The presence of private equity

ALONGSIDE ITS HUGE TRADITIONAL FUND PROCESSING BUSINESS, LUXEMBOURG IS SEEING DEMAND FOR ALTERNATIVE INVESTMENT SERVICES. EXPERTS FROM SPECIALIST ADMINISTRATORS AND SECURITIES DEPOSITORY CLEARSTREAM DETAIL THE ENVIRONMENT.

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Photographs: Michel Brumat

***Funds Europe* – How would you describe the business climate now in Luxembourg's alternatives asset servicing sector?**

Revel Wood, independent director – The expansion of the market for alternative investment funds in Luxembourg is creating new business opportunities for asset servicing firms. With a constant flow of new vehicles being launched in the alternative investments sector, there is demand from alternative investment fund managers [AIFMs] to support their regulatory reporting obligations, and for risk monitoring and oversight to be embedded in the fund depositary or ManCo [management company] function.

Against this background, there have been significant levels of consolidation within the asset servicing area – with asset servicing companies acquiring other providers to extend their product range and to build scale.

"LUXEMBOURG'S LIMITED PARTNERSHIP STRUCTURES HAVE BEEN PARTICULARLY POPULAR, ATTRACTING FUNDS THAT MAY PREVIOUSLY HAVE SOUGHT TO LAUNCH IN THE UK."

Revel Wood, independent director

A host of small fintech and

regtech businesses are also active in Luxembourg, developing creative solutions to many of the pressing regulatory and operational challenges that confront the investment funds industry.

Overarching each of these drivers is a constant focus on margin and cost. This is forcing firms to review their existing technology and to identify where long-term efficiency improvements can be realised through process innovation and technology upgrades. For asset servicing firms, it is essential that they can help their asset managers by distilling high volumes of data into meaningful high-quality key performance indicators (KPIs) in a timely manner, utilising effective data management and workflow tools. This is no small task, but those that achieve this will be the winners.

Vincent van den Brink, JTC – Recruiting suitable talent and expertise is certainly one of the major challenges for asset servicing companies in Luxembourg. Skilled staff in this area are in short supply and it is difficult to recruit talent, even when offering attractive salary packages. For this reason, digitalisation of processing across the industry is particularly important.

Anja Grenner, Intertrust – Some companies are acquiring their competitors to expand their book of business and to extend new opportunities presented by economies of scale. For Intertrust, strategic acquisition has been important, alongside organic growth, in enabling us to grow rapidly in Luxembourg.

Companies are also making acquisitions to fill specific gaps in their service portfolios. Intertrust's acquisition of Viteos in 2019 is an example. Viteos is a top-ten fund administrator in the US, with strong operational capability in India. This reinforces our presence in the North American market across fund services, but also strengthens our technology expertise and ability to deliver automated and standardised transaction processing across all our services. Previously, in 2016, we acquired Elian, which reinforced our expertise in private equity and real estate administration, along with strength in capital markets and corporate services.

"AS LARGE PRIVATE EQUITY HOUSES LOOK TO LUXEMBOURG AS A DOMICILE FOR THESE FUND STRUCTURES, SO THEY ARE EXPECTING HIGHER AUTOMATION OF PRIVATE EQUITY TRANSACTIONS."

Anja Grenner, Intertrust

The market for AIFM services is still relatively young – it is only eight years since the Alternative Investment Fund Manager Directive (AIFMD) was enacted in the EU. During this period, and especially in the last five years, we have seen a phase of expansion with a growing number of firms offering central administration, fund depositary and AIFM services to alternative investment funds (AIFs). However, over time we can expect this sector to consolidate as fee pressures and cost of regulatory adaptation causes providers to review their position in this market.

Neil Wise, Clearstream – We can never undervalue the importance of organic growth and this remains essential to the expansion of our established business lines. However, the three acquisitions that Clearstream has completed in the past six years have been driven by our ambition to expand into new business areas. As always, we balanced the relative merits of self-build against the purchase of an established business.

The major factor that swayed our decision was not the cost of an internal build, but rather the time to market. In the Swisscanto Funds Centre London acquisition, for example, it would have taken several years to develop an equivalent product and to negotiate contracts with fund managers – this simply wasn't a space where we had a base of internal expertise previously. So too, with our purchase of Ausmaq in the Australian market. Prior to this, we had no Australia-domiciled funds on our Vestima platform and no licence to operate in this market. In both cases, we bought a mature service that we could integrate and deliver as a Clearstream service within a short timeframe.

Wood – In most cases the value of acquisition is more than simply adding scale or adding a new product. The major benefit lies in extending new capability. We are now seeing rising levels of cross-industry M&A, particularly with financial services companies buying up fintech companies to access the technology innovation and skills that this type of firm can offer. There may also be clear benefits through M&A for firms that are looking to expand into new markets and to extend their geographical coverage.

While some firms are focused on M&A, there may still be opportunities for boutique fund administrators. Each acquisition requires a period of realignment – in integrating new staff and aligning technology and business culture – and there have been historical examples where client service has suffered as a company becomes larger and distracted by managing the integration of a recent acquisition. In this environment, there may be opportunity for some of the smaller niche players still to excel. Clients also don't like to be treated as an asset purely as part of EBITDA [earnings before interest, taxes, depreciation and amortisation] value creation in preparation for the next exit. Clients want to be valued and serviced by trusted long-term partners.

Wise – There is a lot of private equity finance being injected into the fund servicing sector at the moment, particularly around the development of fund platforms. This is like adding steroids to the sector. We have never previously acquired a like-for-like competitor, but we do not rule it out in the future. It is necessary to have both scale and flexibility to be competitive, otherwise companies run the risk of

being disintermediated. Across the asset servicing sector, the mantra "big is beautiful" has been dominant in recent times. Economies of scale are essential to provide services at a lower cost. Looking ahead, it is through the intelligent application of technology that we will be able to achieve this.

***Funds Europe* – Beyond hedge funds, private equity and real estate, where else is their growth within alternative fund asset servicing?**

Grenner – Infrastructure is an important growth area. In many European countries, infrastructure that was rebuilt after 1945 is now crumbling and demands significant investment to ensure its safety and longevity. This is an attractive business area for fund administrators that can service this asset class. These infrastructure funds tend to be relatively large – few infrastructure funds are smaller than €250 million in assets under management and many are €500 million plus. They also tend to have a long investment horizon, often 20-25 years.

Beyond this, we are also being asked to service asset types where there is little established tradition in Luxembourg. We

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have supported aviation leasing in Ireland for a number of years, for example, and there is now a gradual rise in demand for this service in Luxembourg. This is also the case for non-performing loans and structured finance transactions in Luxembourg – and a number of other European markets – as part of our capital markets product area.

Wood – These areas will continue to grow. There has been longstanding underinvestment in infrastructure in Europe and in the US and this will need to be addressed. Moreover, since the financial crisis, banks have been under pressure to deleverage their balance sheets and AIF managers are seeking access to funding from other sources. This has opened the door for a broader range of companies from the PSF (Professionals of the Financial Sector) community in Luxembourg to extend financing services to AIF managers.

For private equity, Luxembourg's limited partnership – the Société en Commandite Spéciale, or SCSP – structures have been particularly popular, attracting funds that may previously have sought to launch in the UK using a London- or Scottish-based LP structure, for example. Moreover, Luxembourg is creating a strong ecosystem to support this activity – including specialist fund administrators, law firms and independent directors with dedicated knowledge in this area. The presence of Blackstone, Carlyle or Apollo Global Management is testament to the success of Luxembourg's efforts to build a strong environment for private equity investment.

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Neil Wise, Clearstream

Wise – On a slight tangent, we have been successful recently in bringing in third-party alternative fund flows into our custody from the traditional global custodians. Previously this was being 'self-manufactured' since, despite fund-of-hedge-fund and fund-of-private-equity order execution not being core for the global custodians, there was really no one to whom they could outsource this trade execution and processing. It's been interesting to see the takeoff of interest in using a custodian for these asset classes, something that the wealth management and private banking community have been doing for years.

Grenner – One question that is becoming increasingly relevant as large alternative investment fund managers extend their activities is about how much substance they need to have in Luxembourg. For some large international managers, their preference is to do as much of their fund accounting, corporate secretary work and other functions in-house as possible, taking advantage of the global servicing capability that they have established to support their investment activities around the world. In practice, they may prefer to do their own fund accounting using a team-based offshore, and then to employ a local fund administrator to provide oversight and NAV [net asset value] verification in Luxembourg. But there are still discussions around how much local substance the Commission de Surveillance du Secteur Financier (CSSF) will require.

Moreover, this can present operational and administrative challenges for the local fund administrator. To make this work, we need to have access to a client's fund accounting systems – which may be a different accounting system to the one that we employ ourselves – or for all changes to be reported to us each time any recalculation is done.

Wood – The CSSF has provided some additional guidance with the publication of circular 18/698 last year, which is now seen as the EU gold standard for good governance. This supersedes Circular 12/546 and offers some clarification around authorisation and organisation of Luxembourg management companies, including details on substance requirements and what it classifies as a "letter box" entity. There has been a plethora of regulation – including the obligations and liabilities borne by fund depositaries outlined in AIFMD and Ucits V – including safekeeping of AIF assets and provision of oversight to ensure an AIF is compliant with its constitutional documents and with applicable laws and regulation.

Although fund products structured as Reserved Alternative Investment Funds, or Raifs, are not subject to approval and direct supervision from CSSF, these are regulated through the

AIFM. More broadly, all investors in each of these fund types must be subject to anti-money laundering due diligence in accordance with standards established globally by the Financial Action Task Force. The combination of these new regulations has led to greater investor protection, greater transparency and increased demand for on-shore funds that are well governed. In turn, this has led to a significant increase in on-shore AIFs, of which Luxembourg has managed to capture the lion's share, particularly in private equity, debt and real estate.

Van den Brink – It can be difficult to find a balance between the needs of a highly innovative or highly demanding client and the requirement for satisfactory risk oversight in the local market. This demands carefully drafted service-level agreements to confirm exactly who does what within the service relationship and where liability will reside in the instance of any failure or dispute.

Wood – This illustrates the importance of effective risk dashboards to confirm that essential data is being received and processed across the transaction lifecycle. This comes back to questions of data aggregation and how to verify that you have control and oversight of work that is being done by the client or another third-party service provider, perhaps in a location outside of Luxembourg. As was the case with VHS and Betamax, this wave of new products, combined with regulation, creates opportunity. Those who can create governance dashboards with meaningful key performance indicators (KPIs) for governing bodies, based on good clean data, will be the VHS survivors.

Van den Brink – The role of the independent director can be particularly important in these circumstances in providing an additional set of eyes and an additional point of risk oversight.

***Funds Europe* – Why has the alternative investment funds processing business failed to deliver reduction in operational risks and costs that are comparable with the cash securities market?**

Wise – A series of initiatives over the past ten to 12 years have been launched to promote standardisation and automation of order routing for alternative investment funds, encouraging a move from fax-based subscription and redemption orders to electronic messaging using ISO 20022 XML standard messaging. SWIFT initiated the Swift Hedge Fund Harmonisation Project in 2006, for example, and Idea Group co-ordinated the Global Investment Automation Initiative initiative, established in 2014.

However, if one side of the fund transaction does not have the ability to transmit or receive an electronic fund message, the potential improvement in straight-through processing (STP) rates will not be realised. At Clearstream, we have been working with transfer agents to address these constraints. Northern Trust is one of a number of asset servicing companies that have been investing to improve the automation of their subscription and redemption processing. As the largest sender of alternative investment fund orders to Northern Trust, it makes sense to work closely to identify how we can make this order flow more efficient.

The fundamental message, however, is that to increase the level of automation in the hedge funds subscription process, co-operation is required across and beyond the funds industry. To manage such projects, market infrastructures are investing in partnerships with fintech and data providers and exploring new business opportunities often far removed from their own business segment.

Grenner – When analysing operational efficiency, it is important to differentiate between asset classes within the alternative investment fund sector. Significant advances have been made in processing efficiency for hedge fund transactions over the past ten years and, in some cases, the processing of subscription and redemption instructions is approaching that for Ucits and other liquid fund products. However, the reality is typically very different for more illiquid transactions in private markets.

Our objective is to adopt some of the operational advances that have been made in processing hedge fund transactions and to apply these more fully to private equity, real estate or infrastructure, allowing us to strip out manual intervention from what are still highly manual processes. With the creation of SCSP vehicles in Luxembourg in 2016 – enabling private equity managers to launch Luxembourg-domiciled private equity funds utilising Anglo-Saxon-style LP structures – the market has seen a rise in private equity launches and a steady growth in investment flows from limited partners. As large private equity houses look to Luxembourg as a domicile for these fund structures, so they are expecting higher automation of private equity transactions.

***Funds Europe* – How are you rethinking approaches to data management across your organisation?**

Grenner – Two months ago, we established a cloud-based solution for the entire Intertrust Group. This has enabled the company to move away from supporting client data on local servers - in Jersey, Guernsey and Luxembourg, for example - to supporting a consolidated data pool based in the cloud for all of our global locations. This has been an important step to make data management more efficient and cheaper to maintain.

With the increasing volume of regulatory reporting that we support on behalf of our clients, there is no other realistic alternative but to do this digitally. Most regulators, including the CSSF, require that regulatory filing is done in digital format.

Wood – And regulators and tax authorities have typically established reporting templates to facilitate this electronic reporting process. With the increased level of regulatory reporting and pressure on cost and margins, it is essential that providers and in-house managers find efficient front-to-back solutions that incorporate regulatory reporting.

Grenner – If we consider reporting of Annex IV transparency information under AIFMD as an example, all Luxembourg-domiciled funds are required to report here in Luxembourg – as well as in other EU jurisdictions where they are marketing the product. Moreover, any offshore-domiciled fund that sells to Luxembourg investors is also required to provide Annex IV reporting to the Luxembourg regulator. The time and cost associated with filing these multiple reports manually would be prohibitive – and few fund managers are willing to bear this overhead. The move to electronic filing has been essential to provide a cost-efficient means of meeting this regulatory commitment.

"THE EXPANSION OF THE ALTERNATIVE INVESTMENT FUND MARKET HERE IS PRESENTING OPPORTUNITIES FOR ASSET SERVICING FIRMS THAT ARE WILLING TO INVEST AND TO INNOVATE."

Revel Wood, independent director

Wise – Certainly, our move into distribution intermediation has been an active play into the data space. As a custodian with assets under custody of over €2.3 trillion, this offers enormous value if you can tap into the data that is valuable for both sides of a relationship. We are assessing the value of providing fund data to the distributors, and distribution data to the asset managers, on an industrial scale. This is at the heart of our current thinking.

Van den Brink – Inevitably our asset owner and asset manager clients also expect us to remain informed of all current and pending regulatory changes taking place in Europe and to ensure that they are well briefed on the content and implications of these changes.

Wood – These regulatory pressures clearly contribute to the margin squeeze that we have highlighted. However, an expanding community of fintech companies is developing solutions that bring greater efficiency to these regulatory reporting challenges – including product governance requirements under MiFID II and anti-money laundering (AML) and know-your-customer (KYC) reporting.

This area is tailor made for the application of technology. The increasing level of AML scrutiny from financial regulators, combined with a shortage of AML officers and a growing number of clients that need to be supported through this client due diligence and monitoring process, definitely lends itself to the application of technology modules that can support this compliance requirement. However, I believe there is a significant amount of work in distributed ledger and other fields that will have their day soon. Like vinyl, through compact disk, iPod and MiniDisc, when it is achieved it will be like live streaming, a worldwide phenomenon. We can then bring out the vinyl, cigars and whisky for nostalgic reasons and talk about days before distrusted ledger!

Grenner – Although it is difficult to automate AML and KYC obligations, we have been working with Viteos on an automated solution since the beginning of this year.

***Funds Europe* – How are you applying new technology applications – for example distributed ledger technology – to your business?**

Wood – There are niche spaces where DLT is taking effect. For example, to support electronic signatories, where the signatory register is supported on blockchain and updated in real time, with the register visible to each of the participating entities.

Van den Brink – The stumbling block, as we noted earlier, is when some counterparts are not open to employing the blockchain register as their register of ownership for some of their funds. Settlement on blockchain may be completed in close to real time – once the settlement instructions have been received from counterparties – whereas settlement on the registry record may only be finalised several days later. In short, unless counterparties are prepared to commit to the DLT register as their final record of ownership, then the benefits that DLT can offer will not be delivered in full.

Wise – Introducing new technology to our custody offering for alternatives and private equity holdings is essential if we are to build these asset classes to a scale that aligns with our ambitions. We have made large-scale investments into robotics and artificial intelligence in this space and it will be very exciting to see how this develops and is rolled out to support our business. You mention DLT and, of course, on first thoughts this must be a disruptor for us as it looks to carve out and remove organisations like ourselves as a participant in the custodian chain. From our perspective, however, we need to evolve and we believe that any ledger still needs to be operated by a trusted and independent body. We want this to be us.

***Funds Europe* – What key developments do you expect in Luxembourg's asset servicing sector over the coming two years?**

Van den Brink – The major opportunity will be digitalisation of the alternative investment fund sector. This is relevant to all participants around this table. A company may employ multiple systems to meet this digitalisation journey, but it is important that each of these modules feeds into a single centralised system, providing an interface for data flows to and from key stakeholders across the transaction lifecycle.

Beyond technology, talent acquisition remains a challenge for Luxembourg's asset servicing community, particularly as the rapid expansion of the alternative investment funds segment places high pressure on skills in this area. Therefore, it is essential to create an eco-friendly environment for younger talent to come to Luxembourg's financial sector to live and work.

Wood – In the coming two to three years, I do not see any slowdown in the expansion of the alternative investment fund market in Luxembourg. This is presenting opportunities for asset servicing firms that are willing to invest and to innovate. Given the bespoke nature of many AIF products, it is inevitable that some fund processing will still be done via Excel spreadsheets – but there are strong opportunities for firms that invest in the technology required to promote automation and to reduce operational risk.

We have discussed how large asset servicing firms may be able to realise comparative advantage through their scale, including their ability to aggregate large data volumes and deliver sophisticated analytics on this data to the customer. But at the other end of the scale equation, there may be advantages for niche players who service a specialised product range. They are creative in their application of technology, nimble and agile in their development and they can excel in their customer service by delivering client-centric solutions according to real need.

"UNLESS THEY ARE ABLE TO MAKE REVENUE THROUGH OTHER ANCILLARY SERVICES, SOME BANKING PROVIDERS ARE RELUCTANT TO MANAGE THE BURDEN OF THE ACCOUNT-OPENING PROCESS."

Anja Grenner, Intertrust

Wise – The expansion in the alternatives market in Luxembourg and beyond can only present opportunities to asset servicers. A logical progression is the need to increase operational efficiencies and automation in alternative funds processing. This will increase demand for standardisation and a secure environment for cash processing.

Over the next two years, I certainly see the importance of centralisation of AML/KYC processing. This will unburden the asset servicers, and indeed our whole industry, allowing us to manage the complexity of new products and new investments while ensuring that investors are protected at all times.

Grenner – The economics of this sector, and the current focus on efficiency, are having important implications from a practical standpoint. Many Luxembourg banks are looking closely at the services they can deliver within this cost environment.

One obvious example is with account opening. It is a number of years since banks have generated significant revenue through net interest income and, unless they are able to make revenue through other ancillary services, some banking providers are reluctant to manage the burden of the account-opening process if they have concerns about being compensated adequately for managing these cash accounts.

Wood – In these circumstances, asset servicing providers may benefit from working together to establish industry utilities that support efficient processing in areas where firms have limited competitive advantage. The huge cost associated with compliance and risk oversight provides one example. Each firm is required to maintain a compliance officer, risk officers, and to invest heavily in their internal control systems.

However, no firm realises a competitive advantage from supporting a compliance officer and several risk officers on its payroll. This may be an area where firms can collaborate to establish utilities which mutualise this compliance burden. **f**e