Retail Distribution Review: the hidden costs

Wealth managers and private banks have had to deal with inefficient back office processes for far too long, says Neil Wise, Vice President, Investment Fund Services at Clearstream. However, there is growing belief in the market that the Retail Distribution Review (RDR) provides a line in the sand which will force practitioners to opt for better operating and processing models.

Third-party fund processing can be a considerable drain on any company's profitability. However, in the pre-RDR world, this was largely hidden from the wealth management community as their platform providers covered the cost of processing by taking a cut of their full trailer fee entitlement. The historical benefits of using a platform are clear: free order routing, settlement, custody and asset servicing, all of which are very appealing, along with access to a broad range of funds. Traditionally, the charging arrangements tended to be quite simple: a fund provider paid a sales commission to the platform which took a share and passed the rest back to their wealth management clients. For years, private banks and wealth managers have been broadly happy to run with this bundled fee structure, often having little idea (or interest) in how much they were actually paying for their fund processing and custody.

However, when you consider that this sales commission often amounted to 0.75%, or 75 basis points, and only 50 basis points were returned to the wealth manager, you're seeing (or not!) quite a chunk of your 'entitlement' leaving the chain. Twenty five basis points for custody? Not even in the 1970s were fees this high for bonds and equities. Although these platforms appear highly automated and efficient, a look below the surface reveals highly manual processing hubs. It is this lack of investment into the post-trade arena which is now coming to the fore.

Is a better solution available?

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

For example, though fund platform providers may claim that they offer high levels of process automation, this may extend little beyond the order routing component. Downstream of the order routing, processing activities may rely on a huge manual paper flow. The post-trade component, including fund settlement and reporting, corporate action processing, the handling of tax vouchers and cash and securities reconciliation, may all be highly manual with large teams of staff in processing centres chasing fax, telephone and email communication across the investment value chain between retail investors and fund management companies.

Is it appropriate in 2014 that a wealth manager should be content to receive automated handling of just 20% of the fund transaction life cycle, notably the order routing component? Order routing is a commoditised, plain-vanilla activity in the modern fund processing world and electronic order communication should be viewed as a basic requirement. But, when paying significant amounts for their fund processing (through the bundled fee retained by the fund platform), wealth managers should be pushing for high levels of automation across the fund processing cycle, including the post-trade component. Efficient alternatives are available in the market that will offer high STP rates across these processing segments. For example, Clearstream's Vestima solution delivers full automation across order placement, DvP settlement and asset servicing, supporting this activity from the same platform that we use to support customers' fixed income, equities, warrants and a range of other instrument types.

The benefits of this service cannot be expressed simply in terms of cost savings, important though these are. In practice, the risk management benefits may be of even greater significance. When handling large order sizes and large investment portfolios, the risks presented by a failed settlement or a misprocessed corporate action may be extremely large – resulting in late delivery of funds, sizeable claims or even a potential exclusion from the market should you face issues in the CSD. Faced with these risks, it is unthinkable that wealth managers should continue to settle for sub-optimal levels of processing efficiency from their service provider.

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

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Time for change

Faced with these inefficiencies, it will come as a relief to investors that the UK fund industry is now reaching a crossroads and wealth managers and private banks have strong incentives to change how they meet their fund servicing requirements.

Since its introduction on 1 January 2013, the RDR has sought to reshape the relationships between financial service providers, intermediaries and consumers in the UK market. In the past, financial advisers, even those claiming to be independent, were paid largely through commissions when they sold a fund provider's product. In theory, fee-based advice was available, but few members of the public were ready to pay for financial advice. Over time, financial regulators became increasingly uncomfortable with these arrangements, believing this created product bias (financial advisers steered sales towards fund products paying a higher level of commission) and thus poor levels of customer information. To curb this practice, the RDR now attempts to move the UK fund market towards fee-based advice and to eliminate commission-based remuneration to fund advisers.

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

Regulatory push

With the Financial Conduct Authority (FCA) monitoring fund processing and asset protection ever more closely, wealth managers are coming under greater pressure to appoint best-in-class fund processing and fund custody to support their clients' fund assets. These firms are recognising the need to 'futureproof' their business. They no longer wish to be exposed to ancient operational models driven by a paper-based workflow that are a millstone to their development, exposing them to significant risk across the post-trade environment. With these dynamics, we are seeing wealth managers and private banks applying greater rigour to the selection and monitoring of their service providers. Some are now recognising the high levels of risk and inefficiency embedded in their existing providers' custody networks and operational procedures – and they are taking steps to put better arrangements in place.

At Clearstream, we recognise that the world will not change overnight. But it is important to alert the industry to the fact that a better solution is out there.

About Clearstream

Clearstream is a global leader in post-trade securities services with more than GBP 10 trillion in assets under custody, of which over GBP 1.1 trillion are fund assets. Over 2,500 banks, wealth managers and financial institutions around the world use Clearstream.

As a specialised fund-custodian, Clearstream delivers state-of-the-art solutions to standardise investment fund processing and to increase efficiency and safety in the investment fund sector.

With more than 125,000 mutual funds and 23,000 hedge funds from 37 fund domiciles, Vestima is the world's largest cross-border fund processing platform.

Through its Vestima platform, Clearstream offers an integrated fund solution that can handle fund transactions and post-trade processing with a high level of automation. Clearstream reconciles with its fund customers on a daily basis as it feels this is crucial to eliminating risk and to ensuring that cash and securities are where Clearstream thinks they are. Fund managers and transfer agents typically hold accounts within Clearstream, so the fund settlement can be managed via an internal DVP settlement, ensuring the transfer of legal ownership and of cash happens simultaneously with cash credited to the seller's account at 8:00 on settlement day.

As an AA-rated bank with a tradition in providing fund custody and asset servicing, Clearstream offers a one-stop shop through which customers can meet all their settlement and asset servicing requirements for multiple instrument types, including fund shares and units, from a centralised platform. Clearstream continues to grow both organically and through strategic acquisitions to extend the range of assets supported by its central processing hub. This is exemplified by Clearstream's recent agreement to acquire Citco Global Securities Services' hedge fund custody infrastructure based in Cork, Ireland. This will reinforce its ability to service financial institutions investing in the hedge fund sector.

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