pwc

Financial Services Perspectives

NO. 15 MARCH 2018

Asset managers optimistic on growth despite Brexit uncertainties

The key findings from PwC's 2018 Global Asset & Wealth Management Survey show that it will not be business as usual in the years ahead writes PwC's Andrew O'Callaghan.

Global Asset and Wealth Management (AWM) CEOs remain confident about growth prospects in 2018, but they are also acutely aware of the forces of disruption such as Brexit, regulation, technology and changing consumer behaviour.

These are the key findings from PwC's 2018 Global Asset & Wealth Management Survey. Nearly nine out of ten (87%) global AWM CEOs are confident about revenue growth in 2018, with 57% planning to increase headcount. Although Assets under Management (AuM) will be buoyed by rising asset prices, PwC estimates that by 2025 global AuM will have almost doubled – to $145.4 trillion. In Ireland, AuM has the potential to grow to $8.2 trillion by 2025.

Despite this optimism, we expect major changes to fees, products, distribution, regulation, technology and people skills and it won't be business as usual in the years ahead. Threats identified by the survey respondents include regulation (83%), tax changes (77%) and geopolitical uncertainties (80%), such as Brexit. Almost three quarters (73%) are concerned about cyber security threats. With margins under intense pressure in the industry, four out of ten (39%) AWM CEOs intend to cut costs. While the majority (70%) of believe changes in core technologies will prove 'disruptive or very disruptive' over the next 5 years, less than four out of ten (38%) believe that robotics and AI can improve the consumer experience.

Brexit was also identified as a key industry concern as revealed at the recent 7th Annual Global Funds

Andrew O'Callaghan

Congress held in London, attended by over 2,000 delegates. The conference concluded that Brexit is a major uncertainty for the industry, making planning very challenging. While most AMs based in London have advanced Brexit plans in place, much of the implementation is being held off until political decisions become clearer.

Being able to continue to delegate FS activity to the UK from Europe is critical. However, this is far from certain at present. A no deal scenario would cause great disruption and would not be good for the industry as a whole. A key priority, according to the fund managers, is to ensure continuity of service for their customers and may involve 'split' functions. For example, organisations are considering relocating certain aspects of their financial and accounting functions out of London to other EU capitals, including Dublin, Luxembourg and Frankfurt. It was noted at the conference that Ireland and Luxembourg appear to be the preferred destinations for any such relocation of AM operations in a post Brexit world.

The reasons highlighted for Ireland's popularity included common law jurisdiction; protection of contracts; English speaking and Ireland being a relatively easy destination to access.

According to the conference, what happens in the next 3 to 6 months will be critical. Clarity will be needed as companies cannot wait indefinitely to begin implementing their plans. The AWM market wants the closest possible relationship between the UK and the EU and will be important for the industry in Ireland also. While the industry is confident about growth, clarity around Brexit as soon as possible is a priority.

For the sector's CEOs, this is a time of contrasts: optimism and growth but also looming disruption which of course can bring opportunities. Although optimism among CEOs is a strong characteristic of the AWM sector, CEOs realise that fast-emerging disruptions mean the sector must urgently learn new ways to differentiate their offerings, reach the market and gain scale. And with barriers to global businesses likely to rise, digital technology will be an important part of the answer.

Andrew O'Callaghan is PwC EMEA Leader for Asset & Wealth Management

US tax reform and Ireland's FS industry

The most significant overhaul of the US tax code in 30 years is creating uncertainty for Ireland's financial services industry writes PwC's Darragh Golden.

U.S. tax reform has generated immense interest over the past year, arguably longer.

After campaign promises and a seemingly unlikely journey through the House of Representatives and Senate, the proposed overhaul of the US tax system was finally signed into law on 22 December 2017 by President Trump.

What we were promised was comprehensive tax reform. While I am not convinced that is what we got, it still represents the most significant overhaul of the US tax code in more than 30 years.

"Perhaps the most significant change is the reduction of the US federal corporate tax rate from 35% to 21%, coupled with a move from the current 'worldwide' tax system to a territorial tax system."

Perhaps the most significant change is the reduction of the US federal corporate tax rate from 35% to 21%, coupled with a move from the current 'worldwide' tax system to a territorial tax system. The move to a territorial tax system is introduced in conjunction with a one-time mandatory 'toll' tax on overseas earnings. There are also various anti-deferral provisions, including a new minimum tax on foreign payments to related parties (the base erosion and anti-abuse tax, or BEAT).

So what does all this mean for the financial services industry in Ireland?

While it is too soon to answer this question definitively, what is clear is that the impact is not just confined to the US – it has far reaching global implications.

While the reduced U.S. corporate tax rate and territorial tax system should create a more favourable financial

Darragh Golden

environment in the U.S., there are trade-offs – particularly for financial services companies.

The new corporate tax rate of 21% appears favourable, however the reduction in the tax rate will have a major impact on companies' financial statements and deferred tax balances, with a large number of banks already announcing significant write offs of their deferred tax assets which are negatively impacting effective tax rates.

For many financial services organisations the BEAT may diminish the benefit of the rate cut and could, in many cases, result in a significant increase in US tax paid. The BEAT effectively applies a minimum tax if companies are making significant base eroding payments to related foreign parties. Given that both related party interest and reinsurance premiums would be treated as base erosion payments, banks and insurers are likely to be most impacted and may need to restructure global revenue models and supply chains in response to the new rules.

Asset managers will have to reassess long standing structures for investing into the US or attracting US capital with US tax reform bridging the gap between taxation of corporate entities/blockers and flow-through structures.

From an FDI perspective, while there is a substantial reduction in the US federal corporate tax rate, once US state taxes are taken into account, the Irish corporate tax rate of 12.5% is still half of the US combined rate of approximately 26% and should still be competitive in terms of a location for investment. Additionally, Ireland's 12.5% tax rate is often no longer the determining factor as to where companies locate operations.

This is more often driven by the availability of talent, cost of doing business and access to markets, so Ireland as a location of choice for FDI remains competitive.

"For many financial services organisations the BEAT may diminish the benefit of the rate cut and could, in many cases, result in a significant increase in US tax paid."

Equally, the reduction in the U.S. corporate tax rate will encourage U.S. organisations to look at their overseas tax rates more closely as they manage their overall tax positions. This could in fact create additional FDI opportunities for Ireland as global financial services players look to locate their R&D/FinTech solutions in attractive locations with a proven track record of success.

While US tax reform will have broad and far reaching implications at a global level, the exact impact on the financial services industry in Ireland will only become clear in the months and years ahead.

Darragh Golden is tax director at PwC.

Automation for competitive advantage in banking

As some FS companies explore the use of Robotic Process Automation (RPA) the most progressive companies are already moving to the next level of sophistication, Intelligent Process Automation (IPA), write PwC's John Dwyer and Jens Gladikowski who say that this next wave of automation has the potential to improve both sides of the cost/income equation.

In retail banking, strong cost pressures remain. These stem from increasing regulation, operational costs, historic remediation issues and legacy infrastructure. Combined with income challenges in a low interest rate environment they provide a “perfect storm” and as a result, the reduction of cost/income ratios has been a consistent issue across all retail banks over the last few years. This is further compounded by an environment where customer centricity is the primary focus. The emergence of disruptors in the retail banking industry is therefore no surprise, as they can offer a unique customer experience at a much lower cost than any of the incumbents. Thus banks face a real challenge: simultaneously defending market share, lowering cost/income ratios, whilst providing better customer service and dealing with Open API banking and PSD2.

> **“Practically all banks are either considering, planning or executing automation and in approximately three-quarters of cases these projects originated as part of wider, technology-enabled improvement programme”**

Over the last 10-15 years, a popular strategy to address at least part of this challenge has been to optimise and standardise processes and then to offshore to lower cost locations. However, there is increased regulatory scrutiny on offshoring, increased wage pressure from the traditional offshore locations as well as the risk of potentially diminishing customer experience.
Faced with this dilemma, retail banks have turned to technology, often through automation initiatives that are largely focused on relatively simple transactional activities in back and middle-office. Practically all banks are either considering, planning or executing automation and in approximately three-quarters of cases these projects originated as part of wider, technology-enabled improvement programme*. Transactional, rules-based automation (also referred to as Robotics Process Automation, or RPA) has been adopted to a mixed degree in financial services, with some companies employing hundreds, if not thousands, of bots, whilst others are still in the exploratory stage. Many (but not all) of these initiatives are delivering significant benefits, reflecting the rapid maturing of the market in the last 2-3 years, the fact that RPA technologies are not inherently complex (although the automated process might be) and the lessons companies have learned from initial implementations and BAU issues.

John Dwyer

Jens Gladikowski

The use of RPA has gone some way to addressing the cost/income challenges. However, there is a limit to what RPA can achieve, once activities with a clear rationale for automation (scale, repeatability, rules-base) are exhausted. For example, RPA tools are typically less able to address the enablement of enhanced customer experience. To deliver additional value, leaders are now focusing on the adoption of Intelligent Process Automation (IPA) and Artificial Intelligence (AI). IPA/AI are terms that include capabilities such as Natural Language Processing, unstructured data processing, pattern recognition and others. It is estimated that about 10% of banks are using IPA/AI tools in a productive environment*. These tools ‘co-learn’ with the human through feedback loops and enable solutions such as chatbots that have the potential to transform banks’ customer service. In the Irish retail banking market, the expectation is that a quarter of customer transactions will be conducted by a chatbot in the near future, according to a PwC survey**.

> **“To address the cost/income challenge, consideration needs to be given to how automation is embedded into initiatives that address customer-centricity, operating models and tooling.”**

Digital leaders in the Irish banking market are expecting the widespread adoption of IPA/AI powered tools to be imminent. This next wave of automation has the potential to address both parts of the cost/income equation: lowering operating cost and enhancing revenue streams. Even more so than the implementation of RPA, IPA/AI solutions are raising profound questions regarding data protection, governance and changes to the workforce. To address the cost/income challenge, consideration needs to be given to how automation is embedded into initiatives that address customer-centricity, operating models and tooling. The adoption of RPA in the past few years showed that strategic planning, through preparation and precision on the expected benefits are the cornerstones to a successful automation programme. Irish banks that are mindful of these lessons have the opportunity to move quickly into this space and create competitive advantage.

(*)'PwC's RPA in financial services', PwC survey October 2017; (**) Chatbots in Customer service: The impact and opportunity for Irish business. PwC/UCD, 2017

John Dwyer and Jens Gladikowski are directors, Advisory Consulting at PwC.

Business resilience and ‘Brexit’ planning

As Brexit 'fatigue' threatens to numb the senses of business leaders PwC's Jason Hickey and Jason McGee look at what company Boards can do to make the disruption being caused by Brexit an opportunity for their businesses.

How can your Business Resilience Framework support your Brexit Planning?
Since the Brexit referendum in June 2016 boards (across all business sectors) are still struggling to fully understand Brexit and the related impact on their organisation, given uncertainties and limited available information. With the event ever looming the prospect of Brexit ‘fatigue’ may hit sooner than Brexit itself. This begs the question; ‘can boards and organisations be doing more’? In short, the answer is yes.

Brexit is just another business disruptor
Put simply, Brexit is another potential business disruptive event and in essence this is what business resilience is all about. Brexit does represent a systemic, multi-faceted and complex risk but being resilient isn’t just about adapting to the minor 'easy' risks. International Organization for Standardization (ISO) describes resilience as 'a company’s ability to absorb and adapt to unpredictability, while continuing to deliver on the objectives it is there to achieve'.

> **“Tension can exist between being resilient and being agile and sometimes protection comes at the price of agility. Balancing these two needs can be challenging.”**

Resilience itself views business disruptors as being neutral (could materialise into an opportunity or a threat). Therefore, resilient organisations look for growth opportunities hiding in the unknown and have strategies to exploit them.

Business Resilience at a glance
Resilience requires your business to evolve continuously, protected from shocks, while at the same time being able to adapt and maintain competitive edge. Resilience can be measured and therefore support the identification of weak points for management intervention. Some of the key characteristics of resilient businesses include:

Jason Hickey

- Your business has visionary leadership that has invested wisely in resilience;
- Resilience is built into operating models and change management systems;
- Integration is part of your business DNA;
- You see beyond the bounds of your business to the extended enterprise, including third parties; and
- You continuously measure and monitor resilience against key metrics.

Jason McGee

Tension can exist between being resilient and being agile and sometimes protection comes at the price of agility. Balancing these two needs can be challenging.

How to tie business resilience into Brexit planning?
Resilience can be seen as a management discipline which can be further supported by frameworks and external Industry Standards such as ISO 22316 / 22301. These frameworks should be designed, implemented and managed in line with your organisations desired resilience state. There is no correct level of resilience, similar to risk it should be reflective of business objectives and wider operating environment.
Through business resilience and business continuity disciplines your business will have already garnered huge amounts of valuable information which should most certainly be used to assess Brexit considerations and issues;

- Similar to planning for business disruption scenarios, create 'Baseline Assumptions' around Brexit and facilitate scenario workshops with key stakeholders to work through potential impact assessment and response strategies to specific worst case scenarios. Planning for the worst means all other outcomes are an advantage. Some example assumptions could include increased business chain complexity, negative regulatory changes, cost base increase and 3rd party (outsourcing) EU passport impacts.

> **“There is no correct level of resilience, similar to risk it should be reflective of business objectives and wider operating environment.”**

- Using the baselined assumptions start to 'Analyse' your business against them but when doing so ensure to leverage key information already documented in your 'Business Impact Analysis' and 'Business Continuity Plan' such as critical activities, locations, 3rd party dependencies (including outsourcing), staffing requirements and end-to-end business recovery planning.
- Develop a 'Brexit Action Plan' using the collated information and baselined assumptions to reduce ambiguity which will result in a more robust Brexit response strategy. Incorporate the fundamentals of your Business Continuity Planning expertise (Plan, Do, Check Act) and share across the wider organisation to increase awareness and ultimately increase response capabilities.

Jason Hickey is Director, Risk Assurance Solutions at PwC and Jason McGee is Senior Manager, Risk Assurance Solutions at PwC.