WEBINAR:

How Luxembourg is adapting to revolutionary changes in fund distribution

Luxembourg is the London of the mutual fund business. It is the most international fund distribution centre of any. The Grand Duchy is an entrepôt for fund managers drawn from all over the world, using Luxembourg fund vehicles and transfer agency and fund accounting services to support the distribution of funds to over 70 separate jurisdictions. But the fund distribution is grappling with a series of potentially revolutionary changes, with regulators pressing for the standardisation of order-routing and settlement, the elimination of perverse incentives in the remuneration of fund distributors, and fund managers looking to increase assets under management and widen margins through the collection and analysis of data about what investors are buying, where, and why. To discuss these trends, Dominic Hobson, founder of COOConnect, joined Olivier Portenseigne, chief commercial officer at Fundsquare, the Luxembourg Stock Exchange's owned fund order routing, information and reporting services; Pierre Mottion, global head of transfer agency and fund dealing at BNP Paribas Securities Services; and Michael Weber, head of mutual fund distribution operations at Allianz Global Investors, and chairman of the ALFI working group on T2S.

Olivier Portenseigne

Pierre Mottion

Michael Weber

FUNDSQUARE

Hobson: Luxembourg is a fund distribution and servicing centre not just for Europe, but for Latin America, Asia and the Middle East as well. Are the markets serviced from Luxembourg still primarily domestic or is there a rising proportion of genuine cross-border fund business being transacted?

Mottion: We see a growing number of managers from the United Kingdom, the United States, Latin America and Asia locating funds in Luxembourg not only to sell funds back in their home countries but to leverage the reputation of Luxembourg as an international centre to expand their distribution beyond their core domestic markets. Of course, they target Europe first before calling on other countries, but we see Asian managers using Luxembourg to sell their products to Latin American investors, and Latin American managers selling their products to Asian investors. They are both emerging markets, with high returns, so managers want to access them. Luxembourg provides a kind of bridge.

Weber: Genuine cross-border business is rising and we saw strong flows in 2014 and also in the beginning of 2015 coming from Europe, Asia and Latam. When we see a strong demand for a domestic fund we rather launch a Luxembourg fund in our global umbrella and change the domestic fund into a feeder investing in the Luxembourg master. In Europe master-feeder is hence the name of the game because domestic investors still buy or are invested in domestic funds, with a growing proportion going genuinely cross-border.

Portenseigne: Luxembourg is not a distribution centre but an international distribution strategy for asset managers, through structures such as master-feeders or simply via direct distribution into foreign countries. Domestic investors do buy domestic funds predominantly, but there is rising interest in non-domestic funds in domestic markets. Ultimately, investors do not really care whether a fund is French or German or Luxembourgish, provided it is the right product with the right profile.

Hobson: You say that, yet the data is pretty unequivocal: the majority of funds are still domestic funds sold to domestic investors. Are foreign managers getting a foothold in domestic markets or not?

Mottion: People invest to build long term savings, so they look to use the most tax-efficient vehicle, and generally that is a domestic one. Of course, domestic investors can also be naturally shy of foreign funds. This does lead to a lot of inefficiency, with every domestic market having a separate fund pursuing exactly the same or a similar investment strategy as every other domestic market. The only way to increase efficiency and cut the costs of running funds is to rationalise the fund ranges and aim to have flagship fund centralising the investments across distributing countries.

Portenseigne: There is a cost versus tax arbitrage, because tax treatments are favourable to investors in domestic products. For asset managers, however, scale is the way to reduce costs, and domiciling more funds in Luxembourg is one way to do that. So asset managers have to have domestic products, but at the same time maintain global products offshore.

Mottion: What makes Luxembourg competitive in that context is the services it has developed to enable managers to distribute locally. Local regulators know Luxembourg products, so getting approval to distribute a Luxembourg product is now pretty standard across the globe. Service providers in Luxembourg have the knowledge to calculate all the local tax elements as well, so they can provide domestic investors with tax efficiency. This ability to meet local requirements is key to the success of Luxembourg as an international fund centre. Over time, it will drive the rationalisation of the European fund industry, where funds still tend to be much smaller than in the United States, and that will enable managers to obtain the benefits of scale as well as the benefits of enabling investors to enjoy the advantage of local tax treatments.

Weber: Another factor that will probably help Luxembourg grow is competition. Latin American and Chinese asset managers want to reach European investors, and Luxembourg offers them a structure that allows them to distribute everywhere in Europe. Will Luxembourg be the winner? I cannot answer, but I definitely see a lot of foreign asset management companies that want to come to Europe and grow their distribution. Competition is becoming fiercer.

Hobson: Luxembourg has built a global fund administration on the back of all the advantages you cite, but it is based in a high cost part of the world. How can Luxembourg maintain its competitive edge against other fund centres?

Portenseigne: In Asia there will be more and more competition between our product and domestic products. It is not easy to remain competitive because the cost structure is indeed very different. That being said, I still believe that Luxembourg has the expertise, the culture and the long standing brand to remain successful and attractive to asset managers. The ability to speak multiple languages has been crucial to supporting distribution in multiple local markets compared to, say, Dublin.

Weber: I would like to see Luxembourg being more aggressive in terms of promoting what they can do. As asset managers we need global platforms, which can service all the specificities of all the different countries. Where they are serviced from, we could not care less. Luxembourg has highly capable people who understand the complexities of the markets. It is close to all the countries surrounding it. So when I have a problem I go and talk face to face to the people. It has an excellent education system. When new regulations are introduced, the Big Four accountancy firms can sit down around the table with all the major fund administrators, and work out how to implement it. That is what keeps Luxembourg ahead of the curve. If it retains its talent, we do not need cheaper labour. Luxembourg does not promote itself enough on that score.

Hobson: If a manager is distributing funds all over the world, can they be fully supported from Luxembourg or do they have to be supported locally as well?

Weber: For our global distribution, we have our SICAV, which is supported from Luxembourg in term of custody, fund accounting and transfer agency. Therefore a global support out of Luxembourg is reality when it is combined with regional servicing hubs, which either sit with the asset managers or a service provider.

Mottion: The Luxembourg working day is not eight hours, but 24. Distribution support begins in the morning with the Asian funds, and by the evening it switches to North American funds. We have to be able to service the fund distributors in every market. We do have some local centres, such as our hubs in Singapore and Hong Kong, to receive orders and respond to queries from local investors, but in Luxembourg we support fund distributors up to the fund cut-off, which can be as late as 10 p.m. CET. Another challenge is the calculation of the NAV. We have to collect prices from Asia, Europe and

America in order to calculate the NAV accurately. We have a follow-the-sun model to check prices, but in the end every NAV calculation is validated in Luxembourg. In that sense, our model leverages on our hubs around the world not only in the distribution countries of the funds but in their production country as well. Most of the providers in Luxembourg have developed such a model. On paper, it is relatively simple to operate. In practice, it is very complicated. You need experienced staff and a single platform.

Hobson: To what extent would it reduce the complexity if fund order-routing was standardised around the globe, and do you expect that to happen – perhaps via fund platforms as hubs?

Mottion: There are aggregators at work in Luxembourg funds. They definitely add a level of efficiency, because the complexity of managing multiple distribution channels in multiple countries is high. All service providers have invested a great deal to raise the level of STP in their dealings with the biggest fund platforms. But we need to go further and deliver to asset managers enough control over the information exchanged with distributors to ensure that whatever goes through a platform or other aggregator is always appropriate and eligible for the fund.

Weber: I would answer the question differently. Regulations, such as RDR in the United Kingdom, changed distribution dramatically. Until then, a lot of platforms were simply there for IFAs to buy the funds, or collect trailer fees. They earned a good living, but they did not transform anything. Similar regulations to RDR will encourage consolidation, but what will really transform platforms now is the changing behaviour of the consumer. As Michael Weber, I want to be always online. I want advice from people who know what they are talking about. I want access to 100 per cent of the information I need, and I want that access to be simple and easy. Irrespective of what happens to order-routing, consumers are changing the way they access information, and platforms need to re-think their business model to accommodate that. If they do not, modern technology will kill the platforms, because they will not be needed any more. I think platforms will merge to create an NSCC-like infrastructure. We talk in Europe all the time about why we do not have an NSCC here. It is because most of the largest asset managers in the United States do not belong to a bank which is a distributor. They want infrastructure, so they get it. In Europe, asset managers tend to be part of the same groups as the banks which are the major distributors, so they have a totally different bias. Hopefully, we will move in the direction of a more American model.

Portenseigne: TAs in general have done a very good job supporting global asset managers as they have distributed locally as well as globally. TAs have to support distribution in multiple domestic markets off a single global platform, and they have done it well. But we should go to the next level now, in terms of developing a harmonised infrastructure comparable to that of the United States and Canada. The principles by which the NSCC operates are simple: it takes over any function which is redundant across multiple players, and which can be commoditised.

Hobson: Would such a standardised infrastructure not eliminate transfer agency as an unnecessary duplication of registration and settlement functions?

Portenseigne: Not really. If you look at the US market, there are still TAs. They continue to exist because somebody is needed to manage the complexities of distribution: the countries where funds are distributed; the types of distributor; the different types of funds; and the tax aspects. As long as these multiple complexities have to be managed at the product level, TAs will stay with us. They are also finding a new role as providers of data to fund managers.

Hobson: Would you welcome a single settlement process for funds in Europe?

> **"The fund industry needs to understand that other asset classes are already looking to make post-trade servicing cheaper."**

Weber: Since 2006 the ECB has been developing the T2S platform, and the first wave of countries will transition to the new platform in June this year. So by 2017 we will have a single central securities depository in Europe to settle transactions in central bank money. It is for listed securities only at the moment. A large proportion of mutual funds are settling in domestic CSDs already, such as those of France and Germany, so those transactions are effectively in T2S already. The fund industry needs to understand that other asset classes are already looking to make post-trade servicing cheaper. Even when the harmonisation for other assets classes is mainly driven by regulation it finally will result in a competitive advantage and therefore the fund industry needs to embrace changes such as the T2S initiative. We need to reduce the fund share transaction and settlement costs in Europe by a lot more than 10 or 20 per cent to compete in terms of post trade costs with other financial instruments and foremost the really efficient US market.

Portenseigne: I fully agree with that. The real challenge for the asset management industry in general, and the fund industry in particular, is that retirement schemes as we have come to know them in Europe are slowly disappearing. Increasingly, people will have to pay for their own retirement, rather than rely on the younger generation to pay for the older. Funds want to be the vehicle chosen by these investors to pay for their retirement. To achieve that, we definitely need to reduce costs. In Europe, only 10 per cent of people are investing in funds today. The potential is huge.

Weber: Scale can make an important contribution to cutting costs. Only when the European mutual fund industry attains the same scale as the 401(k) retirement market in the United States can we hope to achieve far lower costs.

Hobson: Once objection raised by managers settling fund transactions in CSDs is lack of transparency: they struggle in CSD settlement to trace a transaction back to a particular client of a particular distributor. What is the answer to that?

Weber: One solution is to get information from distributors uploaded to CSD platforms but the data is always out of date. A true solution is earmarking. The industry would agree a unique identifier for each investor client of each distributor, similar to a BIC code for a bank branch, which is always attached to a fund order. Earmarking codes of this sort are

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working, and working well, in France already, although people in the industry are not aware of it. If fund distributors earmark the orders, they can be reconciled against positions held. It is a sensible and workable solution which T2S should pursue.

Portenseigne: If you look at the NSCC model, they do that already. They mark every order. In fact, they go further, and have sub-accounting, where you can see even the underlying retail client and not just the distributor.

Mottion: If we are going to have a common infrastructure for execution and settlement of fund transactions, we need to define the conditions that will make it work in practice. The first challenge is to avoid mis-selling. The only way to be confident that an order to buy is eligible for a fund is to establish that before the trade is executed. The second challenge is to ensure that the order is properly allocated to a distributor which has a distribution agreement with the asset manager. The third challenge is to reconcile the order with the positions held by the fund issuer, and that is more difficult when the reconciliation is between participants of a CSD, so transfers between participants in a CSD are not being notified to the fund issuer. That means the fund issuer cannot be sure the transfer is correct, or allocate the position properly. So asset managers are employing resources to reconcile orders and positions, and reallocate a position to the right distributor. My advice would be to forget about the register and the CSD models, and just make sure that you map the reality of your distribution with the flow of transactions coming in to your funds.

Hobson: If you would welcome a single fund execution and settlement infrastructure to earmark orders and reduce costs, would you also welcome single KYC/AML utility?

Weber: Yes, we need as an industry to refine our thinking about non-core activities, and opt for more utilities and less fragmentation. Otherwise, when we take on a client from the Middle East, for example, we all have to run separate KYC and AML checks, and visit the client separately. It does not make sense. We need as an industry need to agree certain standards in KYC and AML, and make sure that the Luxembourg government is happy with it being done. It just needs to happen.

Olivier Portenseigne

Mottion: Funds have three main steps. One is execution, another is settlement and the third is custody. It is important that we have an efficient infrastructure for all three. T2S is addressing the settlement point, so what we need to work on today is the execution side. In the United States, the DTCC and the NSCC between them address both execution and settlement, and we can do the same. The pre-investment problems are much harder to solve. Screening investors for a fund who does not want any investors having interests in weapons manufacturing or alcohol, for example, is a pre-investment check. It is part of the client on-boarding process in the same way as KYC and AML, but has nothing to do with KYC and AML. The information needed to manage these issues is fragmented, and has to be delivered in different formats to different organisations, and separately every time a client buys fund from a different manager. Collating and maintaining and distributing the information is complicated and costly. We all see the opportunity to reduce those costs by sharing such information on investors, but there are many open questions as to who would participate, and how such collective solutions would actually work in practice.

Weber: An effective solution cannot address Luxembourg funds only. It has to address domestic funds as well. We need a global solution.

Hobson: Are mutual funds actually such a good vehicle for retirement savings, especially for younger people, or should the asset management be investing more in the research and development of new products? Could we move to GDP bonds or real-time NAVs?

Weber: Yes, Mutual funds are well-known and proven investment vehicles. Why would you ever change this? New distribution solutions are being developed, that is true, which in the end make use of mutual funds as the investment vehicle. In the United States, for example, people are using their mobile phones to make micro investments in mutual funds.

Mottion: Already we have funds that are priced multiple times a day. Do we need real-time NAV? What is the value? What is the cost? Fund accountants do not just calculate NAVs. NAVs are audited as well. A cost/benefit analysis would challenge the value of real-time NAVs, especially versus ETFs. The most effective enhancements to mutual funds as investment vehicles lie in increasing the size of funds and the size of the industry as a whole.

Hobson: Fund distribution might also be revolutionised. At the moment, it is dominated by the banks, at least in continental Europe. Do you see fund platforms evolving in ways that disrupt that?

Weber: Not in the big countries of continental Europe, where banks will remain the main distribution channel for funds. On the other hand, banks have to carefully evaluate how they react strategically to the changing client behaviour. Clients do not only want to use the Internet because it is cheaper, then when they transact the same business via a branch. They want a hybrid approach from their bank, which combines the ease, transparency and cheapness of the Internet with the advice offered in the branch. And they want to pay for all different assess channels to their bank one price. In the UK, for example, we have after RDR an advice gap for all assets below GBP 100,000. The big risk is to disenfranchise the client segment that needs advice the most. The social reality is that we are going to have millions of people who are unserviced in the funds industry because they are not wealthy enough to get advice. And the answer cannot be the platforms will take care of it.

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Pierre Mottion

Portenseigne: Banks do indeed dominate distribution in Europe, and the only things that can change that are technology, customer behaviour and the lack of trust in the banking system. That, rather than MiFID II, is what will drive change. Fund distribution in France, for example, is dominated by four or five banks. They are not going to declare themselves independent distributors, so they will continue to be remunerated by trailer fees. Germany, Spain and Italy are exactly the same. The only thing that can change that reality is customer behaviour, and that is not going to change quickly, not least because most fund investors are neither young nor natural users of social media. It might change quicker than we expect if disruptive technology comes into play.

Weber: That disruptive technology is a serious threat. All of the leading social networking brands have payment systems in place already. In Silicon Valley, where is most of the money being invested? It is going into finance. Think of Apple. Compare an Apple store to a bank branch. You can buy Apple products on-line, at a computer retailer, in an Apple store etc. Theirs is a truly multi-channel business. It is starting to happen in the banking sector, especially in the United Kingdom, with bank branches improving their online offerings and altering opening hours so they can deliver advice to customers outside working hours. In addition is the internet offer reshaped with offerings in the pipeline as Atombank. If you are looking for excellence in fund distribution, multi-channel is the word.

Portenseigne: Banks will not disappear. They will be part of the plumbing. We need them to transmit cash. And if you look at the high net worth sector, they will continue to need IFAs, family offices and private client advisers in banks. It is the mass market consumers who need a hybrid solution of the Internet and the branch.

Mottion: The parallel with the US is quite interesting. There is a level of maturity of the distribution value proposition in the US, where fund platforms, broker-dealers and RIAs are all using the same infrastructure, which enables them to give investors a single point of access to the bulk of the funds available for investment.

Weber: Where is the total cost of ownership of a fund highest for the investor? Is it Europe or the US? Counter-intuitively, they pay more in the US because the asset managers operate to tight margins, and the broker dealers take a larger share for distribution. In the US the distribution model changed gradually without any regulation in the past 20 years. Now they are where they are – and the clients pay more. Similar creativity is looming in Europe. We will see asset managers distribute more and more funds directly, because global brands count for a lot. In the United Kingdom you can see already clear move in this direction. Europe should not leave all the creativity to one country.

Mottion: US asset managers are approaching consumers directly with products that are very simple and very cheap. They are successful because they are easy to understand and to access, and because there is a demand for products of that kind.

Portenseigne: What direct to consumer selling lacks is open architecture. The consumers want open architecture, not the products of a single asset manager.

Mottion: That is why we have platforms that offer not only funds, but accounts. Those accounts offer investors access not only to funds but to assets directly.

Hobson: If I asked each of you to describe your ideal European fund market infrastructure, what would it look like?

Portenseigne: Fundsquare was set up by 23 players to provide the ideal infrastructure. Our ambition is to eliminate redundant activities and the spaghetti model. We want to make order-routing, settlement and KYC and AML processes more efficient. We want to collate fund data, but also investor data. Fundsquare is about making life simple in terms of exchanging financial or non-financial transactions. The difference between what we are doing and existing “market infrastructures” is that we are not a custodian, neutral, providing full transparency as we are not intermediating further the market, and not driven by margins.

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Weber: The market will choose what the market infrastructure will be. I foresee a utility for KYC and AML, and for checking the ultimate beneficial owners. I would like to see a fund settlement utility, most probably T2S, with transparency through earmarking of orders. These infrastructures will need regulatory support, however.

Mottion: For me too, the infrastructure must be market-led. It must also be run on commercial lines, so there is no hidden agenda behind it. One point which is not yet clear is who will take responsibility for final payment on behalf of investors. The role of local paying agent, banks, depositories, TA have to be clarification in T2S context. In such context, who will take responsibility for ensuring the investors get paid their redemption proceeds and dividends, and in the currencies they choose as well, since Luxembourg funds are distributed all over the world? We need to be clear about who is responsible for what, and when, within the chain.

FUNDSQUARE

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