Spotlight On...

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Wealth Management – Fund Custody

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Neil Wise, Vice President, Investment Fund Services at Clearstream., talks to *Finance Monthly* about how the Retail Distribution Review (RDR) has improved fees transparency, but further development is needed to automate and streamline back-office fund processing

How has the Retail Distribution Review (RDR), which came into effect in January 2013, affected fee structures for private banks, wealth managers and third-party fund processors?

Third-party fund processing can be a considerable drain on any company's profitability. However, in the pre-RDR world, this was largely hidden from the wealth management community as their platform providers covered the cost of processing by taking a cut of their full trailer fee entitlement.

The historical benefits of using a platform are clear and very appealing: free order routing, settlement, custody and asset servicing along with access to a broad range of funds. Traditionally, the charging arrangements tended to be quite simple: a fund provider paid a sales commission to the platform which took a share and passed the rest back to their wealth management clients.

For years, private banks and wealth managers were broadly happy to run with this bundled fee structure, often having little idea (or interest) in how much they were actually paying for their fund processing and custody. However, when you consider that this sales commission often amounted to 0.75%, or 75 basis points, and only 50 basis points were returned to the wealth manager, you're seeing (or not) quite a chunk of your 'entitlement' leaving the chain. Twenty five basis points for custody? Fees weren't even this high for bonds and equities in the 1970s.

Surely these automated platforms save time, and therefore money?

Although these platforms appear highly automated and efficient, a look below the surface reveals highly manual processing hubs. It is this lack of investment into the post-trade arena which is now coming to the fore.

Can and should wealth managers change their existing post-trade arrangements to find one that is more streamlined and cost-effective?

Put simply, a much better alternative may be available that will allow them to manage risk across their fund processing activities more effectively. The standards of fund processing and custody within their current service package may fall well short of the best available in the market and, when set against this benchmark, this may offer poor value for money. By sticking with these post-trade arrangements, wealth managers need to question whether they are delivering best value to their investor customers – and whether they are truly offering the highest standards of asset protection and operational processing expected from financial regulators.

For example, though fund platform providers may claim to offer high levels of process automation, this may extend little beyond the order routing component.

Downstream of the order routing, processing activities may rely on a huge manual paper flow. The post-trade component, including fund settlement and reporting, corporate action processing, the handling of tax vouchers as well as cash and securities reconciliation, may all be highly manual with large teams of staff in processing centres chasing fax, telephone and email communication across the investment value chain between retail investors and fund management companies.

So what is order routing, what is its worth and what alternatives are there?

Order routing is a commoditised, plain-vanilla activity in the modern fund processing world and electronic order communication should be viewed as a basic requirement. But, when paying significant amounts for their fund processing (through the bundled fee retained by the fund platform), wealth managers should be pushing for high levels of automation across the fund processing cycle, including the post-trade component.

Efficient alternatives are available in the market that will offer high STP rates across these processing segments. For example, Clearstream's Vestima solution delivers full automation across order placement, DvP settlement and asset servicing, supporting this activity from the same platform that we use to support customers' fixed income, equities, warrants and a range of other instrument types.

What are the risk management benefits of automated processing?

When handling large order sizes and large investment portfolios, the risks presented by a failed settlement or a misprocessed corporate action may be extremely large – resulting in late delivery of funds, sizeable claims or even a potential exclusion from the market should you face issues in the CSD.

Faced with these risks, it is unthinkable for wealth managers to settle for sub-optimal levels of processing efficiency from their service provider.

The same applies to fund custody. Few self-respecting private banks would dream of supporting clients' fixed income and equity portfolios without issuing a Request for Proposal (RFP) and conducting rigorous due diligence tests to select the best possible provider. And yet, some private banks and wealth managers are happy to offer fund custody themselves – or to avail of fund custody from their platform provider principally because this service is bundled with their wider service package.

How has the RDR sought to reshape the relationships between financial service providers, intermediaries and consumers in the UK market?

In the past, financial advisers, even those claiming to be independent, were paid largely through commissions when they sold a fund provider's product. In theory, fee-based advice was available, but few members of the public were ready to pay for financial advice.

Over time, financial regulators became increasingly uncomfortable with these arrangements, believing this created product bias (financial advisers steered sales towards fund products paying a higher level of commission) and thus poor levels of customer information.

To curb this practice, the RDR now attempts to move the UK fund market towards fee-based advice and to eliminate commission-based remuneration of fund advisers. This initiative will likely bring greater transparency to the cost breakdown across the investment process.

Fund platform providers will now see a sizeable chunk of revenue disappear that they previously received as a share of the trailer fee paid to the distributor. As a result, platforms will come under pressure to rationalise their processing models and to operate more efficiently. Indeed, they will also have to charge for services which were previously perceived as free. In all likelihood, it will no longer be practical to maintain a sizeable processing centre with hundreds of staff performing highly manual activities.

What are the pressures from the Financial Conduct Authority (FCA) to streamline this process?

With the FCA monitoring fund processing and asset protection ever more closely, wealth managers are coming under greater pressure to appoint best-in-class fund processing and fund custody to support their clients' fund assets. For example with Clearstream being confirmed as a 'Commercial Settlement System (CSS)' by the FCA, inline with policy statement 14/9, there is really no excuse for any self respecting wealth manager to use any provider who doesn't match this best in breed status. These firms are recognising the need to 'future proof' their business. They no longer wish to be exposed to ancient operational models driven by a paper-based workflow that are a millstone to their development, exposing them to significant risk across the post-trade environment.

With these dynamics, we are seeing wealth managers and private banks applying greater rigour to the selection and monitoring of their service providers. Some are now recognising the high levels of risk and inefficiency embedded in their existing providers' custody networks and operational procedures – and they are taking steps to put better arrangements in place. At Clearstream, we recognise that the world will not change overnight. But it is important to alert the industry to the fact that a better solution is out there.

ABOUT CLEARSTREAM

Clearstream is a global leader in post-trade securities services with more than £9.6 trillion (€12.8 trillion) in assets under custody, of which over £1 trillion (€1.34 trillion) are fund assets. Over 2,500 banks, wealth managers and financial institutions around the world use Clearstream. As a specialised fund-custodian, Clearstream delivers state-of-the-art solutions to standardise investment fund processing and to increase efficiency and safety in the investment fund sector. With more than 200,000 investment funds of which 70,000 are hedge funds, Vestima is the world's largest cross-border fund processing platform. Through its Vestima platform, Clearstream offers an integrated fund solution that can handle fund transactions and post-trade processing with a high level of automation.