association of the
luxembourg fund industry

ALFI GLOBAL ASSET MANAGEMENT CONFERENCE 2024

Post-conference report

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Fund industry looks for new opportunities as implications of blockchain and AI loom

The entry into application of the revised European Long-Term Investment Fund regime at the beginning of this year offers new growth opportunities for the fund industry in Luxembourg, already home to around 60% of the ELTIFs established since the legislation was first introduced in 2015, according to speakers at ALFI's 2024 Global Asset Management Conference held at the European Convention Center on March 19 and 20.

The European Commission and the European Securities and Markets Authority (ESMA) are currently wresting with the vexed question of the ELTIF Regulation's regulatory technical standards, but industry experts and the grand duchy's financial regulator CSSF are confident that the impasse will be resolved soon, pointing out that promoters are queuing up to get their funds approved in anticipation of strong market demand from HNWI as well as professional investors.

Participants at the conference, from Luxembourg, Europe and elsewhere in the world, heard that the "tsunami" of new regulation, as it has been dubbed, is unlikely to recede in the foreseeable future. Indeed, industry members are obliged to consider – in many cases unwillingly – the possibility that the European Union might substantially revise its Sustainable Finance Disclosure Regulation in the face of persistent problems of interpretation and measurement affecting the existing article 8/article 9 categorisation.

Meanwhile, fund businesses – like other companies both within and outside the wider financial industry – are examining the implications and opportunities presented by the surge in deployment of artificial intelligence, and of the possibilities offered by digital ledger technology to streamline and boost the efficiency of administrative processes.

Rebound in fund assets

[ALFI chair Jean-Marc Goy]() admitted that this year the fund industry is confronted with an uncertain and unstable economic and geopolitical environment, buffeted by high inflation and interest rates. But he also pointed to signs of growth, including a rebound in Luxembourg fund assets to more than €5.3 trillion at the end of January, following a slump prompted by falling global markets over the previous two years.

Mr Goy also noted the continuing growth of the private assets sector, which has become a substantial share of industry assets since the adoption of the EU's Alternative Investment Fund Managers Directive (AIFMD) in 2011, and Luxembourg's continuing primacy as a hub for cross-border distribution, as well as the world's second largest fund centre measured by assets after the United States. And whatever the ongoing issues regarding sustainable finance regulation, the country remains the key EU hub for ESG funds, with 34% of article 8 fund assets and 51% for article 9.

ALFI has identified a new potential growth area in actively-managed exchange-traded funds, which are becoming an increasingly substantial challenger to traditional mutual funds in the US. Mr Goy said that after the highly welcomed modernisation of Luxembourg's core fund legislation framework last year, another important step would be to exempt active ETFs from the subscription tax on fund assets.

The new government coalition that took office last autumn is receptive to the needs of one of Luxembourg's key economic sectors, according to finance minister Gilles Roth, a senior finance ministry official before he entered politics. He praised the resilience of the fund industry in a difficult environment, noting the challenges it is embracing in digitalisation of processing and distribution, as well as the importance of its role in meeting the needs of society and dealing with an ageing population.

Reduced corporate taxation

Mr Roth says he recognises the importance of ensuring that the financial sector remains attractive and competitive through measures conducive to climbing the value chain. A reduced subscription tax for active ETFs is among a number of promised changes to the country's tax structure, including a 1% cut in corporate income tax as a signal to companies and investors of the government's ambition to bring corporate taxation down to the OECD average.

He also promised legislation to help bolster Luxembourg's position as a leader in digital assets, efforts to mobilise finance for the green transition, support for the EU's slow-moving Capital Markets Union project, and measures to improve the country's tax regime for profit-sharing bonuses as well as the fiscal status of expatriates whose skills and experience are needed to drive business growth.

The global economy has so far survived the vicissitudes of global pandemic, economic turbulence and international conflict significantly better than many experts had predicted, according to Citi's global chief economist Nathan Sheets. He believes that technological advances have made production more flexible and better able to respond to external shocks, resulting in the global economy escaping recession last year; even Europe experienced stagnation rather than the expected severe contraction.

That was due in considerable part, Mr Sheets said, to strong consumer demand, particularly for labour-intensive services, pushing up wage growth and services sector inflation – the critical challenge for central banks as they try to calculate the ideal timing and pace for lowering interest rates. He expects the global economy's resilience to remain but growth to slow this year as consumer spending ebbs after its rebound from the pandemic-era constraints, and also expects a loosening of demand for labour as fiscal measures to support the economy continue to be scaled back.

Vulnerability of non-bank intermediaries

Sustainable finance is a key element running through ESMA's strategic priorities for the years leading up to 2028, according to Evert van Walsum, head of the EU regulatory agency's investor protection and sustainable finance department.

Specific areas of focus include oversight of non-bank financial intermediaries and vulnerabilities including their interconnection with the more regulated areas of the financial system, along with the risk of liquidity mismatches. He cited the concerted measures taken by Luxembourg's CSSF and the Central Bank of Ireland to address liquidity issues faced by investment funds, especially by open-ended real estate funds.

Mr van Walsum says the debate over revision of the SFDR should focus on enabling investors to make informed choices, including simplification of disclosures to make them more comprehensible, as well as whether sustainable fund categories should have more descriptive labels. Policymakers also need to consider how heavy carbon companies that are embracing a switch to sustainable models should be categorised in order to facilitate funding for the transition.

PwC Luxembourg partner Geoffroy Marcassoli argues that EU policymakers should resist the temptation to undertake wholesale changes to the structure of the SFDR, arguing that abandoning the article 8 and 9 categories, as the Commission has put forward as one option, would involve throwing away the work conducted by the industry over the past three years. Most clients, he argues, would prefer instead adding clear minimum standards, adapted to funds' particular strategies.

Reassurance on ELTIF authorisation

The CSSF's head of fund supervision, Marco Zwick, says the regulator is satisfied with the conclusion of the legislative process for the revised AIFMD II and related UCITS VI measures, with a compromise on delegation of functions to providers inside or outside the EU that does not overturn the decades-old outsourcing model that underpins Luxembourg's fund services industry.

As the leading domicile for ELTIFs, Luxembourg is in the frontline of the uncertainty about the detailed technical rules, but Mr Zwick reassured delegates that when the RTS come into force, they will not overturn the authorisation of existing funds, and in almost all cases should not require funds to amend their investment objectives. "This should not stop creation of new ELTIFs," he said.

The Commission's proposed amendments to the RTS proposed by ESMA last December go a long way toward meeting concerns raised by industry organisations such as ALFI, according to Linklaters Luxembourg partner and the firm's global head of investment funds, Silke Bernard.

She told conference participants that as many as 40 new ELTIFs may be in the pipeline. While the CSSF is not proposing a 24-hour application turnaround time – "that's too little for a proper assessment" – Ms Bernard said fund promoters could maximise the speed and efficiency of the process through upfront preparation, and that the regulator's online application form was the key to rapid authorisation.

Debate over Commission's Retail Investment Strategy

Mr Zwick revealed that the CSSF is about to issue an update after 22 years of its circular on net asset value (NAV) calculation errors and non-compliance with investment rules, incorporating two decades of experience as well as the introduction by Luxembourg since 2002 of new types of investment vehicles, including Risk Capital Investment Companies (Sicars) and Specialised Investment Funds (SIFs). The new version, inevitably, will be bigger – 50 pages, Mr Zwick admitted.

He also touched on the European Commission's planned Retail Investment Strategy, a package of legislative measures designed to reinforce investor protection and thus boost trust and participation in financial markets.

The issue was addressed by a panel of regulatory experts from law firms Arendt & Medernach and Elvinger Hoss Prussen, who pointed out the ongoing, at times acrimonious debate over the Commission's proposals, including benchmarking of the value for money of retail financial products, and a ban on intermediary commission inducements for execution-only products. With European Parliament elections and the selection of a new Commission looming, a decision on the final shape of the legislation is unlikely before the first quarter of 2025, and entry into effect two years after that.

The issue of value for money should not focus exclusively on costs, according to Christian Machts, chief administrative officer at Fidelity International. There's no need for products that offer no value to investors, but equating cheaper with better is too simplistic, he argued. In real life, there is no such thing as the 'average investor' beloved of policymakers: "We need to make a broader assessment of value and look at investors individually."

Mixed-asset funds in decline

The most striking trend in fund distribution last year was the sharp contraction in demand for mixed-asset funds, which suffered particularly in 2022 from the simultaneous decline in both global equity and bond markets, according to Lynn Juliet Pattinson, a senior director at data provider Broadridge Financial Solutions. She pointed out that while ESG funds also suffered in 2023 from poor performance, regulatory confusion and concern about greenwashing, demand remained strong for the highest-conviction sustainable funds – essentially those classified under article 9 of the SFDR.

Transfer agents play a critical role in distribution, but investors don't pay attention to them, as long as their subscription or redemption goes through, noted Elisa Alonso Sanz, chief operating officer of ABN Amro Investment Solutions. However, Sebastien Rouyr, head of business development for Europe at IFDS in Luxembourg, argued that they are a critical part of the fund ecosystem, constantly working to maximise the efficiency of the distribution process – including helping the industry to embrace new technology such as blockchain, added Allfunds Blockchain Bank managing director Ruben Nieto Martin-Vares.

Active asset managers continue to struggle to compete with low-cost index-tracking ETFs because of their much higher management fees, said Banque Raiffeisen management board member Sandrine de Vuyst, noting that only 10% of active funds outperformed the market.

Questioned on the appeal of active ETFs by comparison with traditional UCITS, Société Générale Private Banking commercial and solutions deputy director Olivier Paccalin argued that they represented a "door-opener for new generations", while Ms De Vuyst concluded: "ETFs are easy to understand – there's room for both."

The AIFMD II and UCITS VI legislation stands to accelerate new trends in oversight of distribution networks. Laurent Denayer, CEO of online due diligence platform ume, says a standardised common process can offer substantial efficiency gains, replacing individual questionnaires drawn up by asset managers that "ask for the same information with different questions, and are very painful for distributors".

Luxembourg's international appeal

Michael Derwael, a senior director at MFS Investment Management Company, said the firm's internal streamlining process resulted in the number of active distribution contracts being cut from 600 to 250, and significantly cut the workload for ongoing legal review. But he cautioned: "It can't be completely automated because the process is judgement-based, and must remain so."

In a global fund distribution market, Luxembourg continues to enjoy opportunities because of the international appeal of the well-regulated UCITS framework, according to Rob Spanjaard, chief investment officer at Cape Town-based Rezco Asset Management. But he pointed out that local regulations present their own challenges, such as the 45% limit on investment abroad by South African pension funds.

Jim Fitzpatrick, president and CEO of US fund industry association Nicsa, says the American market enjoyed strong bond and equity fund inflows last year. While passive funds have predominated, he reported that active ETFs are particularly attractive because they are traded on an exchange and thus, unlike traditional mutual funds, are not required to distribute 90% of their annual profit each year, triggering taxation for investors. As a result, promoters of open-ended funds are applying to convert them to an ETF structure or to create an ETF share class.

The UK fund market had never seen a full year of outflows until 2022-23, according to Jonathan Lipkin, head of policy, strategy and innovation at the Investment Association. He reported that UK equity funds have been experiencing outflows since 2016, but they were joined last year by sustainable funds after a long period of net inflows, representing a normalisation after the surge in ESG investment between 2019 and 2021.

Exposure to private assets

In Hong Kong the question of retail and high net worth investor exposure to private assets is in its early days, reported Sally Wong, CEO of the Hong Kong Investment Funds Association. Retail banks are lukewarm about offering exposure to alternative products, because of the responsibility not only for educating investors but training front-line staff. Discussions are still underway on how Mandatory Provident Fund pension accounts might be offered some exposure, possible through liquid alternatives products.

Sustainability remains a central issue for the European fund sector, according to Vincent Ingham, director of regulatory policy at the European Fund and Asset Management Association, noting that the EU is the global leader on ESG regulation, helping to shift sustainable investment from a niche sector a few years ago into the mainstream. But he acknowledged that much needs to be done, from clarifying and simplifying SFDR disclosure to fostering the interoperability of international reporting standards.

The role played by fund boards is also increasingly in the spotlight, as well as their make-up. Gender diversity on management company and fund boards appears to have stalled, according to Luxembourg independent director Carine Feipel, whereas in the US the proportion of female board members has risen to 37% from 20% a decade earlier, said Andrew Owen, head of global fund governance at Allspring Global Investments.

Diversity of board skills

Just as important, argued independent adviser and director Solenne Niedercorn-Desouches, is that boards are diversified in terms of the skills at their disposal – especially in critical areas such as cybersecurity. A key responsibility, she said, is fostering a bottom-up culture of innovation among individuals active in operations. Added Sage Advisory CEO Martin Dobbins: "Often it needs people from outside the industry to reimagine models and processes."

Blockchain can become a key tool in making private asset strategies scalable for retail investors, rather than traditional distribution channels, according to Matthias Van Den Eede, head of the Beewise platform at Italy's Azimut Investments. Given the high cost of acquisition and retention of retail investors, he argued, digital ledger technology can provide "seamless plumbing", offering greater efficiency and a better user experience.

Luxembourg needs to keep up with developments already underway in the UK, France, Germany and Asia, where the foundations of the industry's new technological infrastructure are being created, Mr Van Den Eede said: "We are the funds leader, reaching investors in more than 80 jurisdictions. This technology will happen, if not today, tomorrow or the day after."