

Luxembourg Banking Market Challenges and Opportunities Survey 2006*

Viewpoints of CEOs on the entity's positioning within their group



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Executive summary

“Luxembourg has the necessary complementarities with headquarters and with other subsidiaries in the group to be a vector for international growth.”

Participant's quotation

This report is based on face-to-face interviews with CEOs and other leading decision-makers within Luxembourg's banks. It examines the challenges and opportunities they face in the current international banking environment and looks into how they see their business develop both locally and as subsidiaries within a group.

Survey findings underline that building group business synergies is a vector of growth both for the group as well as for the local entity. The Luxembourg financial market has the excellence, solid growth perspectives and a recognised potential for servicing international clients. There is, however, an “individual” challenge for Luxembourg banks to consolidate their local market strategy and objectives with those of the group; and a “collective” one to act as a unified financial community able to overcome local growth constraints and develop a distinctive brand that will help build on the current international recognition of the marketplace.

The key findings of this survey developed in section 01 of this document are the following:

- There is a strong consensus on what the market and organisational challenges of Luxembourg are today. For 94% of CEOs, the quality or performance of client service is a key differentiator vis-à-vis investors, competitors, and the group. Product innovation is the underlying asset that builds client trust, and an important challenge for 83% of banks. Although objectives are clearly set in the search for market growth from a Luxembourg perspective, 90% of participants agree that they are hindered by current human resources issues.
- Today's banking market environment invites subsidiaries to take further responsibilities at group level. According to survey results, 94% of CEOs believe that they are either well or strongly positioned within their group. On the other hand, 60% of banking entities hold international development responsibilities today. The role of Luxembourg CEOs is evolving in an increasingly international business environment. CEOs need to build on the international exposure afforded by the activities of their bank.
- The credentials laying the basis for headquarters support are there. A total of 89% of CEOs confirm that Luxembourg is perceived as a centre of excellence, mainly in private banking and fund administration; and 77% position themselves as a solid business case with regard to their group.
- While 91% of CEOs argue that in their day-to-day business their group positioning strategy consists of an intensive informal dialogue with group decision-makers, over 40% of participants admit that they lack the required integration within the group as well as a clear visibility of Luxembourg's activities in order to grow. Luxembourg banks are in strong competition with other subsidiaries within the group.

- The Luxembourg banking sector is internationally renowned and has the necessary flexibility to efficiently serve European markets and beyond; nevertheless, it also has strong competition from other international financial centres. For 50% of CEOs, an additional challenge for Luxembourg banks is to promote its services not only within the group but also as a financial community that is recognised as such by other financial communities, and in turn, by their global organisation.

In section 02 of this report, PricewaterhouseCoopers specialists in banking and financial services have submitted proposals on how Luxembourg entities can enhance their positioning within their group and potentially gain further responsibilities therein.

Survey participants have provided an insight into some of Luxembourg's opportunities, namely:

- The private equity industry
- Luxembourg as a hub for private banking
- Custody services for investment funds

Luxembourg market challenges are analysed through our viewpoint on current growth impediments as well as future drivers for change and development. The priorities for CEOs are considered to be:

- Quality of client service
- Product and service innovation
- Human resources

On behalf of PricewaterhouseCoopers Luxembourg, I would like to thank the CEOs of all the banks that contributed to this survey for sharing their views and concerns with us. I hope that these fruitful discussions will bring fresh ideas to banks on how to leverage Luxembourg's opportunities, and that new actions will be taken by the financial market as a whole.

If you would like to discuss any of the issues addressed in more detail or provide feedback on this analysis, please speak to your usual contact at PricewaterhouseCoopers or one of the main contacts listed at the end of this document.



Philippe Sergiel
Banking Industry Leader

01 The survey

1.1 Objectives and approach

Luxembourg's financial market offers appealing opportunities for banks, and the way local players face current challenges is a determining factor for their competitive position in the global marketplace as well as within their group.

PricewaterhouseCoopers has conducted a survey on banking market challenges and opportunities among 48 banking entities present in Luxembourg through one-to-one meetings with the banks' CEOs. The results detailed in this report consolidate the responses and impressions gathered over the period of June to October 2006.

Survey participants in this study come from over twelve different countries. The total sample of banks represents, in terms of amount of assets, 35% of the Luxembourg banking sector and 58% of the top 20 Luxembourg banks¹. All participants together employ 52% of the total number of employees in the Luxembourg banking sector².

The study aims to provide financial market stakeholders with an insight into the efforts that Luxembourg entities undertake to remain competitive in the international marketplace. It highlights how the group considers the performance and future development of the Luxembourg entity, and how the latter can improve its positioning within the group.

Key topics developed in this report include:

- Current market and organisational challenges
- The positioning of Luxembourg entities within their group
- The group's perception of the Luxembourg entity
- Promoting the marketplace and individual banks
- Development opportunities in the Luxembourg financial sector

This report also provides the points of view of PricewaterhouseCoopers experts on the potential of some of the opportunities identified and on the main challenges that the financial market is currently facing.

¹ Source: Wort, "Classement des Banques" as at December 31, 2005.

² Source: ABL, as at June 2006.

1.2 Market and organisational priorities for Luxembourg banks

1.2.1 Quality of client service and product innovation: the key market differentiators

“Our challenge is improving the quality of client service through the enhancement of technical platforms to support innovation and staff training in financial products.”

Participant's quotation

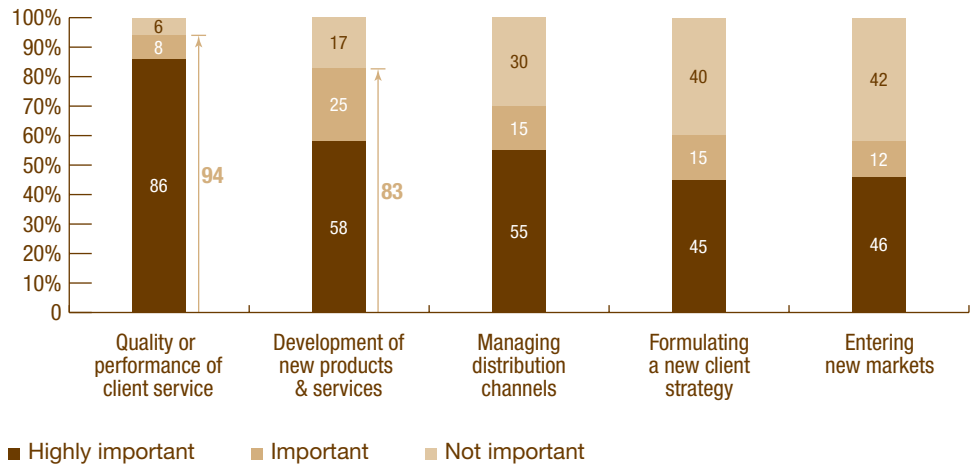
“Innovation is important for the group as it increases added value, and for our positioning vis-à-vis other internal entities.”

Participant's quotation

According to participants, offering a higher quality of service to clients as well as the right value proposition are essential tools in building a complementary position within the strategy of a global banking group.

Differentiating the Luxembourg entity within the network and vis-à-vis clients through the quality of client service is an important challenge for 94% of survey participants today. For 86% it is a key priority. Product innovation is an important challenge for 83% of participants, and highly important for 58% of them.

What are your market challenges for 2006-2007?



Why are quality of client service and product innovation the main market challenges for banks today? For banks to maintain a sustainable business case, quality of service is a must to build long-term profitable client relationships and become the trusted advisor both for private and institutional targets. Quality of service goes hand in hand with product innovation because tailor-made value-added propositions have become crucial to building client loyalty and responding to increasingly sophisticated needs.

These challenges are at the heart of international development, as Luxembourg entities are putting their know-how at the service of the group. Quality of service and product innovation are critical differentiators in today's marketplace as they open the doors to the new markets needed to sustain growth in the years to come (please see sections 2.3.1 and 2.3.2 for our point of view on quality of client service and product and service innovation).

“If the necessary resources are not available in terms of skilled staff, IT infrastructure and organisation, all efforts in developing a sophisticated range of products and services may become worthless.”

Participant's quotation

Meeting these two market challenges strongly depends on the ability of local players to surpass organisational challenges, which consist mainly in finding and retaining people with the necessary skills, as well as controlling the costs of adapting the operational model to a more sophisticated financial environment.

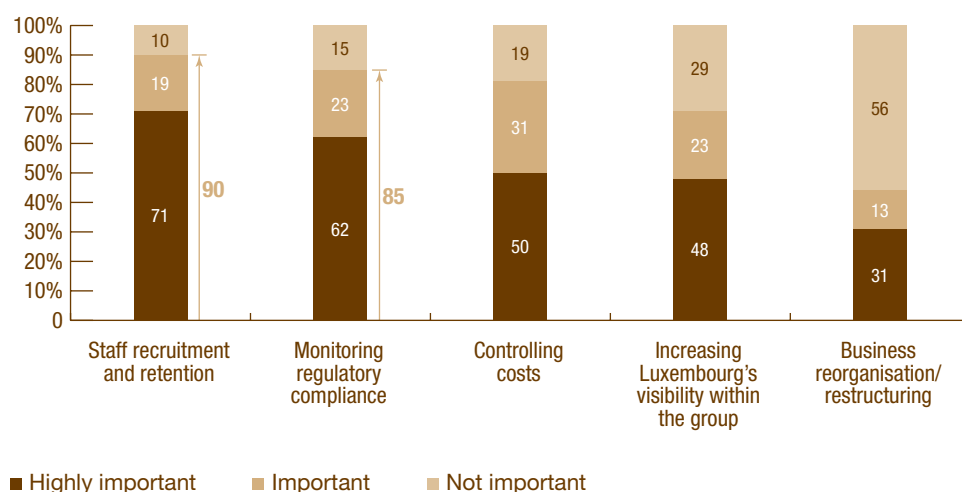
1.2.2 Staff recruitment and retention is a major organisational challenge

“Recruiting is a major challenge as our development and organic growth depends on finding highly skilled labour.”

Participant's quotation

A large majority of survey participants believe in the opportunities that Luxembourg offers in terms of organic growth³ and are satisfied with the flexibility of the legal and regulatory framework⁴; however, human resources are a concern for 90% of participants, and a priority for 71%.

What are your organisational challenges for 2006-2007?



“Without meeting compliance requirements banks cannot survive in the market.”

Participant's quotation

Monitoring compliance with regulations is an important challenge for 85% of participants and a priority for 62%. Participants do not consider it an obstacle to their business development, but as a necessary pre-requisite to running their daily business. It is perceived as a time consuming and costly task but one which allows for a high level of control on business operations.

In terms of recruitment, banks state that the required skills to develop their Luxembourg activities are scarce, which in turn increases the cost of talent acquisition. The turnover is high because it is difficult to keep qualified staff when the marketplace faces an offer level far lower than the demand, despite the fact that a number of banks attract young, qualified people from their home countries.

³ When asked whether participants believe there are development opportunities for their Luxembourg activities, 79% of participants said that they found strong opportunities through organic growth versus 45% for M&As and 29% for alliances.

⁴ When questioned about their level of satisfaction with the legal and regulatory responsiveness to financial market needs, 87% of participants said that they were satisfied.

Moreover, the qualifications required to meet the demand for the increasing sophistication of financial markets are lacking. This market fragility is nonetheless not specific to Luxembourg as similar difficulties are currently identified in other major financial centres such as Paris, London, Dublin and Frankfurt⁵.

According to a participant, “Luxembourg’s disadvantage vis-à-vis other European countries is the lack of a significant financial community”. Luxembourg has a solid traditional private banking base, but needs to develop specialists in tax planning, estate planning or alternative products. It is a centre of excellence for fund administration, but value-added services, such as product development, need to be integrated. Promoting Luxembourg so that it attracts the right profiles is a challenge as much as building the necessary infrastructure to train the existing ones.

Human capital is identified as a main constraint for business growth today. The marketplace needs to question whether its traditional recruitment and retention approach is still valid in the current financial environment. Innovation in human resources is, on the other hand, the responsibility of all market stakeholders. Banks acting as individual entities risk having a limited impact in solving this issue (please see section 2.3.3 for our point of view on HR issues).

⁵ Corporation of London, “The competitive position of London as a global financial centre”, November 2005.

1.3 The positioning of Luxembourg banks within the group

1.3.1 Indicators of Luxembourg banks' integration within the group

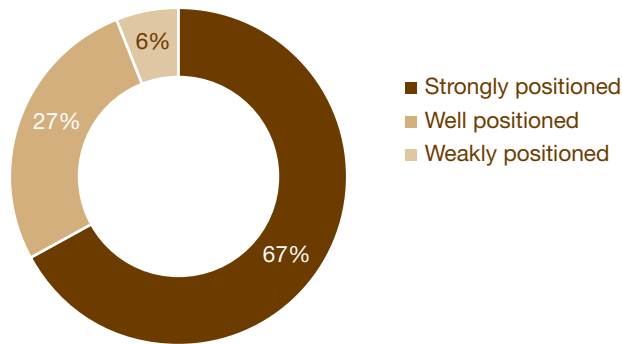
1.3.1.1 Luxembourg banks are well positioned

“Our strength in terms of internal positioning is having common clients and strong links with other entities within the group.”

Participant's quotation

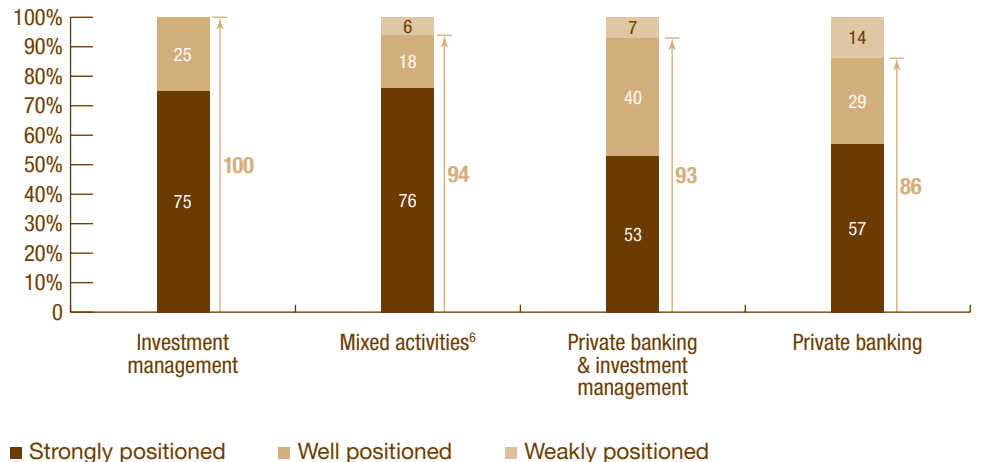
As many as 94% of participants claim to be well or strongly positioned within their group. This reflects the level of trust that banks have in the future of the Luxembourg marketplace; particularly as 67% of participants declare being strongly positioned within their group against 27% just well positioned.

Do you consider your entity to be well positioned globally within your group?



Although Luxembourg banks are well positioned within their group, the percentage of “strongly positioned” entities differs according to their core activities. All CEOs of banks specialised in investment management believe they are overall well positioned within their group, and 75% of them declare to be “strongly positioned”. This confirms the impact of the Luxembourg investment management boom and the ability of the marketplace to build strong credentials both in fund administration and custody, as well as in fund distribution.

Participants' positioning within the group according to core activity



⁶ Banks segmented under mixed activities include those with over three core activities.

Of the CEOs of banks specialised in private banking, 86% state that they are overall well positioned within their group, and 57% of them declare to be “strongly positioned”. The Luxembourg private banking sector is revisiting its international strategy; however, it faces strong competition from the large number of foreign private banking players as well as from other major international banking centres such as Switzerland and Singapore.

1.3.1.2 A solid business case within the group’s strategy

“Our solid business case satisfies the group’s P&L requirements, our historical reputation gives us internal strength, and our international potential is a strategic advantage.”

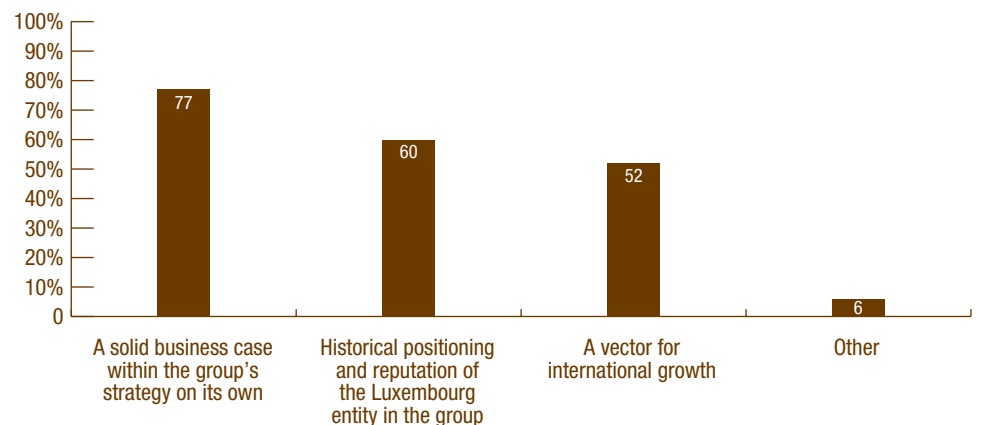
Participant’s quotation

When questioned on the main reasons for obtaining group support, 77% of participants state that their Luxembourg activities represent a solid business case for their headquarters.

Three arguments speak in favour of group support:

- Luxembourg remains a centre of excellence for the group’s international activities
- Improved results over the years are a justification in themselves
- Luxembourg’s favourable legal and regulatory environment is considered as a key contributor to the development of the group’s activities

What are the key reasons your group is actively supporting its Luxembourg entity?



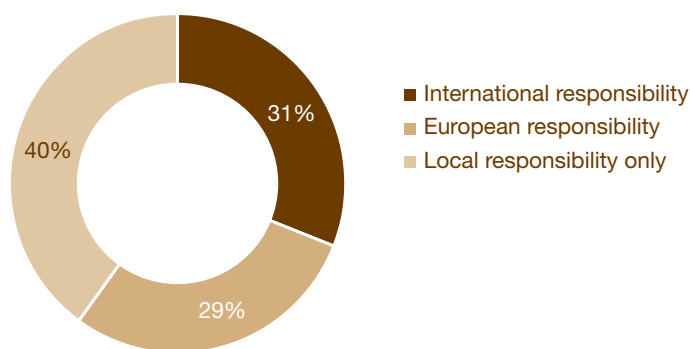
“Luxembourg is the ideal place for pan-European activities.”

Participant’s quotation

Historical reasons and the potential for international growth are correlated factors influencing group support and the current positioning of Luxembourg entities within their group’s strategy. For survey participants, there are significant expansion opportunities from Luxembourg. The fact that Luxembourg is historically renowned as an international financial market contributes to its potential as a vector for international growth in Europe and as a place of reference for new EU countries. The Luxembourg marketplace represents an alternative to other international banking centres with additional onshore opportunities in the EU.

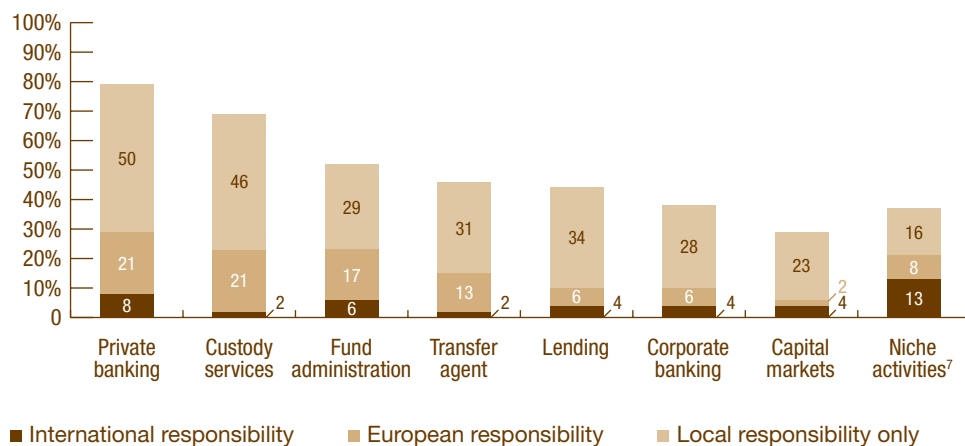
Survey findings reveal that Luxembourg demonstrates the necessary synergies with headquarters and other entities in the group. The fact that 31% of participants hold an international responsibility and 29% a European one confirms the perception that the Luxembourg entity is a key contributor to global clients and the group's growth.

Participants' responsibility level



At an international level, private banking and fund administration stand out as the activities for which the Luxembourg entity represents a source of development for the group. At European level, custody services are also an important activity.

Participants' activities with European/International responsibility



Luxembourg banks have also developed some “niche” centres of competence for their group such as asset management or fund distribution. Although these “niches” are at an early stage of development, it shows that Luxembourg has the assets for developing innovative think tanks on financial solutions and operational models to serve international clients. Particularly as locally generated initiatives are today a main driver of business growth (please see sections 2.2.2 and 2.3.2 for our point of view on hub opportunities and product and service innovation).

⁷ Niche activities include asset management, other security services, distribution, treasury services, precious metals, IT centralisation.

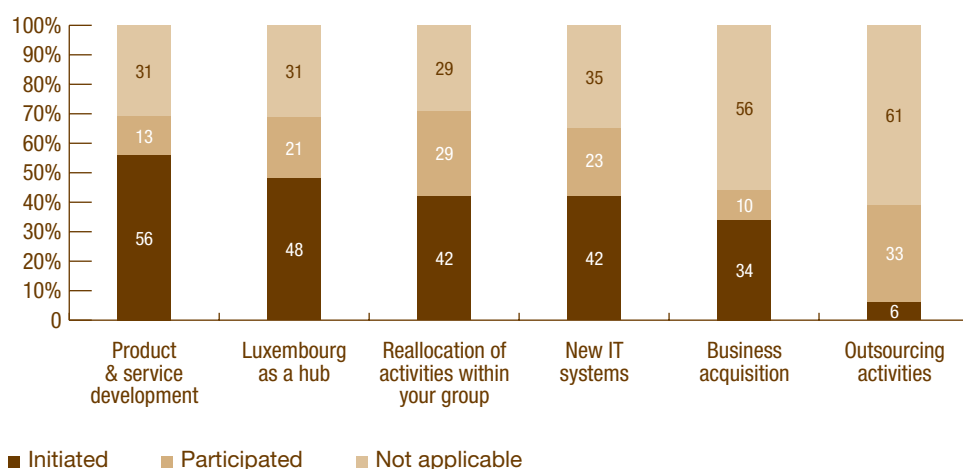
1.3.1.3 “Initiating” and “participating in” strategic market actions within the group

“The more integrated we are in the group, the easier will be to attract business to Luxembourg.”

Participant's quotation

In line with their willingness to differentiate their offer, integrate the group's market strategy and participate more effectively in the international deployment of the group's activities, Luxembourg banks appear as project initiators for product and service development, hubs or shared service centres, as well as IT system developments. The “will” to undertake such actions often comes from the Luxembourg entities.

Have you “initiated” or “participated in” the following actions?



Product and service development ranks first in the list of market actions initiated by Luxembourg banks, accounting for 56% of participants. As discussed in section 1.2.1, product innovation is considered a main enhancer in building client relationships and trust and therefore, a determinant positioning factor in servicing clients at group level.

The development of Luxembourg as a hub and the reallocation of activities within the group rank second and third respectively, as market actions initiated by participants. Within the context of growth, consolidation and evolution in financial market needs, the Luxembourg entity must remain an essential and complementary player in the global strategy of the group. This confirms the opportunity that CEOs of Luxembourg banks find in leveraging on local expertise and specialisation.

The development of new IT systems is as important as reviewing the market strategy of local activities within the group. It ensures that the necessary infrastructure is in place to deliver.

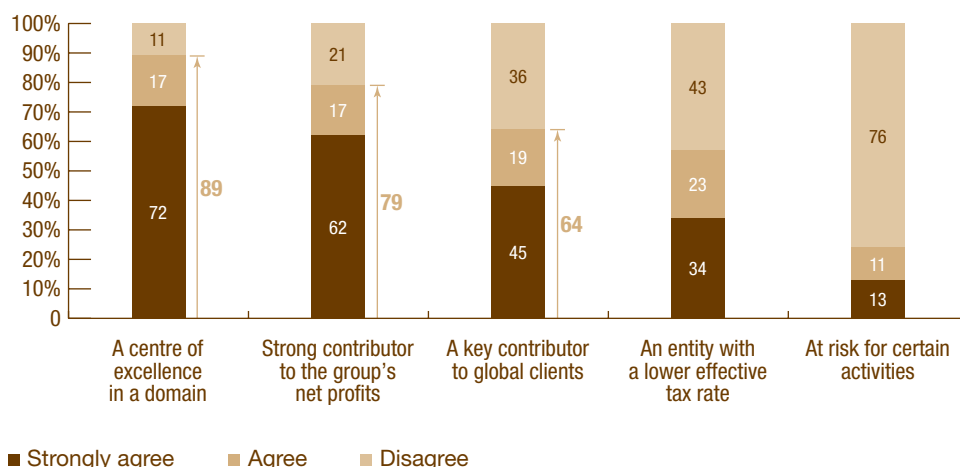
These results confirm that focusing on the development of core activities and intra-group synergies is critical to sustaining international growth and group positioning. Due to the recognition that the Luxembourg entities have gained over the years, they have been able to initiate important and strategic actions.

“We are a solid business case because we are a centre of excellence for the group.”
Participant's quotation

1.3.1.4 Group's perception of the Luxembourg entity

A vast majority of survey participants, 89%, state that Luxembourg is, above all, perceived as a centre of excellence within the group. Half of these respondents say they are considered as a centre of excellence in private banking and 42% in investment management activities.

How do you think your group perceives you?



“We are a cash cow for the group, and as long as our return on investment is positive, we will be strongly positioned within the group, and our existence will be justified.”
Participant's quotation

For 79% of participants, the Luxembourg entity is also perceived as a strong contributor to the group's net profit. Headquarters recognise the current growth of the Luxembourg banking sector. This is despite the fact that some entities contribute more than others to the group's revenues. Not all entities are cash cows but their positive development in terms of the P&L and strategic contributions to the business are good reasons for their group's support.

As many as 64% of participants say their group perceives the Luxembourg entity as a key contributor to global clients, which confirms the level of banks in Luxembourg assuming international responsibilities.

Excellence, profitability and contribution to the group's client strategy are therefore today's key drivers in the integration of Luxembourg banks in their global organisation.

1.3.2 The promotion of Luxembourg banks and their activities

1.3.2.1 How Luxembourg entities promote themselves within the group

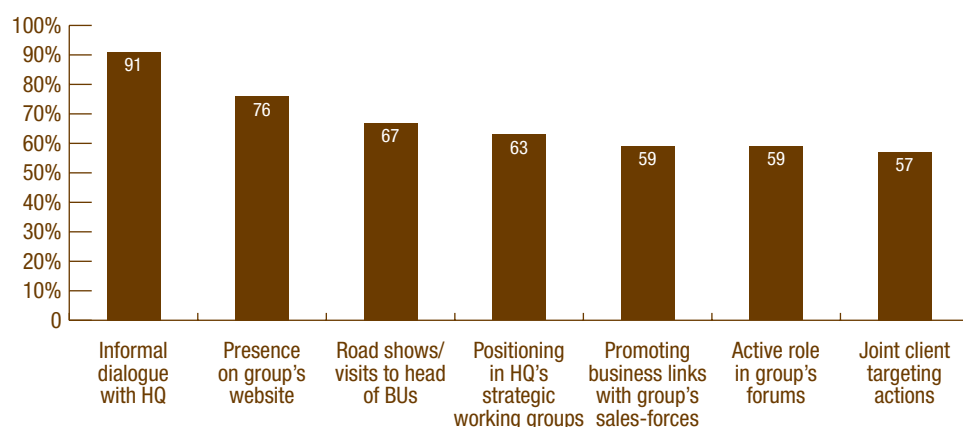
“It is important to have an informal dialogue with headquarters and constantly be on the headquarters decision-makers’ radar.”

Participant’s quotation

Marketing the Luxembourg entity within the group may be done either via decision-making networks or via pure marketing tools such as the Internet or road shows. Survey results indicate that decision-making networks represent an influential driver for the development of local activities and their integration within the group.

In decision-making networks, there is a combination of formal and informal strategic dialogue between subsidiaries and headquarters. For 91% of survey participants, it is critical to hold an ongoing or day-to-day strategic dialogue with group decision-makers. This strategy often runs in parallel with rather more formalised interventions. In fact, presence in headquarters’ strategic working groups is a tool for 63% of respondents.

How do you currently market/position yourself within your group and how do you think you will do so in the future?



Communicating on what Luxembourg can do for the group as well as for clients are mainly the objectives of Internet websites and road shows. A total of 76% of participants are either currently or will soon be present on the group’s website or will create their own one. Web presence represents a necessary visibility tool driven towards the market as a whole. The importance of more active means is clearly underlined as 67% of participants use road shows and visits to heads of business units to communicate Luxembourg’s capabilities.

1.3.2.2 Type of support that Luxembourg banks lack from the market to better promote their activities

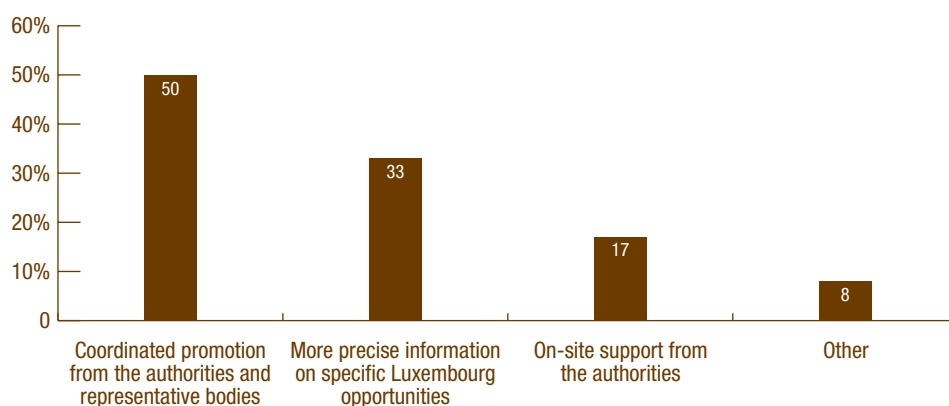
“Coordinated promotion is needed as well as a regrouping of interests with the support of professionals and Government.”

Participant's quotation

A coordinated promotion by representative bodies is the highest concern expressed by survey participants. For 50% of them, further coordination and for some even the consolidation of various representative bodies would facilitate the promotion of Luxembourg's image and competitiveness. These benefits would be reflected at three levels: vis-à-vis headquarters, other national regulators and international clients. The decision recently taken⁸ by the Luxembourg Government to create a “promotion agency” goes in the right direction; the objective being to dedicate a considerable budget for the coordination of promotional activities and the development of the Luxembourg financial centre.

The current situation, where different representative bodies promote Luxembourg without a concrete “common cause”, is perceived as a weakness of the marketplace. According to participants, Luxembourg can only attract new clients if it differentiates itself from Switzerland and other European financial centres.

What type of action or support are you missing to better promote your activities?



Transparency of information is also an issue. Survey participants do not seem to have a global view of the efforts being made by different associations and working groups. Further communication on these actions is presented as a basic need for a global understanding and promotion of the Luxembourg market.

For participants, the trend to build on financial innovation rather than focusing on the professional secrecy aspect of Luxembourg is an additional challenge for the marketplace. The Government's role in the successful Irish model has been mentioned as an example of the potential role that authorities and representative bodies could play together.

⁸ The Luxembourg Bankers' Association (“ABBL”), “Le Ministre Luc Frieden donne des précisions sur l'agence de promotion à l'occasion d'une réception de l'ABBL”, October 20, 2006.

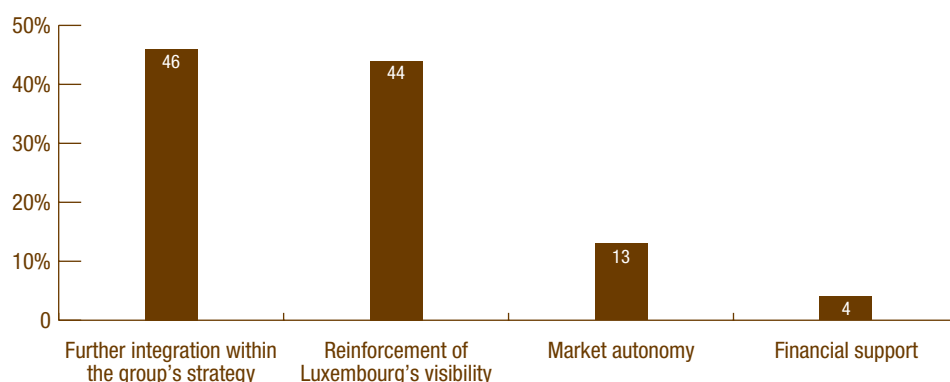
1.3.2.3 Type of support that Luxembourg banks lack from the group to develop their activities

“Visibility is linked to the integration within the group. In order for us to be well integrated, we must constantly inform the group about what our entity does.”

Participant's quotation

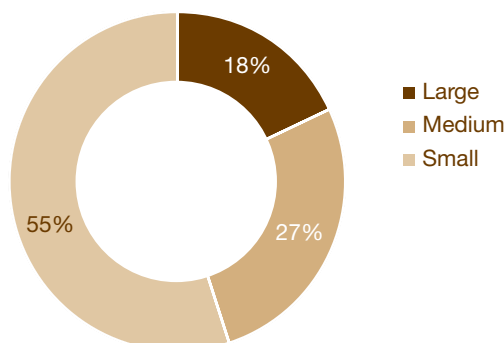
Survey participants are overall satisfied with their market autonomy to develop their Luxembourg activities and with the financial support they receive from their group. The areas where further support is requested relate to the better integration of local activities within the group's strategy, as well as reinforcing the visibility of Luxembourg's services within the group. Joint efforts with headquarters in these positioning objectives represent an area for further development.

What action or support do you lack from your group to better promote your activities?



Among the 46% of survey participants in search of further business integration in the group, small-sized⁹ banks are particularly concerned. More than half of these entities find themselves in strong competition with other larger subsidiaries in the group. They feel they do not have the required economic weight to generate the necessary support for the development of their activities.

Need further integration within the group's strategy according to participant's size in amount of assets



⁹ Segmentation according to size in amount of assets.

In terms of missing actions from the group, a total of 44% of participants are lacking the reinforcement of Luxembourg's visibility within the group. Entities often fight for visibility against other group' subsidiaries; however, this is an issue that goes beyond the size of the subsidiary. Visibility is an issue for all segments.

Participants explain that their main challenge is showing the group the advantages, contributions and opportunities offered by the Luxembourg entity. Initiatives such as Luxembourg visits by board members and staff from other subsidiaries have the objective of materialising the local strategy. An additional challenge in the visibility and positioning of the group is changing the negative or wrong perceptions that headquarters often still have concerning Luxembourg.

02 PricewaterhouseCoopers' point of view

2.1 Reinforcing the entity's positioning within the group

Converting group positioning into group responsibility

The main message of this study is that the integration of Luxembourg banks within their groups is a key driver for increasing their level of competitiveness in the financial market as a whole. Nonetheless, there is a “responsibility gap” between how the positioning of Luxembourg banks is perceived and the actual group responsibilities these hold. While 94% of banks claim to be well or strongly positioned within their groups and 89% claim to be perceived as a centre of excellence, only 60% of them currently hold international development responsibilities. The 30% or so who claim to be strongly positioned, yet who do not hold international responsibilities, may need to revisit their “positioning model”. This is a key requirement for growth in today's European banking environment.

In the following sections of the report, our experts will detail ways to develop Luxembourg's positioning and responsibilities within a group. These are structured around two main strategies, which are group revenue synergies and group cost synergies.

Development of group revenue synergies

The CEO has the challenge of providing innovative project initiatives that generate revenue synergies at group level and allow for the local business to grow. The Luxembourg financial market is mature. It is difficult to build a critical mass, despite the recognition of the marketplace as a centre of excellence in various domains. New solutions among which private equity, hedge funds or real estate funds are just an example, may be considered as new opportunities. How to integrate these solutions within the group's strategy will be a determining factor for revenue growth. The Luxembourg entity may not need to “think big” to begin with, but rather search for a step-by-step solution or limit its strategic scope within the group's business. This will help in building a new centre of competence, which will bring new revenues and assist in gaining global clients.

Development of group cost synergies

The way Luxembourg banks position themselves not only depends on a locally and group client oriented approach that contributes to consolidated profits. It also depends on the potential to generate cost efficiencies by centralising activities in Luxembourg. The marketplace clearly has an advantage to do so because of its know-how, resources and system integration capabilities. Centralisation opportunities may consist in developing middle/back office platforms, identifying international products that can be efficiently distributed from Luxembourg, or creating group client service centres. The right mix of products, services and operational capabilities is essential.

Future strategies, for instance, could aim at enhancing intra-group and even inter-group synergies to the benefit of the financial market. As reflected in this study, Luxembourg is, above all, a vector for international market growth. Projects for development, besides organic growth, could integrate the potential of international alliances or acquisitions, not only to generate revenues but also group economies of scale. This is an area where Luxembourg CEOs can propose innovative solutions.

As identified by CEOs and discussed subsequently, without quality of service, product innovation and the required set of skills, intentions to develop group synergies for future growth are restricted. Let us therefore address these challenges and seize business opportunities.

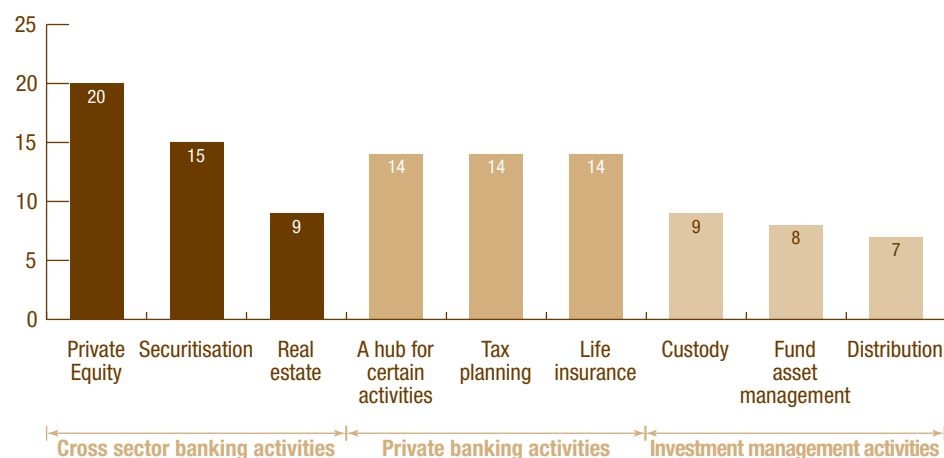
2.2 Opportunities for the development of Luxembourg banks

In the Luxembourg financial market, not only is the mix of products and services evolving but also the operational models behind them. When questioned on current or future new developments in the market, the main opportunities identified according to the core activity of the bank are the following:

- In the private banking sector: hubs or shared service centres, tax planning and life insurance appear as the most important project developments in the short-term;
- In the investment management sector: custody, fund asset management and distribution are the most quoted activities;
- Across the banking sector as a whole: private equity, securitisation and real estate stand out as areas being or to be developed.

What are the “new” activities that your bank is currently developing in Luxembourg?

Number of banks



This section details some of the opportunities that banks are currently seizing in different financial industries. These include the development of Luxembourg as a hub for private banking services, current opportunities in private equity for the banking market as a whole, and the ongoing transformation of custody services for investment funds.

2.2.1 Leveraging on private equity houses' presence in Luxembourg

In the private equity (“PE”) industry, Luxembourg has gained a privileged position over other European markets primarily because of the responsiveness of its regulatory framework to market needs. The marketplace provides a convenient financial environment for PE houses in search of the investment flexibility offered by unregulated vehicles such as the “société de participations financières” (Soparfi); and at the same time, proposes a clear framework for regulated vehicles such as PE UCIs and SICARs.

The opportunities for the Luxembourg banking sector in this industry can partly be linked to the competitive advantage of building on an existing infrastructure and know-how. The ability of Luxembourg to attract PE houses should benefit the local banking industry, in various areas:

- **The SICAR** is a “lightly” regulated fund vehicle, subject to the Law of June 15, 2004 (the “SICAR law”), which is exclusively dedicated to investments in the risk capital asset class. Besides the opportunities that the Luxembourg investment management industry has in servicing this type of vehicle, it is also an optimal value proposition for HNWI in the current trend of “retailisation” of the PE asset class. We strongly feel that this product has not been marketed enough, especially within the private banking division of financial institutions. For instance, a bank could syndicate monies from select HNWI into a SICAR which has the aim of accessing larger PE funds to which the bank’s clients would not have been able to access individually. Furthermore, the bank could generate income in the structuring of the product as well as on the ongoing management and administration.
- **Soparfi** is the most common non-regulated PE vehicle used in Luxembourg. This type of vehicle allows for the establishment of an organisation with holding or financing activities to which an efficient cross-border tax regime applies. As PE houses established in Luxembourg search for increasing their control over their structures, banks could locally offer those services that are often run by other financial centres. Services such as account management and administration, international cash-pooling and securities management are current opportunities in a fast growing sector that are not yet locally well served. This opportunity is in step with the trend of PE houses establishing back offices in Luxembourg.
- **Private equity UCI’s** offering their securities to the public and to institutional investors benefit from a clear and specific regulatory framework. Local banks providing administration and securities services are in a position to increasingly bring value to this sector, particularly in custody and central administration services.

To succeed, banks servicing the PE industry will need to differentiate on their quality of service vis-à-vis other financial centres. For PE funds for instance, bridge loan facilities or pre-financing of investor capital calls are a necessary tool. A number of efficient cash management services such as international cash-pooling for intermediary structures as well as capabilities for tailor-made reporting for fund sponsors will determinate the level of positioning in this sector.

2.2.2 Luxembourg as a hub for private banking

This survey reveals that for a number of Luxembourg banks it is time to take a step forward in their traditional positioning within their groups and search for innovative solutions to benefit the group as a whole. Looking at some successful examples in the Luxembourg market, there is strong evidence that becoming a hub for private banking activities can be a good alternative to some of the current models operating.

Different hub operating models can be envisaged: Hub for products and services, delivering “solutions” for other entities of the group located in other jurisdictions; Hub for operations, whereby the Luxembourg entity provides the other entities of the group with several services ranging from back office processing to securities dealing and IT operations. As of today, there are some intra-group hubs while inter-group hubs have not yet succeeded in establishing themselves.

Essentially, what we have seen in the market is that the Luxembourg entity has over the years built a critical mass, leveraging the historical reputation the financial centre has consolidated by servicing a broad spectrum of international medium to high net worth individuals. On the basis of this critical mass, the Luxembourg entity has undertaken the necessary actions to become recognised as a “best in class” either through streamlining its operations or through offering its “solutions” outside Luxembourg, or combining the two.

Being recognised as a “centre of excellence” within the group has led to the centralisation of some activities in Luxembourg. Hub developers mainly include those with a clear mission to either service entities of the group that do not receive enough “attention” from headquarters or service entities in countries for which there is an interest but not sufficient critical mass and for which the flexibility of the Luxembourg infrastructure is an advantage. The concept of “plug and play” is very attractive in countries where a group wants to position itself using an infrastructure that can deliver immediate benefits.

Hub opportunities in Luxembourg are large and at an early stage of development. Nevertheless, Luxembourg holds clear advantages in terms of financial expertise, knowledge of different regulatory environments, advanced product and service distribution capabilities, close collaboration with local regulatory authorities, a clear cross-country tax and reporting infrastructure and solid risk management processes.

2.2.3 Custody services: what's in it for Luxembourg banks?

Survey results reveal that an important number of banks are confident on the potential to continue growing and developing custody services from Luxembourg. This is not all that surprising when considering that total assets under custody have, on average, grown annually by more than 25% in the last 3 years. But what does it mean for different Luxembourg players? Is this sustainable and do all players benefit the same way from this growth?

At least two different businesses are to be considered when speaking about custody in Luxembourg: custody for private banking and custody for institutional investors. Historically, a number of small players have voluntarily run these two activities together and have been able to provide private banking clients with an attractive offering. They have been able to leverage on assets held for institutional clients.

A large number of players on the market are still working based on this bi-polar business model; around 35 institutions count less than EUR 10 billion in assets under custody as at the end of 2005. For these entities, the question today is whether they can continue offering competitive pricing and the right access to increasingly sophisticated markets and products. This is particularly the case for more demanding HNWI's, whose needs are sometimes approaching those of institutional investors. At the same time, the custody services they are offering to investment funds is seen more and more by their group asset managers and third party clients as expensive and unsophisticated. Today, those players are looking at possibilities of creating hubs, analysing whether this business is core to them, investigating outsourcing options for those activities or using global sub custodians.

Due to specificities in client demand, pressure on fees and an ongoing request for value-added services, the larger European groups have created specialised and dedicated business lines in the Securities/Investors Services. Through these initiatives, these groups are changing the market and are entering a highly competitive sphere where the margins are computed in fractions of basis points. Today, competition concerns size, and custody is a business where "small is NOT beautiful".

A survey conducted by Wall Street Research and the Bank of New York showed that there was a huge gap in the capacity to invest in new services between market leaders and the rest. Out of EUR 100 invested in technology, large players can spend EUR 35 in new developments when for the same amount of investment in technology, the others can spend only EUR 10 in new developments (the rest being spent on production, required maintenance and discretionary maintenance). The gap between large, medium and small players therefore clearly exists and will continue to grow significantly. Custodians need to constantly expand their product offering to cover the whole spectrum from issuer services to post trade administration services and include pre-trade, trade and clearing services.

The question for Luxembourg is whether institutions competing with large American custodians will create beneficial business models for Luxembourg and its custody business as a whole. When trying to improve their market competitiveness at group level, the large institutions have rarely decided to create centralised custody platforms in the Grand Duchy.

At the same time, there are different models operating in the Luxembourg market: centralisation of the platforms, centralisation of the services and of human resources or a mix of both, with a level of outsourcing or off-shoring depending on the historical evolution of the organisation and of its systems' flexibility. Some operating models are more aggressive than others but central to the necessity of keeping the supervision of assets in Luxembourg.

As long as the European passport for the depositary bank is not effective, the custody business will continue to grow significantly in Luxembourg as well as its need for skilled staff. Recent developments do not indicate that the absence of the European passport is considered by the European Commission as a barrier for the development of a harmonised and free financial services sector. In addition, many players still confirm that local presence and the ability to serve clients in the jurisdiction of the product is still a competitive advantage. A revolution in this area is therefore not foreseen in the short-term.

One other question is whether the number of players will remain stable locally, although findings indicate that it will most certainly decrease. This is not because institutions will necessarily leave Luxembourg or because the local market is less attractive, but mainly because of mergers taking place outside Luxembourg. Custody is an activity under intense consolidation, with acquisitions taking place in all countries both in and outside Europe. Europe is still seen as the key market for growth in the coming year in this area. Luxembourg products are being distributed in more and more countries as new markets open up in Eastern Europe, Latin America and Asia.

These new trends may require asset managers to further diversify the assets they invest in, as they may want to offer products that better suit such new markets in terms of investment policy. This will create new challenges in terms of access and ability to be the depositary of those assets. In addition, this will require more sophisticated sub-custodian networks knowledgeable about those new local markets, including their regulatory and tax constraints. Luxembourg's growth potential is still huge and the ability to serve clients through efficient and cost effective automated platforms including value-added services such as distribution support and capacity, will be a key differentiator.

In considering the future model of custody services, the tax aspect is also an important element. The VAT landscape in financial services is changing and could have a considerable impact on current trends. The recent Case Abbey National of May 4, 2006 (Abbey National, May 4, 2006, C-169/04 in reference to the 1977 VAT Directive (77/388/CEE)) declares that trustee and safekeeping services could no longer be considered as exempt management services of investment funds. These services should thus be considered as subject to VAT. The practical implication of this Case is discussed within the dedicated Alfi VAT Working group in order to prepare a discussion with the VAT Administration. Activities in the custody business chain will be revisited in the short-term. Moreover, the current project by the European Commission to review the VAT regime in financial services could strongly impact the current VAT structure vis-à-vis cross-country centralisation projects. There will definitely be new challenges to overcome but also new opportunities to develop.

Luxembourg has a certain number of strengths like its acknowledged pragmatic and efficient legal and tax approach, its foreign language resources, and its quality image for investment funds, especially its ability to distribute products globally. However, we need to pay attention to the scarcity and cost of resources. The custody business is an area where the level of automation can be very high, where the off shoring possibilities are significant and where the margins are very low. The Luxembourg investment management industry needs to rethink the custody business that will be performed out of Luxembourg especially when it comes to competing to keep necessarily low value-added parts of it at all costs. Banking entities with a potential for growth in this market should focus their efforts on enhancing the quality of services around this activity rather than proposing standardised services such as settlement or clearing, which are already strongly centralised and automated. Let us ensure that the adopted business models concentrate on value-added services and on their ability to position Luxembourg as a centre of excellence in this area.

2.3 Three key challenges for the future

Growing and positioning within the group means acting on quality, innovation and people.

In this section, we will further analyse the three main enablers that allow banks to benefit from market opportunities, that is, quality of services, innovation and people. We will look at the way they interrelate within the organisation and their direct impact on local and global business.

We will discuss how increasingly demanding clients and tougher competition are raising the importance of quality of services in the banking sector. As survey results demonstrate, 94% of participants consider it as a major market challenge.

Similarly, innovation cannot be conceived in narrow terms. Innovation is not only about developing new products and services, but also about creating new ways of marketing, organising, and distributing products and services. The banks that have achieved the highest growth are the ones that have been prepared to think and act differently.

Finally, growing through quality and innovation will largely depend on the people within the organisation. Success will rely on the ability to improve the skills of the staff who interact with clients, enhance management capabilities and create an attractive environment.

2.3.1 Quality of client service: the best guarantee for future growth

“Investment performance is not the overriding factor in the minds of investors when they select a bank. Service quality, product offering and cost minimisation are equally important.”

Participant's quotation

According to this quotation, Luxembourg banks recognise the need to provide high quality service so that clients will not turn around and go to a “low-cost provider”. This is particularly the case in mature markets like Luxembourg where clients may believe that the quality of service delivered can still be improved.

Survey respondents admit that their capacity to service clients as well as their sales and marketing skills will be among the most important elements in delivering future growth. This is especially the case as they see competitors increasing client satisfaction through better understanding of their needs and careful segmentation.

Those who are the “best in class” and regarded as a benchmark, make the client feel unique and special. They succeed in building a real tailored value offering and are reachable and responsive to simplify their client's life. This involves working around the key processes that enable better knowledge of the client base. This also means faster innovation in product and service development to manage the client's expectations and perceptions, facilitation of prompt service delivery or quick reaction to market changes, and finally, clear actions to swiftly solve the client's problems.

Responding quickly to clients' opportunities and feedback is key to sustaining quality. The "best in class" are increasingly using the clients' perspective to identify the areas where performance can be improved thereby making the greatest difference to the client's experience. For example, by simplifying the ways in which an account can be opened, a bank has succeeded in attracting more clients; or by reviewing internal procedures, a bank has reduced the time it takes to market "value propositions" by half, enabling clients to better manage their wealth.

Although a universal approach that fits all financial institutions does not exist, quality definition and implementation has to respond to three key drivers:

- The ability to inspire trust and confidence
- The ability to perform the promised service dependably and accurately
- The willingness to help clients and provide prompt service

Although considered a priority, many financial institutions fail to create a cultural climate and business approach conducive to superior quality service. Why? Maybe because they have not yet satisfactorily answered the question "Do we know our clients?".

This explains why the most advanced banks constantly collect and retrieve data to better understand their clients' habits, build tailor-made products and services, and facilitate sales support. This is all done in order to get closer to their client's needs. Banking is no longer a question of adding small boutiques but rather of creating a culture of personalised quality service delivery at affordable cost.

2.3.2 Product and service innovation: moving from a reactive approach to a centre of excellence

Survey results show that as many as 83% of participants consider product and service development as an important market challenge. Innovation adds value to the group and allows the Luxembourg entity to strengthen its positioning within the group. To some extent, innovation contributes to the appropriation of European responsibilities, first in a role of project manager and then as a business leader once the new product or service is on the market.

Research and innovation is not only a strategic tool at company level but also at country level. It is worth remembering that twenty years ago, further to the rapid transposition of the first UCITS directive and coupled with multi-compartment innovation, the first international funds in Luxembourg were launched. Today, this industry represents several thousand jobs.

What is the research and innovation status of the Luxembourg financial market?

Everyone agrees that financial related research and innovation activities are undersized in Luxembourg when compared to the importance of the financial marketplace in the country's economy. The absence of such research projects in the latest Foresight exercise conducted by the Fonds National de la Recherche (National Research Fund), was clear evidence of this deficiency. There are two reasons explaining this:

- Firstly, local banks, subsidiaries of foreign groups, law firms as well as consulting and accounting firms via representative bodies are strong contributors to the development of the regulatory and tax environment in a six to twenty-four month perspective. This commitment was illustrated by the recent transposition of critical EU directives for Luxembourg and by the implementation of new laws such as Special funds and UCITS III directives. However, due to the shortage of available research and innovation resources, and due to their limited size, these local firms are unable to identify or lead medium-term research projects on their own.
- Secondly, consolidated around the university, research activities in areas such as economy, finance, and law are now emerging as a complementary but necessary tool for the development of the financial market. Today, research teams, which are well financed but not yet fully staffed, are responsible for selecting the research project offering the greatest economic potential for market players in a twenty-four to forty-eight month perspective.

At this stage, the main concern and the crucial risk is the absence of dialogue between the university, administrations, representative bodies and market players. This problem does not concern the budget or the competencies available; but is instead a problem of dialogue and priority setting.

Academics frequently select research projects that are of greatest interest for themselves and their fellows. However, it is the economic potential of these projects that should be the top selection criteria. For budget reasons as well as for the sustainability of Luxembourg's financial market competitiveness, it is inconceivable to afford research projects according to personal interests with low economic visibility. Thus, research success must be measured not only in terms of number of printed publications, but also in number of jobs created or maintained.

Five key measures to remain on the edge in the investment product structuring business

The aim of the following measures is to facilitate the development of Luxembourg as a centre of excellence and research in investment and wealth management in order to support the growth of local business entities. These proposed measures evolved after several dialogues with Luxembourg's financial market players and stakeholders and express our own opinions and visions regarding innovation in investment management activities.

Measure 1: Setting up a dialogue platform with the university, administrations and market players

A dialogue platform, which may be composed of volunteers who dedicate some time to the analysis of each topic's potential, should be established with the aim of advising the university on the most promising research topics.

Measure 2: Agreeing on three research projects with potential value creation

When research activities are emerging, it is critical in terms of market credibility to demonstrate the strong links between the university and the marketplace. Below we propose some investment and wealth management research ideas with economic value.

- **Investment management**
 - What is the three-year concept of an international UCITS? What is its best corporate and tax structure? What is the future fee structure in a framework of an international distribution?
 - How can UCITS distribution-related services be optimised in order to provide tailor-made solutions and achieve economies of scale?
 - What is the best regulatory and tax environment for UCITS cross-border mergers?
- **Wealth management**
 - What is the best regulatory and tax environment to serve international entrepreneurs?
 - Quality of client service: what are the future tools to improve client servicing in an international context embraced by complex products?

The contributions of private companies should be considered as key criteria for a research project to be financed by public bodies. This private-public collaboration is a way of ensuring future economic value.

Measure 3: Promoting a concept for Private Public Research Project ("PPRP")

Local financial institutions should be able to outsource some research projects to the university under confidentiality, intellectual property and financial subsidies conditions. A clear PPRP concept would urge the promoters of financial institutions to launch new projects and ask for assistance.

Measure 4: Market watching on key jurisdictions

A structured and systematic European tax and regulatory market watch focusing on selected priorities should be implemented in order to monitor the competition of foreign countries and to leverage on new ideas. The market watch results would be delivered to the authorities, research teams and market players.

Measure 5: Promoting research outcomes to market players

Effectively promoting and communicating research outcomes is essential for gaining adequate support from stakeholders to transform research results into real economic activity. Before being implemented into a legal and economic framework, research outcomes would require additional study, and a clear and valuable communication campaign to facilitate the market process.

2.3.3 Human resources: exploring all ways of meeting the recruitment and retention challenge

Finding and keeping the right resources in the financial sector both when it comes to quantity and quality is indeed difficult today. Nearly all banks agree on this. Our observations of the Luxembourg market across industries indicate that major players in other sectors like high technology have come to the same conclusion. This is not really surprising, as several factors explain the current situation. In the following paragraphs, we explore some of them and briefly describe some of the actions we believe should be initiated to attract and retain talent in Luxembourg.

From our observations and market knowledge, we note that:

■ Past HR strategies were too focused on the short-term

In the context of the economic downturn between 2000 and 2002, very few banks were actively recruiting. It was difficult to anticipate how long the post-Internet bubble crisis would last, but was it impossible? Companies that continued recruiting at that time have less of a problem today in finding people with two to three years experience, they have them in-house.

- **Current recruitment strategies are no longer adapted to market needs**

When looking at how most banks recruit in Luxembourg, we notice the following:

- **Firstly, the geographic origin of recruits.** Today, most of the recruitment efforts are still focusing on Luxembourg and its immediate neighbouring countries, France, Belgium and Germany. Given that these employment markets are drying out, we believe banks should look beyond classical recruitment markets.
- **Secondly, the profile of junior recruits.** The recruitment strategies in Luxembourg focus on finding a maximum match between education and required competences even for junior profiles. In addition, given the high number of highly educated candidates that used to apply for jobs in Luxembourg, there was a tendency in the financial sector to recruit over-qualified people causing motivational issues after two to three years.
- **The “war for talent” started once again causing dangerous collateral damages**

The negative collateral damage of this “war for talent” that we are currently observing is an unfounded increase in salaries due to the fact that each bank is recruiting from its neighbours and competitors in the local market, and offering higher salaries to attract candidates. This is certainly not the best way of preparing for the future.

- **Not enough effort is put into retention**

Retaining current employees is another issue. In Luxembourg, training and development budget levels are below international market practices, most remuneration and reward systems are outdated and tend to still reward length of service instead of contribution to company performance.

- **Luxembourg is not sufficiently attractive for international financial careers**

Attracting business to Luxembourg seems to work. If business continues to flow in actions must be taken to increase the number of resources to deal with this growth. Despite its numerous advantages, Luxembourg is not known by young graduates as a place to find a job and is still not perceived as a major financial centre in which financial experts can pursue challenging and interesting careers.

We propose the following routes for meeting the recruitment and retention challenge that the Luxembourg banking sector is currently facing:

- **Promoting Luxembourg at sector level**

Working on the promotion and attractiveness of Luxembourg as a place of choice for international financial careers should result from a joint effort by all banks with the Luxembourg Government's support, which has recently announced the allocation of a significant budget to promote the financial and industrial centre.

Two key questions must be raised and answered quickly: What will the primary objective of this budget be? Attracting new business or attracting new resources? As the CEO of a large bank has mentioned "Growth is there to stay, we need people to support it".

If we agree on the recruitment objective, the following step would be on one hand to develop on-side innovative promotion strategies to raise people's interest (e.g. marketing clips disseminated through the web), and on the other, a new web platform hosted on the official Luxembourg site to inform on all jobs available in the marketplace. Liechtenstein is currently using a marketing buzz to attract high revenues to the country.

- **Recruiting differently**

Eastern European countries could be envisaged as new sources for recruitment, and some banks are currently recruiting there. But interestingly, as these new economies develop, other financial centres have experienced massive "home returns". Other areas in Europe where unemployment rates are high and the educational systems provide a solid grounding, should be further investigated. Following what some other European countries have already done, the Luxembourg Government has announced that the conditions and process for obtaining work permits for nationals from "new" Member States will be easier. The financial sector would undoubtedly welcome the same being done for non-European nationals.

We also believe that for a number of profiles, the financial sector should consider the Anglo-Saxon approach, which consists of highly investing in deep pragmatic training and development programmes to allow integration of more diversified candidate profiles to meet specific staffing needs. Diversification of candidates' profiles is only possible if combined with an adapted and pragmatic training and development approach. This is an element which is not sufficiently developed in Luxembourg.

- **Creating a Luxembourg expatriate profile**

One of the barriers to attract in highly specialised profiles in Luxembourg which in turn would allow for the development of new products or activities, is the absence of a clear expatriate profile. In other financial centres such as London, Dublin, Paris, Brussels and Amsterdam to name just a few, expatriates may benefit from advantageous tax treatment. This is undoubtedly an advantage for attracting high profiles in group mobility processes. Creating a Luxembourg expatriate profile would also contribute to further developing local entities as centres of excellence through the reinforcement of their strategic positioning within the group. It would also contribute to the future development of the Luxembourg market as a whole. The Government should definitively further analyse such specific regime.

- **Truly rewarding performance**

One of the key motivational factors is making people understand how they contribute to the success of their company and how well they are recognised for it. We are convinced that banks, instead of increasing base salaries as is done today, should dedicate the same amount in variable pay systems in order to attract, motivate and retain high performing profiles. Obviously, the underlying condition to this statement is to have truly efficient performance management and reward systems in place already.

- **Do not forget about current employees**

The cost of one employee leaving the company is estimated at 1.5 times their annual salary. This is a lot of money considering the current turnover figures in the banking sector. We believe banks should seriously rethink some of their retention mechanisms such as encouraging internal mobility, development and training programmes, communication, career and succession planning, etc. These fundamentals of HR management are often put aside causing motivational issues.

As we can see there are still many things to be done. The Luxembourg financial sector is facing an important HR challenge but we are convinced that a number of routes can be explored provided that the market is ready and willing to go beyond traditional approaches.

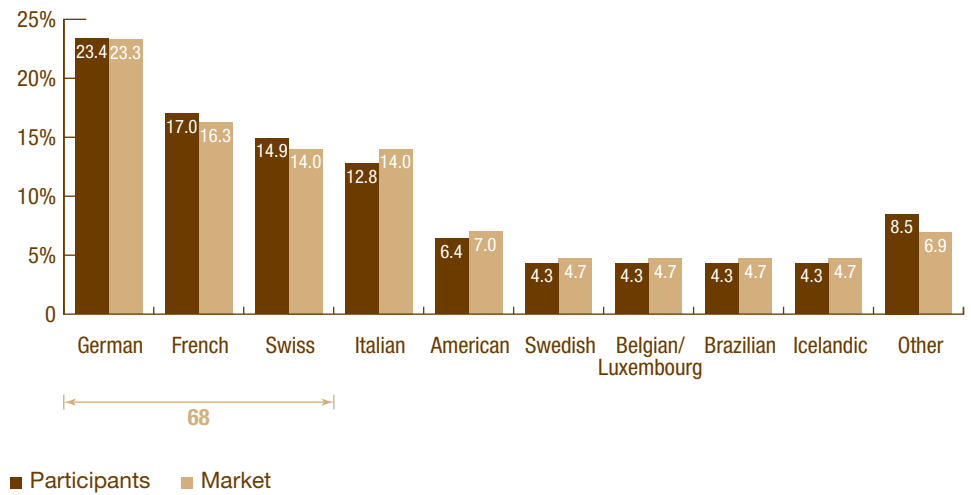
03 Appendix: Profile of participants

The survey sample, composed of 48 banking entities, is representative of the Luxembourg banking sector in terms of size, activity, and nationality. The diversity of this sample has allowed us to obtain an overview of the main issues faced by this sector today.

3.1 Geographic origin of participants

The breakdown of survey participants by geographic origin is very similar to that of the banks currently found in the Luxembourg financial market¹⁰. German, French, Swiss, and Italian banks share 68% of the survey sample between them.

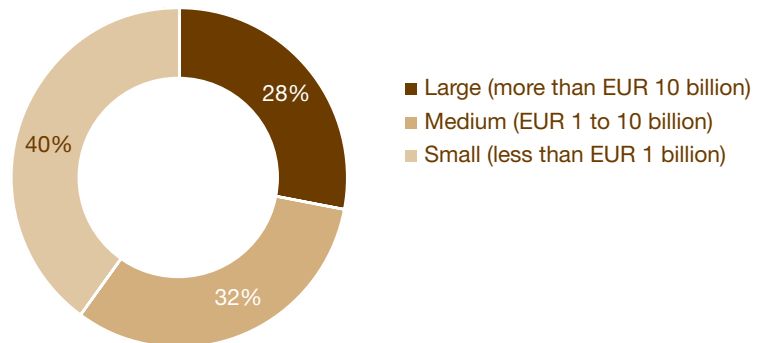
Participants' geographic origin



3.2 Size of participants in terms of amount of assets

When segmenting banks according to their share of total assets, small-sized entities represent 40% of the total number of participants (with less than EUR 1 billion), medium-sized entities represent 32% (with between EUR 1 and EUR 10 billion), and large-sized entities represent 28% (with over EUR 10 billion).

Size of participants by amount of assets



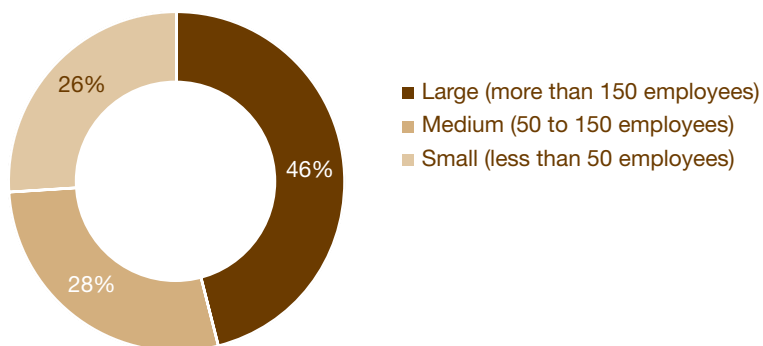
¹⁰ Source: CSSF, March 2006

3.3 Size of participants by number of employees

A total of 46% of participants have over 150 employees and these have been classified as large-sized banks. At this group level, there is an important concentration of banks due to more labour intensive activities such as custody and fund administration.

Around 28% of participants are medium-sized banks in terms of staff, with between 50 and 150 employees and 26% are small-sized, with less than 50 employees.

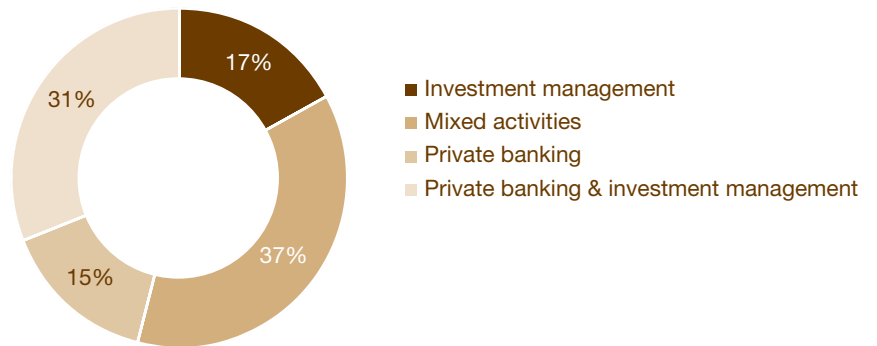
Size of participants by number of employees



3.4 Type of banking entities and activities

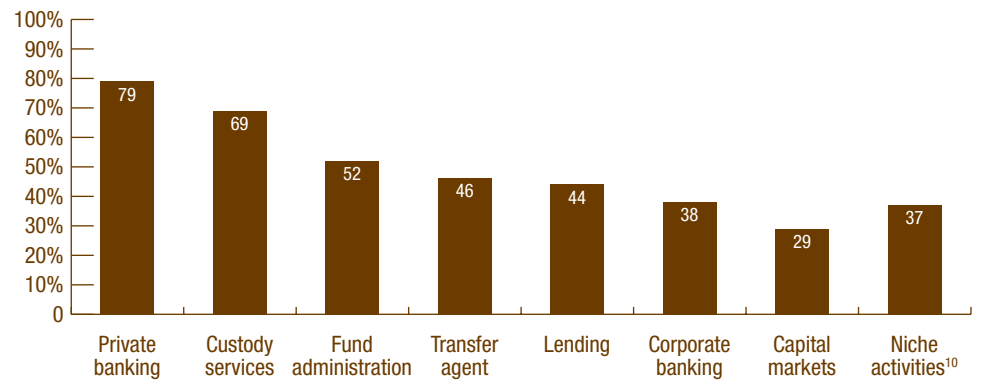
Banks have been classified according to their focus in private banking, investment management or in a broader scope of services. Participants with investment management or private banking as a single activity represent 17% and 15% of the sample respectively. Banks offering both private banking and investment management services under a single entity represent 31% of the sample. Banks with a broader scope of activities represent the largest segment with 37% of the sample.

Core activities of participants



The most common activities of participants are private banking (79%) and custody services (69%). About half of participants have an activity in fund administration, transfer agent services, or lending.

Participants' activities



¹¹ Niche activities include asset management, other security services, distribution, treasury services, precious metals, IT centralisation.

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