ALFI European Asset Management Conference
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Sustainability remains prime focus as fund industry learns to live with political turbulence

As the first large-scale ALFI funds events with a substantial in-person presence since the autumn of 2019, the agenda of the European Asset Management conference was strongly focused on the sustainability transition and its impact on the fund industry, already grappling with implementation of the EU's Sustainable Finance Disclosure Regulation. But the sector is simultaneously having to deal with the fall-out from Russia's invasion of Ukraine and the imposition of sanctions on Russian individuals and companies.

Sustainable fund assets totalled EUR 4 trn at the end of last year, according to Morningstar, but ALFI chairwoman Corinne Lamesch notes that asset managers face a range of challenges. She told the conference audience: "There is concern about the use of SFDR categorisations under articles 8 and 9 as labels, which was not intended".

"We at ALFI urge all fund boards to integrate ESG factors into their business models rather than being passive and waiting for the next round of regulation. Asset managers need to empower investors to plan for their future wellbeing, including sustainability objectives."

Meanwhile Luxembourg's finance minister since the beginning of the year, Yuriko Backes, found herself having to deal with a global crisis barely a month into office. She says that while the fund industry remains a central pillar of the economy, with some EUR 5.67 trn in assets under management at the end of January, clouds on the horizon include economic uncertainty worldwide and at home.

The cost of sanctions

"Even if Luxembourg is only marginally exposed to the Russian economy and clients, sanctions will have a cost through higher inflation, rising energy costs and slower growth," Ms Backes said. And the requirements of the sustainability transition will intensify the challenge of attracting and retaining talent, she argues.

The geopolitical disruption of the past couple of months makes predictions about the medium-term future easier than for 2022, according to HSBC global economist James Pomeroy. "Right now forecasting is unbelievably futile," he admitted. But he expects supply chain disruption – highlighted by a sevenfold increase in shipping costs – to continue for some time; the surge in inflation to be passed on to consumers, who may not complain after two years of suppressed demand; and believes it far from inevitable that tighter monetary policy will lead to a slowdown in growth.

In the longer term, Mr Pomeroy believes automation will continue to spread throughout the economy, and anticipates a surge in online spending powered by improved logistics and the increasing weight of a younger generation who have known little else. And, he insists, governments will struggle in vain to shore up falling birth rates: "The only way to get people to have more children is to crash the housing market."

In this environment, CEOs of asset managers active in Europe see new challenges arising to meet changing customer demand. "One impact of quantitative easing is a shift toward outcome-oriented investing, which involves certainty of returns but also ESG requirements," said BNY Mellon Investment Management's Hanneke Smits. "This requires a combination of human capital and the power of machines."

Regulation fatigue

ALFI deputy director general Marc-André Bechet says that while the industry complains about the burden of regulation, it remains inescapable. He notes for example that while the EU's Alternative Investment Fund Managers Directive was widely decried at the outset, it now enjoys widespread acceptance among industry members.

Nevertheless, he says, national markets led by France and Germany still outweigh cross-border alternative fund business. Meanwhile, Mr Bechet says, business costs increase while fees drop – from 200 to as low as 50 basis points for active equity funds over the past 10 years.

CSSF CEO Claude Marx put the Luxembourg fund industry's exposure to Russia into perspective: some EUR 18.2 bn in assets affected (less than 0.3% of the sector's total), mostly denominated in roubles and around two-thirds consisting of equities, the rest bonds; 61 fund compartments out of around 15,000 had more than 10% of their assets invested in Russian securities, of which 41 had suspended subscriptions and redemptions – more than at the onset of the Covid-19 pandemic – as markets closed and valuation of assets became impossible.

Mr Marx says that so far there has been no liquidity squeeze affecting other assets, such as money market instruments, although it remains possible in the future, possibly as a result of soaring energy prices. He warned conference participants of the importance of financial players notifying any sanctioned assets and investors: "It's not just about the reputation of institutions but of Luxembourg as a whole. I don't want to read about it in the next ICIJ disclosures."

Greenwashing and regulatory breaches

A top priority for the CSSF is overseeing the implementation of the SFDR rules, including the more detailed level 2 requirements due to take effect, belatedly, at the beginning of 2023, along with the EU green investment taxonomy. Noting that greenwashing means not correctly reflecting the sustainability profile of an issuer or portfolio, Mr Marx says it encompasses the regulatory breaches mislabelling, mis-selling and misrepresentation. He urged institutions not to spend too much time trying to unravel the "inconsistencies and imperfections" of the legislation but "to focus on what is clear and well defined, defining data sources and preparing systems. We [the regulators] will not expect the impossible."

Institutional investors such as pension funds and insurance companies are largely driving product innovation, pushing for things they want to do or seeking to capitalise on emerging trends, according to Oaktree Capital Management managing director Peter Preisler. CEO for Europe Finbarr Browne says Schroders monitors what clients say about their needs, both asking them directly and using CRM tools to identify key topics that are arising in conversations.

He said: "It's no longer about putting products on the shelf but personalisation. The risk is of a proliferation of products with small volumes of assets, when asset managers are simultaneously under pressure to consolidate their ranges." Suzanne Williams, global head of product development at HSBC Global Asset Management, says future regulatory evolution will also prompt product innovation in the coming years, noting: “There is always the option of creating new share classes, for example to accrue carbon credits.”

Direct indexing – personalising indices to meet clients’ particular needs – is the latest development for a segment of the investment industry that has been evolving and growing for the past 30 years, argues Morningstar chief indexing officer Gareth Parker. The trend originated among high net worth individuals, but he expects hyper-personalised indices to be progressively made available to any investor. However, he noted: “We need to work out the regulatory aspects, such as how this fits with UCITS diversification requirements.”

Insufficient legislation

A bracing contrarian view to the fund industry’s confidence in its sustainability approach came from Lucie Pinson, executive director of climate activist group Reclaim Finance. She said: “The SFDR and EU taxonomy are insufficient to make a difference – I don’t see gas and nuclear energy supporting the transition to a 1.5ºC warming world. It leaves us dependent on the goodwill of financial institutions. Most financing continues to go to companies that have neither plans nor the desire to make the transition. Engagement, yes, but it must be deeply reviewed and regulated.”

The profile of impact investing has soared in the last couple of years – today it is a staple of SFDR article 9 funds – but it is also under increased scrutiny, says Innpact associate director Adriana Balducci: “Microfinance is considered impact investing, but it is important to measure its actual contribution to achieving the United Nations’ Sustainable Development Goals.” To qualify, she says, investment has to be “intentional, measurable and additional.”

With data critical not just to impact investing but all sustainability approaches, initiatives to improve its availability, accuracy and comparability range from creation of the International Sustainability Standards Board to the EU’s planned Corporate Sustainability Reporting Directive. But these will not resolve all the issues; for example, says Triodos Asset Management Impact Manager Nikkie Pelzer, the corporate disclosure legislation will apply only to companies based in the EU.

Anne Schoemaker, director of ESG Products at Sustainalytics, warned: “Data providers don’t have a magic wand.” Noting that businesses have been obliged to backtrack from claims to be 100% aligned with the EU taxonomy, she says the rule must be: “Don’t inflate, don’t assume.” And the issues are only likely to grow when the European Commission gets round to its social impact taxonomy – the “elephant in the room”, according to Pictet Asset Management ESG head Eric Borremans.

Blockchain and sustainability

Can blockchain technology play a role in easing the data issues? Yes, says Société Générale Securities Services head of innovation Laurent Marochini, as long as the issue of the power consumption required by the proof of work validation protocol is addressed. Investre CEO Georges Bock says the technology can not only make available new sources of funding, by giving more people access to investment, but provide cheap and reliable tracking of financial transactions.

Opening the second day of the conference, ALFI director general Camille Thommes warned that the European Commission’s legislative initiative dubbed ‘Unshell’ Directive, intended to curb lack of transparency and tax avoidance, could have adverse unintended consequences, by ignoring the reality of the fund industry and in particular the role of intermediate entities in private equity, real estate and other types of investment in alternative assets.

European Commissioner for financial services Mairead McGuinness, who provided a recorded address from Brussels, says the Commission's recent review of the AIFMD and the ELTIF Regulation are an important element of the development of the EU's Capital Markets Union, by strengthening supervisory convergence and harmonising rules. "The digitalisation of the financial sector enhances our work on CMU," she said, adding that the revised rules governing loan origination funds under the AIFMD will create for the first time a single market in cross-border lending.

The AIFMD and ELTIF changes are just two elements in an ongoing flow of regulatory change affecting the fund industry, detailed by Arendt & Medernach's Michèle Eisenhuth, Linklaters' Silke Bernard and Elvinger Hoss Prussen's Olivia Moessner. They noted that SPAC shares can qualify as eligible assets for UCITS; that ascertaining clients' sustainability preferences will become part of the MiFID requirements; and that Luxembourg stands to be a prime beneficiary if the Commission's changes boost take-up of ELTIF structures and their appeal to retail investors.

From crypto opportunity to cyber-threat

The CSSF's white paper on digital assets last year has boosted interest in the sector in the grand duchy, which was already home to regulated service providers such as crypto-exchange Bitstamp; Swissquote says it is the country's only bank offering crypto-asset trading.

Swissquote Bank Europe CEO Dave Sparvell told conference participants that the sector will receive a boost from the investor protection and market discipline provisions of the EU's planned Markets in Crypto Assets (MiCA) Regulation (which narrowly escaped amendment in the European Parliament this month that would have banned proof of work-based assets).

Edmond de Rothschild Asset Management (Luxembourg) CEO Serge Weyland argues that the tokenisation of private assets could present a huge opportunity to the grand duchy's financial industry, while Azimut Investment Management Singapore director Marco Cora believes that digital access will democratise and expand investment in the economy, disintermediating functions that banks arguably have failed to perform well.

The risks inherent in the digital transformation were highlighted, though, by Edith Magyarics, now of PwC, who described a cyber-attack on her previous employer as "something you wouldn't wish on your worst enemy". There's no shame in suffering an attack, she says, but it means days or weeks of work to restore operations and to assess any data loss, and "when you lose the trust [of customers] built up over many years, that's even more difficult to rebuild."

The talent challenge

In the broadest sense, the sustainability of Luxembourg's financial industry also depends on its ability to attract and retain the talent it requires to meet future challenges, always a significant issue because of the country's restricted demographic resources but now more acute because of increasing demand for compliance, IT and now sustainability specialists.

ADEM director Isabelle Schlesser said: “We need to be clear about what kind of talent is needed and how we develop the capabilities of people already here. Some jobs will disappear, and others will change very much, so we should be focusing on upskilling and reskilling.”

Luxembourg’s fund industry faces an exceedingly wide-ranging set of challenges, from the burden of regulation and compliance to the demands of a complex economic transition, along with an urgent task of channelling investment into the economy at a time when the market is become more diverse and fragmented – on top of the strains of geopolitical turbulence and armed conflict in Europe. But it is in these circumstances, as Ms Backes observed, that the need for a strong and competitive fund industry is greater than ever.