

Asset Management News

Insights & views from PricewaterhouseCoopers' global Asset Management practice*

December 2009

Featured inside:

Charlie McCreevy speaks at the PricewaterhouseCoopers European Asset Management Senior Executive conference

The new risk paradigm

AIFM – A Directive in flux



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Introduction

In his keynote address to our November European Asset Management Senior Executive conference, Charlie McCreevy, the European Union's Commissioner for the Internal Market and Services, adeptly articulated the full range of Europe's regulatory objectives (see next article) – many of them related to financial stability.

Whether in Europe, the US or Asia, the financial crisis has revealed quite how inadequate accepted risk management practice was. In particular, by focusing on portfolio risks our sector was only mitigating a proportion of the risks faced.

Counterparty, liquidity and even fraud risks have emerged as posing as much danger as portfolio risk. Indeed, the former three areas are capable of destroying a firm's reputation even more quickly than poor investment performance. We live, therefore, at a time of heightened risk awareness, when asset managers are seeking to tackle a far wider set of risks across all operations.

Regulators, too, are striving to mitigate previously underestimated dangers. This is resulting not only in greater regulation, but also in more enforcement action across all of the major financial centres.

This issue of Asset Management News highlights some of the emerging 'best practice' risk management standards. In our general stories section, we also provide views about topical trends and events across the globe.

Improving risk management is a vital business imperative. Achieving this will put our industry on a firmer footing for recovery.



Kees Hage

Managing Editor
PricewaterhouseCoopers (Luxembourg)
+352 49 48 48 2059
kees.hage@lu.pwc.com



Charlie McCreevy on the European fund industry's regulatory challenges

On 17 November 2009, the outgoing European Commissioner for the Internal Market and Services told delegates at the PricewaterhouseCoopers¹ European Asset Management Senior Executive Forum in London that Europe's asset managers had a strong role to play in economic recovery.

Thank you first of all to PricewaterhouseCoopers for the invitation to address today's Investment Management Seminar. This will be one of my final speaking engagements as Commissioner and, as such, this is an opportune moment to reflect on what we have achieved and what remains to be done.

These are testing times for the investment management industry. According to IFSL Research, the assets of the global fund industry fell by around 17% in 2008, after many years of strong growth. Assets managed in the UK fell by 12% over the same period, reflecting the combined effect of depressed asset prices and investor redemptions. While there have been signs of recovery in recent months, it will take time for investor confidence to return to pre-crisis levels.

All financial market participants will need to adapt to this new economic environment. They will also need to adjust to a strengthened regulatory and supervisory framework. There can be no repeat of the excesses that triggered the financial crisis and the ensuing recession. With this in mind, the European Commission and regulators globally are engaged in a comprehensive programme of regulatory reform. We have been working to fill gaps where European or national regulation is insufficient or incomplete, based on a 'safety first' approach.

For example, we have adopted new rules on credit rating agencies and deposit guarantee schemes; we have proposed significant changes to the prudential regulation of banks through revisions to the Capital Requirements Directive; we have adopted recommendations on remuneration; and communications on derivatives and cross-border crisis management in the banking sector.

We are also working to reinforce regulatory reforms by upgrading supervision in the European Union (EU).

Turning back to asset management, you may ask why the regulatory spotlight has also fallen on this industry when it is widely accepted that the financial crisis was not born of the asset management sector. The answer is that, with upwards of \$60 trillion in assets under management in conventional and alternative funds worldwide and around £4 trillion in the UK alone, the importance of this sector to investors, the financial markets and the economy as a whole cannot be underestimated. G20 leaders have all agreed that regulation must be comprehensive: No significant financial market actor can be allowed to slip through the regulatory net.

We cannot afford to ignore the specific lessons of the crisis for this sector. We already knew that the value of investments could go down as well as up. However, some of the risks that have crystallised in recent times were perhaps less well-understood. For instance:

- Ill-fated investments in complex financial products have raised questions about the quality of due diligence, valuation techniques, and the management of liquidity and other risks, even by those managers at the more liquid and conservative end of the market;
- Leverage in this sector was not as high as in the banking sector, but the rapid and simultaneous unwinding of leveraged positions in the hedge fund segment did contribute to market instability;

¹ "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.



- The Lehman default exposed counterparty risks that were often neglected but have proved to be highly significant, not least for retail investors who discovered that their capital guarantees were not as cast iron as they had thought; and
- The Madoff fraud – while hopefully an isolated incident – has underlined the importance, among other things, of clear and robust depositary arrangements.

Together, these risks present a challenge both to the industry and to regulators. I recognise the work that the industry has done to develop best practice standards. However, such standards complement, rather than substitute, robust regulatory safeguards.

Of course, we are not starting from scratch in developing the regulatory framework in this sector. The European Commission has worked closely with the industry and investors over an extended period of time. The development of the UCITS (Undertakings for Collective Investments in Transferable Securities) framework – including the recently agreed UCITS IV framework – has been a major success story.

Let me summarise our ongoing work by focusing on three core objectives, namely: financial stability; investor protection; and the completion of the single market.

First, the maintenance of financial stability

I have said this many times before – the financial crisis was not caused by hedge funds. However, the collective activities of fund managers do impact on the functioning of financial markets. This impact is beneficial in that hedge fund trading contributes to deepen market liquidity and facilitates price discovery. However, the crisis has also illustrated that the build-up of leverage by hedge funds and their subsequent rapid unwinding of leveraged positions made an already dramatically unstable situation much more dramatic and dangerous. And, of course, regulators were not well-equipped to understand and mitigate the pro-cyclical nature of these risks.

This is why a comprehensive system of macro-prudential oversight must include effective surveillance of the fund management sector and, in particular, of hedge funds. All G20 leaders are unanimous on this.

The future AIFM (Alternative Investment Fund Managers) Directive will make a significant contribution in this regard. As well as setting high standards for risk and liquidity management, it will provide regulators with the information and tools they require to detect and respond to risks of a potentially systemic nature arising from this sector. A harmonised approach to data collection and sharing is the only viable approach to risks that are intrinsically cross-border in nature. The European Systemic Risk Board will perform an important role here. At the international level we remain closely involved with the work of the Financial Stability Board to develop a truly global picture of threats to financial stability.

Second, the protection of investors

The asymmetries of information and expertise that exist in retail investment markets are well-known. Investors are often ill-equipped to understand the products on offer. Those selling products to them can be beset by conflicts of interest. These are not new concerns. However, the experience of the financial crisis has underlined once again how important they are. Products have not performed as investors have expected, guarantees have failed and investors have

“Investor protection has always been the cornerstone of the UCITS regime. But there is room for improvement. Research clearly demonstrates that pre-contractual documents are often too long, too complicated and of limited value to a retail investor. We have sought to tackle this problem as part of the UCITS IV package. Through an extensive process of investor testing and expert input from the Committee of European Securities Regulators (CESR), we have developed the ‘Key Information Document’ (KID), which we consider to be a significant step forward”.

found themselves exposed to risks of which they were not fully aware.

Investor protection has always been the cornerstone of the UCITS regime. But there is room for improvement. Research clearly demonstrates that pre-contractual documents are often too long, too complicated and of limited value to a retail investor. We have sought to tackle this problem as part of the UCITS IV package. Through an extensive process of investor testing and expert input from the Committee of European Securities Regulators (CESR), we have developed the ‘Key Information Document’ (KID), which we consider to be a significant step forward.

However, UCITS are only one of several types of comparable product available to retail investors. A variety of non-harmonised funds, structured products and insurance-based products perform very similar functions and compete in the same market. Yet, at present, the protections in Community law are fragmented along sectoral lines. This regulatory patchwork results in gaps and inconsistencies in the protections provided and makes it more difficult for investors to compare products effectively.

In response to this, we have undertaken to deliver a more coherent, horizontal approach to the regulation, taking UCITS and MiFID (Markets in Financial Instruments Directive) as benchmarks. We will consult in due course on detailed legislative options and plan to put forward proposals in 2010.

Investor protection concerns are perhaps less acute at the professional end of the market, where investors are typically thought to be capable of looking after their own interests. Unquestionably, effective due diligence must remain the cornerstone of the professional investment industry. However, the crisis has raised important questions about the quality of this due diligence and the robustness of risk controls in the professional sector. These risks are of wider public concern when the investor manages funds on behalf of individual savers and pension-holders.

The proposed AIFM Directive seeks to establish targeted investor protections for the alternative investment industry. This is not UCITS-style product regulation, which would be neither feasible nor appropriate for the professional and highly diverse alternative investment sector. Instead, standards and supervision will focus on transparency and on functions that are

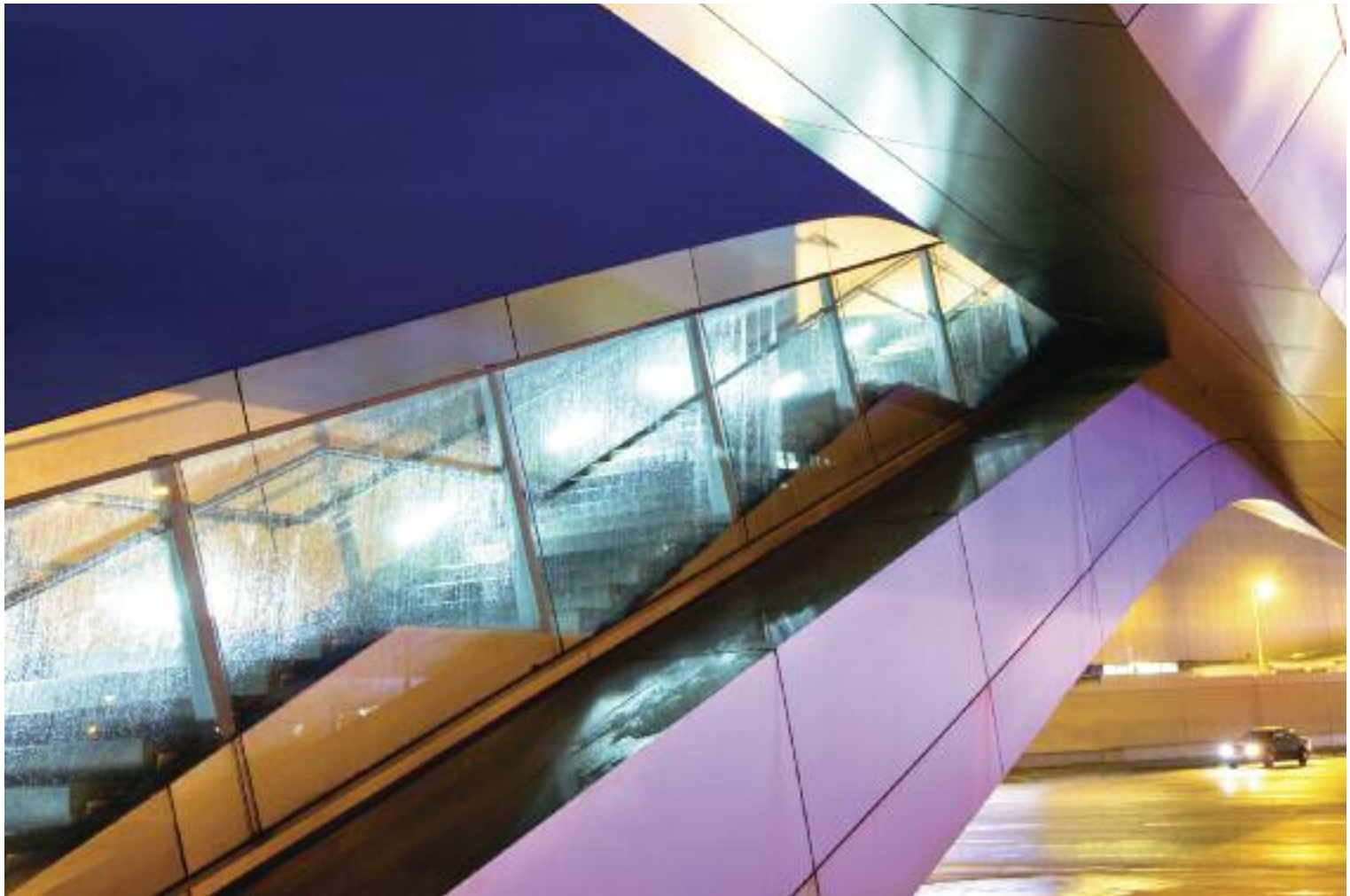
core to the investor experience including risk management, liquidity management, valuation and asset safekeeping.

The Madoff affair has exposed great uncertainty about the responsibilities of depositories. We, therefore, need to clarify and possibly strengthen standards in this area. We have recently concluded a consultation on the UCITS depository function and will make the results available shortly. Any conclusions on this work will be for my successor to take.

Last – but by no means least – market efficiency and the deepening of the single market

Risk mitigation is understandably at the heart of the regulatory reform process. However, good regulation is also a source of opportunity, for both the industry and investors. The development of common standards at European level will help to break down barriers between national markets, thereby stimulating competition, driving efficiency improvements and expanding investor choice.

In the retail market, UCITS has facilitated the development of the cross-border investment management industry, while delivering very high standards of investor protection. The recently agreed UCITS IV



package will make a significant contribution to removing the remaining inefficiencies. I would urge the industry to make full use of the new opportunities on offer.

In addition, we have long heard of inefficiencies in the cross-border placement of products for professional investors. The AIFM Directive will help to remove these barriers. Common standards will allow for the creation of a passport for the marketing and management of all types of alternative investment funds to professional investors throughout Europe. We expect the efficiency benefits to be significant.

Our proposals will also open the single market to managers and funds established outside the EU, provided that they are subject to similar standards of transparency and supervision. This will further foster competition and choice for European investors.

I am, of course, aware that the proposed AIFM Directive has been controversial in this and other respects. However, I consider that the objectives that I have described today are worth striving for and are firmly in line with the mandate established by the G20.

I also recognise that there is room for clarification and improvement. For example, the 'all-encompassing' scope of the proposal does not mean that 'one-size-fits-all'. We will look closely at how requirements can be differentiated to reflect the objective differences between business models.

More generally, we are committed to working closely with the Council of Ministers and the European Parliament to ensure that the resulting regime is robust but workable and proportionate.

This agenda is ambitious and the adaptation required of the industry will not always be easy.

Let me conclude – if I may – on a personal note. As an outgoing Commissioner and a long-time politician who has fought many battles in the last 30 or so years, I hope you will allow me a piece of advice to the asset management industry. Do not try to swim against the tide. It is far too late to question the whole AIFM Directive. It will be enacted. Don't forget that the G20 decided there was a need to regulate and supervise hedge funds. The US has proposals in this sense too. So rather than relishing in doomsday scenarios and damning the interference of Brussels, I would urge the industry to engage with constructive input

as to how we can make the Directive work. I have said on many occasions that the Commission is open during the co-decision process to take on suggested improvements to the Directive that the Council and the European Parliament support. Both institutions are now working on the details.

Hedge funds (and private equity) have a key role to play in the economic recovery. In a context of close to zero growth and massive public debt, and at a time when our industrial output has gone back to the levels of 1998, your industry is desperately needed. Fund managers create opportunities for investors, large and small, to put their savings to productive use. They also help to channel capital from where it is in surplus to where it is in short supply, particularly in the corporate sector. Both of these roles are of paramount importance as we emerge from this crisis. While we may be at a crossroads, we cannot afford standing still. Getting back on the path of growth and prosperity will require huge efforts from all parts of society. I am asking your industry to report to duty.

New risk paradigm

The financial crisis has highlighted the fact that asset management firms have to manage a far wider set of risks than simply investment portfolio risks. A sound framework for identifying risks across the enterprise can help firms better navigate uncertainty and manage risk.



Kevin Barry

PricewaterhouseCoopers (US)
+1 646 471 4711
kevin.b.barry@us.pwc.com

The past two years have clearly underscored the swiftness with which financial markets, risk factors and the correlation among risk factors can change. Following such a perfect storm, attitudes towards risk management are changing. In this new risk paradigm, asset managers are no longer looking at portfolio risk in isolation, and traditional approaches to risk management may no longer suffice in an increasingly volatile and interconnected investment climate.

Risks such as counterparty risk, liquidity risk and even investment fraud have proven that they pose as much risk – if not greater risk – than investment performance risk. Increasingly, firms are focusing on the potential impacts of ‘tail risks’ or improbable, but potentially franchise-threatening risks. This new risk paradigm poses challenges to asset managers in terms of how to respond and retool in an evolving risk environment. As such, firms have been rethinking traditional approaches to risk management with an eye towards identifying emerging risks through an enterprise-wide approach to risk management.

Managing the full set of risks

Enterprise risk management is a systemic approach to identify risk events, prioritise the potential likelihood and impact of these events, and determine a management response. The scope of risk identification should encompass both investment and non-investment risks that could impact an organisation, and should consider internal and external risk factors such as market conditions, the regulatory and compliance environment, and the

quality of the firm’s controls to address these risks. Among the benefits of this enterprise approach to risk management is that it helps management to define its tolerance for risk and helps to establish acceptable boundaries and practices across the organisation. When implemented effectively, an enterprise approach to risk management can enhance a firm’s ability to take “smarter” or better-informed risks. A robust risk framework can also provide transparency and confidence to third parties, including investors and regulators, around the quality of the firm’s risk management processes and controls.

Among the key questions for an asset manager to consider of its risk framework are:

- Is there adequate independence, accountability and segregation of duties involved in the oversight and management of risks?
- Is senior management and the board properly informed of risks and mitigating controls?
- Does our culture and “tone at the top” support sound risk management practices?
- Is risk appetite/tolerance clearly defined?
- Have we identified relevant and material investment and non-investment risks?
- Is management able to aggregate risk exposures, identify concentrations and manage risk as a portfolio?
- Do we have an effective process to escalate risk issues?
- Do current risk reports facilitate timely and informed management decision making for the board and senior management?
- Are we executing our risk management strategies effectively and are they consistent with industry practices?
- Is our infrastructure appropriate and do we have adequate controls around risk and finance data completeness, integrity and accuracy?

The structure of risk management organisations varies widely across the asset management industry and may depend on several factors including the firm’s size, investment strategy and products, the split of client-managed assets versus firm capital as well as cultural aspects within a firm.

Increasingly, firms are appointing chief risk officers; however, various organisational models including risk councils or committees can be effective, providing that appropriate segregation of duties exists, accountabilities are clearly defined and that personnel involved in risk management have the appropriate skill sets.

Promoting risk intelligence and proactive risk management

Creating a risk-intelligent culture is integral to an effective risk framework. Doing this means making risk management a priority for all employees – including portfolio management and investment teams as the “first line of defence” for risk ownership. In order to set the right tone throughout the firm, there has to be visible senior management support for risk management objectives and priorities – and the perception that risk management is viewed as a business partner within the firm. Some firms are beginning to link risk management contributions to employee performance reviews, building risk considerations into their balanced scorecard evaluations.

Proactive risk organisations should develop a process and forum to focus on continuously monitoring the environment to spot developing trends both internal and external to the firm, understand the interconnectedness of risks, and plan responses accordingly. As emerging risks are identified, firms should seek to develop risk indicators to baseline and monitor risk trends. Change agility – or the ability of the firm to respond to changing market events and risks – is increasingly important for companies to manage in uncertain environments and to keep the firm’s risk program relevant and adaptive.

Living in a world of heightened regulatory risk

Asset managers in the US and elsewhere face more enforcement actions and greater regulation. They must respond by improving governance and controls, and by increasing the effectiveness of their compliance functions.



Tom Biolsi

PricewaterhouseCoopers (US)
+1 646 471 2056
thomas.biolsi@us.pwc.com

Within the past 18 months there has been a sea change in regulation. Across the globe, regulators are carrying out a growing number of new initiatives. And in the US and Europe, alternative asset managers will soon have to comply with new legislation, regulations, inspections and enforcement actions, both civil and criminal.

For the time being at least, there is a less forgiving, pro-enforcement regulatory environment. Regulators are focusing on transgressions such as conflicts of interest, safety of investor assets, market abuse, overvaluation and insider trading.

Asset managers now need to assess their operations, processes and procedures to make sure that they have a governance and control environment that can prevent significant breaches of their fiduciary duty, lack of meaningful disclosure to their investors and potential market abuses. At a time when many are struggling to remain profitable, they will be expected to invest in strong infrastructure and controls.

Certain sectors of the financial services industry have lost significant credibility in the US Congress and other legislative assemblies around the world. There is a perception that politicians have not done enough to prevent market abuse and they are under significant pressure to act. In the US, this has been compounded by changes of leadership in the White House, the Securities and Exchange Commission (SEC), the Federal Reserve, the Treasury Department and the Justice Department.

New regulations for alternatives managers

Alternative investment managers will soon be operating in a far tougher regulatory environment. The US Private Fund Investment Advisers Registration Act is likely to become law by the end of the first quarter of 2010. Meanwhile, in Europe, content of the Alternative Investment Fund Managers (AIFM) Directive is currently the subject of heated debate, but some form of it will certainly pass into law at some point.

When private fund investment advisers – mainly hedge and private equity managers – register with the SEC, they will be required to appoint a chief compliance officer (CCO) with sufficient experience and resources to carry out an effective compliance programme. The CCO has to develop policies and procedures designed reasonably to prevent and detect violations of the law.

The Act requires that the CCO assesses at least annually how well the control programme is working. The CCO must make recommendations to management regarding any control or behavioural weaknesses. In fact, however, we would expect that fund boards and investors would expect the CCO to assess the control environment on an ongoing basis.

The top 10 compliance risks

The SEC will be entitled to carry out routine inspections for which asset managers need to be prepared. In general, they should be sure of their controls in the risk areas that are generally asset managers' top 10 compliance risks, not only in the US, but wherever they are based. These risks are:

1. Safeguarding of investor assets;
2. Valuation;
3. Institutional conflicts;
4. Personal conflicts;

5. Insider trading;
6. Investment guidelines and restrictions;
7. Abusive marketing practices;
8. Regulatory reporting;
9. Market manipulation;
10. Risk disclosures.

We are directing firms to look beyond policies and procedures to the effectiveness of surveillance and training programmes, as well as the consistency of disclosure to clients. Across offering documents, pitch books, requests for proposal and websites, firms need to be sure that information is clear and that all relevant disclosures have been made.

Above all, the new importance of regulatory compliance needs to be recognised. Compliance officers must be capable people, with access to good information and the authority to manage regulatory risk effectively.

Tom Biolsi has over 30 years of industry and regulatory experience. Prior to rejoining PricewaterhouseCoopers in September of 2009, he spent three years at the SEC as the Associate Regional Director for Investment Management Inspections in the New York metropolitan area.

New models for managing operational risk

Following 2008's market crisis, alternative asset managers are focusing on managing the operational risks it revealed. Those that do so effectively will be at a competitive advantage.



Keith Caplan

PricewaterhouseCoopers (US)
+1 646 471 1463
keith.caplan@us.pwc.com



Steve Crosby

PricewaterhouseCoopers (US)
+1 646 471 4875
c.steven.crosby@us.pwc.com

Faced with greater demands for transparency and a need to mitigate the operational risks that the credit crisis revealed, alternative asset managers are beginning to develop new operating models. These encompass the entire infrastructure including people, processes, technology, data and organisational design. The goal is to increase the degree, granularity and immediacy of insight and information around all elements of risk, focusing especially on investment and the underlying processing of client assets.

This is leading to a far greater reliance on external parties for administrative and operational functions, as well as significant investment in in-house operations and controls.

As asset managers rethink organisational and governance models, they will have to take actions including seeking third-party assurances related to the existence of assets, positions and trades. Also, it is anticipated that investment managers will continue to avoid self-custody and move to establish third-party custodial relationships. Ultimately, this may be a response to increased regulatory intervention, but also it guards against the prime broker counterparty risk that became evident during the crisis.

Alternative asset managers will continue to take a variety of steps to mitigate the risk of service providers failing. For example, hedge fund managers are beginning to move to two or more prime brokers. Some are taking steps to sign on an additional administrator to shadow their primary administrator. This fail-safe precaution encompasses a secondary set of reconciliations and net asset value (NAV) productions to ensure consistency and integrity in their financial reporting. And, managers are increasingly hiring third-party custodians to safeguard client assets.

Fund administrators will continue to enrich their service offerings by providing specialised, value-added middle office services such as enhanced transparency reporting, through reconciliations with other service providers and counterparties, and providing independent reporting. In the US, they will also look to partner with banks and other third-party custodians to provide independent custody of assets, moving into line with practice elsewhere in the world. Administrators, or specialist firms, are also valuing those assets that are not priced on exchanges, so providing independent valuations.

Reassuring investors and regulators

Transparency and controls will become more critical. Investors performing due diligence will want to see comprehensive controls within the infrastructure supporting all key aspects of trading, cash movements, NAV production, financial statement preparation and so on, rather than the ad hoc or limited control environments seen pre-crisis. And investor requirements for transparency will lead to far greater recognition of the importance of data management and reporting.

In terms of transparency, we are seeing administrators and other third-party service providers beginning to provide far more information to investors on behalf of asset managers. Such information is enabling investors to gain a better understanding of the different dimensions of risk. Investors of all types are demanding more detail about their investments. Specifically, they want to know where the assets are housed and the bona fides of who holds them including the independent review, audit, SAS 70 and regulatory frameworks involved. Who provides the logistics and infrastructure that services their investments? What is outsourced, to whom, where and what are the service levels? Are their "gating" factors around returning assets to the investors' possession?



Regulatory transparency includes many of the same elements, and has an unfolding political dimension. What kind of constraints, reporting requirements and information-sharing across different agencies are involved? Do treaty and offshore consideration apply? What kind of oversight and intervention do current and, more importantly, will future regulatory schemes provide? Finally, the firm's senior management needs an appreciation of what kind of exposure, liquidity, capital adequacy and foreign account reporting are needed. At the end of the day, senior management is fast becoming subject to strict liability and needs to understand precisely its fiduciary exposures and responsibilities.

Administrators are increasing transparency by providing drill down capabilities into account balances; detailed reporting on investor allocations, the existence of cash, asset and over-the-counter (OTC) derivative positions; performance reporting; individual position level reporting; and a wide range of controls and reconciliation reporting. They are also independently valuing portfolios and providing transparency to investors on the steps taken to calculate net asset values at the portfolio and individual investor levels.

There are, of course, operational risks arising from greater outsourcing to administrators. These surround confidentiality and security, the risks associated with the financial and operational soundness of the administrator, and the geopolitical risk associated with many administrators' functions being based in developing countries. All of these risks have to be managed through appropriate governance oversight and monitoring.

Preparing for the future

Asset managers are increasingly asking: are we structured to manage these new areas of operational risk? As a result, we are seeing significant growth in spending on IT infrastructure and a focus on financial and operational controls.

Those firms that have good systems for sourcing, and tracking and managing information – including self-service query and reporting capabilities, and what-if scenario analysis – will be at a competitive advantage to their peers. They will be able to generate the reports that asset managers, investors and regulators demand. Those that cannot provide this will be at risk.

More generally, those firms that actively develop new models for managing operational risk will be the best prepared for growth as financial markets recover.

We are seeing significant growth in spending on IT infrastructure and a focus on financial and operational controls.

Complex UCITS funds pose risk dilemma

As more complex funds such as hedge funds are launched under the UCITS banner, there is a danger that current UCITS regulations are not sufficient to cover the wider set of risks.



Didier Prime

PricewaterhouseCoopers (Luxembourg)
+352 49 48 2127
didier.prime@lu.pwc.com

Hedge funds and other complex, higher risk strategies are increasingly marketed under the UCITS banner, raising the issue of whether the current regulatory framework has sufficient safeguards, and whether the trend has the potential to weaken the UCITS brand.

Certainly, there are safeguards in the Eligible Assets Directive 2007 and EU recommendations on risk management, governing market, concentration and counterparty risks. Yet the way EU Member States have interpreted this into national law through codes of conduct varies significantly.

But what kind of risks are the UCITS funds facing? And, do current regulatory requirements capture all risks? Furthermore, given the degree of mis-selling that came to light during the financial crisis, what protections are in place to ensure that investors understand the products they are buying?

The poignancy of this is evident from the number of UCITS hedge funds being launched. Reportedly, hedge fund managers have launched an estimated 100 UCITS funds and the number is growing. What is more, this number expands to approximately 300 when funds launched by traditional managers rising up the complexity scale are included.

Scope of current regulation

While UCITS funds are exposed to a multitude of risks, current regulation deals solely with market risk, counterparty risk, concentration risk and the valuation risks arising from OTC derivatives. The other risks (mainly operational risk, settlement risk and legal risk) are not directly addressed in those regulations, but the subject of locally defined prudential supervisory standards at the UCITS funds level.

Regarding market risk, there is a limit system consistent with UCITS funds' investment strategies that covers all risks to which limits can be applied. In the case of funds defined as 'unsophisticated' under the Directive, a commitment approach to limits defines, for example, the exposure gained through derivatives compared with NAV. For those defined as 'sophisticated', limits are set according to value-at-risk measures.

Firms' risk management policies have to describe procedures that, in the event of breaches to the risk limit system, result in prompt corrective action. As a minimum, the external auditor should be informed and provided with the specific risk exposure and the plan for corrective action decided upon by the board.

Liquidity risk

Generally speaking, the liquidity of an asset reflects its capacity to be converted into cash quickly and without any price discount. But as far as UCITS funds are concerned, liquidity is also the ability for a UCITS fund to meet, at a reasonable cost, its obligations (redemptions or debt reimbursement) as they become due.

Unfortunately, the market does not have a well-developed and accepted tool for measuring liquidity.

Nevertheless, at the instrument level, monitoring bid-offer spreads and performing liquidity stress tests helps. At the fund level, creating a dedicated stress test scenario showing the amount of redemptions a UCITS fund could bear without modifying its core strategy is key.

So, there are safeguards against risks within the portfolio. But it is reasonable to question whether operational risks are fully covered, especially given problems with hedge fund counterparties that the credit crisis revealed.

Finally, it will be important to make sure that both investors and their advisers understand the new, more complex products. The markets in financial instruments Directive (MiFID) and UCITS IV's Key Investor Document should go some way towards protecting investors within the EU. With a large proportion of UCITS sales elsewhere in the world, however, there remains a danger of mis-selling.

Unlike other fund vehicles, UCITS funds certainly have stringent risk controls. Yet in the aftermath of the financial crisis, now may be a good time to review eligible assets criteria.

With a large proportion of UCITS sales elsewhere in the world, however, there remains a danger of mis-selling.

UK failings reveal structured product risks

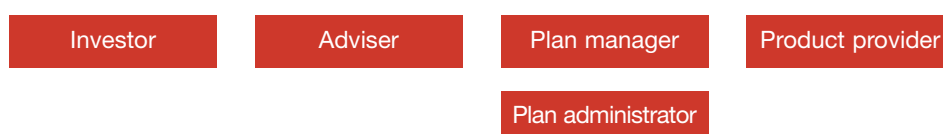
Administrations in the UK are showing the importance of the correct contractual relationships, as well as the need for investors to be fully aware of products' risks.



Nigel Rackham

PricewaterhouseCoopers (UK)
+44 20 7212 6270
nigel.d.rackham@uk.pwc.com

It is important to consider the chain of relationships, which is similar for the different product types:



Structured investment products are in the spotlight in the UK following the recent Financial Services Authority (FSA) review. Losses and investor complaints following the demise of Lehman Brothers, which acted as counterparty to a number of these products, triggered the review. The FSA found a number of failings surrounding advice to consumers and has initiated a redress process. There are also a number of issues that the FSA has identified regarding plan managers' packaging and marketing of such products. Some of the plan managers went into administration earlier this year.

A plan manager that PricewaterhouseCoopers is acting as administrator for was placed into administration last June, largely as a result of failing to ensure that products it packaged, and sold as eligible for the UK Individual Savings Account (ISA) tax wrapper, actually met the basic eligibility requirements. These products were life settlement bonds, not traditional structured products. The company also acted as plan manager for structured products and as back-office administrator for other plan managers.

So what are the lessons coming out of this administration and what are the wider implications? Is there any relevance to the structured product market?

Life settlement products

It is apparent that the plan manager did not have the right contractual protections in place to guard against the product providers not doing what they should have done. This in turn has exposed the plan manager, independent financial advisers (IFAs) and investors to risks concerning:

- Asset security – where are the assets?
- ISA tax status – can you rely on the ISA plan manager? (There is no pre-certification by the UK tax authorities.)

Other significant issues in relation to these products, which were not apparent to IFAs and investors were:

- One asset provider was an offshore unregulated entity (this in turn affects the ability of the UK compensation scheme to help in the event of loss).
- Assets were pooled – fundamentally affecting risk characteristics.
- The ability to exit before maturity depended upon an operative market in the investment product itself, not liquidity at fund level.

There are some common issues with the FSA structured products review here:

- Treating customers fairly² – in particular does the product literature properly describe all the risks associated with the product?
- Do advisers understand the products and the associated risks?
- Is the role and scope of the compensation scheme fully understood and explained?

While in theory the plan manager's structured products were unaffected by the other problems, it became apparent that some of the underlying product providers were not totally on top of their tax compliance, and were not always easily able to confirm ISA eligibility or withholding tax obligations. Product providers are also exposed to reputational risk should the plan manager mismanage, or default on, its investor obligations as investors ultimately rely on the product provider.

Third-party administration

The main issue here is that clients paid an upfront fee, calculated in basis points, for administering plans with (typically) five-year terms. Hence they were exposed to substantial credit risk with the plan administrator. In some cases, the contractual arrangements with the investor meant that this was not necessarily their problem. However, it did expose them to substantial reputational risk, if not legal liability.

Conclusion

The plan manager's business model threw different legal and regulatory responsibilities onto different parties, illustrating the importance of knowing whom you are relying on and for what. Explaining these issues to retail customers is not always easy and can pose additional risks in the current regulatory climate. There are certainly lessons to be learnt in establishing relationships in this market, not least how to mitigate reputational risks should things not go to plan.

² Treating customers fairly is a key FSA regulatory principle, with equivalents under other regulatory frameworks.

AIFMD – A Directive in flux

Asset managers continue to face immense pressures for regulatory change, with the key concern in Europe remaining the draft Alternative Investment Fund Managers Directive (AIFMD).



James Greig

PricewaterhouseCoopers Legal (UK)
+44 20 7213 5766
james.greig@pwclegal.co.uk

The AIFMD is now firmly in the grip of the Brussels legislative process. The original draft produced by the EU Commission, was generally recognised as “not fit for purpose” by virtually all affected constituencies. The task facing legislators is, if possible, to engineer a compromise between the European Parliament and Council of Ministers, acting through their respective committees, which will have European Commission support.

The key ingredients allowing the search for a compromise to proceed are now in place. In early November, the Swedish Presidency issued its proposed draft of the Directive, with a further amended version following on 25 November, reflecting the consensus of views of the member states, where consensus was achievable and the compromise position where no consensus was arrived at. Also on 25 November, the Rapporteur for the EU Parliamentary Committee holding the AIFMD brief issued his proposed draft.

The “Swedish Compromise” draft made considerable concessions to both industry and investor concerns, reducing reporting burdens and significantly reducing the potential impact on current industry business models. It tempered Commission requirements in areas such as the roles and responsibilities of depositories and valuers, it relieved proposed restrictions on the ability of managers to delegate functions offshore, and substantially eliminated some of the “Fortress Europe” barriers being raised against managers and funds established outside the EU selling into the EU.

An unfriendly Parliamentary draft

The Parliamentary Draft is significantly less industry friendly, perhaps reflecting that the majority of changes to it have been mediated by politicians rather than industry or finance experts and that, for many politicians, the distinction between asset managers (alternative or otherwise) and bankers is not recognised.

The Parliamentary Draft re-asserts the Commission’s position in relation to the requirements for independent depositories and valuers (except, as regards valuers, for private equity firms), affirms the ban on delegation of investment management functions to firms outside the EU, removes the de-minimis thresholds which would have kept small funds outside the net of regulation, as well as re-affirming various other controversial Commission proposals in the original draft. The only significant area where the Parliamentary Draft appears to move away from the Commission Proposal is in the area of relationships with third countries, where there is some movement towards the position adopted in the Swedish Compromise.

No clear direction

From the perspective of industry players, what conclusions can be drawn at this stage? The unsatisfactory answer is “virtually none”. With the publication of the Parliamentary Draft and having in hand the Swedish Compromise, the battle lines for the three interested constituencies have been drawn, but how the debate will advance is unclear. The process now will be one of discussion between Council and Parliament, with the Commission on the sidelines. No one player has a veto or the ability to force its view on the others. Furthermore, the Parliamentary Draft is subject to further substantial amendment over the next two months as more changes are proposed. A further complicating factor is that, effectively, the Commission will not be re-established until a new Commissioner, replacing Charlie McCreevy, is appointed and ratified, which is not expected to take place until the end of January, all of which adds up to a worrying lack of clarity on business critical issues until the early spring.

So the whole debate remains wide open and there is still a very large amount of work still to be done in order that the Directive that is finally voted on does not have a disproportionate and restricting effect on the alternatives industry, and there is still no clarity on where this will come to land.

Seeking to clarify the role of UCITS depositaries

The Commission's response to the Committee of European Securities Regulators' (CESR's) recommendations regarding the role and liability of UCITS depositaries is awaited with great interest. The liability proposals are likely to lead to greater capital requirements.



Ken Owens

PricewaterhouseCoopers (Ireland)
+353 1 792 8563
ken.owens@ie.pwc.com



Deirdre McManus

PricewaterhouseCoopers (Ireland)
+353 1 792 7356
deirdre.mcmanus@ie.pwc.com

In the aftermath of the turmoil in the financial markets, the EU Commission has recognised the need for greater clarity and harmonisation in the duties and responsibilities of UCITS depositaries. However, the extent of these duties, liability matters and risk assessment measures – not to mention alignment to the Alternative Investment Fund Managers (AIFM) Directive proposals – have yet to be fully defined and implemented within the UCITS regime.

The CESR, while supportive of the Commission's objectives for greater clarity and for a strengthening of the scope of the depositary function, has made a number of recommendations relating to safekeeping, delegation arrangements and liability.

Safekeeping

The lack of a clear definition of safekeeping within the UCITS Directive, which when linked with the wide divergence in both the definition and duties adopted by each Member State, suggests that a clear and consistently applied definition is a 'must have' requirement. There is some concern as to whether safekeeping duties should be clarified for each class of asset in which UCITS may invest, as this may result in too wide a spectrum of duties being placed on a depositary, depending on the asset class.

Industry bodies such as the European Fund and Asset Management Association have welcomed the introduction of a clear definition and have asked for greater detail on the functions of a depositary, suggesting the inclusion of an annex within the Directive, similar to that included for the functions of a management company.

While there is general consensus with the measures proposed, there is uncertainty about the appropriate measures to adopt for asset types, particularly the appropriateness of the custodial arrangements for over-the-counter (OTC) derivatives and similar asset types. On this matter, CESR recommends the application of a two-pronged approach:

1. Overall control of all assets, where the assets could not be transferred by the management company without prior knowledge or consent of the depositary; and
2. Segregation of the assets from the depositary's own assets, including the imposition of explicit controls on re-hypothecation and clarification that the sub-custodian should also be obliged to put in place proper segregation arrangements.

Delegation arrangements

Depositaries should be afforded the possibility to delegate certain functions including custody, without the liability of the depositary being impacted by this delegation. In its submission, CESR notes that there is significant divergence in the approaches adopted by Member States in the case of loss of assets by the sub-custodian. It believes that the clarification and harmonisation of the duties and functions of UCITS depositaries is a key step towards an agreed and consistent legal framework.

The requirements that apply to entities seeking to act as sub-custodians differ significantly across Member States. To address these differences, CESR suggests a number of reforms whereby a UCITS depositary may entrust UCITS assets under its safekeeping to a third party. This is limited to where the depositary is assured by due diligence in its selection, appointment and periodic review of the sub-custodian. Under such an arrangement, it is expected that the sub-custodian meets with a number of key principles proposed by CESR, including the sub-custodian being subject to robust supervision by a public authority in its own jurisdiction.

Industry representatives, in their own responses to the Commission's proposals, call for clarification of the conditions in which the delegation can take place, as well as a

simple restriction on the parties to which activities may be delegated. Significant concerns exist relating to the practicality and effectiveness of the global sub-custodian network under the proposed arrangements, and in relation to the impact that they may have on the range of diversified and exotic investments currently possible within the UCITS framework.

Liability

While there is a general consensus that a depositary's liability is not affected when it delegates custody functions to a sub-custodian, the question remains as to whether a depositary might be required to restore the assets that a sub-custodian has lost due to improper performance of its duties, its failure or even default. There are differing views as to the extent of this liability within CESR. CESR has recommended that the best approach would be one where the liability regime for UCITS depositaries is clarified, so that it is not susceptible to divergent interpretation and implementation, yet recognising that it is impossible to eliminate all risk from investment products.

Certain industry representatives have relayed their own concerns, requesting a proportionate approach and "reasonableness" test in defining this liability regime. The liability proposals will undoubtedly create additional capital requirements and potential increased insurance costs for a depositary, ultimately leading to increased costs to the investor. If adopted in their current form, the liability arrangements may also limit the range of investments available to UCITS.

The road ahead

While the industry recognises the need for greater clarity and consistency, concerns exist around the pace of change and the practical introduction and application of same. The Commission has yet to respond to submissions received during the consultation period and to CESR's recommendations, but the response is awaited with great interest.

The approaching revolution in Europe's fund industry

Far-reaching changes in market infrastructure and retail distribution will impact the entire industry – from asset managers, to custodians, to distributors.



Olivier Mortelmans

PricewaterhouseCoopers (Luxembourg)
+352 49 48 48 4012
olivier.mortelmans@lu.pwc.com



Laurent Collet

PricewaterhouseCoopers (Luxembourg)
+352 49 48 48 4104
laurent.collet@lu.pwc.com

Europe's fund industry is on the brink of a revolution that will lead to greater efficiency, less cost and a more open market.

From a cost perspective, creation of the TARGET 2 Securities (T2S) Eurozone settlement hub from 2013 will drive down the cost of settling trades, and may lead to further consolidation among both central securities depositories (CSDs) and custodians.

In distribution, regulators and market participants alike are pushing for a more competitive market, in which banks and other intermediaries sell investors the best funds available. At a time when the UCITS IV Directive will ease cross-border marketing from mid-2011, this will intensify the fight for market share by opening national markets to the most ambitious and agile players.

Across the EU's fund industry, the direction of change is clear – as is the fact there will be both winners and losers.

T2S becomes a catalyst for consolidation

T2S will provide core delivery-versus-payment settlement in euros at far lower cost than is currently the case.

According to the European Central Bank, domestic settlement costs in Europe are currently up to 10 times higher than in the US, with cross-border settlement far more expensive than settlement within national borders. Furthermore, the cost of EU cross-border transactions is between two and six times more than domestic transactions. T2S will drive costs down towards US levels, with an estimated 90%³ reduction in cross-border costs.

Following introduction of T2S, CSDs will not only be able to handle transactions within their home countries, but also from across Europe. Furthermore, the actual process of settling will move to T2S, meaning that CSDs cannot continue to charge so much for cross-border transactions. CSDs will start to compete with each other and their profitability will suffer, leading in turn to consolidation.

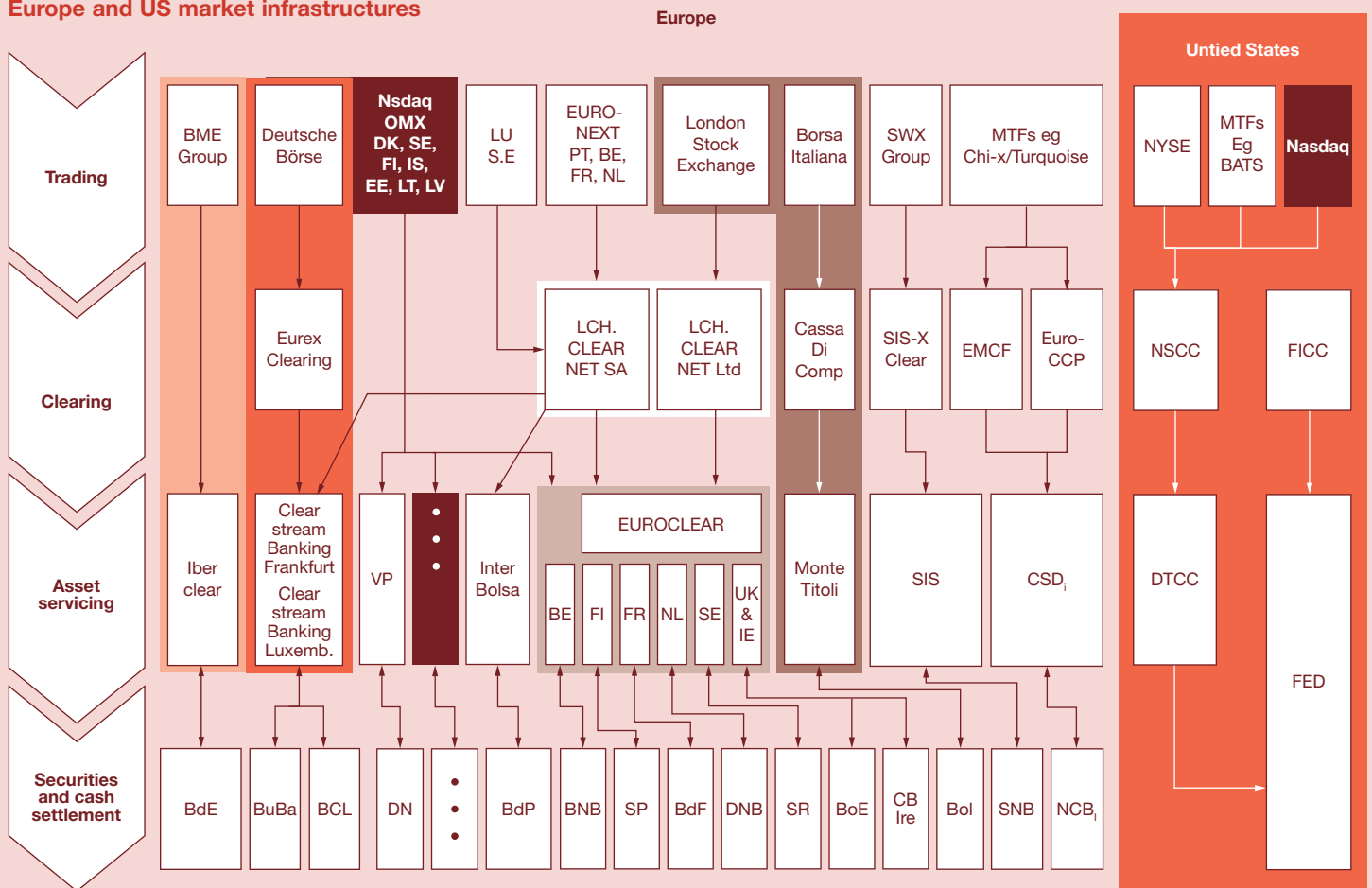
For banks in the sub-custody business, T2S poses a significant threat. By allowing all CSDs to settle trades in securities from any Eurozone country, the clearing and settlement utility potentially allows custodians to dis-intermediate their sub-custodians.

Pressures build for more open distribution

For many years, the competitiveness of fund distribution in Europe has been restricted by the vertically integrated banking model, where banks are manufacturers and distributors of funds. Meanwhile, independent financial advisers have often been suspected of selecting the products paying most commission. Now pressure is building from a variety of sources for change.

New regulations are playing their part in this fundamental shift. Most explicitly, the UK's Retail Distribution Review will ban financial advisers from receiving commission payments from 2012. Instead, they will have to charge for advice, so removing any commission bias.

Europe and US market infrastructures



Source: European Central Bank, Frankfurt am Main, Germany. www.ecb.int/paym/t2s/about/why/html/index.en.html

Across the EU as a whole, the EC is proposing a packaged retail investments products directive, designed to level the playing field between mutual funds and structured products. The EC is also due to review the Markets in Financial Instruments Directive (MiFID) by November 2010, which would give it the opportunity to ensure that the rules on inducements were imposed more consistently across Europe.

Strategic options

During the next decade, the shape of Europe's fund industry will change significantly. The industry's value chain will become far simpler and more cost-efficient, with greater specialisation.

In order to prepare for tomorrow's landscape, it is necessary first to have a clear idea of what it will look like, of its likely cost structure and your firm's true points of difference. Only then can market participants decide whether it presents them with opportunities or challenges.

This article is an extract from the paper entitled: The approaching revolution in Europe's fund industry, published in November 2009 (<http://www.pwc.com/gx/en/asset-management/publications/europes-fund-industry.jhtml>).

For many years, the competitiveness of fund distribution in Europe has been restricted by the vertically integrated banking model, where banks are manufacturers and distributors of funds. Meanwhile, independent financial advisers have often been suspected of selecting the products paying most commission. Now pressure is building from a variety of sources for change.

Germany's post-election changes enhance investment climate

The country's new centre-right government is proposing a range of new regulations, many of which are designed to improve the environment for asset management companies.



Michael A Müller

PricewaterhouseCoopers (Germany)
+49 30 2636 5572
mueller.michael@de.pwc.com

On 26 October 2009 the new German centre-right government coalition signed the Coalition Agreement, outlining policies to be implemented in the legislative period until 2013. This declaration of a working programme aims to amend those regulations that have negatively impacted companies in the financial crisis. The most relevant areas for asset management, such as taxes, Real Estate Investment Trusts (REITs), renewable energy and regulation are outlined below.

Initial tax measures

Based on the Agreement, the Federal Ministry of Finance issued on 4 November the draft bill of the Growth Acceleration Act ("Wachstumsbeschleunigungsgesetz"). For businesses, the draft bill contains a number of initial measures to improve the tax climate and to remove regulations that hinder economic growth, with effect from 1 January 2010.

Interest capping rules

There will be relaxations to the limitations on interest deductions under the complex interest capping rules ("Zinsschranke"). The taxpaying entity shall be allowed to carry forward EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation) for five years, retrospectively since 2007, to achieve a more reliable interest deduction in case of fluctuation in economic activity. The first escape clause exempting net interest payments of up to EUR 3 million (recently increased from EUR 1 million) from the application of the interest capping rules shall continue to apply without time limit. With regard to the third "group escape" clause, the equity ratio of the taxable entity may from 2010 be up to 2% (currently 1%) lower than the equity ratio of the group.

NOL (net operating loss) change of control rule

Under current tax law, an entity may lose its loss carry-forward partly, or in full, when its shares change hands. Exemptions from this strict loss forfeiture rule currently apply for companies being financially restructured up to 2010 and now it is planned to abolish this time limitation. Also, intragroup transfers shall in future be privileged and losses up to the amount of hidden reserves shall become transferable.

Real estate transfer tax

From 1 January 2010, transactions that fall under the German Reorganisation Act shall be exempt from real estate transfer tax, subject to anti-abuse regulations.

Trade tax

The add-back of rents paid for immovable properties shall be reduced from 65% to 50% from 2010 on.

Depreciation on low-value assets

For assets that are acquired after 31 December 2009, the taxpayer shall have the choice of depreciating low-value assets up to EUR 410 or of applying pool depreciation for all assets between EUR 150 and EUR 1,000.



VAT

VAT on short-term accommodation services (e.g. hotels) shall be decreased from 19% to 7% from 1 January 2010 on.

Mid-term tax strategy

Besides the initial measures with effect from 1 January 2010, the Agreement also outlines details of future measures to be implemented at mid-term, starting 2011.

Tax rulings

Fees for binding rulings shall be limited to material and complex matters.

Trade tax

A committee on municipal finances will review possibilities to reorganise the financing of municipalities. One option to be examined is to replace trade tax with a local surcharge on income tax.

Corporate tax

The following issues will be considered: reform of loss utilisation rules, cross-border taxation of business profits, introduction of a modern group tax scheme replacing the current tax group ("Organschaft"), and double taxation at corporate and shareholder level in contrast to one-time taxation of interest.

VAT

To fight tax fraud, the government will examine an expansion of cash basis taxation ("Ist-Besteuerung").

Transfer of business function rule

The rule (also known as "exit charge rule") shall be amended in order to avoid negatively affecting Germany as a research and development location.

REITs

The Agreement is silent on the future of G-REIT and REIT taxation. During coalition talks, it was proposed that all residential property should become eligible to be placed within a G-REIT structure and the exit tax would be extended. There is now uncertainty, however, about whether these measures will be agreed.

Renewable energy

The Agreement includes a clear commitment to developing renewable energies, meaning subsidies will continue. There will be stronger support for wind parks at sea, and for the use of biomass and bio fuels. On the other hand, promotion of photovoltaic is seen as too expensive and will likely be cut.

Regulation of financial markets

The new Government plans to take the lead in regulating the financial markets. Consequently, the agreement includes a clear commitment to the draft of the AIFM Directive, although the Directive should consider the characteristics of the German fund vehicles. To standardise asset-backed securities, the new Government is considering introducing a new securitisation act.

Outlook

It is uncertain whether the rules will actually be implemented or amended. Currently, the parties are discussing how the intended changes can, or shall, be introduced, considering the German budget deficit. Nevertheless, there is a high likelihood that a number of the above outlined favourable rules may be introduced. They should, therefore, be considered in contemplated actions.

Exchange traded funds in demand

At a time when simplicity, liquidity and low costs are valued, ETFs are in demand.



Andy O'Callaghan

PricewaterhouseCoopers (Ireland)
+353 1 792 6247
andy.ocallaghan@ie.pwc.com

Despite recent stock market volatility, demand for exchange traded funds (ETFs) and similar exchange-linked products continues to grow. On a global level, ETFs are very close to the US\$1 trillion mark, with US\$862bn in assets, an all-time record. In Europe, ETF assets have been pushed to an all-time high of US\$192.1bn at end of August 2009. This figure is 5% above the previous all-time high of US\$182.5bn, set in July 2009, and 20% above the high of US\$159.9bn, set in July 2008, according to a recent Barclays Global Investors' (BGI) report.

This continued growth demonstrates that investors clearly value the simplicity, transparency and low costs associated with these products. When compared to other investment products, ETFs can offer investors improved liquidity, reduced credit risk, increased transparency and more efficient competition. ETFs benefit from their inherent simplicity; replicating the performance of an index, charging low management fees and being traded on a stock exchange is appealing.

Actively managed ETFs

As the trend towards ETFs becomes increasingly popular, the ETF industry's attempt at active management is intensifying. Actively managed ETFs are a recent phenomenon, predominantly in the US. The initial actively managed ETFs received a relatively lukewarm response from investors and have been less successful at gathering assets than the traditional ETFs. Some of the reasons are

perhaps for the initial lack of market interest and the steps required to avoid front running and the time needed to build performance records.

The introduction of actively managed ETFs is a positive thing for both investors and the ETF industry, because it provides investors with a greater choice, adds new innovation to the industry and the funds come with all the advantages of a regular ETF.

As the US and global economies recover, the active ETF market will be monitored closely.

Global outlook for European ETFs

Looking forward, the future for European-based ETFs looks bright as they are well-positioned to continue to increase their market share in the investment funds space. Increasingly, we see many European ETFs now widening their focus and considering cross-listing on stock exchanges outside the EU such as Hong Kong and Singapore as the Asian market has a long history of accepting European-based mutual funds for local distribution.

The UCITS brand has been widely accepted in the Asian market over the past decade and, as a result, many of the large European ETFs are making a big push towards the Asian region. Currently, European ETF providers do not have a major share of the Asian ETF market which, similar to the European market, is currently on the rise.

Fund managers domicile of choice for European ETFs

As with traditional funds, there are a number of European jurisdictions such as Ireland and Luxembourg competing to be the domicile of choice for ETFs. There are

a number of factors that fund managers consider when deciding where to locate their ETF structure, such as the availability of qualified personnel with ETF experience, favourable tax regime, the infrastructure in place and the time it takes to obtain regulatory approval for new products. Due to the cost sensitivities of the ETFs, favourable tax treatment tends to be high on the agenda for fund managers.

To date, Ireland tends to be the leading domicile of choice for ETFs with many of the big ETF industry players located there. This has resulted in Ireland having a market share of over 28% of the total European ETF market, with EUR 36 billion as of July 2009, according to the Irish Funds Industry Association (IFIA). The overall European ETF market is EUR 130 billion. Luxembourg had EUR 23 billion in ETFs as of Dec 2008.

Conclusion

The ETF market has enjoyed tremendous growth over the last decade and further strong growth is expected, particularly in the European ETF market. Europe is seen to have some advantages over the US market with the UCITS III Directive, which not only allows for distribution of funds throughout European countries but also allows ETF fund managers to replicate indices with use of total return swaps. The fact that ETFs are products that offer liquidity in a secondary market is becoming increasingly important in the current environment and bodes well for the future of ETFs around the world.

An opportunity to buy US real estate at cyclical lows

Responses to the Emerging Trends in Real Estate® 2010 US/Canada/Latin Americas edition, published by PricewaterhouseCoopers and the Urban Land Institute, indicate that vacancies will increase and rents decrease before the market offers opportunities to buy at cyclical lows in 2010 and 2011.

US commercial real estate industry investors and professionals remain decidedly negative, coloured by distress over prospects for an extended period of anaemic demand and costly deleveraging, according to the 900 leading real estate experts participating in the US/Canada/Latin America edition of the Emerging Trends in Real Estate® 2010 report, published in November.

Survey respondents predict that commercial real estate vacancies will continue to increase and rents will decrease across all property sectors before the market hits bottom in 2010, and anticipate project values will decline 40% to 50% from 2007 market peaks. They also believe that 2010 and 2011 will present generational opportunities for investors to buy at or near cyclical lows.

By the end of 2010, investors believe that capital will slowly begin to flow back into commercial real estate markets, led by all-cash investors seeking quality assets. The debt markets will start to rebound too, but remain “far from normalised” in the wake of unprecedented deleveraging.

Any lending will be conservative, expensive and extended only to the most-favoured banking relationships. REITs, private equity funds and even refashioned mortgage REITs will start to provide loans to battered borrowers, but at a steep price.

Conservative investing strategies

A strong message coming from the survey is that investing with cash is the only way to operate, and only the most liquid can take advantage of the emerging opportunities. Early is the new wrong as the economic uncertainty will hamper the recovery and the absence of ready refinancing in comatose debt markets adds more risks.

Investors should focus on quality and be selective, seeking irreplaceable Class A properties with debt maturity in places like New York, San Francisco and Washington, DC. They should also stick to global pathways where recovery will happen more quickly.

Buying cash flow and real yield is important. It will pay to anticipate creating value by filling vacancies and increasing rents over time, as will focusing capital and resources on retaining and attracting tenants in properties with better long-term value.

Additionally, providing financing as three- to five-year loans can deliver low teen returns.

Global gateways favoured

Survey participants believe that the markets performing well before the crash should perform better coming out of it and the laggard markets will continue to suffer. The report finds that investors will continue to favour global gateway markets on the East and West Coasts. Cities and urbanising infill suburbs with 24-hour attributes, brainpower centres that offer universities and high-paying industries, as well as “barrier to entry” markets where geographic constraints limit development and help control overbuilding will be top market performers.

According to the survey, Washington D.C. ranks number one as the “recession-proof” city. Value declines have been less than other markets as employment is buffered by the federal government. Long-term confidence holds for New York and Boston despite financial industry downsizing. West Coast gateways – San Francisco, Seattle and Los Angeles – have all suffered ratings declines, but remain among the survey’s top 10 major markets. Texas markets continue to show strength after years languishing in the survey basement.



Robert K. Ruggles III

PricewaterhouseCoopers (US)
+1 973 236 4776
robert.k.ruggles@us.pwc.com



Charles J. DiRocco, Jr

PricewaterhouseCoopers (US)
+1 202 414 1407
charles.dirocco@us.pwc.com



You can access the full report at
pwc.com/emergingtrends

Burning platforms: What's in store for Asian private banking?

As Asia's private banks appear to emerge from the downturn, they must learn its lessons and build more sustainable business models.



Justin Ong

PricewaterhouseCoopers (Singapore)
+65 6236 3708
justin.ong@sg.pwc.com

Despite negative growth over the past year as a result of the economic crisis, Asia has remained a strong contender in terms of being the first region to recover. Today, Asia's private banks are evidently optimistic and appear to be returning to growth. But have they learnt the crisis's lessons? Are they cognisant of the inherent weakness in existing business models and cultures? Have they taken steps to ensure that past failures will not be repeated?

The Asian private bank's service offering has always been unique. Clients instruct high levels of transactions, preferring to take active decisions on investments rather than buy discretionary management. The appetite for high-risk/high-return products as part of the asset allocation is an accepted norm, which has returned as Asia emerges from the crisis.

Due to ambitious growth targets, the sector is seen to have a "sales-driven" culture, where product quotas and targets are set to compel greater product-push and increased revenue generation. There has been significant recruitment of relationship managers in the past few years, but they are largely poorly trained, young and without the depth of experience and skill sets needed to advise clients properly through all economic cycles. Instead, increasing pressure to generate asset growth and revenue underpinned what appears to be a general lack of conviction on the part of these young relationship managers to provide sound advice that gave clients what they needed.

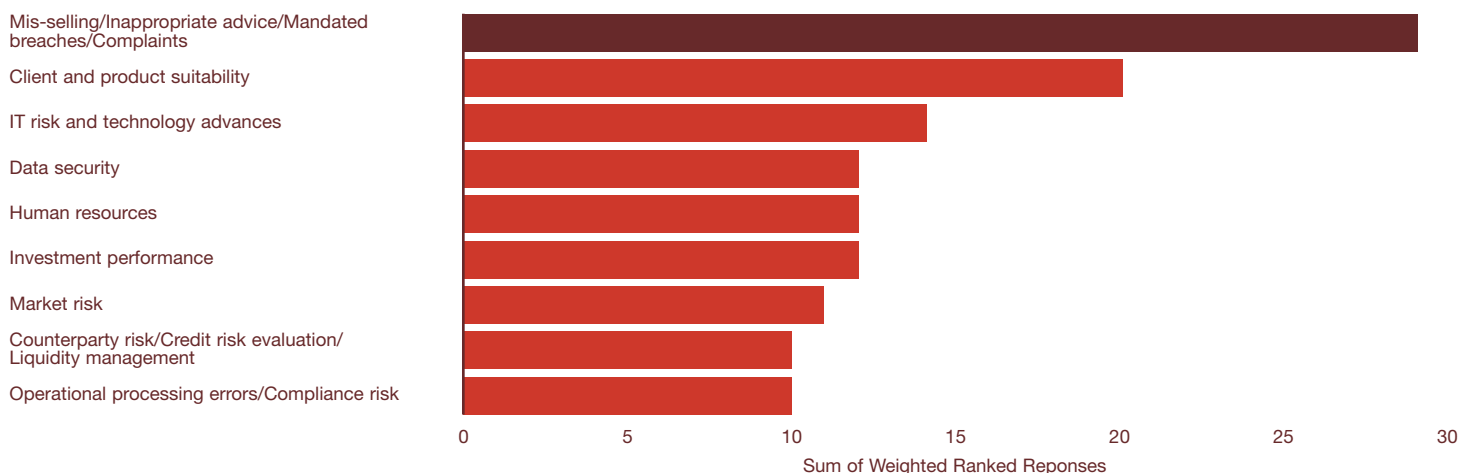
Burning platforms

Across Asia, the 2009 PricewaterhouseCoopers Asia-Pacific Private Banking survey shows a number of critical issues that still need to be assessed and addressed to ensure that continuing growth can be achieved, while protecting the interests of clients and other stakeholders.

1. Managing risks

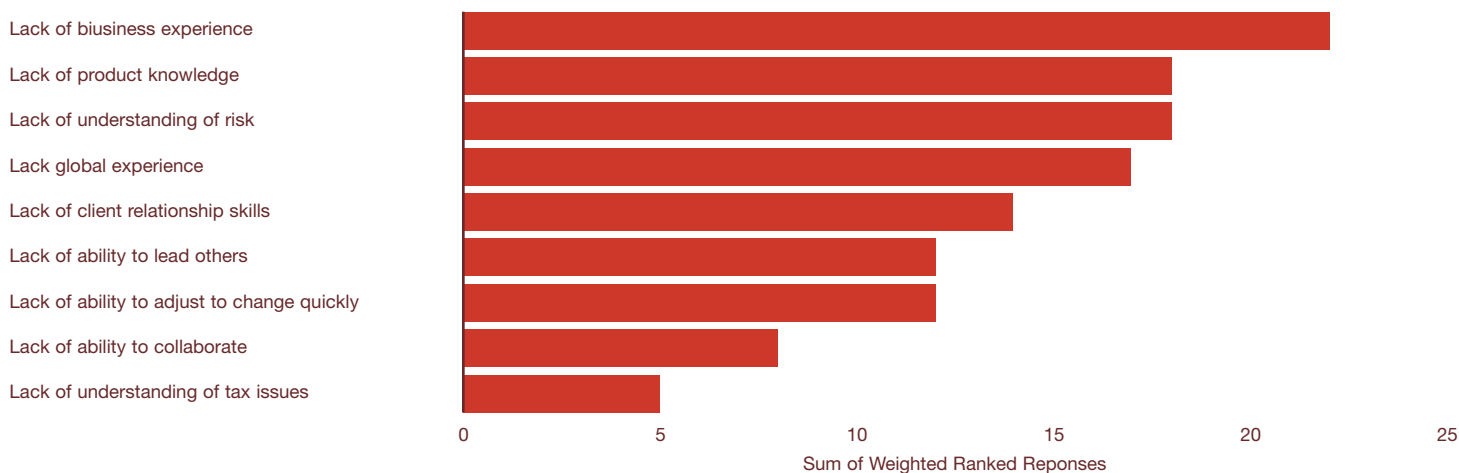
- Mis-selling and inappropriate advice rank among the top risks private banks in Asia need to deal with over the next two years.
- Litigation, which was previously seldom seen in the Asian public arena, has now entered centre stage, with many private clients taking legal action against their private banks for mis-selling.
- Private banks now need to reconsider how they are training their client advisory teams— they need to map product suitability to client investment styles and risk appetites, while ensuring proper controls and documentation.
- Banks need to rethink their onshore-offshore strategies more clearly to mitigate risks. With regulators across Asia keeping a close watch on private bankers' activities, there is heightened risk— regulatory and tax exposures carry significant penalties not only for banks, but also for clients and their relationship managers.

Top 3 key areas of risk needing to be addressed in two years' time



Source: PricewaterhouseCoopers 2009 Private Banking Survey – Asia Analysis

The 3 most common areas of weakness of RMs cited by business heads



Source: PricewaterhouseCoopers 2009 Private Banking Survey – Asia Analysis

2. Talent management and compensation

- Remuneration for relationship managers (RMs) is still designed for a sales-driven culture. The most important factors determining compensation are quantitative, that is, growth of assets under management, revenue targets and net new money. Factors such as investment performance, compliance and client satisfaction receive too little emphasis.
- To protect clients' interests, compensation structures need to be more balanced, with longer term measures such as deferrals, clawbacks, etc. to bring about a change in mindset.

- The quality of private bankers also needs to be raised through more training in client service delivery and broader wealth planning competency.

3. Generations

- As Asia's private wealth expands, increasing funds will be transferred to second or even third generations over the coming decade.
- With intergenerational wealth transfer, a different strategy and focus is required to understand and service this new segment of wealth owners and inheritors.
- Most private banks in Asia are ill-equipped to deal with the new generation, whether from a lifestyle

and culture, delivery channel or product requirement perspective. The survey results indicate that 40% of private banks do not know how much of their clients' wealth will be retained upon wealth transfer to the next generation. This is a concern (and a challenge) that banks must come to grips with sooner rather than later to ensure that they are able to keep, if not grow, their clients' assets with them as the next generation comes of age.

In summary, Asia's private banks need to move to more sustainable business models that have customer needs and regulatory compliance at their core.

Japan's changes to private equity fund taxation

Tax reforms introduced in 2009 may avoid the need for funds investing in Japan to do so through complicated offshore investment structures.



Stuart Porter

PricewaterhouseCoopers (Japan)
+81 3 5251 2944
stuart.porter@jp.pwc.com



Akemi Kito

PricewaterhouseCoopers (Japan)
+81 3 5251 2461
akemi.kitou@jp.pwc.com

The 2009 tax reforms introduced provisions liberalising the application of the 25/5 Rule (as defined below), and provided a safe harbour rule to allow foreign investors to invest directly into Japanese partnerships (Japanese investment business limited partnerships, often referred to as IBLPs) without itself creating a permanent establishment (PE).

Changes to the 25/5 Rule

Under Japanese tax law, gains realised by a foreign partner in a foreign partnership from the sale of shares in a Japanese corporation are generally subject to tax if the foreign partner (together with specially related persons) sells 5% or more of the shares of such corporation during a fiscal year and such foreign partner (together with specially related persons) owned or has owned 25% or more of the shares in such company at any time during a specified lookback period (25/5 Rule). This rule was subject to any application of the terms of an exemption available in a double-tax treaty location of the investor. Note that for investments in real estate holding companies, a more restrictive rule applies.

Under the prior 2005 tax reforms, the interests of foreign partners in a

partnership became aggregated under the concept of "specially related persons" for the purposes of testing the 25/5 Rule. Consequently, many foreign funds investing in Japan had to manage the tax impact of their Japanese investments for their investors' post-tax returns.

The 2009 tax reforms effectively "roll back" the changes implemented in 2005 (subject to certain carve-outs) by testing the application of the 25/5 Rule at the foreign partner level for transactions where: (1) the partnership is similar to IBLP; (2) a one-year holding period criteria is met; (3) the transaction does not involve a shareholding in certain distressed financial institutions; and (4) the foreign partner meets the following conditions:

- Has limited liability with respect to the partnership;
- Is not involved in the management or operation of the partnership;
- Does not own, together with specially related shareholders, 25% or more of the shares of the corporation sold at any time during a specified lookback period;
- Does not otherwise have a PE in Japan; and
- Files certain documentation.

New PE exemption for investors in Japanese funds

Under prior rules, foreign partners investing in an IBLP effectively created a PE in Japan, arising from the joint operation of the partnership business, due to the nature and terms of the contractual and legal relationship of partners in an IBLP. Under the 2009 tax reforms, a foreign partner may invest in an IBLP without the risk of creating a PE in Japan, on account of such investment, provided the foreign partner:

- Has limited liability with respect to the IBLP;
- Is not involved in the management or operation of the IBLP;
- Together with specially related partners, has an investment ratio in the IBLP that is less than 25%;
- Is not specially related to the general partner of the IBLP;
- Does not otherwise have a PE in Japan; and
- Files certain documentation.

Further details on the above conditions were clarified by Q&A guidelines issued by The Ministry of Economy, Trade and Industry (METI) in July 2009.

Impact on the private equity industry in Japan

These changes affect the structuring of foreign investment into Japanese private equity funds, and introduce more options as to how fund managers design their funds, both Japanese and foreign. Additionally, they influence how limited partners engineer their investment structures and also the terms upon which their investments are made in Japanese and foreign funds investing in Japan.

The new rules are technically helpful and may, in certain circumstances, avoid the need for complicated offshore investment structures for investment funds investing into Japan. However, filing requirements and current interpretation of rules to some extent inhibit their full usefulness in practice, and their effect must be reviewed on a case-by-case analysis for any fund manager or limited partner contemplating Japanese private equity investment.

Asian real estate flashes positive

The Asia Pacific Emerging Trends in Real Estate® 2010 survey, published by PricewaterhouseCoopers and the Urban Land Institute, showed a fragile confidence in Asian real estate.



KK So

PricewaterhouseCoopers (Hong Kong)
+852 2289 3789
kk.so@hk.pwc.com

A little over a year after the failure of Lehman Brothers precipitated a global financial and economic collapse, asset markets in the Asia Pacific region are holding up surprisingly well compared to their peers in Europe and the US. While both pricing and rentals in the region fell steeply in 2008 and early 2009 in step with those in the West, markets across the Asia Pacific region have been lifted in the second half of the year by the remarkable resilience of the Chinese economy, which has been buoyed by a series of fiscal and monetary stimulus measures.

As a result, many Asian markets were beginning to flash positive signals towards the end of 2009. Transaction volumes have rebounded, albeit from a very low base and led overwhelmingly by China. Pricing also has improved across the region. While the uptick has been modest in most cases, moves have been substantial in some asset classes and geographies (especially, again, in China).

In addition, there have so far been few distressed sales in any Asian real estate sector. Extra liquidity has played a major role in this. But there are other factors, too:

- Loan-to-value ratios in Asia never reached the nosebleed heights seen in the West. As a result, property price declines have not been sufficient to give many borrowers problems with servicing loans.
- Asian banks have not suffered big losses from derivatives investments and in general remain well capitalised. They therefore have little incentive to foreclose on borrowers who may be in breach of covenant. Local business culture generally frowns on foreclosure anyway.

- Many large investment institutions in the region have been able to recapitalise via the capital markets (especially in Australia and Singapore), allowing them to pay down debt.
- Business sentiment remains generally sanguine.

Challenges remain

Nonetheless, conditions remain extremely tight. Historically, real estate investment in Asia has been financed overwhelmingly by bank lending, and in the aftermath of the crash, banks are reluctant to provide funding to all but their best (and usually largest) clients. Leverage is lower. In addition, loans are expensive, even though base rates remain extremely low. This means that the days of 20%-plus opportunistic returns in Asian real estate deals may be over.

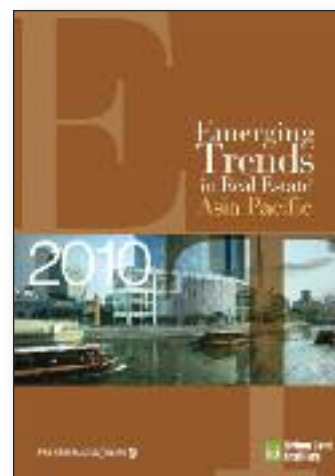
Refinancing is a similarly challenging exercise. Again, however, banks are usually willing to work out a deal, even if it means borrowers must reduce gearing and cough up a significantly higher spread than before. The exception is in Japan, where generally high leverage, together with large quantities of CMBS issuance, has left many borrowers high and dry now that foreign banks have fled the market. Japan, therefore, remains the market most exposed to the prospect of significant levels of real estate distress in 2010 and beyond.

In the meantime, regional investment flows have changed significantly. Allocations to Asia from Western institutions continue, but at a much-reduced level. In addition, significant amounts of money have been withdrawn from the region by investment banks that want or need the capital for other purposes. In their absence, regional investors have stepped up to the plate. Often, these are large institutional investors, including sovereign wealth funds. Similarly, Asian investors are now looking to place funds in the West as more distressed opportunities begin to appear.

Tentative recovery

However, despite the newly bullish atmosphere, the rebounds in most Asia Pacific markets (China excepted) seem tentative and fragile. Although Asia Pacific governments will probably be able to sustain high rates of liquidity for the foreseeable future, in the end, their near-term prospects are probably tied to developments in the West and in particular the US, where deleveraging is far from over. With the prospects for Western economies precarious, confidence in the Asia Pacific region may at times border on complacency.

Based on investment prospect ratings, the top five markets in 2010 are Shanghai, Hong Kong, Beijing, Seoul and Singapore. Chinese cities dominate the rankings this year – a reflection of a remarkable resurgence in Chinese commercial real estate as the government-mandated liquidity boom lifts markets across the country. Another city that has moved significantly is Sydney, which has become a popular destination for foreign funds seeking shelter in Australia's mature property markets and commodity-based economy. The top cities for development prospects are Shanghai, Mumbai and Ho Chi Minh City.



You can access the full report at pwc.com/emergingtrends

An important Chinese anti-avoidance development

China introduces a draft policy for taxing indirect transfers of Chinese equity, highlighting the importance of having “substance” in intermediate holding companies.



Florence Yip

PricewaterhouseCoopers (Hong Kong)
+852 2289 1833
florence.kf.yip@hk.pwc.com



Jeremy Ngai

PricewaterhouseCoopers (Hong Kong)
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

The new China Corporate Income Tax (CIT) Law contains general anti-avoidance rule (GAAR) provisions that empower the Chinese tax authorities to adjust taxable income for those arrangements that are made without commercial justification with the main purpose being to obtain tax benefits.

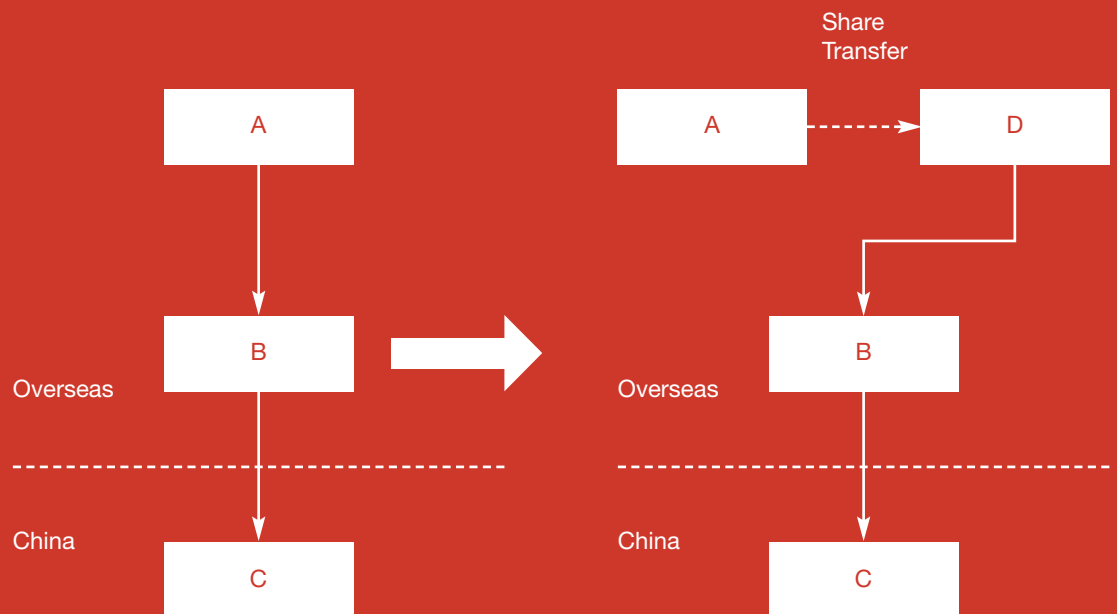
Recently, there was a case in Chongqing, PRC, where a Singapore company disposed of the shares of its Singapore special-purpose vehicle (SPV), which held the equity interest of a Chongqing entity. The shares of the Singapore SPV were sold to a PRC buyer. In this case, the Chongqing State Tax Bureau taxed the Singapore company on the resulting capital gain on the grounds that the substance of this transfer was the equity interest in the Chongqing entity rather than the shares of the Singapore SPV.

Further to the above widely debated Chongqing Case, the State Administration of Taxation (SAT) is drafting a new tax policy that covers, among other things, “indirect transfer” of Chinese equity by non-Chinese tax resident enterprises (Non-TREs) outside of China.

This policy is still in its draft form and the broad direction and key features of that draft policy is set forth below.

Reporting requirements for offshore “indirect transfer” transaction

The following diagram illustrates what the draft policy intends:



The illustration involves a Non-TRE A that disposes SPV B (also Non-TRE), which holds China subsidiary C to another Non-TRE. Upon transfer of SPV B, Non-TRE A is required to provide a list of requisite documents and information (including the transfer agreement and the commercial substance and purposes of SPV B) regarding the transfer. This is required only when SPV B is located in a jurisdiction that has the following specified tax features:

- (i) a low-tax jurisdiction with a benchmark rate (which may be half of the standard China CIT rate of 25%); or
- (ii) that jurisdiction does not tax foreign company (i.e. Non-TRE A) in respect of the gains on transfer of SPV B's shares.

SPVs disregarded by the Chinese tax authorities

With the requisite documents and information, the Chinese tax authorities can examine the true nature of the transfer. Should the transfer of the China subsidiary C's equity be achieved through "abusive use of company structure" (i.e. transfer of SPV B) to avoid China withholding income tax, then the Chinese tax authorities can invoke GAAR and disregard SPV B.

Once SPV B is disregarded, then the transfer would be effectively treated as Non-TRE A, transferring the China subsidiary C's equity, and the gain would be of China source and, therefore, subject to China withholding income tax. The standard Chinese withholding income tax rate is 10% on the gain, subject to the double-tax treaty's special treatments.

Considering the above, putting substance into SPV B can form the first line of defence against the tax avoidance challenge of the Chinese tax authorities. Should GAAR not be invoked, the transfer gain of SPV B by Non-TRE A should not be subject to China withholding income tax.

Unfortunately, there will not be clear rules on what constitutes 'substance' for SPVs acceptable to the Chinese tax authorities at this stage. However, schemes for avoiding China withholding income tax by simply inserting a "sham" SPV in the anticipation of transferring of Chinese investments via disposal of that SPV are no longer feasible.

How to strengthen "substance" of intermediate investment holding company?

Where to set up?

China has entered into more than 90 double-tax treaties with different jurisdictions and the one signed with Hong Kong is among the most favourable. In particular, the withholding income tax on dividends is 5% under the HK-PRC tax treaty, compared to most other treaties where a 10% rate applies. This makes Hong Kong a preferred option for setting up investment vehicles for China investment. Further, the HK/PRC Avoidance of Double Tax Arrangement stipulates that a Hong Kong incorporated company is a Hong Kong tax resident

Many fund management groups have already set up operations in Hong Kong. If they have not, the setting up of a presence in Hong Kong should be considered. It will be relatively easier to justify the commercial substance of HK SPVs to the Chinese tax authorities than SPVs in other tax jurisdictions such as Barbados/Mauritius, etc.

What functions should be performed?

To build substance in a holding company, there is a need for the holding company to perform, or at least to be seen to perform, certain functions as an "investment holding company". In other words, rather than the holding company being only a "shell" (or seen to be a "shell"), it should (actively) manage its investment holding business.

These functions could include:

- Reviewing the PRC operating company's (OpCo's) performance, including operation reports by PRC OpCo, management accounts, etc.
- Supporting PRC OpCo, for example, to provide financial support to the China OpCo, to make business introductions to PRC OpCo, to provide corporate support, such as internal audit, shared services.
- Formulating strategies in relation to deployment of earnings, including dividend repatriation, reinvestment, etc.
- Reporting to the ultimate holding company on PRC OpCo's performance.

How to build substance?

We have listed below some general considerations for a HK Holding company (HoldCo) to strengthen its substance.

However, the following is not an exhaustive list.

- HK HoldCo should have a physical office and telephone number in Hong Kong;
- The office should have employees (including "shared employees"), for example, secretary, and to incur office expenses (such as rental, utilities);
- A clear majority of the directors of HK HoldCo should be residents of Hong Kong;
- All directors' meetings should be held in Hong Kong. The meeting could be in the form of a conference call, but it is better that there is a quorum per the by-laws of the company in Hong Kong;
- Formal documentation (that is, minutes) of such meetings should be drawn up, signed as approved and maintained on file at the HK HoldCo's registered office;
- The board as a whole should exercise its control and make decisions on matters of general policies such as investments, financing and business plan and should demonstrate how each decision is derived;
- HK HoldCo's bank accounts, corporate seal, and books and records (both accounting and statutory) should be maintained in Hong Kong;
- Preferably HK HoldCo should have Hong Kong sourced profits (e.g. service fee, etc.) that are subject to Hong Kong profits tax; and
- The non-Hong Kong directors of HK HoldCo should not be vested with power to override the decisions of the board of directors.

It is unknown whether and when the SAT will release any guidelines on "substance", or they will allow the local-level tax bureaux to make assessments on a case-by-case basis. As such, the suggestions to strengthen the "substance" of the HK HoldCo above are not binding on any tax authorities and there can be no guarantees the local tax bureaux will necessarily accept them. Having said that, the more the substance is in place, backed by timely and complete records, the better chance there is of withstanding the potential challenges by the tax bureaux.

Factors influencing the future shape of Asian asset management

Several emerging drivers will determine the nature of Asia's asset management opportunities – market participants need to tailor their strategies accordingly.



Justin Ong

PricewaterhouseCoopers (Singapore)
+65 6236 3708
justin.ong@sg.pwc.com

The past 12 months have been turbulent ones for Asia's asset managers. Free-falling global investment markets sent investors on a flight to liquidity as risk appetites evaporated. Under pressure from every direction, this relatively young sector has experienced one of its most challenging times.

As the financial markets stagger towards recovery, the crisis is not over. The environment continues to be challenging. Yet Asia's likely superior economic growth and expansion in private wealth make the region one of the world's most promising for asset management in the medium term. When considering their regional strategies, asset managers should be aware of a number of emerging drivers that will influence the future shape of the market.

Market entry and distribution

Asia remains a largely fragmented market, and fund distribution across the various countries can be a minefield. Recent events around the marketing of unregistered products have heightened regulatory scrutiny of cross-border activities. Fund distribution across Asia is currently subject to many restrictions, and clearly the need for more open entry into various markets is required for the asset management industry to grow and flourish. However, this remains difficult, with significant governmental negotiation required before the larger economies

open their doors and recognise products from another jurisdiction.

The imminent danger following the crisis and evidence of fund mis-selling is that some regulators may actually further restrict product recognition, seeking to protect their local markets and investors. This may already be happening in the US and Europe, particularly with proposed EU regulations that could effectively close the borders to non-EU fund products. Such regulations would have repercussions for Asia-based asset managers, who without established platforms in Europe might find themselves marginalised.

Balanced regulations focused on protecting vulnerable investors will improve the industry. On the other hand, broad-based protectionism would create costly barriers to entry for offshore funds and, ultimately, constrict global capital flows. The asset management industry needs to make its concerns known to regulators for a balanced perspective to be taken. Meanwhile, offshore regulatory authorities need to gain credibility. They must prove that they are capable of regulating funds and their managers at an acceptable level, so as to achieve cross-recognition from other regulators.

Transparency and governance

Both frauds and banking collapses globally within the past 18 months have made regulators, pension funds and institutional investors pay more attention to due diligence. Managers and service providers alike are seeing investors demand greater transparency, particularly in respect of financial controls and performance reporting. Benchmarking against global standards such as International Financial Reporting Standards, Global Investment Performance Standards and controls

reporting frameworks such as SAS 70 are increasingly prevalent, especially for the global and larger local players. Such reports are fast becoming baseline expectations rather than luxuries when seeking to procure or retain clients.

Demographic implications

New wealth and the emergence of an Asian society with increasingly sophisticated investment needs have driven the Asian asset management industry's growth over the past five years. Much of this wealth is owned by the current baby boom generation. As this generation starts to age, the transfer of wealth to the next generation will bring new challenges. Anecdotal evidence suggests that not enough has been done to address the next generation's needs; most products are currently developed by baby boomers, for baby boomers.

To meet the next generation's needs, asset managers need to rethink their strategies for product development, marketing, distribution channels and investment styles. They also need to reduce their dependence on a narrow market segment and seek to understand the new wealthy, particularly those in large economies such as China and India. When developing strategies for these markets, they will need to consider cultural values, client sophistication and risk appetites, as well as the relevant foreign exchange and tax considerations. In this way, they will be able to develop appealing products and establish effective delivery channels that will work in each targeted segment.

The ever-changing landscape in Asia presents challenges, but also ample opportunities. Prepared and nimble players will be the eventual winners.

New Zealand offers a lesson in retirement saving

The design of New Zealand's hugely successful "Kiwisaver" defined contribution pension scheme may prove interesting to other countries seeking to boost pension saving.

When New Zealand introduced the "Kiwisaver" workplace-based retirement savings scheme in 2007, there was scepticism about its prospects. Two years on and Kiwisaver's ability to attract members has exceeded all expectations, with almost 30% of the population signed up.

The scheme's success changes the local funds landscape and can be expected to substantially increase investment outflows from New Zealand. As countries around the world seek to increase pension saving, it also demonstrates how a small incentive can significantly affect peoples' savings decisions.

Despite the initial reservations, Kiwisaver has attracted over 1.2 million members, out of a population of 4.2 million, in just over two years. The scheme was not predicted to achieve a million members until 2015. Considering this has occurred during the global financial crisis, and without tax incentives, it is all the more impressive.

Over 60% of enrolments have been voluntary rather than automatic. Of particular significance is the number of young people enrolling, particularly 19- to 25-year olds.

Design of Kiwisaver

The Government makes an initial contribution of NZ\$1,000 (US\$732, €493⁴) to the employee's account and annual contributions up to NZ\$1,040. Employees choose investments from a range of funds managed by private providers – otherwise they are automatically allocated to one of six "default providers" selected by the Government. The funds are not Government guaranteed.

People commencing a job are automatically enrolled unless they opt out within six weeks. Other employees can opt in at any time. They can contribute 2%, 4% or 8% of their pre-tax income (but are still taxed on the contributions). The employer also contributes 2% of the employee's income.

The design of Kiwisaver appears to have been successful in attracting members, with modest government contributions, but no tax incentives. Perhaps this is due to the immediacy of seeing an increase in individual savings balances when the government contributions are credited, although the value of these incentives may be significantly less in the medium to long term than the tax incentives offered in many other countries.

The scheme's future

With more than NZ\$4.25 billion passed on to Kiwisaver providers, it is estimated that Kiwisaver funds already represent 5% of the total funds under management in New Zealand. Given Kiwisaver is still very new, this suggests Kiwisaver funds will be significant players in the local investment scene in coming years, and can also be expected to substantially increase the flow of investment funds out of New Zealand.

There is a widely held view that it is only a matter of time before the scheme becomes fully compulsory. There must be some serious doubt over the continuation of the government contributions at this point.

Given the prospect of looming pension deficits in many countries, the success of the scheme is noteworthy, although its long-term effectiveness is not yet fully proven as members can currently cease contributions at any time.



Mark Russell

PricewaterhouseCoopers (New Zealand)
+64 9 355 8316
mark.russell@nz.pwc.com



Sam Shuttleworth

PricewaterhouseCoopers (New Zealand)
+64 9 355 8119
sam.shuttleworth@nz.pwc.com

The scheme's success changes the local funds landscape and can be expected to substantially increase investment outflows from New Zealand.

⁴ Rates as at 12 Nov. 09.

Global Asset Management contacts

Asset Management News is produced by experts in their particular field to address important issues affecting the asset management industry. If you would like to discuss any aspect of this document, please speak to your usual contact at PricewaterhouseCoopers or a member of our global or territory leadership team.

Global Asset Management Leadership Team



Marc Saluzzi
PricewaterhouseCoopers (Luxembourg)
Global Asset Management Leader
+352 49 48 48 2511
marc.saluzzi@lu.pwc.com



Kees Hage
PricewaterhouseCoopers (Luxembourg)
Global Real Estate Leader
+352 49 48 48 2059
kees.hage@lu.pwc.com



Barry Benjamin
PricewaterhouseCoopers (US)
Americas Asset Management Leader
+1 410 659 3400
barry.p.benjamin@us.pwc.com



Pars Purewal
PricewaterhouseCoopers (UK)
UK Asset Management Leader
+44 20 7212 4738
pars.s.purewal@uk.pwc.com



Brendan McMahon
PricewaterhouseCoopers (Channel Islands)
Global Asset Management
Private Equity Leader
+44 1534 838234
brendan.mcmahon@je.pwc.com



Robert Grome
PricewaterhouseCoopers (Hong Kong)
Asia Pacific Asset Management Leader
+852 2289 1133
robert.grome@hk.pwc.com



Will Taggart
PricewaterhouseCoopers (US)
Global Asset Management
Tax Leader
+1 646 471 2780
william.taggart@us.pwc.com



Tony Artabane
PricewaterhouseCoopers (US)
Global Asset Management
Hedge Funds Leader
+1 646 471 7830
anthony.artabane@us.pwc.com

If you would like to receive copies of this newsletter or would like further information about PricewaterhouseCoopers' Asset Management publications, please contact denise.cook@uk.pwc.com

Editor: Rupert Bruce

Territory Leaders

Argentina

Diego Sisto
+54 11 4850 4715

Australia

Mark Haberlin
+61 2 826 63052

Austria

Thomas Strobach
+43 1 501 88 3640

Bahamas

Dawn Jones
+1 242 302 5300

Belgium

Emmanuèle Attout
+32 2 710 40 21

Bermuda

Andrew Brook
+1 441 299 7126

Brazil

João Manoel dos Santos
+55 11 3674 2224

Canada

Rajendra Kothari
+1 416 869 8678

Cayman Islands

Noel Reilly
+1 345 914 8600

Channel Islands

Brendan McMahon
+44 1534 838234

Chile

Roberto Villanueva
+56 2 940 0070

China

Alex Wong
+86 21 2323 3171

Cyprus

Costas Mavrocordatos
+357 22 555 202

Czech Republic

Richard Jones
+420 2 51 152 161

Denmark

Mikael Sørensen
+45 39 45 9269

Finland

Tuukka Lahkela
+358 9 2280 1333

France

Alain Le Barbanchon
+33 1 5657 1084

Germany

Stefan Palm
+49 69 9585 2571

Gibraltar

Edgar Lavarello
+350 73520

Greece

Mary Psylla
+30 210 6874 543

Hong Kong SAR

Robert Grome
+852 2289 1133

Hungary

David Wake
+36 1 461 9514

India

Gautam Mehra
+91 22 6689 1155

Indonesia

Margaret Margie
+62 21 521 2901

Ireland (Republic of)

Damian Neylin
+353 1 792 6551

Isle of Man

Michael Simpson
+44 1624 689 689

Italy

Elisabetta Caldirola
+39 2 778 5380

Japan

Takeshi Shimizu
+81 90 6515 1754

South Korea (Republic of)

Jae-Hyeong Joo
+82 2 709 0622

Latvia

Juris Lapshe
+371 709 4400

Lithuania

Christopher Butler
+370 5 239 2300

Luxembourg

John Parkhouse
+352 49 48 48 2133

Malaysia

Mohammad Faiz Azmi
+60 3 2173 0867

Malta

Joseph Camilleri
+356 2564 7603

Mexico

Eduardo Gonzalez
+52 55 5263 6072

Netherlands

Fred Gertsen
+31 10 407 6614

New Zealand

Paul Mersi
+64 4 462 7272

Norway

Geir Julsvoll
+47 95 26 05 40

Pakistan

Sohail Hasan
+92 21 2419322

Poland

Antoni Reczek
+48 22 523 4340

Portugal

António Assis
+351 213 599 000

Russia

Richard Gregson
+7 495 967 6327

Singapore

Justin Ong
+65 6236 3708

Slovakia

Christiana Serugova
+421 2 59 350 614

South Africa (Republic of)

Pierre de Villiers
+27 11 797 5368

Spain

Antonio Greño
+34 91 568 46 36

Sweden

Susanne Sundvall
+46 8 555 332 73

Switzerland

Thomas Huber
+41 58 792 2436

Taiwan

Richard Watanabe
+886 2 2729 6704

Thailand

Michael Haddon
+66 2 344 1031

United Kingdom

Pars Purewal
+44 20 7212 4738

United States of America

Barry Benjamin
+1 410 659 3400

