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European

Pan-European property funds grow – as does their complexity

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The last year has seen a gradual but significant change in pan-European fund offerings.

The managers of opportunity funds – the higher risk, higher return real estate private equity funds traditionally focused on US institutions – are now broadening their investor baseinvestor base to include institutions in Europe. The asset allocation to real property by European institutions is expected to increase over time, as is their desire for greater diversification through cross-border investment. The funds are also targeting high net-worth individuals, either directly or through private banks. The increasingly diverse investor base has added to the difficulty of creating a fund that works for investors from a taxation and regulatory perspective, resulting in the development of significantly more sophisticated fund structures.

The range of pan-European property funds has also broadened significantly, with a number of core and core plus (value-added) funds introduced. As many tax planning and structuring approaches were developed for opportunity funds which focus on capital gains rather than income, core-plus and income funds typically require more complex planning.

Another key change has been the development of real estate fund-of-funds, driven by an increasing range of assets in which they can invest. The growth in domestic real estate funds (as well as their sophistication) across Europe allows fund-of-funds to invest in local one country funds. There has also been a growth in specialist property funds investing by property asset, for example retail, logistics or hotels. Finally, and potentially most significantly, is the development of REIT type regimes creating a traded, tax transparent property investment company. The SIIC regime introduced in France in late 2003 has been a great success both in terms of entities converting to SIIC status and subsequent market activity. Both the UK and Germany propose introducing REIT-type regimes (see articles on p7 and 8), although there is some uncertainty as to the timing.

Following a four or five year period during which property fund structures gradually became more similar, innovation seems to have become fashionable again.

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PRICEWATERHOUSECOOPERS

Welcome changes to Austrian foreign fund taxation

On 9 December 2004, a new law passed the Austrian Parliament providing – under certain conditions – a level playing field for the taxation of income from domestic and foreign funds. Foreign fund promoters, however, must be assiduous in meeting requirements.

Until now, if foreign fund certificates were held by a domestic custodian or depositary, only cash distributions were subject to 25% withholding tax. All deemed distributed income plus taxable realised capital gains had to be included in the tax return of the private investor and taxed accordingly.

Where certificates are purchased/sold, the investor only had the right to choose to be taxed either with the deemed distributed income for the whole financial year of the fund or to be taxed with the higher of the increase of the NAV or at 0.8% of the NAV for each holding month, as no net interest income was calculated on a daily basis for foreign funds.

Both of these measures meant that the complexity of investing into foreign funds was significantly higher than for domestic funds. In addition the taxation treatment could in certain circumstances be inefficient as compared to a domestic product.

Changes to foreign funds tax treatment – effective 1 July 2005

Now, the advantage of complete final taxation may also be applicable for income from foreign funds for all foreign funds with year end after 28 February 2005 (i.e. income received by investors after 30 June 2005). After 30 June 2005, Austrian banks will deduct 25% withholding tax on distributions and on deemed distributed income as calculated by the local tax representative if the following requirements are met:

- The foreign fund has an appointed local tax representative who calculates the deemed distributed income once a year. The foreign fund company provides the Oesterreichische Kontrollbank (OeKB) with the relevant deemed distributed income figures within four months after the financial year-end of the fund (this in practice is a tighter deadline than previously). In addition the annual tax return has to be filed with the Austrian Ministry of Finance.
- The foreign fund provides the OeKB with information on the net interest income (interest income minus expenses plus/minus equalisation on interest income) on a daily basis.

If these criteria are met, an Austrian private investor will be taxed on a similar basis on foreign fund investments as on returns from domestic funds.
In summary:

- The income from such foreign funds is subject to complete final taxation at 25% tax rate (it is therefore not necessary to include the deemed distributed income figures in the tax return of the investor).
- If fund certificates holdings are purchased or sold, the investor will receive a 25% tax credit/deduction on the net interest income only; no lump sum taxation or taxation on basis of the deemed distributed income for the full financial year of the fund will be applied.
- No safeguard tax will be deducted.

If the foreign fund company does not calculate and publish the net interest income on a daily basis, the situation for the investor remains unaltered and Austrian investors' taxation treatment would not be optimised. If the foreign fund company or the local tax representative calculate/publish the wrong tax figures, they can be held liable.

The Austrian Ministry of Finance plans to issue a decree shortly covering the detailed procedure for the daily calculation and publication requirements. It is to be hoped that the detailed requirements do not place unnecessary administrative burdens on foreign fund promoters.

Other changes – effective 5 December 2004

Finally, the new law also allows investors themselves to provide the tax office with information on deemed distributed income of "black" funds (foreign investment funds without tax representation) to avoid lump sum taxation (tax base: minimum 10% of the NAV at year-end). Previously, the proof of deemed distributed income was only accepted if it was performed by a local tax representative (Austrian CPA or bank), which had been officially appointed by the foreign fund.

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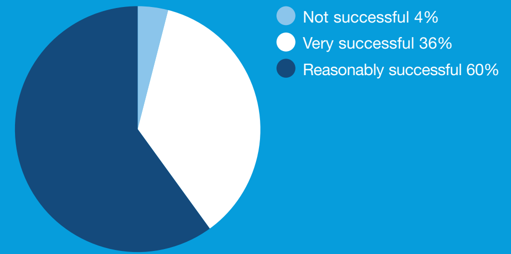
Outsourcing: Bringing together views from both sides of the deal

Outsourcing is high on their agenda, according to senior executives from Europe's leading asset managers and service providers at a recent PricewaterhouseCoopers European conference.

Figure 1: How successful has your outsourcing activity been to this point?



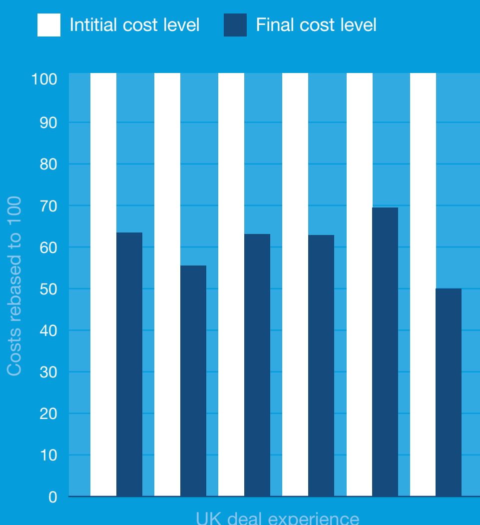
Source: International Fund Investment. Outsourcing in European Asset Management, 2004.

Recent surveys (by International Fund Investment and by PricewaterhouseCoopers) facilitated the sharing by asset managers and service providers of views and concerns. Here are some insights into how outsourcing in Europe will develop.

The pace of outsourcing in Europe is certainly expected to pick up, with one in five European asset managers considering outsourcing a "major" aspect of their operations in the next couple of years. This likely increase in activity is not unexpected, given that 96% of European asset managers who have already outsourced a portion of their operations view their outsourcing deals as successful (Figure 1, from IFI survey).

With such positive findings, it is somewhat surprising that European asset managers have not outsourced more of their operations. Many have, however, chosen to "in-source", i.e. set up internal centres of excellence to deal with processes at a group-wide level. In such instances, "in-sourcing" is seen as a lower risk alternative than outsourcing, as ultimate control for the operations still rests within the group, although the financial benefits might not match those of an outsourced solution.

Figure 2: The cost reduction case



Across all geographies, cost reduction is seen as the key reason why asset managers look to outsource. However, cost reduction is not the sole driver of the decision to outsource; other factors are increasingly important to asset managers, particularly: the level of service quality, satisfying regulatory requirements and ascertaining what the core aspect of their business really is.

European asset managers are still very sceptical as to the extent of the cost savings that could be achieved through outsourcing, and yet PricewaterhouseCoopers' deal experience in the UK shows that cost savings in the range of 30% to 40% could be achieved across the life of the outsourcing contract (see Figure 2). Most asset managers do not consider appointing consultants or investment banks to advise on their outsourcing transactions, which may explain why the financial benefits are not always optimised. Conversely, PricewaterhouseCoopers' experience in the UK has shown that, while the ultimate selection of service provider is based on factors including strategic fit, personal chemistry and reputation, a competitive auction process between service providers ensures that a very favourable financial deal is also achieved.

Service providers and asset managers alike expressed legitimate concern that in some of the recent deals done, pricing was at a level that would not be sustainable in the future. The attractive deals currently being struck with service providers were felt to reflect their willingness to buy strategically into new service areas and geographies, both to expand their client base and to prevent new competitors entering the market. From an asset manager's perspective, this is encouraging news for early movers in the sector, who are able to obtain very favourable deals for their "cornerstone" status, albeit at a higher risk with new entrants.

To service providers, the maturing UK and Benelux markets still offered significant growth potential, but Germany and Italy were the markets where outsourcing activity should increase the most in the next few years. Both the size of the markets and the impact of changes in legislation contribute to making them attractive for the service providers. They plan to attack these markets initially through more back office products such as fund accounting, or through expanding the custody service into stock lending, for example. The growing trend to outsource middle office functions as experienced in the UK is likely to take some time to develop in Europe.

So where does all of this leave the industry? With the pace of outsourcing in Europe picking up, and with global service providers keen to make an early impact in the region, European asset managers will see some significant changes to their business models, with strong downward pressure on operating costs likely to follow.

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Keeping pace with evolving fund distributors

The cross-border distribution landscape is changing rapidly. It is shaped by local tax and regulatory barriers, as well as by the resistance of large proprietary networks to open architecture and re-intermediation. Many promoters feel frustrated that their cross-border sales efforts have been plagued by high sales volatility.

In the near future, some local tax and regulatory barriers are likely to be abolished and the current distribution business model transformed by new EU regulations, such as the Insurance Mediation Directive and the Markets in Financial Instruments Directive (MiFiD). As in the Netherlands, some large retail proprietary bank networks will open up to third party funds. Intermediaries, such as fund distribution platforms, investment firms, insurance brokers or IFA networks will play a more significant role, both locally and internationally.

It will be strategically important for cross-border fund promoters to understand the impact of these changes and how the market framework will evolve for their different distribution partners. Knowledge and the ability to assess and adjust the value proposition to the requirements of a new regulatory landscape will be critical in gaining and retaining market share.

Changing distributor business models

Financial services intermediation will be affected by the 15 January 2005 transposition of the Insurance Mediation Directive, introducing new "passporting" opportunities for insurance brokers. Some insurance brokers are looking to expand their business geographically by setting up a hub somewhere in Europe and some are also planning to expand their range of products and services to UCITS.

When MiFiD is transposed in each EU country, additional national transparency requirements are likely to encourage intermediaries to review their business model. In France, the new status of "Conseiller en Investissements Financiers" has emerged, introducing transparency requirements on distributor remuneration, product selection and shareholding relationships with product manufacturers. In the UK, the FSA has recently enabled financial institutions to introduce multi-tied arrangements (multi-providers) because the 16 year-old regime of polarisation (either tied or independent) was not working efficiently for consumers. Under the new regime, UK IFAs need to publicly declare whether they are paid by "fees and commissions" or "fees only".

Additionally, the limited market activity and persistent sales volatility have put significant pressure on financial intermediaries with a transaction-based remuneration model. Clients' needs are also changing, both in the products and the service they expect. The concept of independent advice is becoming better recognised in new regulation and the qualifications of advisors.

Add to these arguments the expected consolidation of intermediaries and the next three years are likely to herald significant changes in the structure of financial services intermediaries.

Cross-border promoters need to understand the future business models of their key direct and indirect distribution partners. These business models include distributors' client value proposition (product or service driven), client segmentation, advisers' qualifications, their remuneration mode, their official status and their compliance management infrastructure particularly in terms of anti-money laundering. From a practical viewpoint, it means that, on an on-going basis, cross-border promoters need to collect, analyse and respond to data that tracks changes in financial intermediary services. This information, whether gathered internally or through an outsourced service, needs to be delivered to the promoter's marketing team in a timeframe and format that ensure competitive advantage. The kind of data needed falls into three categories:

1. Distribution country market watch
   An efficient regulatory, tax and market watch on distribution countries needs to capture all information that may impact the intermediary business. This should be tailored to promoters' needs regarding product specifications and features of distribution channels in the relevant countries. It should also cover related industries such as life insurance that, with specific regulation on products and distribution, could impact fund distribution in several countries at once.

2. Distributor service quality assessment
   As the media, regulators and some investor segments increasingly support the concepts of independent advice and good advice, promoters should know where their distributors stand. Key elements to monitor are: provision of comprehensive financial services, assessment of client wealth situation and risk profile, information provided on product differences and fund provider differences, distributor remuneration policy and distributor anti-money laundering procedures.

3. Distributor product and services appetite
   Which promoter products and services does this distributor buy, hold or sell? In the face of high sales volatility, some cross-border promoters have difficulty understanding the volatility drivers and defining corrective actions. In addition to changes in the market, sales volatility may be caused by competition from a new provider, a structured product or a tax or regulatory change. Those promoters which can make the assessment of the their distributors' fund appetite available to their marketing departments are not only better placed to monitor the competition but they also have a very efficient tool for developing new products in accordance with distributors' and, ultimately, clients' needs. For quality reasons, this strategic information needs to be sourced from different providers; it must also be checked and be independent of promoter interpretation.

A strong competitive intelligence process will be essential to cross-border promoters as they tackle future developments impacting financial intermediaries. The benefits of a well-coordinated market watch should render their marketing activity more efficient and ease the path to meeting new compliance requirements.

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Pension pooling progresses

In May 2003 the European Union Council adopted a Directive establishing a framework for pan-European pensions. There are a number of obstacles still to be overcome before full cross-border pension arrangements covering assets and liabilities will be truly viable, but progress is being made on a halfway position – the pooling of assets from funds based in different territories.

The prospect of pooled pension arrangements raises important questions for investment managers. For example, in which country should a pooled vehicle be resident? Luxembourg and Ireland have advantageous tax regimes and expertise in funds and their administration. The UK and the Netherlands have expertise in pension fund management and reasonable tax regimes.

Financial services providers are considering innovative techniques to achieve financial benefits similar to those derived from the globalisation of investments into a single fund, namely the pooling of assets through the use of the master-feeder concept.

This technique uses an approach under which local pension funds feed their assets into a common investment pool, which is established as a mutual fund.

In some cases, this 'master' fund is composed of several asset classes. The various pension-fund sponsors may have different objectives (and a single sponsor may run several funds), so a number of pools with different asset allocations may be created.

The main benefits of pooling the assets are:

- The grouping of individual pension plan assets into a common pool provides economies of scale in the management, custody and administration of these assets.
- The pooling of assets can allow small and medium size pension plans to implement more efficient asset allocation strategies and access more diversified multi-manager structures.
- The master-feeder structure can also generate economies of scale in the oversight by the trustees of the asset management processes as this allows the monitoring and control of only one entity rather than the management of investments by each separate pension fund.

On the cost side, the pooling structure adds the cost of setting up the pooling vehicle and the operating cost of such a structure to the operating costs of the individual pension funds. However, the benefits of pooling will outweigh its cost if the structure is large enough and if it is tax neutral.

Legally, the master fund should be considered as tax transparent in order to receive the same tax treatment as a pension fund investing directly. Withholding taxes on share dividends are generally determined by tax treaties between source states and investor (pension fund) states and most treaties offer favourable tax rates to pension funds.

The tax transparent master-feeder fund would benefit from this. Standard collective vehicles, by contrast, can suffer considerable tax leakage. For example, UK or Dutch pension funds investing in US shares will not suffer any withholding taxes on dividend payment while a collective vehicle may be subject to a 30% withholding tax on the same dividend payment. Tax strategy planning is therefore essential to ensure the arrangement implemented for a particular multinational is optimal from a taxation perspective.

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A vision for valuation

A new thinkpiece on the current and future challenges facing the real estate valuation profession has recently been published by the Royal Institution of Chartered Surveyors. Here PricewaterhouseCoopers partner Barry Gilbertson, who is the 2004-5 President of RICS, summarises the report he co-authored.

Valuation matters. It underpins a major proportion of financial decisions in mature economies, especially when it serves as collateral for loans or as a key element in published company accounts. Failure to ensure assets are properly valued risks financial exposure for a wide range of stakeholders. All users of valuation services, including the public, businesses and governments, expect valuers to meet fundamental standards of competence and to demonstrate integrity, objectivity and independence.

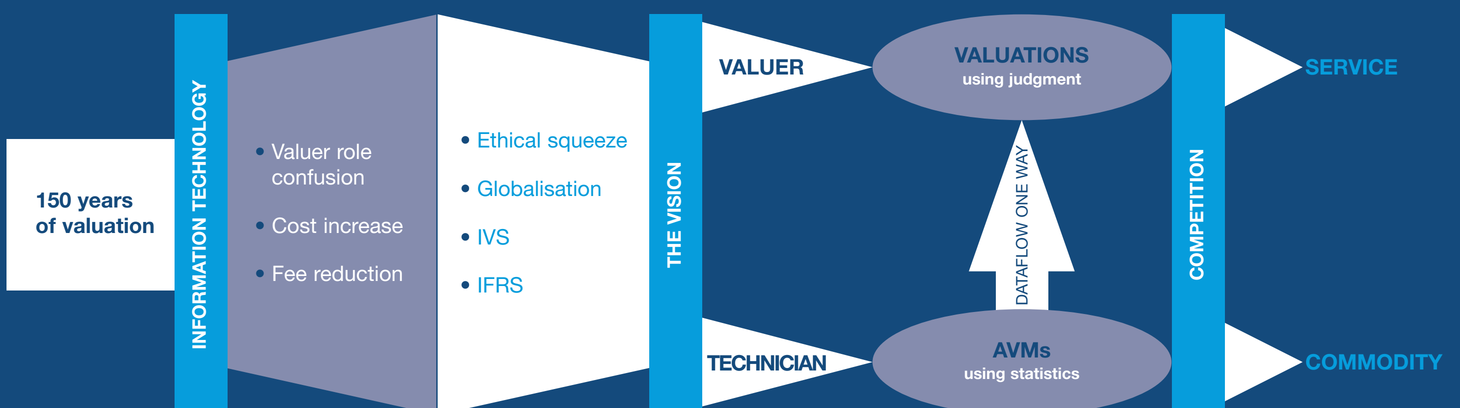
Valuation, as we know it today, is under pressure. What are the trends affecting the nature of, and need for, valuation services in the short-to-medium term?

- Globalisation, increased levels of cross-border economic activity and the emergence of global clients are driving international financial reporting standards in accounting, together with international standards in banking and valuation. International Valuation Standards (IVS) will improve transparency and so secure sound financial services in the public interest.
- To thrive, valuers must understand the dynamics in their market and anticipate, or always respond to, change. They will be supported by education and training provided by their professional bodies.
- More automated valuation processes and products have an important role to play in the future provision of valuation services, but must be distinguished from traditional methods with clear standards for their use.
- The professional ethos and the public interest priority in valuation are in growing conflict with creeping commoditisation and cost pressures that threaten to reduce valuation to a product rather than a service, drive small firms out of valuation work, and push big firms into greater automation.
- There will be increased polarisation in valuation services. On the one hand there will be those who can provide strategic business services and innovative property solutions, probably as part of a multidisciplinary team. On the other hand there will be a growing demand for more technical skills, use of automated valuation models, data analysis and software implementation.
- The need for professional valuers is particularly acute in emerging economies, where global investors rely on them to bring about much needed market transparency and ethical standards.
- Governments have a major role to play in both consumer protection and in leading by example on good quality valuation in their jurisdictions.

The graphic below shows some of the issues and the way forward.

After some 150 years of traditional valuations, the methodology had evolved from simple comparison, to capitalisation of the rental stream, through to a discounted cash flow. Then, no more than a decade ago, information technology brought with it the need to make more formal decisions on a whole range of assumptions required to complete the different fields of the computer model. At the same time, the profession was faced with the cost of developing, supplying and purchasing the software, just when there was a determined push from clients for fees to go down, based on the premise that increased automation must be cheaper. This pressure continues, as clients view valuation as a grudge purchase – one that they have to make (by statute, convention or regulation) regardless of whether the valuation adds any real value to their business.

Figure 1: A vision for valuation



The vision is for the creation of two streams of service. One is conducted at a technical level inputting researched data into an Automated Valuation Methodology (AVM) model, providing fast and efficient valuations as a commodity, e.g. in some Canadian provinces, an online valuation of any single residential property can be bought for C$29.95 (€18.64).

The other stream is a more value-added professional service conducted by valuers or consultants who understand the client's business. They interpret the number-crunching and use experience and judgment to interpret the consequences of the output. They will operate on a cross-border basis and work with the client's other professionals, especially their accountants and lawyers, to integrate international financial reporting demands and legal title issues into their output.

Whatever the drivers of change in the valuation marketplace, it is fundamental for the survival of professional valuation services that the public interest is protected.

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Copies of "A Vision for Valuation" can be downloaded from www.rics.org

? What is a REIT?

REITs are used to invest in land-related assets (e.g. freehold/leasehold interests in land/buildings, real estate-backed mortgages, derivatives, etc). Most REITs are owned by a designated minimum number of shareholders and are often listed (but not always) on a stock exchange. They are usual structured to be effectively tax transparent, where the REIT itself does not pay tax if it meets certain conditions. Instead, REIT investors receive distributions that are subject to tax only if the investor is a taxpayer. Consequently, a REIT enables investors of different tax status (taxpaying and non-taxpaying) to invest alongside each other. The vehicle does not suffer any tax so returns for non-taxpayers closely mirror direct investment but with the benefit of access to a greater pool of properties and therefore a greater spread of risk.

UK REITs awaited

The Chancellor raised hopes in his Pre-Budget Report, announcing that a further paper on a Real Estate Investment Trust ("REIT") would be issued for discussion with "industry representatives" on Budget Day 2005 (held in the Spring). Clearly, the prospect of a general election could delay such reform but it looks hopeful that the UK may join the many other countries that have REITs.

If a UK REIT were to be introduced, it could take many forms. The UK government's Consultative Document, Promoting More Flexible Investment, issued in March 2004, advocated:

1. the REIT should "align the after-tax returns from holding property indirectly more closely from holding property directly". (However, the Government specified that where income and gains were distributed, the investor would be taxed as if it had received income. As a result, an investor with capital losses or an unused annual capital gains exemption would have been worse off than if he had invested directly in property).
2. the REIT structure would increase market efficiency in the residential and commercial sectors but would also focus on protection of investors' interests. (This led to the Government looking at many areas where market forces rather than government intervention is needed, e.g. gearing levels).
3. any reform should not lead to a reduction in the tax take for the Exchequer. (However, the proposed conversion charge to be levied on companies that wish to convert to REITS could be set too high and become a barrier to giving the market sufficient initial liquidity).

What the industry has proposed

The property and investment management industries have proposed a vehicle to be called a REIT:

- which could be structured as a close ended listed vehicle but where other vehicles such as unit trusts could qualify for similar relief
- which does not suffer tax on its income if it meets certain distribution requirements
- where income distributed would be subject to withholding tax with the option of an application to receive income gross
- which is not subject to tax on gains if the proceeds were re-invested
- which could distribute gains if no suitable replacement investments could be found
- where the market decides issues such as gearing levels, whether management is internal or external etc
- where qualifying investments are related to real estate in the UK and EU including investment in private finance initiative projects, hotels, etc.

It is also proposed that, for investors, the income received should retain its characteristics and be taxed as income or gains accordingly but only where the investor is a taxpayer.

The challenge for the Government is to develop a vehicle with scope to provide acceptable returns for investors linked with appropriate regulation. If regulation were too onerous, it would be difficult to persuade fund managers to set up these vehicles. Too much tax would reduce returns. Consequently, investors would look elsewhere given the plentiful supply of REIT type vehicles in other nations (US, Australia, Netherlands, Japan, etc.), with more countries introducing REITs, for example Germany is discussing doing so in 2006. The industry awaits an effective framework to enable the UK to continue to compete in the international property investment market.

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Flashline

Germany: New developments in fund investment laws

Early indications of which vehicles will qualify as foreign funds have been given by an official circular letter decree released by the German Ministry of Finance on 13 December 2004 that comments on the German Investment Tax Act (InvTA). While this circular clarifies some outstanding issues, the long awaited comprehensive circular on InvTA is expected to be published in Spring 2005. The main topic of the circular is a limitation of the extensive definition of what constitutes a foreign fund under the InvTA rules. According to the circular, the German offshore fund rules of the InvTA will cease to be applicable to:

- fund type partnerships (except hedge funds);
- listed property corporations that are not subject to specific investment supervision (e.g. REITs, but will continue to apply to Luxembourg SICAFI for example);
- collateral debt (cdo) emitting funds, if according to the terms of contract the percentage of assets of the issuing company sold before redemption is limited to 20%.

These vehicles are hence not subject to the special taxation and reporting rules under InvTA rules. REITs in form of trusts are not specifically addressed, although it is thought that in the more extensive decree they will also fall out of the scope of InvTA. However, for the time being uncertainty remains. The statement is valid so far only for the year 2004 or first alternative business years to which InvTA is applicable. The more extensive decree is eagerly awaited.

On 31 January 2005 the German REIT initiative "IFD Initiative Finanzplatz Deutschland" presented its final report on the introduction of REITs in Germany. Subject to satisfactory short-term clarifications concerning tax issues and budget impacts, the parliamentary process of the REIT-legislation can be pursued, as a first legislative draft of the "REIT Act" is expected to be issued in March 2005.

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Delving into hedge fund risk

While the hedge fund sector has continued to grow, returns in the last year have fallen, partly as a consequence of increased competition. To maintain competitive position, hedge funds and funds-of-hedge-funds could look to increasing their leverage and risk-taking to meet performance targets. Counterparties with exposures to hedge funds (such as investors, prime brokers, providers of credit and trading counterparties) could be at risk if they do not stay vigilant in this complex area.

The use of credit derivatives has provided another means for credit risks to be spread, but their rapid growth has also put pressure on firms' back office and documentation procedures. The trading of derivatives products that are complex and less liquid has increased. This can result in greater mis-pricing and legal risks. Operational risks associated with credit and market risk management may also have multiplied as collateralisation and netting agreements become more widespread. Therefore it is essential that legal documentation be clear and enforceable, and that documentation keeps up with the nature of the business.

A recent Financial Services Authority review, conducted in the UK, noted that market discipline, including solid counterparty risk management standards, provides an important constraint on the ability of hedge funds to accumulate excessive leverage. This can help control the degree to which the hedge fund industry presents a risk to financial stability. However, competition for prime brokerage mandates could lead to a weakening of counterparty risk management standards. For example, the leverage employed by hedge funds generally appears to remain low and many unutilised facilities exist. This has been driven by competition between prime brokers and the use of more sophisticated margin techniques, such as cross-margining. Furthermore, prime brokerage relationships with hedge fund clients generate other sources of revenue for firms, such as through trading activities. This can lead to conflicts of interest and could prompt breakdowns in market discipline.

Enhanced regulatory oversight of hedge fund credit providers, stronger risk management by hedge funds and managers, enhanced public disclosure by hedge funds, and improving market infrastructure (including documentation standards, collateral and valuation practices), can help reduce the perceived risks associated with hedge funds.

In many respects, hedge funds help make the financial system more efficient. They help arbitrage away mis-pricing, and provide extra liquidity to a wide range of capital markets. Hedge funds can also provide diversification for investors. Given the growing profile of hedge funds, especially within the EU, it is likely that investors' interest in this area will grow. It is important for hedge fund promoters, managers and service providers to manage the risks associated with hedge funds in the interest of the investor. Otherwise they could just walk away.

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How a Luxembourg fund can be good for the environment

Under the Kyoto Protocol, the European Union has put in place a system of “emission right” aimed to encourage industries in their efforts to reduce carbon dioxide (CO_2) emissions. An innovative fund in Luxembourg has been set up to invest in these “emission right”.

The mechanism works as follows: “emission right” are allocated in advance to heavy polluters (plants and factories). Each right corresponds to emissions equivalent to one tonne of carbon dioxide. Industrial sites which emit less carbon dioxide than allowed under their quota will be able to sell their unused quotas to those sites having polluted in excess of their allocated quota. An exchange platform has been set up by IXIS (a major French financial group previously known as CDC), Euronext (the pan-European Bourse) and Powernext (French electricity bourse).

A major challenge for such a market is achieving sufficient liquidity. This is the reason why IXIS has set up an innovative Luxembourg fund (the “European Carbon Fund”) investing in these “emission right”. IXIS has seeded this fund with €25 million, with other institutions also subscribing, with the goal of increasing the fund size to €100 million.

The fund will be a SICAV subject to prudential supervision by the CSSF. It will be dedicated to institutional investors such as corporates, insurance companies, financial groups, pension funds, holding companies, etc.

This regime offers attractive features: the label of a “regulated” product but with a reasonable administrative burden, very low taxation, and a quick and business-minded supervisory authority.

In this context, VAT turned out to be one of the major issues. A strict reading of EU VAT rules implies that transactions should be liable to domestic VAT of the Member State selling these rights. Even though this VAT could be recovered, huge pre-financing issues (up to two years) were anticipated in some Member States. Fortunately, on 19 October 2004 (as discussed in our December issue, p.3), a European VAT committee decided to treat these services as located where the customer is established, thus avoiding this VAT issue. This decision seems more opportunistic than justified from a technical viewpoint; however, from a pragmatic approach, it makes sense to keep a regime set up by one EU Directive from being annihilated by another!

The significance of this new fund is both in its impact in the developing area of emission right, and in demonstrating the flexibility of “traditional” Luxembourg vehicles for new products.

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Flashline

Securitisation takes off in Luxembourg

Continued strong growth is expected in European securitisation in 2005, with overall volume forecast at 12.1% (representing €255 bn) for the year according to the European Securitisation Forum (ESF). High hopes are held for European issues of secured bonds, and also for the German market generally, if the country manages to recover from its economic recession.

The very young Luxembourg securitisation business is poised to take advantage of this positive climate. With the introduction of a new law on 22 March 2004, which provides a very flexible platform for securitisation business, the first securitisation companies were founded in the second half of 2004. By early January 2005, more than 20 companies were set up with more projects and structuring transactions in the pipeline.

All securitisation structures except for two have chosen an unregulated form, i.e. where they are not subject to the supervision of the Luxembourg regulator. The securitised assets are mainly composed of loans, followed by securities, life insurance and real estate. A legal feature that has been used in several of the structures involves splitting the company into different compartments which can be treated as separate entities for issuance of notes (including with special characteristics), management of assets, and liquidation, all without impacting the other compartments or overall structure.

Thus the securitisation business in Luxembourg is off to a good start and bound to be one of the growing sectors of the local economy in the years ahead.

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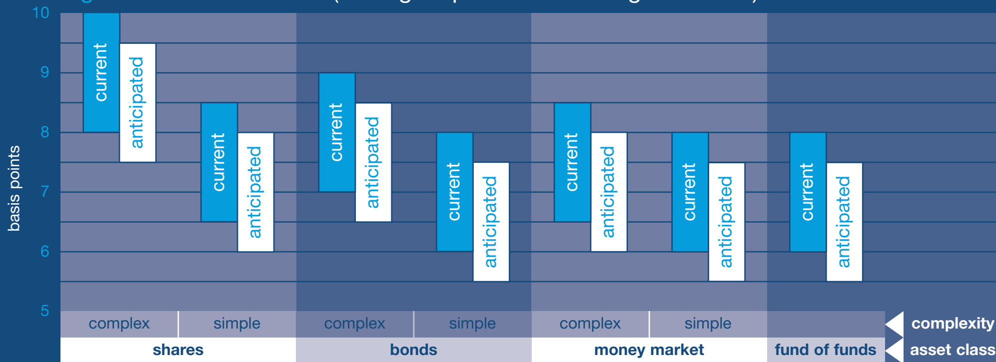
Germany moves to all-in fees for depositary services

PricewaterhouseCoopers' Investment Management Custody Funds Expense Survey 2004 – Mutual Funds/Germany shows the growing trend from stand-alone pricing of depositary fees, safe-custody fees and transaction (ticket) fees to an all-in (bundled) fee as a combined price paid for the service package.

All-in fees provide greater reliability in planning and simplify comparisons for depositary banks, investment companies and mutual funds. Respondents from 18 depositary banks (totaling 70% of assets under administration in Germany) were queried about a wide range of fees, business models and standards and future services.

Figure 1: All-in fee levels (among respondents offering all-in fees)



When asked about offering an all-in fee to their investment company clients for mutual funds, 44% of respondents said they already offered an all-in fee (33% also offer stand-alone fees for the services; 11% offer only all-in fees). Of those offering all-in fees, one quarter have defined service package prices reflecting standard and additional services offered to funds.

Respondents were asked the current levels of all-in fees, whether they considered fee levels reasonable, and what they expected fee levels to be in the future. The highest all-in fee levels were 10 basis points for complex share portfolios; these were usually capped. All respondents considered current all-in fee levels reasonable, but significantly, three-quarters of them thought the levels of all-in fees would drop by 2 basis points (bps) from current highs – these were true of all asset classes.

Investors demand more information

Investors seek relevant, timely and useful information from the companies in which they invest. At a recent INREV conference in Paris to discuss the future of investor reporting within the annual financial statements, there was lively debate and a consensus that current reports of non-listed real estate vehicles (NLREV) can improve.

International Financial Reporting Standards (IFRS) set the scene for improving consistency in financial accounting for listed companies across Europe from 1 January 2005, with pressure on non-listed companies to follow suit. However, IFRS does not require an entity to present, outside the financial statements, a financial review by management that describes and explains the main features of the entity's financial performance and financial position and the principal uncertainties that it faces – these are determined by local regulations and best practice.

INREV's Reporting Committee (led by PricewaterhouseCoopers) aims to improve consistency in accounting and presentation of information and encourage greater transparency within the annual report. It has issued a draft annual report for NLREVs to provide guidance on best practice disclosures; an illustration of key rental information by sector is shown in Table 1. The manager's report includes suggested commentary and charts on the vehicle's performance and an analysis of the property results. The report is a live document in order to improve on the suggested disclosures; further comments are encouraged.

Table 1: Key rental information by sector

	Annual net estimated rental value		Annual yield on present income		Lease length as at 31/12/04	
	2004 €m	2003 €m	2004 %	2003 %	Median years	Mean years
Retail						
Industrial						
Office						
Total						

As shown in Figure 1, the level of all-in fee depends on the asset class and the complexity within asset class (simple "plain vanilla" portfolios cheaper than complex portfolios).

What about the 56% of respondents who do not currently offer all-in fees? Of these, 90% thought all-in fees could be useful, and 78% could see their own depositary fee services charging an all-in fee in the next three years.

PricewaterhouseCoopers is now preparing benchmarks for depositary services in the German market, which may be of interest to asset management companies as well as depositary banks and custodians.

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Some managers query the value of further disclosures in the annual report when investors already receive quarterly information and competitive disadvantage could result. Investors are weary of management hiding behind the 'competitive disadvantage' argument and would welcome a timely annual review and commentary by management.

Increasingly, those managers which are willing to work with investors to provide transparent and relevant disclosures in the annual report will benefit from a stronger reputation in the market and a resulting increase in available funds.

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To obtain the draft INREV annual report, contact david.catterall@uk.pwc.com

Transfer pricing: offshore may not be off-limits

Investment managers may wish to review procedures following a recent case which examines the reasonableness and relevance of overseas information requested by the UK Inland Revenue during a transfer pricing enquiry into transactions between a UK company, Meditor Capital Management Limited ("MCM"), and its parent, Meditor Capital Management (Bermuda) Limited ("Bermuda")

MCM maintained the pricing of services to Bermuda was based on the comparable uncontrolled price ("CUP") method, with third party clients used as comparables. It submitted supporting information to the Inland Revenue on its margins, risk and prices, to show that the pricing was lucrative for the UK and sustainable under the arm's length principle.

The Revenue pointed to differences in the contract terms and to differences between Bermuda and the third parties themselves, which as established private banking businesses had client lists, brands and marketing knowledge. The Revenue also pointed out that the fees Bermuda received from some of its clients were 1.2% for management and 20% for performance, whereas it only paid MCM 0.4% and 8% respectively; what did Bermuda actually do to earn the difference?

Rounds of correspondence ensued as the Revenue asked for documents and information regarding, inter alia, the nature of activities performed by Bermuda, the role and number of its employees and its interests in the funds under management; the case was brought as MCM attempted to assert its statutory rights as a taxpayer to limit the Revenue's investigation and bring the enquiry to an end.

The Special Commissioner hearing the case judged the Inland Revenue to have specific rights to request information, these being "… documents and particulars which are:

1. relevant to [MCM]'s liability to corporation tax;
2. reasonably required …to ascertain that liability…;[and]
3. within the power or possession of [MCM]."

MCM argued that Bermuda's activities were irrelevant to the question of MCM's liability to tax. In response, the Revenue cited the OECD guidelines which state: "an uncontrolled transaction is comparable to a controlled transaction…if…none of the differences (if any) between the transaction being compared or between the enterprises undertaking those transactions could materially affect the price in the open market…"

The Special Commissioner concluded that the activities of MCM, Bermuda and the third parties were all relevant. Furthermore, having determined the relevance of the information requested and the inadequacy of the information already provided, the request was almost bound to be reasonable unless obtaining the information would be unduly onerous or burdensome.

Finally, MCM claimed that, as a matter of fact, it did not have legal power to obtain documents from its Bermudan parent. However, MCM had previously demonstrated the ability to obtain similar documents. The Commissioner was thus disinclined to exclude, as a matter of law, the Revenue's request for documents held overseas since MCM had not shown that, as a matter of fact, they did not already have access to such documents.

This case relied on the OECD guidelines to support the reasonableness and relevance of information requested during a transfer pricing enquiry. Thus the Meditor case underlines the importance of adequate, contemporaneous documentation to support transfer pricing policies, including, where appropriate, details of overseas affiliates.

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Guaranteed Funds and UCITS III

Guaranteed products have been popular for more than a decade in several European markets. But in the last five years investors have been taught that, although it is true that equity markets often outperform bonds and cash, over the "long term", it is equally true that the longer you invest in equities the greater the chance of significant capital loss. Thus demand for guaranteed products has soared.

Products with a degree of capital protection are not particularly difficult to engineer (although it is not always clear precisely what protection is being provided.) The traditional model of a zero coupon bond plus a call option nowadays tends to produce poor returns in a low-interest world. Attention has turned to dynamic hedging techniques often embedded in structured products. These products can provide a good balance between stock market-related returns and capital protection.

The search is now on for techniques which meet investors' requirements and can be granted a UCITS certificate and can therefore be distributed in several markets. Careful attention has to be paid to the new regulations on derivatives, counter-party risk and collateral; to the fund accounting; and to taxation issues.

Products are appearing that address these requirements. In the current market they are likely to be met with significant demand.

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Flashline

UCITS III: new CESR recommendations!

In its final guidelines issued on 3 February 2005, the Committee of European Securities Regulators recommends that European regulators significantly shorten the transition periods originally foreseen in UCITS III as follows:

- by 30 September 2005, any grandfathered UCITS I fund should provide a simplified prospectus,
- by 31 December 2005, any grandfathered UCITS I fund which has launched a new sub-fund after 13 February 2002 must be approved as a UCITS III product by its home country regulator,
- by 30 April 2006, any grandfathered management company managing or wishing to launch UCITS III funds should comply with the UCITS III management company requirements, particularly on "substance".

While CESR is non-binding, conversion to UCITS III should now be viewed as a priority to limit passporting risks!

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