

Cross-border master-feeder structures

A way of adapting your product development strategy to new market challenges

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Time to streamline

Since the introduction of UCITS IV in July 2011, the asset managers have spent their time and effort producing Key Investor Information Documents (KIIDs) and adapting their risk management processes to comply with the 'requirements' side of the directive.

This first step was heavy and costly, but unavoidable. It did not leave much room to look at the opportunities offered by the regulation (management company passport, cross-border merger and master-feeder structures). Indeed, the European industry is facing challenges: margins are continuing to decrease, competitiveness is becoming fiercer—making it a good time to improve the cost/income ratio of the product ranges, and to have fewer and larger portfolios to manage, as it is the case in the U.S. market.

Streamlining projects are now emerging everywhere, mainly with the aim of reducing costs, optimising fund management (i.e. to avoid having two funds with the same investment strategy) and having a coherent range of funds available.

Cross-border structure is an appealing solution for asset managers to streamline their existing product range and generate economies of scale.

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When are master-feeder structures appropriate?

Investment managers who have ranges in several countries may have products with similar or even the same strategies. To achieve cost reductions, two such funds could be merged, or a master-feeder structure could be created. To achieve vehicle reduction, a cross-border merger could be more efficient, but in this case, investors of the merging fund would have to accept that their investment has moved to a different country and vehicle, which may have different conditions and characteristics. Given many drawbacks for investors, the master-feeder structure may be an appropriate solution.

Let's take as an example a French SICAV invested in by an insurance company. Merging the SICAV in another SICAV based in another country, means that insurer will have to change the name of the funds in all insurance-linked contracts, which may create complexity, cost and risk for the insurance company to implement the change and does not show immediate benefit for the insurer. On the contrary, a master-feeder structure, will not create any system impact for the insurance company as the investor's contract is linked to the future feeder investment fund.

In other words, one of the very first steps when streamlining is under consideration is to analyse the impact on the client. In most cases, there is a lesser

impact on the client when a master-feeder structure is created than with a merger.

Below, we give an example of what will change for an investor in a fund that is to become a feeder:

- The 'new' and 'old' prospectuses may not have the same wording to designate the same criteria in the investment strategy and the risk sections, so an amendment will be needed—though this can be explained in simple terms
- The feeder fund will no longer be eligible for funds of funds investment. Therefore the candidate to become a feeder must be analysed from a registrar angle, and the funds investing in it need to agree to transfer directly in the master or to redeem their positions
- There are some particular characteristics of certain countries that cannot be aligned. For example, a UK fund generally releases its NAV on the calculation day, with the cut-off and snapshot at midday. If the fund becomes a feeder of a Lux master fund, it will be impossible for the feeder to receive the master fund's NAV on the same day. In this specific example, investors will have to accept these new conditions or leave the fund

This shows that cultural aspects of the industry need to be taken into consideration too. A UK investor who only wants to invest in UK vehicles can use a feeder based in the UK that invests in a master fund based in a country with an international service level, i.e. a fund that offers wider distribution.

It is also important to remember that from an investor point of view a number of characteristics remain the same when a fund becomes a feeder fund. For example, the fund keeps the same name, ISIN code, track record, entry/exit fees, dividend distribution policy, cut-off, reporting (for which a look-through approach must be adopted), etc. It may therefore be the preferred solution for investment managers and their clients.

What benefits can be expected, are we creating concrete savings?

The first and immediate visible effect is the decrease of the asset servicing in the feeder fund. If the investment manager pays service providers, the decrease of the invoice will be quickly become apparent. In case of in-house asset servicing one can review, enhance and streamline its operating model concerning the feeder. Given the 15% liquidity, the feeder fund is composed of one security account (units or shares of the master) and one cash account. The feeder can then be operated with a light touch, e.g. placements from the feeder to the master can be automated and there will be a maximum of one transaction per day. The NAV can be controlled using a light approach—if the cash buffer remaining in the feeder is well established, the security line is already monitored as the master fund's price is based on a standard control setup.

It may even be possible to remove the middle office function. The asset manager must consider whether a hands-on or hands-off approach is appropriate.

A hands-on approach means continuing to operate as if the feeder fund is a standard fund, with the same level of monitoring and control, as well as middle and front office access. A hands-off approach means the NAV is controlled because it derives from the control structure of the master, the cash buffer is controlled on a daily basis and the order placed from the feeder to the master is based on a set-up which takes into account remaining cash—in this case, no middle office function is needed, and no front office activity remains. The set-up needs to be well designed but the hands-off approach will bring major direct and indirect savings for the asset manager.

On the custody side, the workload—and therefore the associated costs—will be reduced, with a maximum of one transaction being settled each day, while custody of units or shares of a foreign fund cost less than direct line securities.

Nonetheless, the feeder's ongoing charges will not completely disappear. The fees can be aggregated at the level of the master, and at some point, some of the costs—which did not exist before—will be passed on to feeder investors. For example, if the master is in Luxembourg and the feeder is in France, French investors will have to pay of the Luxembourg subscription tax (*taxe d'abonnement*).

As for the indirect portion of the costs to be borne by feeder fund investors, given that in all cases the legal vehicle continues to exist, all the marketing and distribution costs also continue to exist—and therefore the time spent on such activities by the fund manager will be considerably reduced: the feeder funds clearly require less workload. This can become a source of efficiency real savings once the asset manager concentrates on one portfolio rather than duplicating the same strategy in several portfolios.

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Before starting the implementation, let's have a look at the common operational issues

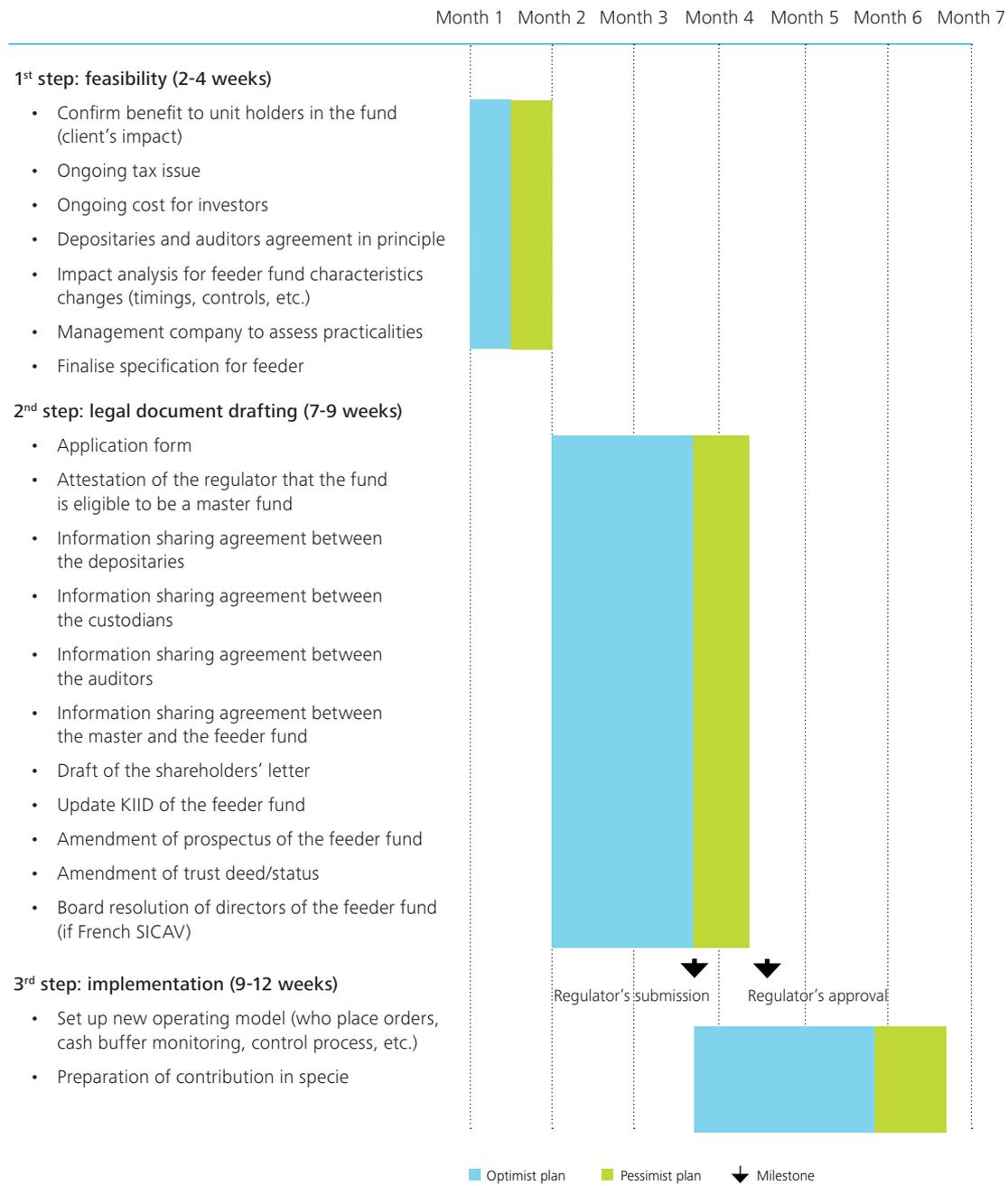
Master-feeder restructuring strategy: frequent operational issues

Regulatory/ legal	<ul style="list-style-type: none">• Prepare master/feeder information sharing agreements and ensure both master and feeder meet UCITS IV requirements• Check if master/feeder rules and country laws allow contribution in kind, direct investments by the feeder in OTC derivatives, etc.• Ensure auditors and custodians agree on the information sharing policy• Define process to deal with different compliance constraints in master and feeder countries and report compliance breach• Compilation of the full regulatory package (different from one country to another)
Change management	<ul style="list-style-type: none">• Transfer full investment decisions at the master level• Calculation and monitoring of the minimum cash buffer in the feeder• Management of the 15% liquidity pocket• Lighten the control process (even with the possibility to outsource or remove it)• New order routing process to automate the orders between feeder and master• Potential new distribution process
Other considerations	<ul style="list-style-type: none">• Ensure that cut-off, valuation point, NAV release, settlement cycles and end-of-year closing are aligned or can be aligned between master and feeder• Determine if the feeder will invest in a 'no-load' or 'loaded' share class• Potential increase of ongoing charges of the feeder (depends on fee policy)• Ensure Forex management, in case master and feeder have different currencies• Funds invested in the feeder may invest directly in the master (potential revenue impact)• At conversion, ensure securities are priced on a same policy (mid/bid/ask) and apply swing pricing

Fees: when adding the master's administrative costs to the feeder's ongoing charges, the estimated ongoing charges of the feeder could increase. For commercial reason the asset manager has to work on the estimation of the ongoing charges for the feeder.

What needs to be done to implement a cross-border master-feeder structure?

Regulatory timeline: master-feeder*



* Assuming that both future master and feeder funds are existing funds

Conclusion

Creating master-feeder structures can lead to major savings in the long term. Although at first sight it seems that the creation of such structures requires a significant effort, they can be applicable to the strategies of certain asset managers, which have a large fund range in various domicile and wish to limit the impact of their streamlining initiatives at the client level.

To the Point:

- The master-feeder can generate direct and indirect savings for asset managers
- The feeder's operating model can be enhanced and can become lighter
- Impact in client's side of a master-feeder is smoother than a merger
- Thanks to these portfolio structures master portfolios will become larger and will be sold more easily

