Alex Maturri, S&P Dow Jones Indices

Proprietary indexes are getting confused with the products, IIA

Pablo Conde-Herman
14 June, 2016

Following a recent meeting of the Index Industry Association (IIA) in London, SRP caught up with its chairman Alex Maturri (*pictured*) - who is also the chief executive officer at S&P Dow Jones Indices - and chief executive, Rick Redding, to discuss the trade's body most recent activities and the challenges and opportunities in the index market as a result of the upcoming regulatory overhaul.

The increasing pressure from regulators targeting conflicts of interest in the financial markets and the uncertainty around the impact of the new benchmarking rules have forced some investment banks to review and offload parts of their proprietary index businesses. The biggest trend [in the index market] is the fact that an increasing number of investors are moving away from some of the banks involved in the index business because the fear of the unknown around regulation, says Maturri.

"This has benefited independent index providers," he says. "Because of S&P DJI's business model investors feel more confident in what we offer than getting a similar product from a bank. We have seen already a number of banks lining up to offload their index business and some have already changed hands (Barclays/Bloomberg). We think this trend will continue and we're in a good position to capitalise on any opportunities arising in this segment to continue to capture market share."

According to Redding, banks are feeling the pressure of the regulatory overhaul but not only around benchmarks. "Banks are having to address many issues around their business model, and as we have seen the pressure has forced some banks to exit the index business or partnering with third party calculating agents to address the conflict of interest around creating indices for their own products."

The main consequence of this drive towards a regulated environment is the consolidation of the market, says Redding. "We believe this will continue. Regulation is needed to have a functioning market but regulators must be aware that over-regulating could impact investor choice and the competitive landscape could also be damaged," he says.

The number of regulatory issues under the radar of industry watchdogs and the ramifications of the different rules and regulations suggest that "this will continue for some time".

"We are moving from the discussion stage to the implementation stage around some of the main pieces of regulation. We will see how these new guidelines pan out and impact the industry as a whole," says Redding, adding that thee competitive pressure has also triggered a search for innovation over the last few years, "and that is a positive outcome".

Competition seems to be getting increasingly tight in the index market with the arrival of new players such as Bloomberg, and smaller niche-type providers such as Solactive, Finvex or Bluestar. "For us competition is healthy and keeps us on our game," says Maturri. "Some index providers have sat back and continued doing what they did with their licensing business. Some did not realise that to have a competitive edge in this market you have to be first to come to market with some of these concepts, you have to find the right partners and support what you do with research, white papers, etc."

According to Maturri, some of the most recent developments (Barclays keeping some parts of the index business and selling other parts to Bloomberg) are very interesting and no one knows how they are going to play out. "With some of the new entrants coming into the market (Bloomberg one of them) you don't know what their business models are going to be," says Maturri. "We have seen a shift in the equity index business which was pretty much run from the traditional side of the business model but in fixed income the business model is different and more focused on trading."

As a result, says Maturri, some of the providers had to establish how to make money in a different way. "It is not clear yet what direction some of the new players are going to take," says Maturri. "With consolidation there are always losers. Scale becomes more important because it gives you capabilities around research and distribution and those are very important elements to have a successful index business."

New entrants to the market have been welcomed from many quarters for their ability to tap into new opportunities very quickly and offer a competitive service, but there are issues around regulation that could put smaller firms at odds with new developments, and is important to establish who is offering what.

"The issue with small index providers is not about their ideas and unique IP, but about meeting regulatory burdens, the separation of functions, etc.," says Redding. "There is a cost for index providers to do business and smaller providers may find it difficult to meet some of the requirements. Regulator's starting point when they began to look into benchmarks was that all indexes are the same, like Libor, and we disagreed because they did not considered the different business models but they now understand that survey indexes are different to indexes priced on equities or from traded prices on regulated trading venues."

"We acknowledge that regulators have come a long way from their original approach of putting the whole index segment under the same light," says Maturri, pointing that the Iosco principles have been adjusted to clarify where the industry stands, "and regulators are now understanding what the role of independent index providers is".

According to Maturri, at the same time, banks have started to get rid of their index business or outsource some functions (third party calculation) to address conflict of interest. "One of the problems we found is that people have forgotten that these indexes started as benchmarks, and all of a sudden the indexes are getting confused with the products," says Maturri. "We have spent a significant amount of time demonstrating to regulators that products come on many different forms and are regulated different across jurisdictions, but a given underlying index will be the same regardless of the wrapper."

According to Maturri, the association has put a good deal of effort "in explaining to regulators that their focus should be on how the index is put together and what safeguards are in place".

"We think we have been successful in helping regulators understand how indexes are used in different market functions," says Maturri.

Regulation should not be a problem as long as you have legal certainty about what can you do and what not, but there are still issues to be addressed around cross-border implementation. "Most market players in the

indexing industry are global institutions and we have seen some discrepancies between US and European firms," says Maturri. "It is becoming increasingly difficult for administrators to deal with the different approaches in different jurisdictions."

The amount of rules to comply with has also had an impact on innovation which "has been somehow limited because the cost of compliance to do due diligence on a good idea could be too high", according to Maturri.

"Regulation to stop products that only offer value to the issuer or the distributor being pushed is good for the market," says Maturri. "Fiduciary standards in this context makes sense. Products should not be sold on the basis that makes the issuer the highest possible money but on the basis that will help clients achieve their goals."

Reputational risk has also come to the fore and some financial services providers have already retreated or scale down their retail operations. "If regulation becomes too much of a barrier investors could move offshore and that would defeat the purpose of regulation," says Redding, adding that the mandate of the association is to cover all these issues. "There is also a danger of having an unlevelled playing field across the globe with different approaches. We do recognise the challenge for regulators to standardise some of the rules, and that's why we engage with them regularly."

According to Redding, however, the association's work and engagement with regulators will continue as "when it comes down to the detail it is very difficult to have a standard blanket-rule that is applied across markets".

"For example, the Iosco principles went through a process of consultation and evolution because the regulators found out that no country in Apac has a common whistle-blower provision, and that the rules in Europe and the US around whistle-blowers are different," says Redding. "The association is playing a key role in coordinating a message and delivering it with one voice, although the individual firms can continue engaging with the regulators to address their own concerns. Not every member of the association is going to agree on 100% of every issue because there are different business models, but having a trade body that represents the industry can only be positive not only because it can help to shed light on issues affecting the industry but can also educate." **SRP**

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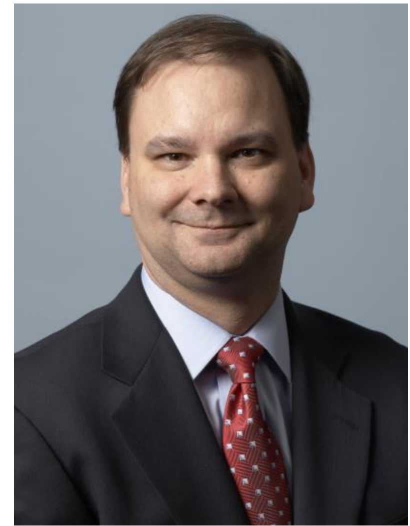
Q&A with the IAA: structured notes and ETFs have helped to democratise the industry (part 2)


Rick Redding, IIA

Pablo Conde-Herman
16 June, 2016

In the second instalment following an interview with the Index Industry Association (IIA), Alex Maturri and Rick Redding (*pictured*), chairman and chief executive of the trade body, respectively, talk about bad indexes, why some indexes are better suited for some wrappers and how the lack of transparency around the marketing of some strategies can be misleading for end investors.

Are there bad indexes out there? Has the IIA done any work to bring standards to the industry?
Maturri: There are bad indexes out there. The black-box approach has been detrimental to the industry. A bad index is one that does not represent the market fairly and has flaws in its methodology, is not transparent or based on a consulting process. There are certain standards that are mandatory to implement before even you launch an index. Now that processes have become more regimented, documented and tracked, the workload and resources needed have increased but this will pay off because the end investor can understand the methodology and access the information needed to assess if the index suits their investment goals.

We have communications channels opened with many index providers and exchanges across the world, and the perception is that the indexing industry has come to terms with the fact that the new regulatory framework is going to be global and that we all will have to comply with it. Is not so much about the complexity of indexes but about the transparency around the construction and calculation of indexes. We believe that as long as the methodology of indexes is transparent and rules-based, complexity is not an issue if the right suitability checks are in place. If you're sitting in Japan and you're licensing an index for a structured note that is going to be issued in Europe, you will have to comply with European regulation. However, the levels of unpreparedness are quite surprising.

Redding: The IIA was created before the regulatory over-haul. We came together because there was a risk that all index administrators would be perceived based on the actions of the worst participant in the market. The association's code of conduct was launched as a framework of best practice for the industry. The indexing market is very different today to what it was years ago. We have seen how indexing has expanded its asset class scope and investors have benefitted from some of the active asset management techniques brought into the passive investing world with new rules-based indexes. Investors have benefitted by seeing fees move down. The role of the IIA has been key particularly in Europe because each of the members of the association may have different and unique needs and concerns and there was no one out there explaining to regulators what the difference is between a Libor type index and an index based on

regulated market data. IIA has played a very important educational role and taken the discussion to a higher level than individual firms would have been able to do, and explain the economic reasons behind indexes.

Some indexes seem to be getting more traction in the exchange-traded products (ETP) segment while others seem to be preferred by structured products providers. What is the reason for this?
Maturri: The wrapper is just a delivery mechanism. There is a lot of talk about active products moving to the ETF market and we don't see that as an inherent bad thing. The problem is that active managers have struggled to outperform their benchmarks. ETFs have helped to democratise the industry and have created a shell that is very transparent and liquid, but because of that transparency some of the fees embedded in other products cannot be applied anymore. The same applies to structured notes. They are just instruments to achieve an investment goal but because they have the credit risk element attached to them it makes them less appealing for some investors. As an index provider we are all up for transparency and investor choice, and we are pretty agnostic when it comes to how our indexes are deployed. If an investor wants to pay a high price for a product that is fine but investors must be able to make an informed choice.

Some investment strategies that were only available for a limited amount of investors are now being used by indexes and ETFs. Many concepts done in active management in the past are now available through rules-based indexes and distribution products such as ETFs and structured notes, at a considerable lower cost, and we think that is healthy for the growth of the capital markets.

The concept of being able to target volatility is a pretty sophisticated concept. Not everybody understands the risk volatility trade-off. Some concepts work better with ETFs and other with structured notes. Considerations around the time to market and advice. Although we're somehow agnostic we do spend a significant amount of time doing due diligence before we license one of our indexes because there is reputational risk involved. SRP

Q&A with the IAA: Prop indexes are over-engineered (part 3)

Pablo Conde-Herman
17 June, 2016

In the third article following an interview with the Index Industry Association's (IIA) chairman Alex Maturri and chief executive Rick Redding, the pair provide insights into the conflicts of interests around banks' proprietary index businesses, how suitability and education go hand by hand, and what is driving activity in the index market.

Some investment banks continue to rely heavily on their own proprietary indexing capabilities to bring products to market. Is

this a result of high fees from index providers?
Maturri: Our fees are very small in the scheme of things, and investment banks cannot claim that you can get a better pricing by using proprietary indexes. Banks usually like their proprietary products because they don't have the same level of transparency and they don't disclose where they make the money. That's why that part of the business faces a downfall because if they make it more transparent people will then make a choice. There is value for index providers in that trend. However, we have noticed when approached by banks to calculate their indexes that some of the secret sauce for some of the so-called proprietary strategies is not so secret and in fact not too different from the bank next door. As a calculating agent we see some of these strategies are over-engineered and there is also a bit of trend-following (risk control, smart beta...). That's the nature of an intellectual property business, the marginal cost of producing these concepts isn't very high, and that's where brands can differentiate because with a brand you differentiate your service level and the quality of the information you put out there. We believe that is the reason people come to us.

Redding: The problem with proprietary indexes is that they are not available to others, and they are used in products issued by the same company which can create potential conflicts of interest. One of the principles any index provider has to adhere to be a member of the IIA is that they have to make their indexes available to competitors. That's the main reason why we don't have many banks or asset managers in our ranks.

There has been a lot of talk recently about smart beta, but factor investing is not new. What is the reason for all the noise?
Maturri: We have seen it with the smart beta concept. All of a sudden the market is flooded with smart beta strategies. This is nothing more than quantitative investing. The problem is that anything that is not market cap weighted is now smart beta and that can be confusing and misleading to the end investor. This again goes back to transparency. As long as you offer a clear and transparent set of rules enabling investors to understand what they are buying into, we don't see any problem. The assets invested show that smart beta will never be a threat to traditional market cap indexes, but we believe they can add value to investors' portfolios and investments because they can be used on their own or in combination. Smart beta indexes can be very useful as an overlay in a portfolio to hedge some risks and for diversification purposes. That is where we see the value in smart beta indexes. Like any other strategy smart beta have a place in investors' portfolios but could also be a dangerous investment if it ends up in the wrong hands.

Redding: Education is a very important element to understand suitability. People continue to invest on the basis that back-testing shows outperformance but without knowing the risks they are taking and the market environment that produced that performance. Understanding the products, the risks involved and the issuers of the products are all key elements to make an informed decision

What is the main strength of the index industry and what is your outlook for the short-term?
Maturri: The index industry will continue to innovate because there will always be a need to measure a market or market segment or as the basis for a product. The way indexes are deployed in products is a different issue, and is more a question for the product issuers. The market will continue to be driven by the traditional well-known benchmarks because those are the indexes that people understand and see on the paper every day. Black-box type products will not disappear but it will be more difficult for those to end up in the wrong hands. Simple and transparent indexes capture most of the return anyhow, but some sophisticated investor seeking more return may be willing to invest in more complex strategies

What is driving activity in the index market in the current financial markets environment?
Redding: In times of uncertainty people go back to what they know and can understand.

Those indexes with a track record will always resonate with retail investors. People use different benchmarks and indexes for different purposes... to get the best read of the market, or to invest in liquid products. As an association we think it is important to cover the needs of investors and we value the competition in this segment. Some providers have very broad indexes and others have very narrow exposures that may work in futures trading but don't provide a good view of the market or economy. For us it is also very important that our members offer the indexes that investors want to meet their goals.

Maturri: The S&P 500 will continue to be our flagship index. It is a benchmark and an index and is the most widely used in any possible format. In terms of assets benchmarked to the index, it is the most utilised index in ETFs, mutual funds and structured products. That's a unique status and to protect that we have built a whole range using that brand. We prefer to refer to the S&P 500 as a core brand rather than our core index. Some of our best ideas and innovations have been deployed under the S&P 500 brand. Some indexes because of they are narrow in their exposure are better suited for futures trading and other because they have a very wide exposure may be good to be used as a benchmark. We believe our S&P 350 index will resonate with investors because it sits nicely in the middle. **SRP**

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