DISTRIBUTION: The central question

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If Luxembourg's funds industry is to bring down costs, wider support for centralised utilities is essential. But as the topic drags on, it's beginning to sound a bit old-fashioned, finds David Stevenson.

Luxembourg can boast that it is the second-largest funds domicile in the world, after the US. A benefit of this is that its funds can gain great economies of scale – a great weapon for combating costs in back and middle-office fund processes.

Yet Luxembourg still faces the pressure of bringing down costs in the front office – specifically those of distribution.

Industry figures show that levels of automation in fund order processes are going up all the time. So, can anything else really be done at the front end?

A joint report by Deloitte and Fundsquare last year said that bringing funds to the market still costs the industry €1.3 billion per annum. The report, 'The benefits of mutualising the cost of distribution' suggested this could be slashed by 70% (€1 billion).

One of the proposals it contained was for a centrally automated system for fund orders between distributors and fund managers – a way to remove costly frictions in fund distribution, and central to the idea of cost 'mutualisation'.

A mutually owned, utility-type structure would remove fragmentation of processes, cut down on manual errors and create vast economies of scale.

The authors do not suggest arriving at this model would be easy, though. Paolo Brignardello, senior business development manager at Fundsquare, says: "We preach for economies of scale, but in the end it will be the players in the industry that agree to realise these savings."

Tilman Fechter, head of sales and relationship management at Clearstream, is sympathetic to this view (Clearstream produced an earlier report on this topic, also with Deloitte). He says he agrees with a lot of the new report's proposals, such as a central order routing system, and, in a similar vein to Brignardello, thinks Luxembourg and the funds industry cannot change processes unless investment houses get on board with it too.

"As long as they let investors use any method and as long as asset managers want the inflows, you can't bring cost down," adds Fechter.

Distributing to a few large institutional investors has little real impact on costs, unlike distributing to millions of individuals. "It's always the wide distribution of your retail fund that costs the money," says Fechter.

MORE RADICAL, MORE MODERN

Industry figures in the Luxembourg market might largely agree on the need for cost savings. But some want even more radical – and perhaps more modern – measures than the type of co-operative model for the distribution supply chain implied by mutualisation.

Mario Mantrisi, senior adviser to the chief executive officer of Kneip, a tech-based documentation and filing provider, says: “We think too much, we’re not disruptive enough as an industry. We can make savings but need to be braver.”

The fact that competition against funds “is not about peers, it’s outside the industry, it’s other products”, should provide more incentive for the industry to be braver, he says.

Fechter agrees. “If the market concentrates on making the existing structure more efficient, they’re losing the plot, missing the bigger picture. Their existing distribution channels might be the Walkman of the last decade.”

The idea of utilising social media to gain the interest of end-investors has been around for some time, even if no one has quite cracked the solution. Clever use of social media may allow some fund managers to go direct to the customer (D2C), an increasingly attractive area now that intermediary distributors are less incentivised by sales commissions under new standards moving through Europe.

Yet D2C distribution is still very much in its infancy. According to a report last year by fund research and analysis firm Mackay Williams, D2C accounted for only 1.5% of European fund assets.

The introduction of D2C platforms and ‘robo-advisers’ might revolutionise fund distribution in the future, but in the meantime, efficiencies still focus on existing models.

EMBEDDING INFRASTRUCTURE

One of the main potential cost savings identified in the Deloitte/Fundsquare report is the proposal to introduce a US-style clearing system, embodied in America’s user-owned Depository Trust & Clearing Corporation (DTCC). In such a mutualised cash-processing environment, each market participant would process one payment per value date and per currency, independent of the number of counterparties with which it deals.

The report states that this could be achieved using a “central cash compensation account” in Luxembourg. The cost of issuing and receiving payments using Swift, an interbank messaging utility, brings fund settlement costs in Luxembourg to around €160 million a year. Using a central cash compensation account, the same activities would cost the industry only €3.5 million.

These savings assume that payments are settled in euros, dollars, Swiss francs, yen and sterling; payments settled in other currencies would have to be performed on a bilateral basis.

The DTCC system could not be easily mapped on to Europe, though, given the cohesion of the US funds market.

Fechter says: “You can’t compare the numbers to DTCC. The problem is you can’t even force it, as the choice is with the customer. In the USA, there’s no choice, so you have to use DTCC; here you can even go old-school faxing.”

Brignardello says he realises that there are additional costs due to the cross-border character of Luxembourg’s funds industry. Multiple languages and multiple documents are factors and increase costs.

But he says that even “if we skip that part”, then models with less centralised infrastructure are still more expensive.

Luxembourg’s strength is its capacity for cross-border distribution. Mantrisi, at Kneip, hopes that regulation will provide the solution.

“I think that the EC will realise, if you want a CMU [Capital Markets Union] you need standardised distribution,” he says. “On the product side we are quite harmonised. We miss harmonisation on the selling side. Regulation helps.”

Conversely, Brignardello thinks it is regulation that could escalate costs if market participants do not respond to it appropriately. However, he references the second Markets in Financial Instruments Directive (MiFID II) as an example of how using a model similar to the US DTCC could bring down costs.

Part of MiFID II concerns suitability of products, in which asset managers have to make sure their products are suitable for the end investor. Currently, each player develops their own approach to exchange information in a peer-to-peer framework.

“This creates inefficiency and greater costs,” Brignardello says.

Today’s industry model involves distributors receiving a significant amount of duplicate requests from the fund promoters they work with. A mutualised approach, whereby a single document request could be shared across fund promoters, would be beneficial to both distributors and the wider funds industry, according to the Deloitte/Fundsquare report.

Other areas where cost savings could be achieved by mutualisation includes know-your-client (KYC) activities and cash processing.

Regulation about anti-money laundering and KYC has been on the increase. Mutualisation could lead to significant savings here, the report says.

However, KYC responsibilities cannot be outsourced so easily compared to other activities, such as automated orders. This is due to the regulatory framework, which deems the fund management company and the transfer agent responsible.

Therefore a centralised KYC would require a strong willingness from market players to enter into robust, binding contractual agreements. If this were the case, it would reduce the compliance cost and increase the willingness to accept new business relationships by getting rid of the multiple model of KYC processes between transfer agents and distributors/investors.

STILL GROWING UP

Kneip’s Mantrisi compares the funds industry to car manufacturers. In relative terms, he says, the funds industry is still young, while car makers have had decades to come up with savings such as shared airbag technology and even shared engine technology.

He also cautions against being the first-mover in an industry that is ripe with innovation, especially in the fintech arena.

“You don’t want to miss the boat, but you don’t want to move too quickly,” he says.

As for a realistic level of efficiencies that could be achieved, he is less hopeful than Fundsquare and Deloitte’s report, estimating a saving of 20%-30%.

Until a new solution to distribution costs is found, then the size of an individual Luxembourg cross-border fund is still its driving force, or its Achilles’ heel.

Olivier Renault, country head of Société Générale in Luxembourg, says: “The bigger your fund is, the lower the cost; when you have a small fund, it’s the same cost.”

This is to say that whatever the size of the fund is, the administration charges are the same. Fund costs are driven largely by economies of scale. Whether this can be reduced further by introducing a layer of infrastructure similar to that seen in the US is debatable, but there are savings to be made nonetheless.

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