2 THREE KEY THEMES THAT WILL SHAPE THE UK INDUSTRY

2

KEY FINDINGS

- Growth in AUM to £9.1trn in 2023 shows that the investment industry is adapting in a period of significant change. The three themes addressed in this chapter are critical to the future development of investment management.

MAINTAINING THE UK'S COMPETITIVENESS IN A NEW ECONOMIC CYCLE

- Governments worldwide and in the UK are prioritising policies that support economic growth, attract investment to domestic capital and private markets and address the needs of ageing populations including providing adequate income in retirement.
- The newly elected UK Government has placed economic growth at the forefront of its agenda. The investment management sector has a crucial role to play in helping to achieve this goal as well as driving good investor outcomes.
- Clear, consistent, and proportionate fiscal and regulatory frameworks are critical to maintaining a stable environment for investment managers. Priority areas include pensions policy and a consistent and proportionate tax policy.

THE EVOLUTION OF SUSTAINABLE INVESTING IN A MORE COMPLEX OPERATING ENVIRONMENT

- Since 2019, the sustainable and responsible investment landscape has evolved significantly, marked by an investment boom and major regulatory and political changes. However, sustainable investing is now operating in a more complex environment. There are three important dimensions driving this:
  - **Diverging political views** across jurisdictions on sustainability and sustainable investing: increasingly, political considerations are affecting the attitude of governments towards implementing measures to achieve the transition to net zero.
  - **The volume and pace of regulation** on standards of disclosure across the EU, the UK and the US is affecting the development and communication of sustainable products and strategies.
  - **Changing investor demand** as investors are influenced by diverging political and societal views and lower returns on sustainable investment strategies through 2022/2023.

SUPPORTING INNOVATION AND HARNESSING THE BENEFITS OF AI AND TOKENISATION

- There is a significant focus from investment managers on using technology to drive efficiencies and to control costs. Investment managers are focused on implementing AI to streamline operations and to enhance research and analysis. The development of Distributed Ledger Technology (DLT) and tokenisation is focused on both fund operations and capital markets with progress on digital bond issuance and tokenised Money Market Funds.
- These developments signify a period of accelerating change and firms must also keep pace with emerging risks and strengthen their operational resilience strategies. Two pressing threats are cyber security and the emergence of quantum security risks.

Growth in industry AUM of 3% through 2023 shows that the industry has adapted to new market conditions following the 12% fall in AUM through 2022. Nevertheless, we continue to operate in a period of significant change as firms navigate a more complex operating environment and the end of the era of low interest rates and quantitative easing, which helped to power consistent annual growth until 2022.

Looking ahead, in this chapter we have focused on three themes that are important to the future development of the UK investment management industry.

1. Maintaining the UK's competitiveness in a new economic cycle

2. The evolution of sustainable investing in a more complex operating environment

3. Supporting innovation and harnessing the benefits of AI and tokenisation

MAINTAINING THE UK'S COMPETITIVENESS IN A NEW ECONOMIC CYCLE

In 2024, more than 60 countries are holding national elections bringing around 2 billion voters to the polls across the globe. Elections are taking place in the US, UK, India and the European Union bringing new governments to power. There may be significant differences in ideology between newly elected parties around the world but there are three important goals that most new governments share that have implications for investment management:

- A focus on delivering economic growth.

- The desire to attract investment to domestic capital markets.

- In developed countries, ageing populations and the imperative to deliver adequate retirement income.

SUPPORTING GROWTH IN A NEW ECONOMIC CYCLE AND THE ROLE OF INVESTMENT MANAGERS

Delivering economic growth comes high up the priority list for newly elected governments. Global GDP grew by 2.7% in 2023 with the UK's GDP growth at 0.1% and the US doing relatively better at 2.5%. Maintaining economic growth post pandemic whilst trying to dampen escalating inflation, where raising interest rates cools economic output, has been extremely challenging. In the UK, the new Labour Chancellor, Rachel Reeves, has made it clear that economic growth is her priority and the investment management sector can play an important role in helping to achieve economic growth.

"In the UK, the main issue for us is having a government that is pro-business, pro-financial services and pro-investment management both in what they say and in what they do. It's clear that the current government is in favour of financial services in what they say."

The government can help to unlock growth in the UK by attracting more investment to domestic companies through the capital markets and private markets. There is widespread support for deploying capital to support the domestic economy but there is an equal focus on delivering stable, long-term risk-adjusted returns for investors: the fiduciary duty to the investor remains of central importance to investment managers.

"There is particular pressure on asset managers to invest more capital to support domestic markets; this could be seen to clash with firms' fiduciary obligations – this goes to the heart of asset management and ultimately our fiduciary duty as stewards of our clients' money."

There is also the opportunity to support economic growth through investing in private assets including infrastructure and real estate.

MAINTAINING THE UK'S ROLE AS A COMPETITIVE INTERNATIONAL CENTRE OF INVESTMENT MANAGEMENT

As a new government establishes itself, the relationship between the Government, the regulator and the industry will be critical to helping to deliver good outcomes for investors. There are four important areas that will help to strengthen the UK's competitiveness according to senior leaders in investment management.

- Stable and proportionate policy making: ensuring that fiscal stability is maintained and that taxation is proportionate. Implementing a consistent tax policy across the next parliamentary term allows investment managers to better plan. For example, if the Government rows back on measures such as removing the Lifetime Allowance for pensions, this would penalise pension savers seeking to increase their pension pots to help fund their retirement and re-introduce complexity around managing the Lifetime Allowance threshold.

- A regulator that focuses not just on consumer protection but on enabling firms to innovate and to be competitive.

- A more collaborative relationship with international jurisdictions, including the EU, that spans regulation, trade and investment and the movement of people. Attracting and retaining talent in the UK from around the world is a critical success factor in maintaining the UK's position as global investment management centre.

- Helping to support investment in the domestic market and attracting investment through delivering economic growth.

"It is very important for the UK to continue to be a base for global managers ...if you want firms to establish themselves here you also have to encourage the domestic market and foster a culture of investing... The UK has to be competitive, tax friendly, regulation friendly and it must think about this holistically."

If investment managers have a clear view of fiscal strategy and regulatory priorities, that enables them to plan effectively and to make longer term business decisions. If tax increases are going to come, then once they are in place, maintaining consistent tax policy for the remainder of the parliamentary term will help to support stability and make the UK a more attractive location for international firms.

"We're in this phase of uncertainty as to whether there are going to be tax increases and where those tax increases are going to be."

The UK regulatory landscape is an important factor in the competitiveness of the UK as a centre of investment management. In recent years there has been a strong and consistent focus on consumer protection.

"The FCA have historically been seen as being a sensible, proportionate regulator. We've supported the Consumer Duty - it is inherently at the heart of what we believe which is ...that we think about good customer outcomes."

The Consumer Duty has established a solid foundation for protecting UK financial services consumers. There is now an opportunity to look at the next set of regulatory priorities and to think about how the FCA can deliver on its secondary competitiveness objective. Regulation that continues to champion consumers remains pivotal but enabling firms to continue to innovate within regulatory parameters is also key and we look in more detail at the FCA's work in supporting the tokenisation of funds later in this chapter. Indeed, the FCA's accommodative stance on allowing firms to roll out artificial intelligence without imposing regulation that could stifle innovation is an example of the willingness of the FCA to work to support innovation in UK financial services. The FCA is also looking at digital disclosure and at closing the advice gap in the UK by delivering regulation on advice/ guidance that works better for consumers.

In our interviews, investment managers have also told us that they want to see a change in emphasis away from a focus on delivering the post-Brexit agenda, which has driven a significant amount of regulatory change.

“The regulatory landscape in the UK has been a constant churn over the last 8 to 10 years... the whole debate on competitiveness has partly come from the UK’s exit from the EU and the need to show tangible examples and benefits...”

As we look ahead to the next 5 years of a new government, there is the hope and expectation that the relationship between the UK and the EU will become more productive and collaborative across trade, regulation and immigration, which would allow investment management firms to operate more effectively cross-border.

“We would like to hear a softening in the rhetoric in terms of the UK and EU partnership and more clarity about what that partnership will look like over the next 2-5 years.”

“We are absolutely 100% behind promoting the UK financial services hub as the place to do business, but not the only place, and we recognise that we need to have strong partnerships with other jurisdictions, including our European neighbours. One of the clear advantages of the UK as an international centre is the access to talent that it provides; this must be preserved as it is a clear competitive differentiator for the UK.”

“What has made UK asset management successful is talent, it's innovation and it's having an open and collaborative global approach... The UK’s biggest selling point is access to talent. You need to have open borders, you need to have ease of immigration so that talent can move with less restriction and so that we can make the UK a hub for innovation.”

Supporting the growth of the UK’s domestic market is a critical factor in promoting the competitiveness of the UK investment management industry. In listed equities, UK equity AUM is down by a third from 10 years ago. If the Government can help to create a virtuous circle where the UK economy becomes more competitive and grows, this will attract further investment and good companies headquartered in the UK and overseas could be attracted to list on the UK stock exchange. Geo-politics could also play a role in driving up London listings for Chinese companies who find listing on the US exchanges closed to them but this is probably a peripheral trend rather than a fundamental shift.

In July 2024, the FCA introduced new listings rules to promote the UK as a more attractive place to list, raise capital and grow. This is the culmination of a programme of regulatory reform that started with the UK Listing Review in 2021. The changes are also designed to place an emphasis on disclosure that puts information in the hands of investors to inform their investment decisions.

Reform of UK listings must balance driving UK competitiveness and the needs of companies and their ability to raise capital through public markets with the obligation that investment managers have to investors to deliver sustainable returns and to protect the value of their client’s investments. The need to maintain the integrity of, and confidence in, well-functioning public markets remains critical and is a delicate balance.

“It's principally about the size of the UK equity markets and listings. We know that the proportion of what has been allocated to the UK in global market caps has been falling and therefore demand for UK shares has been falling. How do you automatically reverse that? You try to bring more to market in the UK and there’s a couple of elements. It's the regulatory regime around listings, and the competitiveness of that, and corporate governance and remuneration.”

Focusing on retaining young companies at IPO so that inventions, patents and technology are commercialised in the UK and not abroad is also an important component of supporting a vibrant domestic market and requires significant focus.

"... lots of our startups and...our inventions, patents, technology end up being commercialised somewhere else in the world or the scale up happens with foreign money. Changing this is a very complex issue and changing the whole rhetoric around it is really important..."

Whilst reforming the UK listings environment is an important component of supporting growth in the UK's domestic market it is not the silver bullet. In our interviews, there was a clear view that listings reform is only part of the solution to attracting capital to the UK. Domestic and international investors will re-deploy their capital back to the UK if the economy grows.

"The best thing the Government can do is make the UK more competitive as an economy. If the UK is a fast growing economy with great industries and great businesses, we will want to invest in it."

"I'm a little sceptical about just simplifying the rules of listing, which can have a marginal impact. The real point to consider is how the UK economy is going to become more effective and that's really what makes the difference."

At the time of writing, the UK has seen the first incremental rate cut from the Bank of England as inflation has fallen to the 2% target set by the Bank. If the Bank of England is able to cut rates further, this will help to reduce the cost of borrowing and support growth in the domestic economy. The UK government is focused on delivering measures to boost economic growth whilst maintaining fiscal stability, a strategy that may not be pursued by more populist politicians in other major global economies. UK companies are also valued cheaply in the context of other markets such as the US. The outlook for attracting capital back to the UK is improving.

SUPPORTING ECONOMIC GROWTH THROUGH INVESTING IN UK PRIVATE MARKETS

Unlocking opportunities to invest in private assets is another means of supporting economic growth, helping to boost investment into the real economy through allocating to infrastructure and other types of real assets. Investing in private equity and private credit enables access to the full spectrum of investment opportunities across public and private markets and unlocks capital and debt financing for companies at different stages of growth. The establishment of the new National Wealth Fund, which combines the British Business Bank and the UK Infrastructure Fund, is a signal of intent from the Government - it wants to boost investment into green and growth industries.

Establishing a proposition in private markets is also an important way of diversifying revenue opportunities for investment management firms that could help to manage the shift in the economic cycle. Investors also benefit from the illiquidity premium provided by private assets over long term investment horizons and there is general recognition that investing in private assets could benefit DC pension scheme members in particular.

"In the UK, asset managers have swung too much to risk aversion and insurance companies took money out of risk assets."

"Defined benefit pension funds are essentially taking no risk at all. If you look at the allocation of DC, it's still heavily into traditional ETFs and a lot of fixed income target date products whilst being restricted from alternatives."

The Long-term Asset Fund (LTAF), a fund structure designed to hold less liquid assets, is also helping to open up access to investing in private markets. We look in more detail at deepening access to private markets in Chapter 3.

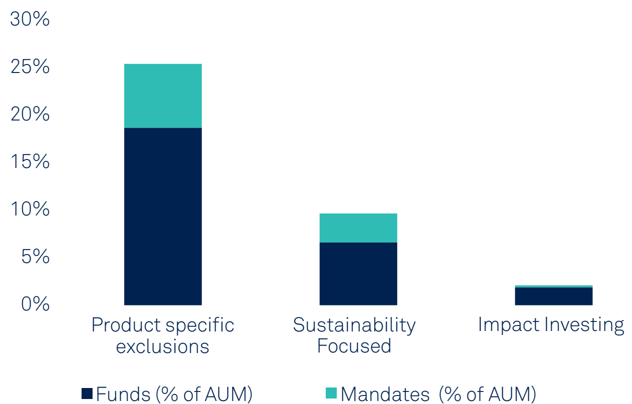
THE EVOLUTION OF SUSTAINABLE INVESTING IN A MORE COMPLEX OPERATING ENVIRONMENT

Since 2019, the sustainable and responsible investment landscape has gone through a significant period of evolution encompassing an investment boom and an intense period of regulatory and political change. As the economic cycle shifted in 2022, responsible and sustainable investment strategies faced challenging market conditions following the outperformance of oil and gas industries and investor demand for sustainable investing has reduced as returns have lagged traditional investment strategies.

Many investment managers have firm-wide approaches to assessing ESG risk factors through ESG integration and have adopted norms-based exclusions at entity level, such as controversial weapons, as investment managers develop firm-wide policies. However, in order to understand how firms are developing products and strategies that are marketed to investors as responsible and sustainable, the IA has collected data on product-specific strategies. In 2019, the IA launched its Responsible Investment Framework, an industry-agreed framework to help categorise common approaches to responsible and sustainable investing. In 2020, we started to collect and report data based on the characteristics set out in the framework – three of the main characteristics appear in this chart and sit alongside ESG integration and Stewardship. This year, we cannot report the year-on-year progression of assets because it is clear from the data reported to us that the way that firms are classifying approaches is changing, driven by new definitions and standards of disclosure set by regulators in the EU, UK and the US. The data provided in Chart 8 is therefore a snapshot of industry AUM rather than a representative data set.

Chart 8 indicates that 25% of AUM is managed according to product specific exclusions in 2023, one of the core sustainability characteristics. Funds and mandates with a focus on sustainability account for 10% of AUM and impact investing strategies remain relatively niche at 2% of AUM – indications are that this percentage has grown from 0.5% in 2021, although there are challenges in reporting year-on-year progression in this data set.

CHART 8: PROPORTION OF ASSETS MANAGED ACCORDING TO SUSTAINABILITY CHARACTERISTICS (2023)



Source: The Investment Association

Sustainable investing is now operating in a more complex environment. There are three important dimensions driving this:

- **Diverging political views across jurisdictions on sustainability and sustainable investing:** increasingly, political considerations are affecting the attitude of governments towards implementing measures to achieve the transition to net zero. Investment management firms pursuing sustainable and responsible investment strategies are navigating political views that in some countries are becoming more sceptical about financing the net zero transition. The political rhetoric on sustainability in the US is perceived by investment managers to be more negative than in Europe. This has made it more complicated for firms to show how they can invest in sustainable companies and provide stable, financial returns for investors whilst also meeting sustainable investment objectives. For example, in the US there are complex cross-currents at state and federal levels. The Inflation Reduction Act has provided powerful incentives to develop green infrastructure in the US. In states like Texas, which has a strong history of oil exploration, there has been significant development in solar and wind technologies and the state is now the leading provider of US solar power. The US has succeeded in drawing capital from around the world to invest in green infrastructure but there are vocal politicians who remain sceptical of

investment in de-carbonisation strategies and the green economy preferring to support industries such as shale oil and gas to improve the national security of energy supply. Against this backdrop, investor views on what is responsible and sustainable are changing. Whilst the development of an EU taxonomy has helped to set out a framework for sustainable and responsible investment activity in Europe, the UK's taxonomy is still under development. Investment managers are often allocating capital globally and must navigate diverging standards and expectations.

"There is a populism agenda emerging and asset managers suffer in the public arena where we are seen to be trying to do good at the expense of customer returns. Of course, that's not what we are doing but if we don't describe what we are doing well enough, we run a risk of being misinterpreted."

"We need more clarity around what the role of asset managers and financial services is when it comes to the global transition to net zero."

- **The volume and pace of regulation on standards of disclosure** across Sustainable Finance Disclosure Regulation (SFDR) in the EU, Sustainability Disclosure Requirements (SDR) in the UK and the SEC's ESG disclosure rules in the US, is affecting the development and communication of sustainable products and strategies. At the heart of this is a focus from regulators on preventing greenwashing and ensuring that the industry better articulates how it is helping investors to achieve their sustainable investment objectives and make more informed choices from the range of sustainable products available, whilst setting minimum standards of sustainability. This should help investors who want to achieve a financial return whilst also using their capital to support good social and environmental outcomes.

"We're seeing the impact of political polarisation globally in the ESG space, for example, the difference between the SEC rules, European rules, and SDR and other labelling rules in the UK. If you're building and distributing products to investors, you've got different disclosure standards, different reporting standards... a lack of consistency leads to rising costs and a complete lack of clarity for investors..."

In the UK, from December 2nd, the FCA will require sustainable funds to have a sustainable investment objective and to use a robust evidence-based standard to provide proof of process.

"The industry needs to get better at explaining how investing sustainably can either enhance returns or lower the risk of bad returns. When you then invest with both financial and sustainable lenses, you seek to pick corporates that will do well on both accounts and outperform in the long term."

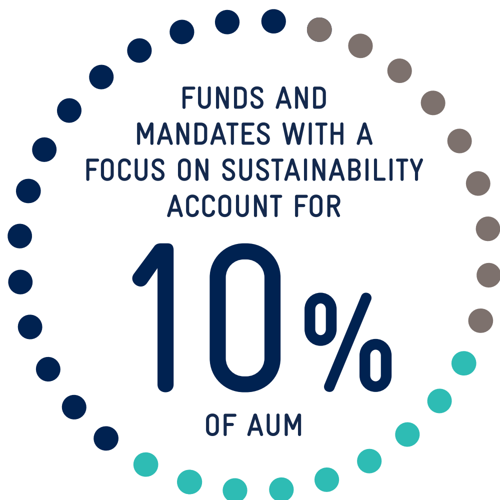
- **Changing investor demand:** investors are not operating in a political vacuum and changing government attitudes to responsible and sustainable investing will have some impact. UK investment managers have a very international client base as 49% of AUM is managed on behalf of overseas investors and the attitudes of Middle Eastern or Asian investors is likely to be different from European investors, coloured by regional differences in attitudes to climate change, social norms and increasingly to defence as in Europe, attitudes towards the importance of supporting investment in defence are influenced by the recent Russia/Ukraine war and evolving views on the role that investing in defence can play in protecting democracies against authoritarian actors. Coupled with this is the impact of performance on investor demand and in the UK, we have seen the waning of retail investor demand for sustainable investment strategies through 2023 as performance challenges affected investor appetite.

"You had all these low carbon green funds that just avoided sectors like oil and gas and then horribly underperformed."

Most think that this is a cyclical challenge, and that investor sentiment has been affected by lower returns compared with in 2020/21 following the outperformance of oil and gas sectors in the aftermath of the Russia/Ukraine war. Sustainable investment strategies often exclude these sectors.

"A lot of the initial wave of product construction and product development to create differentiated product has started to wane. There is a little bit of regulatory scepticism around it as well. Demand will dampen down a little bit but I still think you'll see an element of cyclicality where it comes back."

"In the UK, Europe and Asia, we've seen clients focus their money on areas other than ESG, investors are tightening their belts and putting money into lower risk cash type investments."



SUSTAINABILITY DISCLOSURE REQUIREMENTS

The FCA's Sustainability Disclosure Requirements (SDR) and investment labels regime aims to give investors better visibility and an improved understanding of sustainable funds and to strengthen investor confidence. These aims are wholeheartedly supported by investment management firms and the industry recognises that the FCA is setting a high bar for sustainable funds by implementing a minimum requirement that funds must set a sustainable investment objective supported by a robust, evidence-based standard and metrics. By the 2 December 2024, firms must either adopt a sustainability label, which is voluntary, or change the name of the fund, if the fund name includes restricted terms such as 'sustainable', 'sustainability' or 'impact' (or a variation of those terms) and if the fund does not have a sustainability label.

Firms must also change the way that they market the sustainability characteristics of their funds. Their approach to the marketing rules will depend on whether the fund has a label, where there are set disclosures and requirements that must be set out in the regulated disclosure documents including the prospectus and the KIID and in a new Consumer Facing Disclosure document (CFD). Unlabelled funds with sustainability characteristics will also have to produce a CFD. Whilst SDR labels and naming and marketing rules initially only apply to UK domiciled funds, and overseas domiciled funds being marketed in to the UK will not have the opportunity to voluntarily apply labels, we anticipate that the SDR regime will eventually be extended to overseas domiciled funds. HM Treasury will further consult with the industry on the implementation of extending the scope of SDR to overseas domiciled funds. In the interim, investment platforms and advisers must provide investors with a 'caveat emptor' notice on overseas domiciled funds (i.e. recognised schemes, including ETFs), to clarify that the fund is not subject to the UK sustainability disclosure and labelling regime.

Complying with the SDR requirements has exposed some of the complexity in implementing rules and standards around sustainable investing, particularly for funds that are investing across multiple sustainable themes.

“SDR is... costly and time consuming but once it's finally implemented, it's going to bring more clarity and value. It's a very demanding regulation and the bar is set pretty high. The labels are a very positive tool that we can actually use and they create a lot of clarity.”

Whilst in the UK, there has been a significant focus on implementing the SDR regime, the pace of regulatory change in the EU continues to accelerate. The proposed introduction of new naming guidelines for funds by ESMA ensure that '...ESG- and sustainability-related terms in funds’ names should be supported in a material way by evidence of sustainability characteristics or objectives that are reflected fairly and consistently in the fund’s investment objectives and policy.’

Managing the differing legislative regimes in the EU, UK and US is complicated and there is some concern from firms that the different jurisdictional approaches will fail in their objective to provide greater clarity to investors whilst driving up the cost of managing sustainable and responsible strategies, some of which will ultimately be passed on to investors.

"There needs to be a genuine focus on end investors and assessing what the impact of regulation or policy will be on end investors."

OPPORTUNITIES AND RISKS AROUND THE NET ZERO TRANSITION

The transition to net zero is a critical ambition for governments, shared by 195 countries and the EU. The Paris Agreement was adopted in 2015 to limit global warming to well below 2°C (and preferably to 1.5°C) above pre-industrial levels. In the UK, the Conservative Government set a legally binding net zero target in 2019 and the new Labour Government sees the energy transition as a priority.

Allocating to companies that are changing to take account of climate transition targets requires constant monitoring. Committing as a firm to make the transition to net zero, as many investment managers have, requires a similar level of focus.

“For global asset managers, the macro themes including sustainable finance, particularly the path to net zero, have ramped up the political pressure to do more or less in that space depending on the jurisdiction. The Europeans have front run and are trying to drive forward net zero and the transition to a green economy. The UK is also trying to be seen as a as a leader of net zero but the economic reality is hitting and they are thinking about how to fund this at the macro level.”

The net zero transition has brought about new investment opportunities as new industries are developing to promote climate transition and firms have launched climate transition funds with an objective to invest in companies that are improving their sustainability credentials, often through a commitment to making the transititon to net zero. We are also seeing investors opt for index trackers that follow Paris-Aligned and Climate-transition indices.

“On the opportunity side, for governments that have signed up to Paris alignment deals, there's new industries to be developed. There are new solutions to be found and investing in the companies that are at the forefront of that might be really strong investments. The negative of course is the companies that are polluting water might become very bad investments over the medium term, they could be fined, could be regulated. So as part of our core investment process, we want to be careful about companies that are misbehaving on any of these risks.”

The UK has had good reason to promote its track record on decarbonisation. Official national statistics on UK territorial greenhouse gas emissions show that total greenhouse gas emissions in 2022 were 50% lower than they were in 1990. However, in its report outlining the key outcomes from COP28 and suggesting next steps for the UK, the Climate Change Committee noted “a perception of slowing UK climate ambition by members of the international community.”

Domestically, the Government had continued to face criticism of its net zero strategy, and in May, courts found that the UK’s net zero strategy was unlawful because it contained insufficient detail on how decarbonisation policies would be achieved. This sense of drift in UK decarbonisation policy had begun to impact negatively on the UK’s reputation with business and investors and, when compared to the significant investment of the US Inflation Reduction Act, a sense was developing of an opportunity lost following the UN climate conference which had been hosted in Glasgow in 2021.

Since the UK hosted COP26 there has been an intense focus on developing a framework to ensure, quality and consistency in climate disclosure. This package – under the banner of making the UK the world’s first net zero-aligned financial centre – had included the development of transition plan standards, consideration of a UK green taxonomy, and a process for developing sustainability standards. It has built on the work of the Taskforce for Climate-related Financial Disclosures (TCFD) and sought to encourage new standards including the Taskforce on Nature-related Financial Disclosures (TNFD).

Progress had been mixed and a change of Government in July presented the opportunity for a new direction to be taken and the potential for negative sentiment to be reversed, with boosting green energy identified as one of five “national missions” by the new administration. It is too early to know what will become of incomplete projects on climate-related disclosures.

In its first full week, the Government instead made a series of high-profile announcements on energy policy including approving the building of three solar farms, reform to the planning system, a new policy to permit onshore wind generation, the creation of a National Wealth Fund to invest in green and growth industries, a new ‘Mission Control’ to coordinate clean energy expansion, and a decision not to defend a legal challenge to a previously permitted new coalmine. The King’s Speech, which sets out the Government’s legislative agenda, included plans to establish a public energy company called GB Energy and to build more offshore windfarms by reforming the Crown Estate.

For investors who have become accustomed to asking for policy clarity and certainty, this has been a clear and early demonstration of intent. Both GB Energy and the National Wealth Fund will be established with a remit which includes catalysing private finance. Inevitably, any policy announced in the first week of government will be short on detail having received limited input from the civil servants whose job it is to make political ideas into practical reality. At the same time, an investment industry that has been arguing that capital will follow clear policy pathways must begin to engage in good faith.

Ultimately the legal responsibility for transition in the UK rests with the Secretary of State. The public sector must therefore take responsibility if it wishes to achieve its treaty and legal responsibilities. However, the public sector cannot act alone. It will need to collaborate with industry, the finance sector, and investors to create a supportive ecosystem for economic transition that can leverage the expertise, innovation, and capital of the private sector. Investors will now have to judge whether they have confidence in the UK Government to deliver on its ambitions, whether a second term is necessary for this goal, and if this “mission-driven” approach is more attractive than the vast subsidies currently available across the Atlantic.

SUPPORTING INNOVATION AND HARNESSING THE BENEFITS OF AI AND TOKENISATION

Following a tough two years for investment performance amid a difficult operating environment, there is a significant focus from investment managers on using technology to drive efficiencies and to obtain cost control.

As we approach the end of the second year of the genAI era, much of the debate has been around the relative significance of DLT/tokenisation and artificial intelligence (AI). While views differ on which could be the most transformational, there is no doubt that the effect of implementing these technologies signify a period of accelerating change.

> *““AI has great ability to gather data, improve processes and create customised reports. As long as it's using existing data, it has great potential in creating client reports or on gathering investment research on corporates and summarising corporate strategy and activity. Productivity gains could be quite immense if used well. That might lead to the ability for us to become more efficient, keep up with fee pressure and enable us to explore wider investment universes and offer improved investment performance as a result.”*

Members have generally been embedding GenAI within their firms in an incremental way, with small applications focusing initially on productivity gains. The adoption of tokenisation has been more gradual but could offer a more dramatic transformation across the capital markets ecosystem in which investment firms operate. That promise, which has been a long time coming, does appear to be being realised as projects in funds and assets scale up.

HOW INVESTMENT MANAGERS ARE USING AI

Our conversations with investment managers tell us that there two principal applications for AI within firms:

- Using AI to streamline operations to speed up manual and repetitive processes.

  > *“AI will bring efficiencies that could allow our employees to focus on some higher value more strategic things, whether that's leading and developing teams, or focusing on clients' needs. It's more of an efficiency tool rather than something that will replace our human capital.”*

  > *“With Copilot there's little micro efficiencies happening right through the business.”*

  > *“We are looking at how AI can assist in the commentary we produce and the KPIs we send to clients. Instead of having the portfolio manager spending two hours every month writing commentary, we can have a machine learn and understand what the portfolio manager wants to say, then build the database and pull out the data of 10, 20 products at the same time.”*

- In active management, AI-powered investment research and analysis is unlocking insights from large data pools. The ability of AI to analyse historical data is complemented by investment teams bringing a critical skillset in interpreting the market outlook. The view from firms is that AI combined with professional investment teams is a powerful combination and that AI will not replace investment managers, at least in the near to medium term, given its current inability to forecast opportunities for outperformance.

"If you've got 100 or so investment analysts, and then 6000-7000 global stocks that you might want to research, you need to narrow that down somewhat. One of the things we do is think thematically – what themes are going to drive stocks? Then the large language models can help us identify the thematic intensity of the stocks and narrow down the universe."

"Whatever way you cut it, artificial intelligence shares a lot of commonalities with the machine learning and quantitative approach to investing, in that it's learning from history. It's able to crunch volumes of data that humans couldn't deal with, but the ability for humans to imagine a future that is different from the past, is still going to be required."

Other use cases are detailed in the recent paper for the Asset Management Taskforce[8]. There remain challenges, however, in assessing the accuracy of AI, with some investment managers commenting that they are more comfortable training AI on their own data and analysis than allowing it to sift through large external data sets unchecked. This provides a reassuring element of quality control.

"We've been using generative AI to build. We've created our own data lake that's got all of our own proprietary research, as well as every company report, as well as all investor marketing materials. We've been able to put all of our research in and now we can ask questions like: which assets will be most impacted by a far right victory in France's election, for example. pooled from our proprietary thoughts about it."

Firms have also identified issues with data governance and proprietary data: there is a fear that using CoPilot and other generative AI models developed by external parties could allow data to leak into the public domain.

"Our organisation is currently not allowed to use Copilot due to concerns about proprietary information coming out into the public domain."

This problem would become more acute if AI was designing investment solutions or setting investment strategies, because the ability to explain the process if the solution goes wrong or is subject to challenge remain critical and this is not currently possible using AI.

"When it comes to using AI for designing investment solutions, from a governance point of view you always have to think about if something's designing investment solutions, there's always the possibility that they go wrong and it bcomes subject to challenge, so there's always going to have to be somebody who is held accountable."

[8] The Investment Association: Intelligent Investment October 2024.

This is leading firms to be concerned with the future regulation of AI. The new UK government has indicated a slight shift from the previous principles-based, innovation-friendly approach, though at present the exact details remain to be seen. Firms recognise that regulators will have to strike a balance between protecting consumers from poor or harmful outcomes and allowing innovative solutions to common challenges. There is agreement that it will be challenging to navigate inconsistency across global frameworks, with the comparison with the EU requirements being the most stark.

"You've got a scenario where the EU and ESMA are coming out saying that in the AI space there are multiple risks to think about, whereas in the UK this is far less pronounced. What we need is consistency and proportionality. Different regulatory standards leads to higher implementation and run costs for global firms."

"In the AI space, it's about getting the balance right between doing too much and doing nothing but being proportionate.... It's great that the UK is aligning with Singapore to do more around AI and tokenisation. I think that's impressive and should be encouraged. On the other hand, it is important that by front running with legislation, the EU does not go too far too quickly, thereby limiting growth opportunities and slowing innovation."

Almost all firms that were interviewed stressed that AI use must be combined with human oversight to achieve the greatest benefits. Many investment managers have relatively nascent AI competencies but it has the potential to bring significant efficiencies, allowing investment teams to focus on higher value tasks.

"We've had an AI strategy running for a few years ...We're now using it to help us with the research process to help our investors, combining AI with a human, rather than trying to have something that's purely AI, or purely human."

TOKENISATION

Whilst there is widespread recognition that an AI implementation strategy is a critical component of driving operational efficiency in the near term, firms have differing views on the use case for tokenisation and the best path to systematic adoption by the investment management industry. As we noted in our tokenisation reports[9], a step within the sector's own control is the tokenisation of investment fund structures. However, the tokenisation of assets could solve some longstanding challenges around modernising post-trade processes and liquidity in some asset classes. This is seen as potentially transformational but firms recognise that significant investment will be required to deliver the right infrastructure.

"The biggest application of tokenisation would be in private markets. It could enable distribution of private markets to retail but there are many challenges because with tokens, you don't improve the liquidity... we need to solve that ability to be able to keep the price near to the NAV...

"Tokenisation may have applications to semi-liquid asset classes. However, just talking about economics, if I'm going to buy a building, having 100,000 investors in the building, or one institutional client do the same. I'd rather my business is aligned to the latter. Maybe some will be aligned to the former, but I suspect there'll be very high fees if required to make that work."

[9] The Investment Association: Investment Fund 3.0.

The development of tokenisation internationally is seeing a focus on both capital markets and funds. Through late 2022 and into 2023, there were multiple experiments internationally in digital bond issuance. These proof of concepts, when paired with greater legal clarity in some jurisdictions, have now made tokenisation a reality. There are now emerging use cases within investment products, with numerous examples of tokenised funds now operating across the globe, bringing the benefits of DLT to end investors and furthering the debate about how investment firms will deliver investment solutions to consumers in the future.

Multiple firms have brought tokenised funds to market or partnered with fintechs to tokenise some of the units/shares of their conventional funds to provide an alternative access point for digital native investors. There has been significant interest in money market fund (MMF) tokenisation, as firms seek to capitalise on the higher yield environment in the new market cycle and to provide a digital temporary 'parking space' alternative to stablecoins[10] for digital investors, or to provide the option of using the MMF tokens for collateral.

On the assets side, the corporate and sovereign bond markets have offered the most growth in terms of the number of digital issuances, with the first World Bank and EU member state digital issuances increasing the amount of debt available digitally.

It has been our aim to ensure that the buy-side voice is present in the debate around the structure and features of digital conventional assets and to make sure the funds industry is making concurrent progress to secure its place in the digital marketplace. As a part of this, the debate around the shape of the market infrastructure of the future continues, helped with the start of the first UK Digital Securities Sandbox (DSS) sandbox and other initiatives such as Global Layer One[11], which aim to provide interoperability across markets and jurisdictions.

MANAGING RISK IN TECHNOLOGY AND INNOVATION

As the pace of technological change accelerates, firms must keep pace with emerging risks and strengthen their operational resilience strategies. The FCA has made managing complex change a key priority for investment management firms. Two pressing threats are cyber security and the emergence of quantum security risks.

Cyber threats

The risk of disruption stemming from cyber-attacks is a persistent and serious threat to the industry. The criticality is demonstrated by the speed and scale at which incidents can play out and the fact that such incidents are perpetrated by malicious actors intent on deliberately causing harm.

Significant incidents of recent years, such as the Log4J zero-day vulnerability and the MOVEit vulnerability, demonstrate the extent and reality of the cyber threat faced by the industry. They also underline the need for firms to not only maintain constant vigilance and a focus on cyber hygiene but to further develop incident response plans should the firm need to protect clients and help to recover critical activities, systems and data affected by cyber incidents. This is a growing area of resourcing and activity across the industry, with support from regulators and external agencies such as the National Cyber Security Centre (NCSC), the Connect Inform Share Protect (CISP) platform, the Joint Cyber Defence Collaborative and the FCA's Cyber Coordination Groups.

This year has seen a remarkable increase in the number of disruptive events, reflecting the dominance of digital services within the global economy and its interconnectedness. From data breaches to cyberattacks from both malicious actors and state-sponsored groups, to failures within payment systems demonstrating the fragility of the UK's payments infrastructure, investment firms have needed to be alive to the risks posed from outside the sector. This was prominently demonstrated by the sprawling CrowdStrike incident in mid-2024 which tested firms' resilience and that of investee firms and the wider supply chain.

[10] A stablecoin is a form of digital currency that aims to maintain a stable value by pegging it to another currency, such as the US dollar, or to gold or other commodities.
[11] MAS: Global Layer 1 (GL1) Whitepaper.

Quantum risks

The potential of – but especially the risks posed by – quantum computing are coming more clearly into view and firms are beginning to assess the two most pressing risks: cryptographic vulnerabilities (breaking of passwords) and market instability (unfair or unequal access to market data).

Quantum computing has the potential to break many of the cryptographic algorithms currently used to secure data and access to sensitive information. This is because quantum computers can solve complex mathematical problems much faster than ordinary computers and so existing encryption algorithms could be easily broken by a sufficiently powerful quantum computer. This could lead to data breaches, the undermining of privacy protections, and other security risks.

Furthermore, the adoption of quantum technology could create disparities of access and capability and ultimately lead to market instability. Organisations with early access to quantum technology could gain significant advantages, potentially leading to monopolistic practices and market imbalances.

While it appears that the technology is still some way off the commercial application of quantum computing at a viable price, the potential destructive force it could wreak is beginning to have an impact within the market as firms seek to secure their perimeters.

Managing risk: strengthening operational resilience

Emerging technologies are poised to reshape the underlying operating models of firms. Resilience considerations clearly arise as a result and these changes also have implications for broader financial market infrastructure. The potential sources of disruption and vulnerability will likewise evolve as new technologies are developed and adopted.

Firms relying on third parties need to be able to demonstrate that they are effectively managing the risk of disruption and harm to their clients and end investors. However, there are numerous challenges involved in forming assessments over third party providers' resilience in adequate detail. Driving improvements in this area is likely therefore to be an area of focus over the coming years.

Similarly, the growing importance of technology providers from outside the financial world is creating new potentially systemic risks that firms and supervisory authorities must manage. To address this trend, proposals are afoot in both the UK and the EU to manage the systemic risks that could be caused by disruption at a third party providing key services to multiple firms. In the UK, the FCA, Bank of England and the PRA are developing policy on Critical Third Parties (CTPs) which aims to manage the systemic risks presented by large technology providers to the joint regulators' objectives on UK financial stability, market integrity and consumer protection. The proposals are likely to capture major cloud service providers and other technology providers. The proposals complement the regulators' UK Operational Resilience Rules, which come fully into effect in March 2025. They are motivated by HMT's assessment that the regulators' current powers are not sufficient to tackle the systemic risk that disruption at CTPs could cause.

These proposals involve designating certain entities outside of the regulatory perimeter as critical to the sector and introducing minimum resilience requirements and direct regulatory supervision of their services to financial services clients.

Firms with an EU presence or distribution model have also been developing their plans for the Digital Operational Resilience Act (DORA) which provides a comprehensive framework for the management of suppliers and digital risks. Firms are closely monitoring the detailed regulations which are being designed by the domestic authorities across the bloc.