# LUXEMBOURG looks to the future

## A panel of experts discuss opportunities from Brexit, trends in investor demand, links with China and fintech

**Chair: Does Brexit represent an opportunity for Luxembourg?**

**Rajaa Mekouar:** Luxembourg has been very clear about its reaction to Brexit, for example in the repeated statements of LFF. Brexit is an opportunity to partner even more closely with the UK, as and when local managers need an EU base, because the toolbox at the disposal of investors is wide and deep in Luxembourg. The Grand Duchy prides itself in being pragmatic, reactive and innovative to suit an ever-changing environment, which makes it a great partner for ex EU countries.

It is also international, with three widely-spoken languages, which further extends its attractiveness. I moved here from London, where I spent 15 years in the PE industry, and was impressed with the local environment which proves to be professional and international. The scale is obviously smaller geographically, but the depth of the financial industry can rival any larger market.

**Chair: What trends are you seeing in demand for asset management structures and products?**

**Sandra Mueller:** At MEAG, the asset manager of Munich Re group, we offer our expertise to institutional investors and insurance companies. When it comes to choosing the right financial product (Ucits/AIF), the investor is at the heart of our decision-making process.

### PARTICIPANTS

- **Diana Senanayake,** managing director, global client coverage, RBC I&TS
- **Sandra Mueller,** managing director, MEAG
- **Camille Thommes,** director general, Alfi
- **Dušan Gladovic,** legal and regulatory manager, Luxembourg Private Equity Association (LPEA)
- **Rajaa Mekouar,** syndicate, investments & partnerships, Kharis Capital

Institutional investors are looking closely at alternative strategies to bolster performance. In the past, we saw growth in liquid alternatives under the Ucits wrapper that may be rebalanced by AIFMD compliant structures, as Ucits rules impose stricter investment limits to ensure adequate investors protection. Institutional investors with a longer term horizon, such as insurer clients and pension funds, do not want the disruption of daily liquidity imposed by the Ucits rules. Nor do they want to have their investment strategy curtailed.

An increasing demand for Unit-linked insurance products can be noted from insurer clients with a preference for Ucits-compliant underlying funds as they are also eligible for retail clients.

Alternative investment strategies are increasingly used by institutional investors to achieve both return and diversification goals. This creates opportunities for managers who can capitalise on new strategies and be creative in offering tailored client solutions rather than products.

We see strong demand for liquid alternatives and growth in passive multi-asset investment strategies with target volatility mechanism or total return concepts.

Investors are looking for comprehensive investment strategies, market decorrelation, transparency and robust risk management underpining every investment decision.

Investors are navigating in a changing interest rate environment. As a consequence, asset managers are adjusting their investment strategies by focusing on shorter durations to mitigate valuation and liquidity risks and selective bond picking in the high-yield universe to improve the fund performance.

Furthermore, sustainable investments are entering center stage and evolving form a niche market to a megatrend.

**Chair: What has the Reserved Alternative Investment Fund (Raif) structure added to the Luxembourg?**

**Mueller:** The Raif is a beneficial Luxembourg investment vehicle extending the Luxembourg toolbox with enormous potential. Depending on the investor type, certain investor types still prefer regulated fund structures. Other investors that are used to the concept of entity supervision and who are closely involved in product management, wish to benefit from accelerated time to market, cost savings and contractual freedom with the protection of the AIFMD. The Raif offers key advantages for the set up of new funds as well as for the conversion of existing AIFs. Insurance companies welcome the Raif as they are already used to this regulatory concept.

**Senanayake:** Raif improved the go-to-market time as no specific approval is required as long as the Raif is AIFMD regulated. Raif, especially as Limited Partnership (LP) [SCS and SCSp], is very successful and mainly used for real estate (RE), private equity (PE), infrastructure and private debt structures as it is the most flexible structure and aligned with US and UK LP structures.

AIFM and the security it offers to investors, is a great catalyst for the REPE business into Luxembourg and Brexit further lends support to domicile in Luxembourg.

Across the industry, there are growing expectations for transparency and reporting. In meeting this demand through regular information and communication, fund managers are helping investors become more comfortable with the asset class.

"Luxembourg has positioned itself as a leader in financial data, setting it apart from other markets"

**Diana Senanayake, RBC I&TS**

**Chair: What attracts so much of the global PE industry to have a presence in Luxembourg?**

**Mekouar:** In the PE industry, end users are clearly international firms that need a base in the EU and access to structures that are cost and tax effective. As of today, nine of the 10 largest PE firms, such as KKR, have an established presence in Luxembourg. Kharis Capital is just three years old and Luxembourg was a natural choice to base our general partner, although the investment team is spread across Switzerland and Belgium, aside from my presence here.

We invest in mid-cap consumer companies with the financial backing of family investors, on a deal-by-deal basis, and Luxembourg allows us to choose from a range of SPV structures while ensuring legal security to our backers. We recently launched a Raif to accommodate our investment strategy, because it is flexible while being supervised by an AIFM that is regulated by the Luxembourg financial regulatory authority (CSSF). This is key and explains why after just one year of existence, over 100 Raifs have been initiated in Luxembourg.

**Dušan Gladovic:** Luxembourg has seen steady growth of its industry fuelled by an increasing investor appetite for alternative asset classes and a proactive positioning of Luxembourg as a hub for alternatives.

Luxembourg reunites all the hard factors that are necessary for a PE hub – a broad and evolving legal toolbox making Luxembourg a great jurisdiction to structure PE deals from, a highly-skilled and multilingual workforce sourced from across many EU countries and the world –nearly 50%

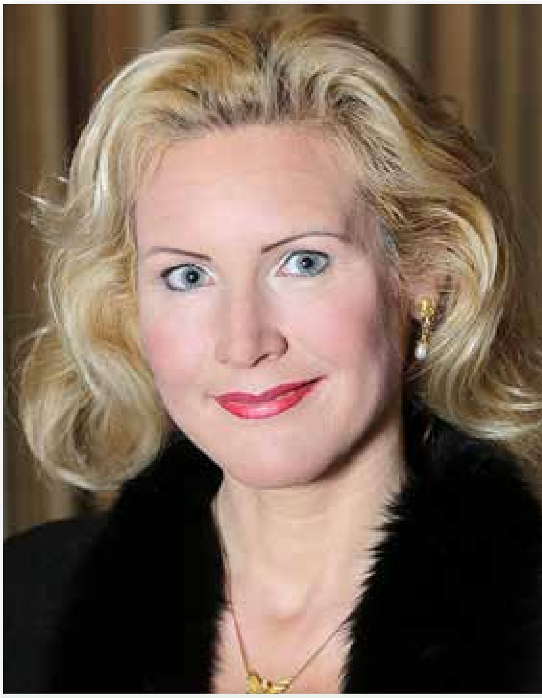
of Luxembourg's population is foreign-born – a good connectivity to other European capitals and, perhaps most importantly, a strong record of political and legal stability.

Globally speaking, the PE industry has benefitted largely as an alternative to traditional investments. Especially in times of record-low interest rates, investors have been flocking to PE as an asset class.

The world's top 13 PE firms are present in Luxembourg and some of the major players have announced they increase their local offices in light of Brexit. The PE and venture capital (VC) industry in Luxembourg greatly appreciates the new set of legal structures that have come about in the aftermath of AIFMD. To start with, Luxembourg modified and extended its partnership regime much to the liking of Anglo-American GPs.

In 2016, the Raif was added to the toolbox and has been successful from the start. There is a trend in the Luxembourg PE world that sees a strong preference for partnerships over fund structures. As a matter of fact, some GPs seem to be exclusively opting for partnerships nowadays while previously they opted for the traditional structures that were available before the transposition of the AIFM Directive. As regards the Raif, there has been a strong interest in this unregulated vehicle.

The strong rise of the industry has also been confirmed by employment data. LPEA has kept track of the PE labor market and seen a steady increase of job openings in the industry – since June 2016 the number of job openings has doubled.



> “Technology enables global interaction between business functions, fund transparency and reporting solutions to investors”
>
> **Sandra Mueller, MEAG**

**› Senanayake:** The last few years have seen healthy amounts of capital invested in PE and real asset funds as investors pursued long-term yield and diversification. More traditional investment classes were considered comparatively too volatile or lacked yield.

Driven by performance, we expect investors to continue to allocate capital. In line with this trend, we anticipate continued activity of fund launches in these asset classes by both first-time and experienced fund managers.

**Chair: To what extent is Luxembourg involved in the expanding private debt market?**

**› Gladovic:** Historically, leverage through bank lending played an important role in the world of PE. One reason to explain the enormous surge of debt funds is that banks simply can no longer provide as much leverage. Since the financial crisis banks have been put under increased scrutiny and consolidation obligations. Their leverage function has in some part been replaced by debt funds.

Debt funds have become an extremely attractive asset class and recent numbers confirm that Luxembourg's importance for this sector has steadily grown. Some institutional investors are structuring their debt funds as Special Investment Funds (SIFs) from Luxembourg. In some cases, institutional investors such as German pension funds see this Luxembourg vehicle as their best option to launch their debt fund.

CSSF has clarified in an AIFM Q&A published in June 2016 that AIFs, whether they are regulated or unregulated, can originate debt. The CSSF also confirmed that for the same reasons, loan participation and acquisition is also a permitted activity for AIFs. Everything seems set for this sector to grow even further in the near future. The Luxembourg-based European Investment Fund (EIF) has also been active in this new asset class by deploying a specific loan funds instrument investing in selective debt funds.

**› Senanayake:** Institutional investors recognise the value in debt financing as debt strategies can secure regular distributions. This is reflected in the industry figures. Preqin data published early this year showed that private debt globally posted the strongest three-month period with $50bn secured in Q4 2016. Moreover, infrastructure debt fund confirmed renewed investor appetite with approximately $11bn raised as of August 2017, exceeding the 2013 record of $12bn raised.

**Chair: How will CMU affect the global and local markets?**

**› Camille Thommes:** If common EU rules on marketing through a single rule book issued by Esma are introduced, including a common definition of marketing or distribution for both Ucits and AIFs as well as what constitutes reverse solicitation, this will largely address the problem of current national barriers to capital flows.

Alfi therefore supports the Commission's call to 'identify a common understanding of pre-marketing and reverse solicitation practices' with the view to review 'national rules, with the aim of promoting convergence in this area'.

Furthermore, the CMU proposals should also ensure clarity and transparency in the national regulatory fees framework. Some current local requirements such as the need for a paying agent are not always clearly justified and most of these facilities could be provided on a cross-border basis without compromising investor protection. If this situation is improved in the context of the CMU, cross-border distribution will benefit from it.

Finally, the idea of a digital investor passport – which would allow a consumer to open accounts or purchase other investment services with more providers and individually manage his or her digital account in a consolidated manner – would also enhance cross-border distribution of financial products including investment funds.

**Chair: Did the financial crisis and subsequent wave of regulation help or hinder the growth of the PE industry?**

**Mekouar:** Demand for PE, my area of expertise, has only increased since the crisis, on the back of volatile public markets and growing central bank intervention. PE has emerged unscathed after a period that saw the best performing PE managers grow larger, and an abundance of cash allowing for dynamic fundraising environment. Regulation has increased too, with the AIFMD, and more transparency has been on the cards as required by the top PE investors, such as pension funds. Also, PE remains the remit of qualified investors and less so that of retail investors, at least in Europe, which helps alleviate the impact of an increased regulatory burden.

**Mueller:** The fund industry's operating environment is constantly changing due to an evolving regulatory landscape and market developments. Management companies must fulfill strict conditions in terms of activity scope, organisation and functioning.

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> **Camille Thommes, Alfi**

The volume of regulation, the cost of implementing and complying with new regulations and the time that it requires, is creating challenges to the industry.

At the same time it is reinforcing the importance of the compliance function, who is connecting the regulatory dots and compiling all regulations impacting the activities as well as the search for qualified persons, ensuring a proper interaction between the regulatory watch function and all the business lines within the organisation.

**Thommes:** Mifid II applies to all investment firms that manufacture or distribute financial instruments and services. This means that product manufacturers that are not directly subject to Mifid may need to put in place organisational arrangements that meet the requirements of the directive and accommodate to the needs of their distributors in this regard. In Luxembourg, the board of directors of a UCI, including self-managed Sicavs, and/or, as the case may be, of its management company, while currently not being subject to Mifid, may therefore be impacted by the directive to the extent their products are distributed by Mifid entities.

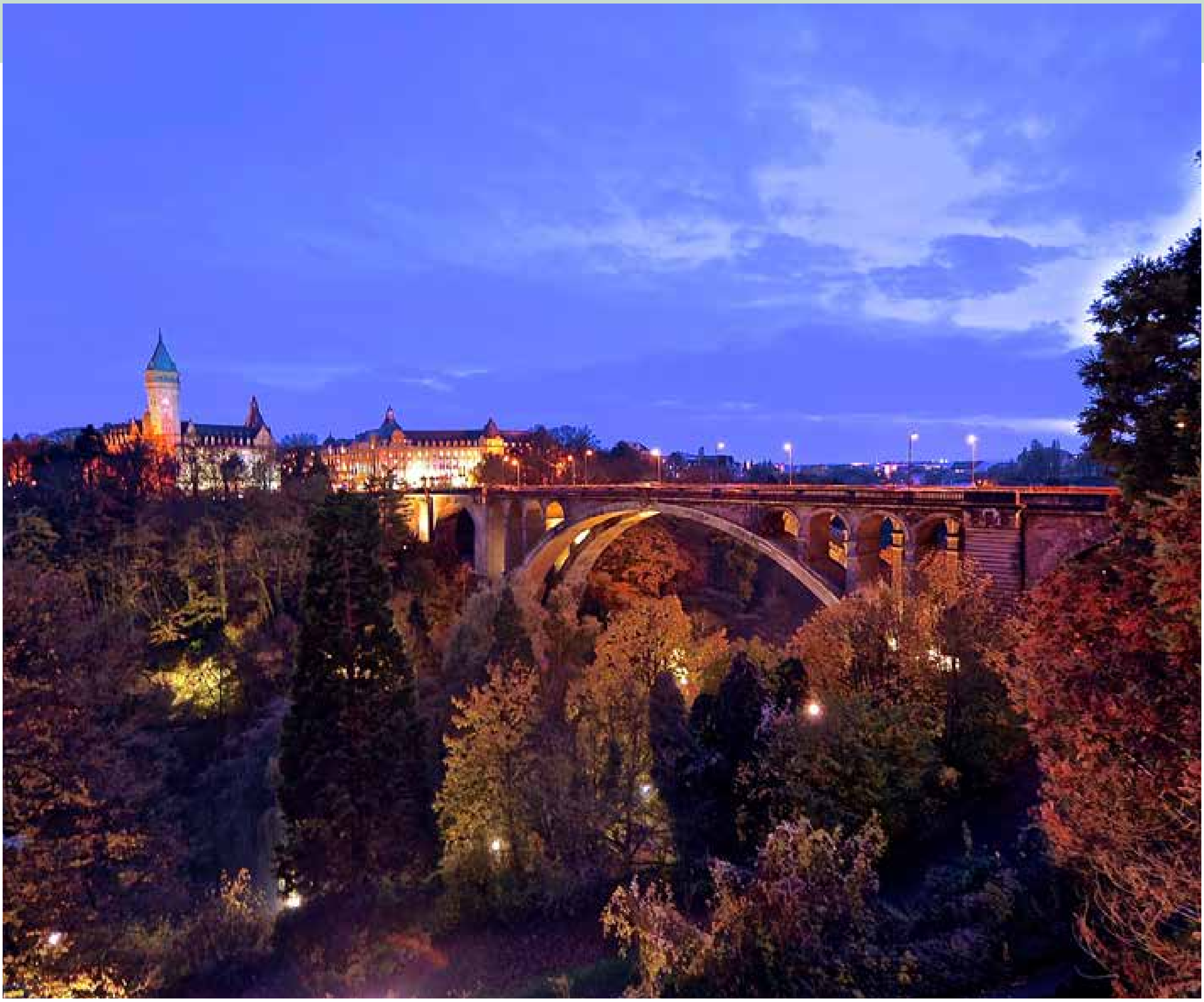
Although most players have done a lot of preparatory work to ensure they are ready on time to face these challenges, this remains challenging as the delegated texts and guidance from Esma were issued rather recently.

Alfi is finalising a Q&A on the impact of the new rules for the industry, which will cover product governance, rules on inducements, costs and charges and appropriateness.

**Chair: What about the impact of PRIIPs?**

**Thommes:** Managers that must produce KIDs as from January 1 2018 for alternative investment funds sold to retail investors are gearing up for the implementation of the new rules. Even though the ESAs provided in the meantime provide further guidance, a number of questions are still open or not clear. Alfi published a Q&A document to its members in order to help them getting prepared.

**Chair: Luxembourg has a long history of collaboration with other jurisdictions. What are the most exciting developments currently underway?**



**Senanayake:** Asia Pacific and Luxembourg markets have a strong history of co-operation including greater information exchange and pan-regional discussions on simplification of cross-border distribution. The routes to access China were established, for example, with the first Renminbi Qualified Foreign Institutional Investor (RQFII) Ucits fund authorised in Luxembourg in 2013 and the approval of the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect by the CSSF. These initiatives established Luxembourg as a settlement hub and opened the doors to investments in mainland China.

The recent acquisitions of 90% stake in BIL Luxembourg by China's Legend Holdings, Sal Oppenheim by Fosun Group and the recent inauguration of the seventh Chinese Bank in Luxembourg, China Everbright Bank, are other great examples of the commitment of China to Luxembourg and the very close cooperation between the countries. Luxembourg has worked hard to attract Chinese financial institutions and can be proud to be the European hub of seven large Chinese Banks and the largest listing centre for 'dim sum' bonds outside Asia.

**Thommes:** Luxembourg enjoys a special relationship with Mainland China.

Our country has traditionally been the gateway of inbound and outbound investments to Mainland China, it thus has a sincere interest in supporting the development of new channels of cooperation between its own market and/ or the European market and China. It is the main domicile of RQFII funds in Europe and 65 % (by AuM) of all European investment funds investing in Mainland China are of Luxembourg origin.

**Chair: Luxembourg has also traditionally had strong links with the United States. How is this developing?**

**Senanayake:** The large US fund houses have established Ucits & AIFM management companies in Luxembourg and US asset managers continue to dominate the Luxembourg funds' market with nearly a third of AuM, although we saw a slight dip in the latter part of 2016. Further to Brexit and to increasing requirement in substance in Luxembourg we observed a shift in risk management and supervisory roles from London to Luxembourg. This shift enabled them to ensure good governance and meet increasing regulatory requirements.

**Chair: In what areas is Luxembourg contributing the most to global fintech and regtech?**

**Senanayake:** Luxembourg has positioned itself as a leader in financial data, setting it apart from other markets. Interestingly, it hosts around 40% of Europe's tier IV data centres. The CSSF proactively supports financial and regulatory technologies and is creating the context for these industries to develop.

With the industry focus on transparency and the need for dynamic, on-demand data and analytics, regtech and fintech have the opportunity to make significant change. They bring a whole new way of interacting with clients, enhance customer experience and radically transform the approach to innovation, including data accuracy, speed and transparency.

Digital distribution is already happening and we'll see more. We are seeing a shift towards higher digital expectations from younger generations. From robo-advisors and social media for investment advice at the front end, all the way through to artificial intelligence supporting the middle and back office.

Technology has always been part of the custodians' DNA and they hold vast amounts of data that have the potential to add significant value for clients. RBC I&TS for example, recently enhanced its Fund Sales Intelligence, a tool which leverages TA data to give clients insight into distribution performance versus their peer group and analysis of growth trends in AuM.

Technology is the key to the industry's future success and many institutions including RBC have recognised early on that we need to adapt and leverage technology in providing more efficient and valuable services.

**Thommes:** Multiple stakeholders in Luxembourg are looking into a wide spectrum of fintech activities such as compliance & risk management, blockchain & distributed applications, security & authentication, automated investment services as well as big data analytics.

We do have a start up ecosystem in place and the Luxembourg House of Financial Technology (LHoFT) provides co-working desks to fintech start-ups that are looking to launch their activities in Luxembourg. Beyond incubation, it also provides support and access to technologies, knowledge and competencies.

In addition to that, we witness a close collaboration between private sector and class-leading research institutes.

> "Brexit is an opportunity to partner even more closely with the UK"
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> **Rajaa Mekouar, Kharis Capital**

**Mueller:** Technology has become an increasingly important catalyst and differentiator. In prosperous times, the asset management industry tends to pay less attention to its operating model as the vast majority of resources are targeted at growth. During financial downturns, the focus at many management companies tends to shift to immediate cost savings. The industry efforts to keep costs low in the last years have, in some cases, resulted in underinvestment in technology platforms.

A solution may be found in the outsourcing of functions such as fund administration, which is offering substantial benefits and the ability to migrate onto constantly modernised technology platforms that can scale to support growth, while at the same time spread the cost of system enhancements, such as for regulatory updates, across a wide customer base. Risks and costs can be reduced and quality improved, via shifting to variable cost structures and a shared service model.

Furthermore, robotics is driving efficiency of standardised processes. Where possible, manual procedures are being optimised, rationalised and replaced to reduce processing time and costs. Also the demand for new capabilities and IT solutions in the mobile arena necessitate investment in technology.

At the same time, technology enables global interaction between business functions, fund transparency and reporting solutions to investors accessible through online portals 24/7 globally. This connectivity is paving its way and fostering global distribution as well as tailored client solutions.

In order to grow our business, we need to facilitate customer-centric solutions and foster strategic innovation to enhance our current operating models faster. Understanding the direct link between customer care and product innovation are essential ingredients in the recipe for sustainable business growth and closely tied to our ability to contribute to lasting success of our clients.

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> **Dušan Gladovic, LPEA**

**Chair: Which investment areas do you expect to see the most significant growth?**

> **Mekouar:** PE remains a growing industry, with increased appetite from all types of investors, particularly family offices. The new trend is in the wealth management industry. The LPEA, the board of which I sit on, clearly noted this in our latest conference LPEA 360: GP Insights, which was well attended in April by private bankers and wealth managers.

The key driver of the industry's success is PE's outperformance of other asset classes. Now, whether PE will actually attract substantial private money will depend on accessibility and liquidity options, which the latter is used to. At the LPEA, we are working on this and are spending time on helping to demystify the industry. This entails explaining how PE works and why the so-called illiquidity premium is justified and worth the patience of investors.

It is a long-term game, as Warren Buffet often remarks. At Kharis Capital, for example, our investments don't have a pre-set holding period although we build our investment cases on a four-to-five year timeline. As PE grows, it becomes increasingly important to segment the industry and understand what fits best each type of investor, between private debt, venture, infrastructure and more traditional growth capital or LBOs.

**Chair: What progress has been made to fulfil the aims of the Alfi 2020 Ambition project?**

> **Thommes:** Alfi sees the proposal to create a standardised pan-European Personal Pension Product (PEPP), which is envisaged to be a long-term retirement savings product, as a priority project for the future, next to the development of Capital Markets Union, the elimination of barriers for cross-border distribution.

Recently, while reviewing our Alfi 2020 Ambition, as it was defined in 2015, we decided that we should not only confirm our initial commitment, but also strengthen our focus on supporting the industry's twin objectives of serving investors and fostering economic growth.

Our mid-term report on the Alfi 2020 Ambition explores the recent changes that affect the asset management industry, and details Alfi's achievements and ongoing efforts to meet its five key objectives.