Market turmoil throws up new challenges for service providers

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Created *30/07/2009 - 19:44*

As Europe's largest fund jurisdiction, Luxembourg is intimately concerned by the ongoing debate between EU member states, officials and industry members about the future shape of regulation for the industry. It already seems certain that alternative managers face much stricter oversight and new burdens in terms of reporting, risk management and capital adequacy, but wide questions remain open about the role of service providers, their duties and legal responsibilities.

Although it does not specifically involve alternative funds, the Bernard Madoff fraud and in particular the role played by Ucits feeder funds established in Luxembourg and other jurisdictions has raised the question of how far fund custodians have a duty to make good investor losses resulting from fraud or mismanagement. Service providers in Luxembourg are adamant that to impose open-ended liabilities on custodians would overturn the current economics of the industry.

French investors, and members of their government, have accused the grand duchy of offering investors a lower standard of protection than that available in other parts of Europe - on questionable evidence, according to José-Benjamin Longrée, managing director of Caceis Bank Luxembourg.

'It's not true that a Luxembourg depository doesn't have the duty to provide restitution for the assets it has been given,' he says. 'Worldwide there is a duty to provide restitution the assets with which a depository is entrusted. But are we talking about an obligation of means, or results? Is it a best efforts basis, or an objective obligation? Many European countries do not have that objective obligation.

'If at the end of the day the depository bank is supposed to be the insurer of the investment vehicle, bearing all the economic or management risks whatever they are, the whole concept of the depository bank has to be revisited. If we have to insure funds with anywhere between USD100m and USD3bn in assets, we have to possess the right structures and stringent rules to supervise them; in particular we have to be adequately capitalised and revise our prices. But that position is not shared by many European countries right now.'

Retail investors in particular need protection in order to preserve the good name of the investment industry, but the questions of responsibility need to be resolved in a way that makes economic sense, according to Chris Adams, global product head for alternative funds with BNP Paribas Securities Services in Luxembourg.

'What really concerns us is that we're often asked to take investment bank level of risk in return for custodian fees, and have unlimited liability to the fund upon the occurrence of x, y or z. We are sometimes asked by why we are charging the levels that we do for depositary banking services in particular when the direct physical activity relates to checking that title deeds are sitting in a lawyer's vault in Madrid.

'The answer is that we're not charging solely for the activity, but also for the risk. If the fund manager doesn't want to pay that, they can set up their fund with another service provider, but I'm sure most of our peers in the market would say exactly the same. We are affording their investors a level of protection that is in fact not insubstantial. We are charging a risk premium, but it's not 100 or 50 basis points, it's an order of magnitude lower than that.'

Longrée says the economic crisis and its fallout for the fund industry has provided an opportunity to reassess how well its existing risk monitoring and management models have performed, both within individual firms and across jurisdictions. For example, he notes, Luxembourg was left unscathed by

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the collapse of Lehman Brothers, many of whose London prime brokerage clients still had their assets frozen nearly a year later. And he points out that all jurisdictions have seen investors affected by fraud.

'In Luxembourg, we have always tried to anticipate what was needed and to meet clients' needs, and we are still doing so,' he says. 'I would cite all the efforts made on the risk management side. When Ucits III came into force, many people said Luxembourg would disappear because it would require substance there that no-one would want to provide.

'But many promoters saw it as a strategic opportunity to put more resources in Luxembourg because they knew there were able people there and that they would have all the support they needed in terms of transparency from service providers. So they put more resources into risk management and compliance processes for Ucits III management companies in Luxembourg.'

Longrée says the travails suffered by the alternative fund industry have forced promoters to think not only about the quality of their portfolio management but that of their relationships with investors. 'The most professional asset managers have a fantastic relationship with their institutional and high net worth investors, and they explain everything that is happening with great transparency on an ongoing basis,' he says.

'In these circumstances, many investors are not leaving the funds but accept arrangements such as side-pockets, lifeboat solutions or reallocation to other products. This is easier to handle if our clients are able to communicate with their shareholders - in the same way that our own relationships with alternative clients has benefited from our willingness to provide support such as liquidity to those who needed it most, those invested in mortgage-backed securities, credit derivatives in general and funds of funds.'

Adams sees a buoyant outlook for jurisdictions like Luxembourg, as well as Dublin and the Channel Islands, which offer managers and their investors a well-regulated market. 'These locations will be the winners for new fund launches over some of the traditional jurisdictions,' he says. 'There will be an ongoing sustainable business in places like the Cayman Islands, too, but we think new launches will favour well-regulated economies that still offer tax transparency but provide greater levels of asset and investor protection.

However, the drop in asset levels is forcing service providers to manage costs rigorously. 'The challenge facing Luxembourg and all the centres from where services are delivered is that potentially the economic impact is greater, as it costs service providers the same amount to service directly an asset on our books whether it's worth USD100 or USD50,' he says. 'When asset values are depressed and fees are primarily driven by levels of assets under administration, service providers come under pressure.'

Nevertheless, to date there have been few cutbacks among Luxembourg administrators, industry members report. 'There have been some layoffs but not many,' says KPMG partner Georges Bock. 'What you do see is firms taking the opportunity to prune less strongly-performing employees, who would be retained in times of strong growth when you need everybody. Obviously if the value of assets goes down, so does income, but big redundancies do not seem necessary for the moment.'

Didier Prime, head of alternative investments at PricewaterhouseCoopers, believes that the process of consolidation among fund administrators in Luxembourg, the pace of which has at times seemed glacial, may well speed up. He says: 'We should see more consolidation in the coming months, with the crisis as a spur, and there are opportunities for players that are still not in Luxembourg but have an interest in moving here to develop a business or to buy one. We may also see consolidation at the service provider level resulting from consolidation among asset managers.'

The past couple of years have seen the arrival in the grand duchy of a significant number of alternative fund administration firms. 'A lot of specialised firms are setting up offices in Luxembourg, and if they are doing so in the difficult times, it suggests that once the market turns there will be increased activity,' says Mariusz Baranowski, managing director of one such business, Custom House Fund Services (Luxembourg) 'They are preparing themselves for the time when investors start

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coming back.

Baranowski says Luxembourg service providers are also receiving increasing amounts of business from funds domiciled in traditional offshore jurisdictions. 'We have clients who still domicile their funds somewhere like Cayman or the BVI, but they choose all their service providers in Luxembourg in order to obtain the best service from an auditor, custodian, administrator and transfer agent. Investors enjoy the security Luxembourg offers even if the fund is domiciled offshore, because all the services must be provided to Luxembourg standards.'

In fact, he suggests, a number of managers are thinking about redomiciling their offshore funds in Luxembourg. Adds Olivier Sciales, a partner with law firm Chevalier & Sciales: 'We are starting to see a lot of interest in the migration of funds to Luxembourg from offshore jurisdictions such as Cayman and the BVI.'

A further step that would benefit Luxembourg's fund industry - and its custodians in particular - would be greater asset management activity taking place in the jurisdiction and the provision of prime brokerage services locally, Baranowski believes. 'Prime brokerage and trading is quite limited here, and the problem is that for a Luxembourg-domiciled fund, the custodian, auditor and administrator must be here,' he says.

'If the custodian is domiciled in Luxembourg but the prime broker is not, the problem is how far supervision and fiduciary responsibilities can be exercised by a Luxembourg-based custodian over prime brokers in London or New York, which may be covered by different regulations. At the moment a look into the prime broker's records and assets is possible, but control is limited. I would welcome prime brokers setting up here and being supervised by the local regulator, which would make the life of local custodians and investors more comfortable.'

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Source URL:
http://www.hedgeweek.com/2009/07/30/market-turmoil-throws-new-challenges-service-providers

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