



Association Luxembourgeoise
des Compliance Officers
du Secteur Financier

Le Bulletin d'informations

N°25

Novembre 2013

Editorial



Chers membres de l'ALCO, chers amis lecteurs,

Votre Conseil d'administration considère que bulletin de l'ALCO reste le support idéal pour traiter plus en profondeur de grands thèmes relatifs à notre profession de Compliance Officers et parfois même d'élargir cet horizon. Comme sur toutes les autres activités de l'association, vous aurez l'occasion de vous exprimer sur le bulletin lors de l'enquête qui vous sera soumise très prochainement.

La nouvelle équipe qui compose le GT16 sous la houlette de Karine Vilret et de Thierry Grosjean envisage une modernisation du bulletin et vous propose déjà en introduction quelques **actualités légales et réglementaires**.

Bruno Gossart a rédigé un article circonstancié sur **les premiers défis pour les assureurs-vie de la mise en place imminente de FATCA au Luxembourg**, abordant successivement les aspects légaux, l'accord inter-gouvernemental négocié par le Luxembourg et surtout les implications concrètes sur le secteur.

Tham Liêm Nguyen nous décrit quant à lui les **obligations supplémentaires imposées aux SIF en termes de Gestion des Risques et des Conflits d'intérêts** : la mise en place d'une fonction de gestion

Le Bulletin

des risques, son organisation et la gestion des conflits d'intérêts. Ces dispositifs seront directement applicables dans le contexte AIFM.

Pour donner le maximum de diffusion au travail réalisé par le GT33 qui répond aux questions posées par un membre de l'association, le bulletin reprend plusieurs de ces **réponses qui peuvent intéresser beaucoup d'entre vous** et participer ainsi à l'objet principal de l'ALCO, l'échange entre ses membres.

Vous trouverez aussi les résultats de la dernière Table-ronde organisée par le GT34 sur **l'Impact pratique du Règlement CSSF 12-02** avec des graphiques représentatifs des réponses au questionnaire envoyé préalablement.

Voici donc encore un bulletin copieux et détaillé. N'oubliez pas de participer à l'enquête que vous recevrez bientôt, si vous voulez améliorer le bulletin et l'ensemble des activités de l'ALCO et ainsi mieux répondre encore à votre attente et à vos besoins.

Bonne lecture à toutes et tous.

Jean Noël Lequeue
Président

* *

Le Bulletin

Si le client refuse de fournir la *self-certification* ou des renseignements complémentaires, il sera enregistré comme récalcitrant et reportable et ne pourra plus acheter aucun produit d'assurance dans le scope de FATCA.

3. 4) Obligation de reporting progressivement plus complet

Le premier reporting, dû pour le 31 mars 2015, reprendra pour l'année 2014 le montant en *cash value* des contrats de chaque *US person*, avec ses données d'identification, ainsi que le nombre total de clients récalcitrants et la valeur totale de la *cash value* relative aux contrats de ces récalcitrants.

Le deuxième reporting relatif à l'année 2015 délivrable pour le 31 mai 2016, reprendra en outre les primes et les versements reçus (« *income paid or credited* »).

Pour les reportings suivants, relatifs aux années 2016 et suivantes (dû pour le 31 mai 2017 et des années suivantes) l'information sur les « *Gross proceeds* » (bénéfices bruts) s'ajoutera.

En vertu de l'IGA model 1, les compagnies devront communiquer ces informations à l'administration fiscale luxembourgeoise.

3.5) Obligation de retenue à la source

Ce n'est que rarement que l'assureur devra appliquer à partir du 1^{er} janvier 2017 cette retenue de 30%. Des guidelines devront encore être communiquées.

FATCA est donc un vaste chantier auquel sont confrontés les assureurs. Dans la liste des travaux, on relèvera notamment l'aménagement de la documentation contractuelle (en tenant compte du respect du secret professionnel et du traitement de nouvelles données personnelles), le renforcement des données traitées, l'adaptation des procédures et des traitements informatiques, et la due diligence renforcée sur les nouveaux clients et clients existants de manière à détecter les clients *US persons*. L'Association des Compagnies d'Assurances jouera un rôle important et précieux en émettant des guidelines FATCA qui permettront aux assureurs luxembourgeois de s'adapter aux diverses exigences légales qui rentreront progressivement en vigueur.

Bruno Gossart
Head Legal, Tax & Compliance
ING Life Luxembourg SA

18 septembre 2013

Risk management in a SIF: A Practical Application.

The Specialised Investment Fund (SIF) is a regulated, flexible and fiscally efficient multipurpose investment fund regime for international, institutional and well informed investors. CSSF Regulation n° 12-01 described in detail how to apply Article 42a of the law dated 13th. February 2007 (amended) which relates to SIFs and which is particularly concerned with requirements for risk management and conflicts of interest (Mémorial A – No. 192 of 6 September 2012) (the **Regulation**). For several years this part of the Luxembourg financial sector has enjoyed significant growth: in 2007 there were 572 SIFs as opposed to 1485 SIFs in 2012, with assets totaling an estimated 276, 9 billion Euros at December 31st. 2012. As a result of this significant expansion, we will look at the practicalities of this successful vehicle from the perspectives of both risk management (I) and the management of conflicts of interest (II).

I) Risk management process

According to the Regulation, SIFs are obliged to establish and maintain a risk management function which must:

- (a) implement and maintain an appropriate and documented risk management policy. The policy has to allow for adequate detection, measurement, management and monitoring of exposure to market, liquidity and counterparty risks. In addition, it needs to cater for all other risks, including operational risk, which may be significant in the context of the activities of a specialised SIF investment fund;
- (b) ensure compliance with the risk limitation system of the SIF.

The SIF must consider the nature, scale and complexity of its activities, as well as the structure of the SIF itself.

Point 6 of Article 4 of the Regulation states that, as part of the application for authorisation, the SIF must provide the CSSF with a description of its risk management system. Any subsequent major change to the risk management system must also be notified to the CSSF.

Article 3 of the Regulation also defines some specific risks:

[...] “(1) “*counterparty risk*” shall mean the risk of loss for the SIF resulting from the fact that the counterparty to a transaction may default on its obligations prior to the final settlement of the transaction's cash flow;

(2) “*liquidity risk*” shall mean the risk that a position in the portfolio of the SIF cannot be sold, liquidated or closed at a limited cost in a sufficiently short time frame and that the ability of the SIF to comply at any time with the terms and forms of redemption laid down in the management regulations or in the articles of incorporation in accordance with Articles 8 and 28, paragraph (2) of the law of 13 February 2007 in relation to SIF is thereby compromised;

(3) “*market risk*” shall mean the risk of loss for the SIF resulting from fluctuation in the market value of positions in its portfolio attributable to changes in market variables such as interest rates, exchange rates, equity and commodity prices, or an issuer's creditworthiness;

(4) “*operational risk*” shall mean the risk of loss for the SIF resulting from the inadequate internal processes and failures in relation to people and systems, or resulting from external events, and includes legal and documentation risk, and risk resulting from trading, settlement and valuation procedures executed on behalf of the SIF;” [...]

A SIF may delegate all or part of the risk management activities to third parties provided that the third parties are properly regulated and able to perform these activities in a reliable, professional, and efficient manner.

Delegating required activities does not exonerate the managers of the SIF from their responsibilities with regard to risk management. Article 5 of the Regulation is clear that managers have a continual obligation to monitor SIF associated risk, and to ensure that systems run by third parties on their behalf are adequate and efficient. Below is a description of the processes for managing both risk and conflict of interest, as specified by Article 4 of the Regulation, for a SIF which invests in photovoltaic projects.

A) Organisation of the risk management process

Risk management must be fully independent from operational management of the fund both in terms of hierarchy and function. .

Appropriate measures must be taken to avoid conflicts of interests and to manage risk, for example by a third party with the necessary competencies and capacities to act professionally. Alternatively, the risk manager could be a non-executive board member, so ensuring there is unfettered access to all relevant information necessary to perform the prescribed duties.

Regardless of which route is chosen, the Regulation stipulates that the executive directors of the General Partner (**GP**) remain responsible for the implementation, efficiency, and constant, regular documented monitoring of the risk management process. There is no way of delegating these tasks which exonerates the SIF's managers from their responsibilities in this area.

Let's review the risk management process of a SIF investing in photovoltaic installations which produce electricity when connected to the grid. The risk management process must clearly identify the risks, give them a ranking between 1 (low probability) and 5 (high probability of the risk occurring), and demonstrate, whenever possible, what measures are being taken to mitigate or reduce the risks. We are not going to list here all types of risks associated with such projects, but will simply demonstrate the process of risk management analysis.

B) Risk identification process, ranking and mitigation procedures **(Type of risk)**

- 1) *Counterparty risk: largely that risk associated with failure to complete the acquisition of projects.*
- i) Transfer of the land/building (land register, ownership, leasing agreement), the building permit and all relevant legal procedures
 - ii) Transfer of authorisations, licences
 - iii) Acquisition of the SPV

Ranking medium/high:

- Installation delay
- Time to obtain the legal permit and length of legal procedures relating to the process

Mitigation measures:

- The GP favours projects where the EPC contractors are companies of high standing with a proven track record in this specific sector. Large groups with a strong economic balance sheet are preferred. This choice facilitates the exit strategy at a good premium. An EPC is generally a single party in charge of project design (Engineering), purchasing components and materials (Procurement), and building the works (Contracting).
- The contractor is bound by the terms of the contract and must provide adequate insurance coverage. In turnkey operations, the risk is fully borne by the contractor.

Le Bulletin

2) Liquidity risk: relates to the fact that photovoltaic projects may provide lower returns than expected, thus making it difficult to sell them in the future, hence the liquidity risk.

- i) Illiquid investments
- ii) Acquisitions of photovoltaic projects in countries with possibly fewer regulations
- iii) Lower returns for investors if the projects cannot be partly financed with debt

Ranking: medium/high. Mitigation measures:

- Seasoned professionals, leaders in their market
- Projects are acquired with well-known developers
- Projects are acquired with all building permits granted with no recourse
- The GP is to provide one of the critical components of the total cost of the photovoltaic project, in this example, the solar panels, and is installing them, reducing considerably the total cost of the project
- The GP is looking to get financing from local banks
- When the project is completed and linked to the grid, the cash flows are constant and predictable over a long period
- There is a lock-in period of three years allowing the projects to be realised and to generate the expected return
- The GP has an extensive and successful track record with the installation and operation of photovoltaic panels

3) Operational and specific risks related to photovoltaic projects:

- i) Changes in technology
- ii) Theft, damage to installations
- iii) Plant deterioration
- iv) Climatic changes, incorrect estimates of solar radiation

Ranking: medium. Mitigation measures:

- Photovoltaic technology can be considered a 'mature' technology, as it has been in use for many years
- It is highly reliable with an increased capacity and capability for transforming solar radiation into electricity
- The lack of moving parts means it is subject to fewer operational issues than other technologies
- The GP is contracting with reliable components manufacturers
- The installations are covered by an extensive insurance policy specifically designed for such installations, and sophisticated monitoring procedures are in place to verify that the installations are working properly
- The plant yield deterioration data is provided by the component manufacturers and is included in the economic investment model
- The GP can rely on a database providing long-term solar radiation predictions in regions where the photovoltaic installations are set up. Based on these extensive studies, any deviation in the expected solar radiation is not statistically significant over the period of time during which the plants will operate.

4) Reliance on management.

The SIF is relying on the GP and its managers. The loss of key individuals' services could materially affect the SIF's operations.

Ranking: low to medium. Mitigation measure:

- The GP has formed a company with five years specialised experience in photovoltaic installations and projects, and which has a staff of more than 100 people. This is team work, as many specialists are involved in selecting the best photovoltaic projects.

5) Newly launched Fund.

The Fund has no operating history.

Ranking: medium. Mitigation measure:

The GP has an extensive and successful track record installing and operating photovoltaic panels stretching over many years.

In summary:

One of the key points in the risk management process is that the risk manager should be able to justify his experience and ability to perform his duties in a professional manner. This issue could be addressed successfully by the risk manager using a valuation approach to the projects based, in this specific case, on a discounted cash flow analysis. The photovoltaic projects can be characterised by a precise breakdown of costs and revenues. Due to a certain stability in the feed-in tariffs on the revenue side, and the ability to compare the costs of the projects to similar ones in the sector, (as photovoltaic installations are widespread), the risk manager can perform his duties effectively by checking the costs and revenues of his projects with similar projects using the DCF method. This will allow detection of potential discrepancies between projects of the same nature.

II) Management of conflicts of interest

In Chapter III, the Regulation makes several points regarding the management of conflicts of interests:

- 1) criteria for the identification of conflicts of interest (Article 6),
- 2) the conflicts of interest policy (Article 7),
- 3) the necessary independence with regard to conflict management (Article 8),
- 4) the management of activities giving rise to a detrimental conflict of interest (Article 9).

The Regulation's description of the various situations is quite lengthy so we will summarise below by using a sample case managing conflicts of interest. Once again we will take the specific example of a SIF investing in photovoltaic energy, and will describe both the potential conflicts of interest and the appropriate measures being taken to mitigate them.

The SIF is implementing effective and adequate management of conflicts of interest.

The management of these potential conflicts of interest is conducted by a third party, meeting the requirement for full independence.

The investment management process, the control procedures put in place, and the monitoring of measures implemented to prevent or mitigate conflicts of interest are considered sufficient to

protect the interests of well informed investors in the SIF. We now move on to describe briefly the situations in which the GP and its operational managers are involved, through their positions, to interact with the SIF's acquisitions.

A) Links between the GP and acquisitions made by the SIF:

The GP and its operational managers are specialists in the installation of photovoltaic panels. The SIF will therefore rely on the operational capabilities of the related companies which the GP controls to install the photovoltaic panels in the various projects acquired by the SIF through the SPVs controlled by the SIF.

However, this strategy is not detrimental to the interests of investors for the following reasons:

- 1) The GP, through its related companies, can obtain a much better price for the photovoltaic panels acquired by the SPVs in the different countries where the projects are implemented. This is because the executives of the GP have perfect knowledge of the market for photovoltaic panels and they can enjoy significant volume discounts because of the quantities ordered from their suppliers.
- 2) By acquiring the solar panels through its related companies, the GP can significantly reduce project costs as the solar panels could represent a significant part of these total costs. If the GP had to buy the projects with the panels installed, it would probably pay a much higher price. The contractor would likely put a sizeable mark-up on the price of the panels purchased and may not be able to obtain favourable prices from solar panel suppliers.
- 3) Most importantly, the GP is fully connected to the success of the SIF. The GP has several similar projects; it is in its own interest to obtain a high return on the SIF as it could attract substantial performance fees whenever the actual performance is over 7% net of fees. The GP might reach a performance fee of 25% above this rate.
- 4) The GP, through its expertise, could build several photovoltaic projects and execute a very profitable exit strategy by selling the collection of projects some years later to a larger electricity operator or some other operator interested in the growing market for renewable energy and one which provides a predictable revenue stream.
- 5) Therefore, it is in the GP's interests to maximise the projects' value in order to be able to eventually sell them to the abovementioned investors and generate substantial returns for the Fund.

B) Control procedures by the risk manager.

The risk manager, as a non-executive board member of the GP, will have access to all the projects' financial statements at the SPVs' level. He can control project costs related to the installation of solar panels, and compare them to generally accepted costs for similar projects. The control process is straightforward as photovoltaic projects costs are largely similar from one project to another, especially with respect to solar panels. Therefore the risk manager should be able to detect deviations or sizeable discrepancies between the expected costs and the specific costs for projects acquired by the SPVs.

Thanh Liêm Nguyen, CFA.
Administrateur délégué
Alpha Wealth Management Luxembourg S.A