Alternatives in the Grand Duchy

WITH THE GROWING MATURITY OF THE AIF SECTOR AND THE IMPLEMENTATION OF THE CAPITAL MARKETS UNION, LUXEMBOURG FACES A CHANGING LANDSCAPE. OUR EXPERT PANEL DISCUSSES THESE DEVELOPMENTS, AND THE GROWTH OF CLIMATE INVESTING.

PANEL

MICAELA FORELLI
Managing director Europe, M&G Investments

IAN HARCOURT
Board member, country head Luxembourg and head of institutional banking, Luxembourg, RBS International

PHILIPPE RENARD
Chief executive, RBC Investor Services Bank S.A.

MATTIA SCABENI
Chief executive, Generali Investments Luxembourg

MODERATOR *David Blackman*

Funds Europe – Will 2022 be the year when alternative investment funds (AIFs) truly emerge as a widely adopted part of an institutional investor's toolkit?

Mattia Scabeni, Generali – I see a very rosy future. The appeal of alternative asset classes has been driven by a combination of changes in both the investment and regulatory environments.

As far as the investment environment is concerned, investing in alternative assets such as real estate, private equity, private debt and infrastructure may represent an additional tool to meet investors' needs, particularly when they are looking for alpha, a source of income, and diversification.

Therefore, a strong private asset framework is essential to build a resilient portfolio and address the specific requirements of institutional investors, such as insurers. Insurers' needs are driven mostly by asset-liability management. For such reasons, I see more and more investors willing to pay the liquidity premium and commit their capital for longer.

As far as the regulatory environment is concerned, there have been huge improvements, especially here in Luxembourg. This is a leading jurisdiction in that respect, and Luxembourg should keep aiming at becoming the funds hub for alternative assets and position itself as one of the most trusted and worldwide recognised jurisdictions for structuring and operating AIFs.

Philippe Renard, RBC – Since the establishment of the AIFMD [Alternative Investment Fund Managers Directive], we've seen a massive appetite from investors to invest here in Luxembourg. Statistics from Alfi [Association of the Luxembourg Fund Industry] show double-digit growth in these assets. The market is realising that alpha and risk-reward is in alternative assets.

The limitation of the AIF for now is that because it is illiquid, it cannot be

cross-distributed in Europe to retail investors. That may change as we see that the regulatory appetite is there to favour distribution to investors who are more retail in type. I think it would be a big boost to the industry if we can get to that point.

Ian Harcourt, RBS International – The alternative sector is already well established: in that sense, I don't see it as emerging. The predictions are for double-digit growth across the sub-sectors of alternatives. There are a number of factors driving that, which have all of a sudden coincided, and which make this a very interesting industry and sector to be involved with.

The first thing that's clearly happened is the pandemic, which has hit a number of industries and sectors quite hard. To recover properly from the pandemic is going to require a public/private partnership. The alternative sector has always been focused on partnerships, whether it's infrastructure, real estate or other types of joint ventures, so I think private capital has a very big role to play in that transition.

The other coinciding factor is, of course, ESG. Climate and sustainability form a big macro trend. To change our business to become more purpose-led is something we're very keen on focusing on and it's also become a focus for investors. There's a lot of innovation going on both in regard to digital but also how we measure and understand if something is green or not green.

Most recently, the correction we're seeing in equities, the rise of inflation and supply-and-demand issues, mean that some alternative assets can be perceived as an inflation hedge, especially commercial real estate. All these things underpin a wider change in society and the global economy where the alternatives sector is well placed.

Luxembourg's reached a tipping point where there are now complete structures available in one jurisdiction for a global and not just European reach. People are realising that Luxembourg is a much more practical place to go to. If you were to do this in the US, you would need a Delaware structure and very often a Cayman structure. The fact that a firm could come to Luxembourg and get everything under one roof with one or several service providers with the transparency and stability that European regulation gives via Luxembourg, makes Luxembourg an attractive global domicile for funds in the alternative sector, and generally there are those macro trends attracting capital to the sector.

Micaela Forelli, M&G – AIFs have already emerged as a very widely adopted part of the institutional investment toolkit.

Yields remaining so low means that institutional investors continue to have a need for returns that cannot come from the traditional bond space. As interest fades in traditional bonds, and as inflation grows, floating rate characteristics are quite important in many of these alternatives to protect returns.

AIFs can span a very broad liquidity and return span from products offering cash + 2-5% with monthly liquidity, right up to double-digit returns in completely illiquid fund structures.

It's difficult to generalise about institutional investors' needs because they may have different requirements across the spectrum, but generally speaking, the AIFs' success is not going to end and a trusted alternative investment fund manager who can advise on multiple different subsectors of the large and varied alternative universe is set to be in a strong position.

Funds Europe – The European Commission recently announced its next steps for implementing the Capital Markets Union (CMU). What do you see being the main implications for the European fund industry?

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Micaela Forelli, M&G Investments

Harcourt – Clearly, one of the aspirations is to create the European single access point – as they say:

'Putting data at the fingertips of investors'. The transparency of sharing data is particularly important in relation to sustainability-related products. As we and companies wrestle with understanding what is the best way to measure and track sustainability, sharing information broadly and transparently will help allow us to share best practice. I see that particularly as an accelerator to really achieving a better understanding of ESG and how we should track and consistently report ESG data. It's a tool to allow us to avoid greenwashing, which will be of benefit to the investors but also the funds themselves because then they'll also be able to benchmark their performance *vis-à-vis* their peers.

Also, it will help promote the alternatives sector even more, not just with institutional investors but potentially facilitating greater access and interest from retail investors.

The next step in that development will be how we adopt things like tokenisation and different types of blockchain technologies to give less sophisticated investors access to some of the AIF structures we currently have.

The single data access point is the key thing because that's one of the Holy Grails people are struggling with and wish to resolve, especially around ESG and sustainability issues.

Renard – Europe is still very fragmented with regards to its rules and requirements. At the global level, Europe is really at a disadvantage if you compare it to larger markets such as the US, which can operate at scale and deploy capital very effectively and efficiently. So, the whole industry welcomes the trajectory towards a more level playing field.

The CMU will make it more effective for asset managers to deploy capital across Europe. Following more harmonised rules and increased passporting will increase effectiveness and efficiencies.

Forelli – The key piece of the Commission's new package for CMU is the proposed amendment of the AIFMD framework. The Commission noted that the AIFMD has generally worked well. It's been going for more than ten years now, I believe, and has ensured an orderly functioning of the funds market in Europe. Today there are more than 30,000 AIFs, which is almost 40% of the European fund industry, with over €7 trillion of capital. The AIFMD has worked well and we are happy that the Commission has noted the efficacy of it.

It is also very positive that the Commission recognised the delegation of investment management has benefited and contributed to the success of the regime. For companies like ours, it's important to be able to perform investment management at a global level where the expertise is, and of course offer that to our investors. The recognition that the rules are good for the firms and investors is a good outcome.

There is also an ambition that the oversight and the governance rules need to be tight and perform well: that is also welcome. We have seen the proposal that AIFMs and the traditional ManCos [management companies] have at least two full-time equivalents who reside in the European Union. This is based on a principle of avoiding the creation of letterbox entities – but I think Luxembourg has more than adopted these practices. Our ManCo in Luxembourg has followed these principles from the start.

The other aspect is for the 'mega-ManCos', AIFs and ManCos to have the appropriate resources from a technical and a human-resources point of view, where they apply for authorisation. Again, considering the regulatory environment, know-how and deep expertise that exists in Luxembourg across both practitioners and service providers, this is already well achieved.

Scabeni – A legislative amendment that captured my attention is related to liquidity management tools. This is no surprise given the liquidity issues that investment funds have faced in the recent past. At present neither the existing AIFMD nor the Ucits directive provide this harmonised liquidity management tool framework. I see the European Commission here pushing its objective to bolster investor trust, giving them more and better protection by encouraging investment managers to use these liquidity management tools appropriately. I am sure this will help the fund industry deal with liquidity risks in a more effective fashion and preserve the value of the investments during times of market stresses.

Funds Europe – Within these proposals there was a revision of the rules surrounding the European Long-Term Investment Fund (Eltif) vehicle. What do you see as the outlook for the Eltif, given the difficult start it had?

Harcourt – From a banking perspective, the thing that held this back was that the amount of borrowing relative to the capital committed was very low: it was at a threshold of 30%. That's now been increased to 50% if it's being marketed to retail investors, so clearly the leverage in these vehicles can be increased.

The other key change is the broadening of the assets which are now applicable. It was also feared there'd be a restriction that the assets would need to be within European jurisdictions, but that's not the case.

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Mattia Scabeni, Generali Investments

I still think the European-advised investment structures that exist won't adapt or fit into the new framework. It will require new strategies, new structures and new products to be created by European investment managers and advisers. What remains to be seen is whether there is an underlying market outside of the existing products that exists for investors, both institutional and retail, which will kickstart the growth of this product group or subset.

With the previous restrictions, there were only about 20 or 30 such structures created since 2015. From what I've read, the legislation has been broadly welcomed, but people are still very much sitting on the fence as to whether this is something that is going to be picked up as a useful tool by the market and the European adviser community. The changes are very much welcomed. It's still very hard to judge as to whether this has gone far enough, but the consensus seems to be it's a step in the right direction.

Forelli – We see it the same way. It is very pleasing to see recognition that the previous regime was too restrictive. Removing the European long-term project from the definition of eligible assets will remove the geographical constraints and will allow Eltifs to pursue a more global investment strategy.

Renard – The new regulation addresses the shortcomings in terms of barriers to distribution and deploying of assets. Hopefully the Eltif will be picked up because it's an interesting tool in terms of risk diversification and alpha.

Scabeni – As we all know, Eltifs have not fulfilled their potential. They may attract further private capital, in particular retail capital, to sustain recovery in Europe after the pandemic phase. The changes introduced by these proposals will create further opportunities for more participation by retail investors, and Eltifs for sure will become a more interesting and appealing fund vehicle in the mid-term.

For the time being, however, I think that the RAIF [Reserved Alternative Investment Fund] should remain the preferred set-up for private assets investments. Looking forward, the Eltif might become an attractive vehicle if the proposals are accepted. In the best-case scenario, the Eltif amendments will be live in January 2023, but from now until year-end, I deem the RAIF as the most suitable vehicle to fulfil investors' requirements in the private assets field.

Funds Europe – With the dramatic growth in climate investing, asset managers and asset owners face the reputational risk posed by the perception of greenwashing. How is Luxembourg aiding investors to operate as credible environmental investors?

Scabeni – Luxembourg is fully embracing the European sustainable investing framework. The local supervisory authority is very strict and challenging towards local players. Moreover, I see a lot of initiatives taking place in Luxembourg to upgrade the understanding and awareness of the stakeholders working in the investment management industry on the topic of ESG investment. For instance, Luxembourg has been a pioneer in the field of sustainable finance labelling through LuxFlag, which is a tool for asset managers and fund managers to highlight our investment funds' sustainability and ESG credentials.

Luxembourg has all the prerequisites to establish itself as a leading jurisdiction in sustainable finance. Generali Group created our Fenice 190 initiative here, which supports the sustainable recovery in Europe, especially in the real economy impacted by the pandemic crisis by investing in infrastructure, innovation, digitalisation, green housing and healthcare.

Forelli – There are expectations on investment managers like us to make more robust sustainability-related disclosures so various stakeholders can make better-informed decisions.

The frameworks are there and implementing them into a full

regulatory package will be decisive in addressing the concern over greenwashing. At the same time, we know the EU is pushing legislation for improving ESG disclosures by investors through the SFDR [Sustainable Finance Disclosure Regulation] but also improved corporate disclosures with the CSRD [Corporate Sustainability Reporting Directive], building on other more general non-financial regulatory disclosure requirements.

As an asset manager looking at companies all the time, we think that the CSRD is very important to help the investor understand the investee companies' climate and other sustainability risks and also provide investors with the necessary information to report effectively to their customers and other stakeholders. But we know there have been issues about the timing of some parts of this legislation with financial disclosure regulations coming into force before corporates are expected to disclose to investors. Generally speaking, the intent is right, the outcomes should be positive and once this framework is in place, everybody should have a better safeguard.

Harcourt – There are two ways to approach this. Clearly, the early establishment of the Luxembourg Green Bond Exchange put Luxembourg front and centre of green finance. Because Luxembourg is a globally significant centre for alternative investments – which are adapting and adopting ESG standards quite rapidly – it is well positioned to support that journey. As we know, it's also set up the Sustainable Finance Initiative, which is a joint venture between government agencies, the stock exchange and Alfi, so there's a public/private collaboration. I'd also point towards the LHoFT [Luxembourg House of Financial Technology] and the fintech clusters in Luxembourg: some of those are focused both on developing reporting technologies, but also other aspects related to sustainable investments.

In Luxembourg, we have this critical mass of investors, financial institutions and asset managers, and all three are evolving and becoming more self-critical in regard to the way that they evaluate green funding, green financing and their own green key performance indicators. I know asset managers that have rejected green finance products because they thought it was greenwashing. I know banks like ourselves, which are purpose-led and focused on climate and sustainability, are developing new products and new ways of evaluating sustainable loans or, more importantly, developing the new green loans financing sector. These are loans to funds which deliver an immediate benefit to climate and sustainability.

COP26 has helped focus people's attentions on that as well, and I know Luxembourg was represented there by the ministry and by the various interest groups that work on sustainability programmes for the Grand Duchy. Investors, financial institutions and asset managers are evolving together and because we are all located here, I think you'll see a quicker evolution in Luxembourg than maybe in other jurisdictions and markets, so that's our key advantage in this area.

Renard – You just have to look at the huge success of the listing of green bonds on the Luxembourg Stock Exchange. It's huge, and not only Luxembourg; it's huge at the European level. As another example, the minister of finance was pushing all the actors to get prepped well ahead of the taxonomy definition so that at least we, collectively, as an industry, have an idea where we stand and the efforts that need to be made. It's really pushing in the right direction.

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Ian Harcourt, RBS International

Funds Europe – The UK left the EU in January 2020. Have there now been any discernible effects for how UK fund managers interact with Luxembourg?

Renard – Funds reacted and responded

early enough and even ahead of the deadline with domiciliation of assets in Luxembourg, one of the preferred countries for distribution across Europe. It has been a shift over the years, but we haven't seen a massive domiciliation of people and capital.

So, yes, Luxembourg benefited from that move as other capitals in Europe. I am not sure if there is more to come from an asset servicing or an asset management perspective.

Forelli – For us it's been more about opportunities opening up in Europe. We had a migration of our funds back in 2018 and that has brought part of our assets back to Luxembourg closer to the investors. Our AIFs were already largely domiciled in either Luxembourg or Ireland, and the operation of these is now managed by our Luxembourg hub. We have also been able to increase investments in the region as well as doing more origination in the region with more investment professionals now being based in Europe, although we had established robust and long-term relationships with our clients in Europe prior to Brexit, since we opened our first offices in 2002.

Apart from that, nothing has really changed in the practice for us. The business has grown in terms of assets. We continue to emphasise the very strong links between the UK and Luxembourg. Both places are facing similar challenges and both, particularly the City of London, are centres for financial communities, people and know-how.

Scabeni – It is the same for us. As of today, the cooperation and interaction we have with UK fund managers has not been dramatically affected by Brexit. Of course, there have been adjustments, but no disruptive effects have arisen so far, which bodes well for the mutual interest of UK and Luxembourg financial centres. In fact, Luxembourg has always had a very sound relationship with the UK financial industry, so Luxembourg can continue to become the doorway to the European market for UK fund managers.

Harcourt – As was said, we saw a migration and adaptation of most sectors and companies prior to Brexit. For example, European insurance companies separated their businesses into a UK and a European entity, and dozens of new insurers established in Luxembourg, migrating their business from various parts of Europe, not just the UK, to Luxembourg.

Some asset managers and fund managers strengthened their portfolio activities in Luxembourg, but once again that was pre-Brexit.

One discernible effect for not just fund managers, but the industry as a whole, is that there is clearly more red tape and bureaucracy if you have a UK citizen that you wish to transfer even internally to work permanently in the European Union. That impacts on Luxembourg as well, which is clearly something that we need to reflect on because one of Luxembourg's key needs going forward is to be able to access a wider talent pool, from both the UK and globally.

The UK has become like any other global country that's working with Luxembourg and the European Union. But clearly, given its importance in the financial industry, Luxembourg and those that operate here have an interest to access that talent pool. A key thing we need to think about in the future is to ensure that Luxembourg experiences sustainable growth and has access to talent because we can't limit ourselves just to the close-to-hand cross-border talent, we need a broader talent pool as we get more and more sophisticated.

The only point I'd really emphasise is that Luxembourg historically has become perceived as being the primary domicile for European investment structures. We're at a tipping point now where there's more of a global focus. Asian and North American capital is understanding that Luxembourg is not a domicile for feeder funds and sleeves – it's actually a domicile where managers might potentially want to establish funds with a global reach. There has been an increase in interest from North America in Luxembourg and I think with the growing amount of dry powder being built up in Asia, we'll see more interest from there too in establishing long-term investment funds that might not just invest in Europe, but globally. **f**e

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Philippe Renard, RBC Investor Services Bank