INTEGRATION AND COMPETITIVENESS OF THE EU FUND MARKET

1. Competitiveness issues in the EU asset management sector

1.1. Balancing competitiveness objectives and investor needs

A public representative considered that there remain challenges ahead to integrating the European fund markets and ensuring that the European fund industry is sufficiently competitive. Market statistics show that there are many more funds being offered and sold in Europe than in the US, and they are also smaller and hence more expensive. The market is still rather fragmented; 70% of all assets under management are held by investment funds registered for sale only in their domestic market, and only 37% of UCITS and 3% of the alternative investment funds (AIFs) are registered for sale in more than three member states. It is therefore still largely a domestic business. Further progress is needed to achieve a single market for funds, which would support improved capital allocation and also better risk allocation within the EU. In the US about 75% of shocks are absorbed by private risk-sharing due to more integrated capital markets, whereas that proportion in Europe is only 20%. The efficiency of the underlying cross-border securities trading and post-trading processes also needs improving. Cross-border post-trade order execution costs are 10 times higher in Europe than in the US, which also increases the costs of the EU fund business.

An industry representative considered that the EU fund industry has many positive features. UCITS provides a strong framework for asset management activities and is a successful brand both in the EU and other regions. The diversity in the number of asset managers and funds in Europe shows the dynamism of the industry and also provides investors with choice. Another industry speaker agreed that the positive features of funds and the benefits they provide investors with must not be forgotten in this discussion. They indeed allow savers to pool their assets and prepare financial needs for the future, and provide retail and professional customers with investor rights.

In addition the statistics showing a high number of funds in Europe are somewhat biased, the first industry speaker felt. There are indeed many funds that are managed either for one institutional investor or high net worth individual who wants to have a more specific or tailored fund (e.g. separate account funds) or for a limited number of institutional investors such as so-called special funds in Germany. In France, there are also many employee investment schemes usually dedicated to a given company that use fund vehicles. One potential issue is that Europe does not have many flagship funds. There is probably room for some mergers. Economies of scale can also be made using pooling systems which may help to have parallel management for different funds that have comparable investment strategies, but it is important not to create barriers to entry to the industry in doing so.

A regulator agreed that although the size of funds is a factor of competitiveness, it is also important to maintain diversity and that includes having both active and passive funds. That is important for competition and investor choice but also for financial stability reasons. According to prudential regulators, if funds are all tracking the same indices or investing in the same products there can be herd behaviour, which could facilitate the propagation of some risks.

1.2. Potential implications of Brexit for the EU fund sector

An industry representative considered that much will hinge upon the future arrangements between the UK and the EU, but if the UK is no longer in the single market there will no longer be the possibility for UK funds to passport into the EU or vice versa. Equivalence determinations will be a major issue going forward for both EU and UK regulators, particularly in the event of a hard Brexit where any divergence between jurisdictions is likely to raise the bar of competition between the UK and the EU. A hard Brexit is most concerning, as after any transition period or temporary authorisation mechanisms, EU-domiciled funds will have a significant advantage in obtaining regulatory approvals in a timely manner, as well as marketing to EU investors and also in respect of cost of regulatory compliance compared to UK-domiciled funds looking to gain access to EU investors. UK-domiciled funds marketing to UK investors would have similar advantages compared to EU-domiciled funds looking to gain access to the UK.

These relative advantages however, come at a cost and a risk to all investors, whether in the EU or the UK, and who today, thanks to the passport system, benefit from a wide range of investment products and strategies managed by the best in class managers in any jurisdiction. Those benefits will inevitably be reduced as a result of increased regulatory burdens from having to deal with multiple regimes. It remains critical that regulators in the EU and the UK work together to ensure that the best possible products are available to all investors. For that to happen, and to prevent more fragmentation after any transitional Brexit arrangements are over, it will be essential for the delegation model of portfolio management to be maintained. It should not matter whether substance is provided in the EU, the UK or anywhere else, so long as it is easily accessible for proper supervision. If the current business model changes following a hard Brexit, there will be no winners but extra costs and worse performance for end-investors.

Another industry representative agreed that Brexit will have negative short-term implications because with it, the single market is being rolled back and the UK is a key player in the market. However, business will adapt. It will be more costly to have a split of liquidity pools and operations built on both sides of the Channel, but investment firms are putting the necessary arrangements in place. For asset managers, the challenge ahead with Brexit is being able to continue providing investors with access to the best portfolio management talent in every circumstance, wherever they are. There has to be flexibility but also a proper framework in place for supervisory cooperation for that to be possible, while answering the understandable concerns of EU regulators.

2. Addressing fragmentation issues in the EU fund sector

2.1. Inconsistency of fund rules across regulations and EU jurisdictions

A regulator explained that although much has already been done to improve and harmonise the EU regulatory fund framework. There could still be simplification. Rules applying to management companies and funds - UCITS, AIFMD and more targeted fund rules - differ to a certain extent, which has an impact on management costs and also makes the comparison between different types of investment vehicles more difficult for investors. As an asset manager always manages various types of funds, more consistent regulation across fund categories may be worth considering in order to simplify internal control, risk management, etc. An official noted that there are good reasons why rules applying to management companies and funds differ across regulations.

An industry representative agreed that there are negative impacts on the fund sector from the current differences across regulations. In addition to the UCITS and AIFMD directives, broader capital market legislations apply to investment funds in the EU: i.e. EMIR for derivatives, MiFID for distribution and SFTR for repo and securities lending, amongst others.

A first problem is that despite this high level of regulation there are still discussions, as part of shadow banking assessments, about whether regulation of asset management is sufficient. But in addition to this, a major issue is that these rules are not completely aligned. Remuneration and reporting obligations are not totally convergent. With reporting, once the setup is made the preference is to maintain it instead of changing, but if there is a change then it should move towards convergence. IT processes are heavy to change and it is important to have stability in this field.

Different member states also interpret the same rules differently. For example, leverage under AIFMD is not computed in exactly the same manner in all EU countries. That should be addressed as part of the review of AIFMD. There should be a clear view on leverage calculation, which should be consistent between AIFMD and UCITS and also with the upcoming IOSCO principles. The industry indeed wishes IOSCO to take stock of the strong experience the EU has on the topic, especially with UCITS, notably taking hedging into consideration.

Another industry representative concurred that some details still need adjusting despite all the iterations of UCITS and AIFMD. The truth however is that the present framework works reasonably well at the EU and international levels and has helped Europe to acquire a leading role in this sector. Fundamental reviews of UCITS, AIFMD and other rules impacting the fund industry are not needed. There are always issues, but supervisory convergence in the context of ESMA can deal with most of them, the speaker believed.

2.2. Cross-border distribution issues within the EU

A public representative mentioned that a legislative proposal was recently passed that should help to facilitate the cross-border distribution of funds in the EU and wondered whether, beyond the marketing obstacles addressed by this legislative text, European citizens are also hesitant to invest in non-domestic funds. A regulator agreed that cross-border distribution barriers are an important issue as they create fragmentation in the fund sector. The new legislation should facilitate cross-border marketing to a larger extent, with less cost for asset managers. Answering the question of the previous speaker, the regulator did not believe there is a strong domestic bias in fund investment, however, the way fund distribution channels are organised plays a role in this. Banks favour the distribution of products linked to their group, which is a problem both at the domestic and cross-border level because it reduces choice for investors and also increases domestic bias.

A regulator was positive about the current developments in the EU fund regulatory framework. New rules have just been implemented and need to be tested. The passport is a reality in Europe. Other regions envy the European UCITS framework; elsewhere e.g. in Asia memoranda of understanding are the main tools for exchange of information between supervisors. However, some issues need further assessment. In Belgium, multiple types of funds are distributed through different distribution channels and the number of foreign EU funds offered to Belgian retail investors has more than doubled since the financial crisis. For every Belgian fund, five foreign EU funds are now being offered to the public. However when looking at volumes invested, the proportion between Belgian and foreign EU funds is more the opposite. That is not due to domestic barriers, because the rules are fully in line with all ESMA requirements, or to taxation, since the same rules apply. It may be due to the way in which the freedom to provide services works across the EU, because administrative notification of EU funds on a cross-border basis is very easily done by email. The result is that many funds are potentially available in each country but only few of them are actively marketed.

An industry representative hoped that the costs associated with cross-border fund distribution can be addressed in the future with the new package recently adopted. A regulator noted that new digital and fintech technologies could also help to improve distribution and reduce fund management costs. New platforms based on these technologies could allow asset managers to issue funds, reach investors directly and also maintain a record of transactions, thus cutting costs.

3. Improving investor education and protection

3.1. Investor education

A regulator noted that there are differences in terms of retail investor education and financial literacy that contribute to explain the difference in size of market-based finance in Europe vis-à-vis the US. This is important to consider at a moment when the EU and domestic authorities are pushing to develop capital markets in the EU with investment funds playing a significant role in this objective. When investors lose money on their investments, part of the problem can come from mis-selling but another cause is usually insufficient investor education. Some investors believe that investing in capital markets should always bring gains and others do not understand all the implications of the products they buy.

An industry representative considered that when comparing the EU and the US key differences are the importance of defined-contribution 401K pension plans and the equity culture that they have helped to develop. That culture cannot be easily created in Europe merely with additional regulation and CMU. It is nevertheless a positive objective, and progress can be achieved, but this issue does not come under EU competence. Action is needed at member state level to improve pension regimes and to get people to save more. The key issue is getting people to understand that they have to increase long-term savings and put money in equity finance for their futures. Education plays an important role in this, but it is mainly a member state responsibility.

3.2. Investor protection

An industry representative considered that where the EU can play a role regarding retail investors is in the improvement of investor protection and investor disclosures, which would help to further develop the EU fund sector. Asset management is a long-term business and trust is needed. The desire is to engage investors for a long time and encourage them to invest for their future needs. Investors should, however, not be over-protected. The worst protection is when people do not make any changes because they think it is too risky to do so or if they are put off making investments in the first place.

A major problem with EU regulation, perceived by investors, is that it is silo-based. There are many different regulations applying to investment products that investors might consider relatively similar i.e. UCITS, AIFMD, MiFID and IDD. Consumers do not care about the legal form of products and many do not understand the difference between a fund and life insurance. They want to buy a certain product with a certain risk profile at a certain cost, and to understand those basic elements. The regulation should make sure that these disclosures are clearer for investors and more aligned across different products. That was the objective of PRIIPS, which is a great initiative encouraged by the fund industry and aiming to provide customers with the necessary information for them to be able to understand and compare the costs, risks and objectives of different investment products. Unfortunately it was a collective failure in the end. There must be another attempt, and it is good that the Commission has mandated a review of the delegated acts of PRIIPS. The EU has to get investor disclosures right so that they are encouraged to save. Some parts of MiFID II also need considering because it creates a great deal of red tape and administrative burdens, with pages of documents where people have to tick boxes. People are being scared away from investment.

Improving disclosures and distribution rules is the role of the EU, whereas member states need to fix the appropriate level of taxation, improve investor education and improve their pension systems. In that respect, PEPP is a great idea, but many member states have indicated that they will not provide the same tax advantage as for domestic products, which is a concern.

A regulator agreed that ensuring a level playing field across different types of investment products is essential and that it is difficult to achieve with different product and distribution frameworks. What is needed is a common and comprehensive approach covering products that most retail investors consider similar in terms of investment features, such as UCITS, many life insurance products and some structured products. Confidence is linked to quality and clarity of information, as well as the possibility to buy and invest in simple products. However the distribution, marketing, tax rules and information provided are all different across these different product categories. The ban of excessively complex products for retail customers could also be considered at the EU level. There has been a successful experience in Belgium with regard to complex structured products (a voluntary standstill on the distribution of particularly complex structured products).

An industry representative stressed that cost disclosure rules need to be improved so that investors can understand exactly what is covered and compare costs. The way that transaction costs are defined under PRIIPS is problematic in particular. Transaction costs[1] are part of the costs that funds need to disclose. They include explicit costs, which are the costs of trading underlying investments in a fund (i.e. broker commissions, research costs, taxes and exchange fees, securities lending costs) and also implicit costs, which are calculated as the difference between the price at which an asset is valued immediately before an order (the arrival price) and the price at which it is actually traded, therefore taking into account different factors including market impact[2]. Implicit costs[3] however are typically something that is already dealt with under the MiFID II best execution obligation and it is therefore surprising to see it as part of the transaction cost that needs to be disclosed under PRIIPs. It is hoped that this can be changed with the review of the delegated acts. The best way to tackle this would be to withdraw the market impact element and put that in the best execution analysis. Otherwise this will make calculations very complicated for a very limited effect since it is a question of basis points, which is not very significant in the total cost for investors. In addition, transaction costs are not meaningful by themselves if not linked to the turnover and the performance of the fund. Frequent transactions and arbitrage are necessary to obtain sufficient performance in an actively managed fund, which is less the case for funds pursuing a buy and hold or a passive strategy.

Distribution costs also depend too much at present on the way distribution channels are organised, the industry speaker felt. For example, so-called inducements are part of the distribution cost for integrated distribution networks, but they are not in other cases.

A policy-maker accepted that some aspects of EU legislation applying to funds need to be reconsidered, and PRIIPS is the main issue. Retail investment is a priority for the capital markets union agenda. There were the best of intentions with PRIIPS, but following the legislative process and different consultations the proposal did not end up exactly in the right place. It aimed to provide more transparency, more disclosures and clear, short factsheets in order to break the silos between products and create some comparability. Some parts of it, such as the KIDs (key information document), are considered to be useful, but changes can be considered. Some tweaks are already being made in the PRIIPS delegated acts but a more thorough review will be needed in the next few years, taking into account all of the issues raised. The exemption from UCITS has been extended so that when they come under the PRIIPS framework they can already use the adjusted rules after the update of the delegated act.

Moving towards a more comprehensive framework is a direction being envisaged by the Commission, looking at how MiFID, PRIIPS, IDD and other regulations interact and overlap. The question is how to put in place a more sensible and simpler framework for retail investors. AIFMD will also be looked at with care. A study by KPMG was commissioned, so there is some preliminary information on what is and is not working. Overall, the result is that AIFMD has created a harmonised market, though there are minor differences depending on the transposition and the extent to which national law applies. For instance, half of the survey participants said that there are differences in the way the rules are applied but asked for there to not be changes because those differences are small enough to handle. The market will be consulted when it comes to the review.

1. Transactions costs are defined as the total of explicit and implicit costs minus any swing pricing that may occur. Swing pricing is a mechanism used to protect long-term investors in a fund from having the value of their investment eroded by the costs involved in managing short-term fund inflows and outflows – especially during times of extreme market volatility. If a fund experiences unusually high inflows or outflows, the buying or selling price will be systematically adjusted up or down to absorb the impact of higher-than-usual transaction costs.

2. A difference between the price at which an order to trade is given and the price at which it is executed can result from a number of reasons including: (i) Trade impact: Instructing a large trade can have the effect of moving the security's price up (if buying) or down (if selling). Managing this impact is a key skill for asset managers and their trading desks. (ii) Opportunity cost - Sometimes it is not possible to execute a large trade in one go. Executing a trade in stages can create gains or losses depending on how the market price of the security moves. (iii) Delay impact - If a transaction is delayed, for whatever reason – even by a minute or so – market movements in the meantime can contribute to the arrival cost. Powerful trading systems that minimise latency (the delay between a trading request and response) are vital.

3. Implicit costs can be positive or negative and vary depending on the liquidity of the financial instrument.