Administrators adapt to changing market environment

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Like all international financial services centres, Ireland was hit hard by last year's upheavals both in the industry and in the wider economy, but so far the impact of the economic crisis on the country's fund sector has been comparatively marginal - certainly compared with the country's banking sector, where the government has had to take drastic action to keep the country's major institutions afloat.

That's not to say there have not been significant changes for fund industry players. The fall in assets across the industry has been difficult for many administrators that have built their technology and personnel infrastructure around higher revenue figures, but they remain confident they can emerge from the downturn stronger - especially if Ireland becomes a prime beneficiary of a switch by hedge fund managers to more regulated products and domiciles.

Administration firms are closely monitoring developments on the proposed new hedge fund and private equity regulatory framework unveiled in April by the European Commission. 'This year promises to be a busy one on the regulatory front,' says Mark Mannion, managing director of PNC Global Investment Servicing Ireland. 'We have the management company directive as well as a potential hedge fund directive to address. In addition we have ongoing discussions around minimum activities rules which impact the competitiveness of our industry.'

Some of the EU proposals are aligned with recent research into the industry, notably a white paper published by Bank of New York Mellon and New York-based management consultants Casey Quirk, that forecasts a greater alignment of the interests of shareholders and managers in the future.

Since no evidence has been uncovered that hedge funds caused or made any significant contribution to the global crisis, knee-jerk regulation is an inappropriate response, industry members believe.

Andrew Dillon, managing director at insurance brokerage Baronsmead Partners Ireland, says: 'I don't believe that the funds industry has suffered as much as some other financial services sectors, and the regulatory framework has stood up well considering the carnage experienced in global markets over the past 18 months.'

Ireland's existing strong regulatory framework promises to give it an advantage over competing jurisdictions, according to SEI managing director Barry O'Rourke, who says: 'This means Irish organisations will be able to play a lead role in the renewed growth of the financial services industry once the global environment has stabilised.'

Fund administration firms face the challenge of increased investment in new processes and products, including expanded geographic and time zone servicing capabilities for European-oriented offshore funds, the extension of web-based services and straight-through processing capability, with particular focus on payments, derivatives processing, virtual pooling and pension pooling.

The industry is also gearing up for the impact of the European Union's Ucits IV directive, which will further liberalise the rules governing funds that can be marketed to retail investors in all member states under the so-called EU passport. The new legislation has essentially been agreed by EU member states and the European Parliament, and is due to be implemented in 2011.

'This has proven timely since there is going to be an increase in demand from investors for more regulated and transparent funds,' Mannion says. 'I expect many leading hedge fund groups to establish Ucits products to satisfy this demand and access investors they would previously not have targeted.'

Adds O'Rourke: 'We are seeing a lot of activity in Ucits products as investors seek out regulated products. We're also seeing more hedge fund managers set up managed account structures to accommodate investors' demands for greater transparency and liquidity.'

However, Willie Slattery, country head of State Street Ireland, points out that a major issue has emerged regarding the liability of custodians, especially for Ucits funds. 'This issue has arisen in the context of both Madoff and Lehman, and some voices in the EU are suggesting that custodians should bear strict liability over funds held with sub-custodians, irrespective of the circumstances,' he says. 'This is not a risk that the balance sheets of custodians or the economics of the business can bear.'

With many banks looking to sell off their non-core assets, including fund administration businesses, industry observers are expecting an increase in mergers and acquisitions activity, although obvious obstacles include difficulties with financing and lack of potential buyers.

O'Rourke argues that increasing demands on technology and infrastructure will place fund administrators under immense pressure. 'Those who do not have the existing tools to provide services that are now essential to the market, such as independent record keeping, daily reporting and transparency, and do not have the investment budget available to obtain this technology, will have a challenging time,' he says

The current focus on cutting both aggregate and unit costs and the eventual stabilisation of financial markets will help to boost M&A activity, but Mannion believes that it is likely to be on a smaller scale. 'For the sale of fund administration businesses to become practical there would have to be potential purchasers,' he says. 'Due to current economic conditions the universe of potential buyers has contracted significantly, making the sale of any large-scale administrator difficult.

'But at the smaller end of the scale there will inevitably be administrators that are struggling to remain solvent following the outflows experienced by the industry. These players may seek to merge to obtain economies of scale or to raise capital from other sources.'

Slattery agrees, saying: 'Further consolidation is likely to involve [acquisition] of regional, niche and sub-scale businesses by larger players.'

Adds Dillon: 'Very few financial institutions have enough free cash to consider an acquisition at this time. One thing certain is that if we do see further consolidation in the industry, transactions will not be taking place based on the multiples of earnings that we saw in the pre-financial crisis markets.'

An encouraging indicator, however, is the number of new entrants into the market, despite the tough environment for anybody setting up a new business. Diversity in the size, skills and culture of administrators is a key factor in maintaining a robust industry in Ireland.

The sector has certainly been boosted by a wave of scandals in the US that have highlighted the extra degree of security offered by appointing an independent administrator - a norm for European hedge fund managers but not yet on the other side of the Atlantic.

In the new environment, it appears logical that investment managers in the US will increasingly need to show their investors independent administrators and robust governance structures for the funds they manage. The vast majority of fund blow-ups over the past decade have involved US managers, and industry members say many could have been averted by independent service providers.

Administrators that can differentiate themselves by providing services that enable their clients to grow and succeed will prevail, O'Rourke says, noting that while the current environment poses significant challenges to the industry, it also opens up a broad spectrum of opportunities.

'As more institutions look to increase their exposure to alternatives, this is putting added pressure on managers and their administrators,' he says. 'Managers will be able to differentiate themselves by implementing institutional-quality infrastructure and operations, meeting investor demands for increased reporting and greater transparency, building stable management teams with a full range of skills, and shifting their focus from performance to investment disciplines. This will put them in a better position to take on reasonable business and find success.'

Changes are also taking place in related areas. For example, the insurance industry is seeing greater demand for well-constructed directors' and officers' insurance cover - mostly on the back of litigation risks from investors, who in the event of mishaps are more inclined than ever to seek recompense from organisations with deep pockets.

As institutional investors continue to increase their allocations to alternatives following last year's hiccups, due diligence is playing a much more central role in the decision-making process. Says O'Rourke: 'There continues to be a strong focus on data tools and technology as clients look for ways to manage their data and get better insight from their data to enhance their risk reporting and portfolio analytics.'

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