knowledge of financial products and markets.

Tricumen has research centres in Croatia and in the United Kingdom, and an office in London.

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