Signs of recovery despite uncertainty

Sponsored by Credit Suisse Fund Services and Société Générale Securities Services, and in partnership with the Association of the Luxembourg Fund Industry (Alfi), a panel of experts convened at the Alfi Spring Conference in March to discuss the outlook for Luxembourg, in particular the Alternative Investment Fund Managers Directive and the final rules under Ucits V

alfi association of the luxembourg fund industry

CREDIT SUISSE

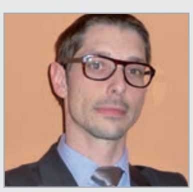
SOCIETE GENERALE Securities Services

The Panel

François Drazdik is senior industry affairs adviser and head of administration at the **Association of the Luxembourg Fund Industry (Alfi)**, which he joined in June 2009. He also acts as programme co-ordinator for Alfi events and regularly handles regulatory or industry-related topics analysed in technical committees and forums. François began his career in 1981 at Banque Internationale à Luxembourg and, with the exception of an 18-month stint as head of business development with the European Fund Administration, he has spent the majority of his career in the Dexia BIL Investment Fund business line.

Charles Muller is a partner with **KPMG Luxembourg**, in charge of the investment management arm of its Europe, Middle East and Africa Financial Services Regulatory Centre of Excellence. After studying law in Paris and London, he became a Luxembourg barrister. In 1994, Charles joined Banque Générale du Luxembourg, then the Association of the Luxembourg Fund Industry in 2003 where he held the position of deputy director general. Charles was also a member of the management committee of the European Fund and Asset Management Association.

Olivier Renault is deputy chief executive and country manager at **Société Générale Securities Services (SGSS)**, Luxembourg. After studying science and economics at university, he began his career as a consultant in banking strategy before going on to become management control director with a large services company. He joined Société Générale in 1999 in corporate functions before discovering the field of asset servicing in Paris. Olivier took up the position of deputy chief executive of SGSS Milan in 2006 and has been country manager of SGSS in Luxembourg since 2010.



Jean-Daniel Zandona is sales director for **Credit Suisse Fund Services**, in charge of sales and structuring. He promotes and advises on structuring and asset servicing solutions for fund managers, together with white-label platforms and management company services. Before joining Credit Suisse, Jean-Daniel held various senior positions in multiple locations for a top-10 global custodian in the field of product development and sales. He is also an active member in several industry bodies, and a regular lecturer and speaker at funds-related conferences.

Custody Risk: **With a risk-on attitude returning to markets, what effect has this had on the funds industry in Luxembourg?**

Jean-Daniel Zandona, Credit Suisse: Over 2012 we saw a shift in terms of preferred asset classes, with bond firms collecting more assets even if, over the last couple of months, equities have come back on track. Investors need more transparency, enhanced governance and oversight, which has been a strong driver of the recent regulatory changes impacting the industry. These changes require more mitigating controls, and reinforced diligence on providers, sponsors and investors.

Olivier Renault, Société Générale Securities Services: I would say that by September 2012 we could identify an upturn in the market. On the one hand, there is evidence that investors are coming back to equities and to higher-risk products such as mortgage-backed securities, loan funds and contracts for difference. On the other hand, regulatory developments are introducing enhanced controls, extended reporting and increased liability for custodian banks and asset managers. Strange as it may seem, these two trends may have the same effects, such as increased demand for specific expertise in the market due to the Alternative Investment Fund Managers Directive (AIFMD) and the need for additional resources and expertise in the areas of risk and data management, because of the greater reporting requirements and look-through obligations for certain products imposed by the directive.

Charles Muller, KPMG: From a regulatory point of view, the number of Ucits in Europe is not increasing anymore. There has been a push from the European Commission, which says there are too many funds around and that those funds are too small. One of the aims of Ucits IV was to increase efficiency, and the Luxembourg figures are an example of this European trend. In the Ucits sphere, what is increasing is not the number of funds but assets under management. It is on the alternative side that the number of funds is increasing. AIFMD comes into effect in July, but all funds created before then will have a one-year grace period before they have to adapt. As a result, a number of funds are being created before the deadline.

Custody Risk: **What are your expectations for the final rule-making under Ucits V?**

Olivier Renault: Ucits V will have three main effects. The first will be an increase in depository liability. The second impacts remuneration policy, while the third will be the sanction regime. Although the general rules are known today, the level-two text and the final rules are not yet finalised. Nonetheless, I imagine there will be a strong convergence between AIFMD and Ucits V, so in future we can expect equivalent rules governing Ucits and non-Ucits funds in Europe.

When we speak about depository liability, the main question will be around the impact and cost for the final investor. An Ernst & Young study, published last year, found that, depending on the level of liability and risk managed by the depository, the overall cost could range between 20 and 150 basis points. Today, people talk about five to 20 basis points. But, at this stage, we could hardly imagine a final client willing to pay that much.

François Drazdik, Association of the Luxembourg Fund Industry (Alfi): It's not only about cost. I think Ucits V should have been about more protection for the investor, better reporting to the investor and a more harmonised regime. I was always under the impression that, even under Ucits III, we had a harmonised custody regime in place. Now I think


François Drazdik

there are companies that do not believe that to be the case. We need to revise what is applicable right now in the best interests of investors.

Charles Muller: The topics that are not dealt with in Ucits V are interesting. Ucits V was meant to be a reaction to the financial crisis, so the three topics that are still under consideration – depository, remuneration and sanctions – were on the table from the start and the European Commission wanted to move quickly. But, since the Ucits box was opened, everybody has had an idea about what else could be changed, so we had this discussion on eligible assets, investment techniques and the depository passport. Only a year ago, the Commission was saying there would be five or six revision points in Ucits. Finally, it came out with the three original ones and all the others went out to consultation. That comes from the fact that the Commission has been heavily criticised for not consulting enough. AIFMD came out without any sort of consultation, which created a lot of bad blood. I suspected until recently that the rapporteur at the level of the European Parliament would want to re-add some points to Ucits V, but he doesn't seem to have the majority in the Parliament to do that.

Obviously the depository liability is a difficulty, but it's now more or less something depositories and the funds have started to accept. I have seen clients that are very worried about the new remuneration rules and how they will affect the way they do business – especially non-European asset managers who say 'if those are the rules, then I'm not sure I want to have Ucits funds in Europe'.

Custody Risk: **In terms of unintended consequences, could the liabilities imposed on custodians by AIFMD discourage funds invested in overseas securities, where the liability burden could be higher, and encourage the prevalence of domestic-focused funds?**

Jean-Daniel Zandona: Although one of the objectives of AIFMD is – on the contrary – to build pan-European champions reaching more critical size and to facilitate cross-border agreements, there will always be investors favouring more domestic structures. This is for a number of


Jean-Daniel Zandona

reasons, such as proximity, tax framework and local expertise. But AIFMD is really likely to foster more standardised types of fund structures in terms of engineering, governance and oversight, which is exactly the purpose of the directive and, to some extent, in terms of investment policy. If you consider the custodian liabilities, those reinforced liabilities will make custodians think twice before accepting liabilities for investment in some countries where they don't necessarily feel comfortable.

Olivier Renault: That's a very good question. It is linked to the fact that, due to AIFMD, the depository's liability will increase. A French fund invested in French equities and securities will be within the depository's proprietary custody network, so the liability will be quite manageable. But if a French fund invests in, for example, 10 countries, the bank may have to engage external sub-custodians and the oversight requirements, and therefore the cost, could be quite different. If the cost of that risk becomes too high, an asset manager may well opt to manage domestic funds in different countries to remain competitive.

Charles Muller: I think custodians are increasingly becoming the deep pockets of the industry. Whatever goes wrong, if assets are lost, it's going to be a depository liability if they have the liability to return the assets. If the asset manager has not managed the assets in accordance with his own rules, it will also be the depository's fault because they should have supervised what the asset manager was doing. There must be somebody who can pay if something goes wrong, but we will see it passed on in the price of services – because, if you have the liability, you obviously have to price it accordingly. Will that affect onshoring and offshoring? I meet asset managers from outside of the European Union (EU) who say there is no way they are going to adapt to AIFMD, so they are going to use private placement for as long as they can. They say that, although they will stop marketing in Europe, they are well-enough known in Europe for people to come to them. So they work with reverse solicitation. They will keep funds offshore, out of the EU, such as in Cayman Islands funds with a manager in the US. Then you have those that really want to market in the EU and at some stage will want to comply with this new regulation, but perhaps not with the whole fund. They might very well create a separate fund – with all those additional costs and liabilities for the European market – and keep their main flagship out of the EU provisions so then they can work on a less costly basis.

Jean-Daniel Zandona: It's an interesting point. A well-established trend that most of us may have seen is domestic and Caribbean funds re-domiciling, especially to Luxembourg, to benefit from many different advantages, such as jurisdiction offers, in an AIFMD/Ucits-compliant framework where size will matter. It's all down to which investors you are targeting, their buying criteria and the level of protection they are willing to pay for. The custodian liability is, therefore, only one element.

Custody Risk: Under Ucits rules, asset managers need to return profits from securities lending to investors, but what constitutes acceptable operational costs?

Charles Muller: The aim was to react to exaggeration – to those who think that 100% of the profits represents acceptable operational cost. If you take the assets of a fund, I think it's clear that the benefit of securities lending should come back to the fund, minus the cost of services for these transactions. But now, unfortunately, the rules are not very clear and it will be assessed on a case-by-case basis according to the amount of work that has effectively been performed. If you can justify your model and the costs that you incur in the operation, I think it's going to be accepted. But if the solution takes 100% of the profit then it's not going to be accepted.

Jean-Daniel Zandona: The question is how transparent you are in remunerating the intermediaries for what they do, and how transparent they are in disclosing what would be a fair return to the fund.

Custody Risk: Would a prescriptive list of acceptable operational costs help here?

Charles Muller: If you have strict rules, then it's the same for everybody. But we do not expect the European Securities and Markets Authority (Esma), to go into that level of detail. Esma's job is to set the principles of regulation and co-ordinate between national regulators. For me, it would be more the job of a national regulator.

Custody Risk: Under the Markets in Financial Instruments Directive (Mifid) II, what requirements are there for the fund industry?

Charles Muller: There are two elements of interest in the Mifid II discussions that are not final. One is the funds that can be sold without previous advice or assessment, so-called non-complex instruments. There is a proposal from the European Commission that some of the more complex Ucits funds should become complex products under Mifid, and that would mean you could not sell them without having first assessed whether your client knows what they're buying and whether it fits with the client's strategy and aims.

The even bigger debate, and one that might totally revolutionise the way funds are distributed, is about inducements. At this time, inducements are accepted but some countries have started to ban them. The Retail Distribution Review in the UK is a good example, and the Netherlands is following suit. That means if a distributor sells a fund he would not be allowed to gain commission from the fund producer – so he is giving advice to the client free of charge. If he cannot get money from the producer, where will he earn his money? The answer is probably going to be that he will charge a fee for his advice. But are clients ready to pay for something they have been receiving free of charge? I believe quite a lot are not ready to pay and that means they will no longer seek advice. It means a lot of financial advisers will find it difficult to survive.

Olivier Renault: To me, it is about transparency. I understood the main aim of Mifid was to offer increased transparency to final investors. There are few published figures on the topic, but it is estimated that trailer fees could account for anywhere between €20 billion and €40 billion per year in Europe alone. As I understand it, as long as you provide full fee transparency to the final client, you can still receive these trailer fees, but you must inform the final investor that the distributor will receive these commissions. That is exactly what is done in Sweden, for example, and that is the new model in Switzerland.

Charles Muller: You are totally right. That is the proposal the European Commission has made – to have two different sorts of advisers. Those that still accept the trailer fees but have to be open and transparent towards the clients, and those that call themselves independent and do not accept the trailer fees. The problem is that some politicians are pushing very hard to have a total ban on trailer fees and Esma wants to prohibit such fees.

Jean-Daniel Zandona: I think it is a matter of finding the right balance between protecting investors and protecting industry professionals. There is a whole sector of the industry that is likely to disappear if they are no longer entitled to receive remuneration for the advice they give. How far is the end-investor willing to go in order to be protected and to be independently advised?

Custody Risk: How should the funds industry continue to prepare for the possibility of a member state exiting the euro?
Olivier Renault: The situation in Cyprus confirms that we live in very uncertain times. If a member state were to exit the eurozone, it would not be a major issue for the funds industry. Why? The industry is used to working with different countries and distributing funds in various currencies, so it has the technology and experience to introduce a new class of share. The bigger challenge would be if a country exited the EU. In that case, it could be difficult to manage because a Ucits fund would become a non-Ucits fund overnight. But, for Société Générale, the break-up of the eurozone is not a central scenario.

Jean-Daniel Zandona: Most risk managers have built scenarios to map out a member state leaving the euro or the EU, so let's say that the groundwork is done. Some of them have already written off some losses rebalancing their portfolios. Of course, insurance companies, banks and funds are monitoring what is going on in different countries. This, coupled with tighter capital requirements, has resulted in cross-border bank lending at historically low levels – even within the same company – and to the emergence of non-bank lenders, such as debt and loan funds.

Custody Risk: What effect will non-fund-related legislation such as Solvency II and the Foreign Account Tax Compliance Act (Fatca) have on the funds industry?
François Drazdik: With Solvency II, as an association Alfi was rather astonished to see how the industry reacted when we canvassed views on its possible impact on the investment fund industry. We created a working group and gained the impression that, at least with the people that we had around the table, there wasn't much interest in the problem. That was back in 2011, so we launched a survey within the industry. We sent a questionnaire to a number of pre-selected asset managers and personally interviewed a number of them. The outcome of the survey is that it seems that the industry – at least the fund industry – is not really worried about the possible impact that it might have.

Custody Risk: On Fatca, Ireland has announced that it is the only international funds centre to reach agreement with the US.
Charles Muller: I'm not sure that it is the only funds centre to reach agreement, but the point here is that Ireland has and Luxembourg has not. Luxembourg is still in negotiations with the US authorities and is confident that it will also reach an agreement.

Olivier Renault: For me, Solvency II and Fatca are very different. Fatca is a new cost for banks and for distributors. Asset managers may also be affected slightly, but the cost of compliance will mainly fall on the depository banks. Solvency II is a new regulation that will impose more controls and more reporting, but it is also an opportunity to deliver a new service. Fatca seems to simply deliver additional cost.

Custody Risk: Can you quantify it?
Olivier Renault: It will be extremely costly. I read in a financial newspaper that one international bank estimated it could cost €150 million.

Jean-Daniel Zandona: Solvency II, together with Basel III, is a very interesting case as it creates opportunities. For the last couple of years, there has been strong debate around core Tier I ratios and risk-weighted assets. What we've seen recently are some interesting secondary transactions, mainly arising from banks and insurance companies selling off – sometimes at discounted rates – their exposures to risk-weighted assets and less liquid assets. In many cases, funds – in particular


Olivier Renault

Luxembourg funds – have played a key role in acquiring those discounted assets or repackaged loans, real estate and private assets. What we have also seen is many banks or insurance companies entering into sales and leaseback operations on their properties. This is again where some funds, and especially Luxembourg real estate funds, have played a role.

Fatca will mainly play on the cost side of the equation, although it is hard to quantify. I think it's all down to how sizeable your business is with the US. Players with a limited US clientele will need to decide whether to keep on servicing US clients or to exit that business because the revenue does not offset the increased costs.

Charles Muller: I'm less concerned about regulation that directly affects asset managers because you know it is coming, you can try and influence it and you know the people that are creating it. I'm more concerned about regulation that was not primarily meant to affect asset managers but, through a back door, suddenly does. You might not even know about it, because you can't follow all proposed legislation in detail, and when you do find out, it is often too late to do something about it. Even those who take the decisions and have drafted the regulation might not have known that it would affect a part of the industry it was not meant to affect.

There are asset managers in a difficult situation because they are very often either owned by a bank or an insurance company, and that is why the regulation affecting banks and insurers on the ownership side will also affect the asset manager. Then you have the banks and the insurance companies that are clients of asset management products, so things like capital requirement rules or solvency rules for insurers will also affect asset managers. There are also banks and insurance companies that are distributors of asset management products, so distribution legislation for banks and insurance products, such as the Insurance Mediation Directive, will affect asset managers. So there are quite a few pieces of regulation that are not directly meant to affect asset managers, that do.

Custody Risk: What are your predictions for the coming year?

Olivier Renault: I am quite sure of two things. First, we will see an increase in uncertainty, which is exactly what we experienced in the past year, though in my opinion, the future will be even more uncertain. This means that we will need to be more flexible. The second thing I am quite sure about is that regulation will increase and will continue to increase. So we will face these two movements – increased uncertainty and additional regulation. It means that we will need to continue to invest in our businesses and, as a result, we can expect to see a reduction in the number of actors in the financial industry. We will need to adapt to these changes and continue to propose new services to asset managers. This will be a challenge to balance, on the one hand, the need to perform increased controls with, on the other hand, the need to be more flexible.

Charles Muller: I am certain of three things. One is that by July this year almost no country will have implemented AIFMD. We will be in a terrible regulatory mess with consequences I cannot predict, but it is going to be very difficult. I am also certain regulation will continue. This is, perhaps, positive news because the European Commission is working on proposals for long-term savings products and could, this year, come up with a concrete proposal – not just for regulation that adds cost but also a regulation that creates opportunity for once. The third thing I am certain of is, with European Parliament elections next year, by the end of 2013, politicians will have other things on their minds than running after asset managers or bankers. So there will be perhaps a period of respite, but also a period of uncertainty about the new decision-makers that will take over in 2014 following the European elections.


Charles Muller

François Drazdik: The European asset management industry saw an increase in assets in 2012 of €300 billion, roughly speaking. Alfi intends to support all of its members so that in the coming months and years the industry continues to grow. However, we are quite aware that, taking into consideration volatile financial markets and the fact that there are some threatening regulatory and tax issues on the agenda, it might be more difficult to ensure assets can continue to grow. But this is clearly our will, and it is also the will of the industry. One of Alfi's priorities for this year is to help fund managers and institutional investors benefit from the development of regulated European alternative funds, through AIFMD. Alfi is doing everything possible to position Luxembourg well. Finally, we need to diversify beyond Ucits. We intend to go for more specific products, such as those dealing with responsible investing, microfinance and Islamic funds. So, I think new products will definitely come – you name it and we will try to develop it.

Jean-Daniel Zandona: From the peak of the crisis in 2008, we see clear recovery trends in the Luxembourg fund industry and across Europe. There was €2.4 trillion in Luxembourg funds as of January 2013 and €9 trillion across Europe. The numbers are back to where they were pre-crisis. In terms of the current macroeconomic environment in Europe, Luxembourg emerges as a safe-bet domicile for funds. There is very strong consensus among industry professionals over AIFMD to make it a success, as Ucits is as a brand. Finally, we see more and more interest in European and/or Luxembourg products arising from emerging countries or already emerged countries in South America, the Middle East and Asia, where savings levels and reserves create demand for investment products.