Challenges and priorities of the EU fund sector

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Asset management regulation challenged by climate change and digital developments

Asset management in the EU is embedded in robust regulatory frameworks, including the UCITS Directive and AIFMD, to the benefit of the market operators and the investors. The success of the UCITS label is recognized both in the EU and abroad. Broadly spoken, AIFMD has worked well. Therefore, at this moment, there does not seem to be a need to launch a thorough AIFMD review, even if in some areas are welcome (e.g. in the area of segregation duties in case of delegation of the safekeeping of assets by the depositary). It is in the interest of the EU to have a stable framework for funds, while at the same time be responsive to new challenges, and this against the background of a prolonged low rate environment and of the corona crisis.

Firstly, asset management has a role to play in the European ambitions to achieve sustainable finance and, ultimately, the ambitious EU climate goals. In this respect, the EU should take a leading role, but should engage as well at a global level to contribute to the adoption of standards and practices that are internationally adoptable. Mobilizing sufficient private investment will not be possible without efficient capital markets and an important role for asset management. In this respect, enhanced transparency of sustainable features of financial products allows investors to identify viable sustainable investments. However, this evolution can give rise to investor protection concerns and can lead to greenwashing, especially given the risk of confusion about existing terminologies. Adequate disclosure and a harmonized taxonomy should address the risk that investors end up buying products, which are marketed as sustainable when in reality they are not.

Asset management also has to keep pace with digital developments in finance. Among the relevant developments are online digital services, robo advice, artificial intelligence and machine learning, each of which entail risks, benefits and opportunities. Regulators' strategy in relation to technological developments can be summed up by three actions: facilitate, monitor and supervise. Innovation hubs are possible channels to facilitate the contacts at an early stage between Fintech players and supervisory authorities and allow for better monitoring of the innovations. Supervision should ensure that innovation happens smoothly, so not to endanger consumer protection, fair and efficient markets or financial stability.

The increasing volume of the assets under management has finally led to a greater focus on asset management from a financial stability perspective. The FSB has issued recommendations intended to address financial stability risks from structural vulnerabilities associated with asset management activities that could materialize in the future. IOSCO has operationalized these recommendations concerning possible liquidity mismatches and fund leverage. Both aspects merit close attention at EU level. Although existing tools in the EU already address many of the macroprudential concerns, it is recommended that the relevant authorities review their existing regimes and consider making adjustments as appropriate to ensure potential financial stability risks are addressed in a forward-looking and internationally consistent manner. ●

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Key supervisory priorities for asset management

2020 key supervisory priorities include:

- Liquidity risks of investment funds, with a focus on UCITS;
- Cost and performance of funds, e.g. performance fees, closet index trackers;
- Data quality, availability and usage in relation to AIFMD, SFTR, EMIR;
- Review of AIFMD and related impact on UCITS;
- Sustainable finance and ESG;
- Anti-Money Laundering and Counter Terrorist Financing.

This article focuses on two of these key priorities: liquidity risk management and cost and performance of investment funds, which both are essential to maintain the highest degree of investor protection.

1) Recent isolated issues concerning liquidity risk as well as the strong growth of total net assets in funds have raised concerns with securities regulators. Hence, a closer look at the liquidity position of UCITS and AIF by investment fund managers and their supervisors is warranted. Having said that, we believe that the currently existing regulatory framework, which is based on international and European rules, overall provides for a solid basis to address liquidity risks in investment funds. Therefore, the primary focus for investment fund managers ▶

should be on adhering to those rules. Compliance with the rules is key to ensure financial stability, investor protection and the orderly functioning of financial markets.

With this objective, ESMA, together with National Control Authorities, has recently launched the Common Supervisory Action (CSA) on liquidity risk management. The CSA is a two-stage process starting with a data-driven screening on a large set of asset managers followed by a risk based, in-depth analysis on a smaller sample of managers, whose objective is notably to verify adherence to liquidity rules, to assess the existence of potential vulnerabilities and possibly suggest future improvements.

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2) Work in relation to costs and performance of investment funds is being performed at various levels:

- ESMA will soon publish its second annual report on costs and performances of retail investment products (including investment funds), produced under the EU Commission's Capital Markets Union Action Plan and aiming at facilitating increased participation by retail investors in capital markets by providing consistent EU-wide information.
- EU work in 2020 will also encompass the implementation of the forthcoming ESMA Guidelines on Performance Fees in UCITS and retail AIFs, which notably apply to actively managed UCITS.
- Work will continue on so-called "closet index trackers" which, according to their official documentation, claim to be managed in an active manner while in fact staying very close to a benchmark and, by doing so, overcharging for their investment management services. ESMA published a related statement in 2016 and at national level, and closet tracking remains a key issue for the CSSF in 2020. Following the initial investigations in 2016 / 2017, the CSSF thereafter continued work with a particular focus on enlarging the scope of the investigations.
- Finally, we monitor that, from a legal and regulatory perspective, the investment fund regimes remain stable and verify the conditions under which the respective product and management passports, which have contributed to the investment fund success story, continue to function effectively.

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ESMA's priorities for asset management in a changing world

There is no shortage of exogenous stress factors for the asset management sector currently, from the COVID-19 pandemic and its economic fall-out, the prolonged low-interest rate environment to the shift of money associated with the emphasis on sustainable finance. In addition, the asset management sector is facing evolving customer preferences, pressure on fees, and the growth of the passive asset management business model.

ESMA is monitoring these trends as well as the potential risks that may flow from them. As a result, one of ESMA's key priorities is liquidity risks in the asset management sector.

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ESMA launched on 30 January 2020 a Common Supervisory Action (CSA) with national competent authorities (NCAs) on the supervision of UCITS managers' liquidity risk management. NCAs will assess simultaneously whether market participants in their jurisdictions adhere to the UCITS liquidity rules in their day-to-day business,

on the basis of a common methodology developed together with ESMA.

The CSA should be seen in the context of ESMA's broader work on stress testing. In July 2019 ESMA published Guidelines on Money Market Funds' stress tests, followed by Guidelines on liquidity stress testing (LST) in

UCITS and AIFs in September. On 5 September ESMA also published a stress simulation framework for investment funds, simulating a large redemption shock affecting investment funds and the subsequent impact of asset sales on financial market.

Regarding sustainable finance, ESMA recently issued its strategy. ESMA will promote ESG transparency by issuers and market participants to help investors to better understand the ESG impact on their investments and improve transparency on investments' contribution to a sustainable economy. ESMA will do this by:

- drafting technical standards and advice to the Commission (such as the Joint Committee technical standards under the Disclosure Regulation),
- providing guidance to market participants, building awareness, ensuring a common approach to supervisory activities on ESG,
- supervising transparency and application of relevant ESG requirements (relevant for credit rating and benchmark in the future); and
- developing risk identification of ESG factors, monitoring market developments of products with ESG characteristics and adjusting stress tests to incorporate ESG.

ESMA's renewed strategic orientation for 2020-2022 has emphasised the need to actively promote retail investor engagement in the European capital markets. Essential to these aims is ESMA's ongoing work on costs and performance of retail investment products, including the work on closet indexing and the technical work on the key information document for packaged retail and insurance-based investment products (PRIIPs).

Finally, the European Commission's process to review the AIFMD should not be forgotten. The AIFMD has formed an essential part of the European asset management sector legislation since it came into application in 2013. ESMA will ensure that lessons learned from the years of NCAs' practical experience supervising AIFMs are considered as the primary legislative framework is under review. ●

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Key priorities and opportunities ahead for the European asset managers

While representing the second largest region in terms of assets under management, the EU still substantially lags behind the US. In 2020, the American asset management market size is expected to be roughly 52 US$ trillions, outperforming that of Europe[1], that barely exceed 29 US$ trillions[2]. Certainly, the mere quantitative comparison has its limits, as it does not take into account structural differences (notably the importance of pension funds in the US). This being said, a number of well-known reasons including the absence of a fully integrated market, the lack of supervisory convergence along with a burdensome regulatory environment, are some of the challenges to the development of asset management in Europe.

Proportionality, stability and predictability should then definitely inspire the EU regulation applied to the asset management industry. We need European players able to compete with the rest of the world in order to fully address the funding needs across the single market. Together with a strong focus on the importance of preserving a real level playing field with other jurisdictions, it is essential to ensure that we are properly mitigating market fragmentation and avoid as much as possible supervisory divergences orchestrated by various NCAs. In this respect, the forthcoming AIFMD review should be the opportunity to recognize the notion of EU group as a way to strengthen European asset managers' competitiveness and take the full benefit of the single market. This would definitely facilitate the exercise of the delegation or outsourcing of management between two entities belonging to the same group - provided that they are both subject to EU legislation. The AIFMD review could also allow for a clear recognition of AIFs that are UCITS-like and only address material shortcomings without reopening the directive's overall framework. Furthermore, great attention should be paid on the suitability of the current reporting framework.

The needs in terms of retirement savings and preference for the long term can also make the difference in the future. There is a tremendous opportunity to channel EU citizens' savings into long-term investment products. To achieve this goal, a balance has to be reached between risk-mitigation techniques and the need to invest in illiquid assets in order to achieve returns. Our industry together with policy makers must find solutions that certainly include a better consideration of the time horizon of investors.

> *The AIFMD review should be the opportunity to recognize the notion of EU group.*

Having all this in mind, the EU asset managers should be able to seize decisive opportunities in order to play their cards right. In this respect, sustainable investing has become a must-have for the asset management industry. The regulatory framework is evolving quickly, with the European Action Plan launched in March 2018 already taking effect, notably through the taxonomy, disclosures and benchmarks regulation. In parallel to the upcoming NFRD review, that should extend access to more comparable and reliable data, it is also essential to provide a European Ecolabel based on a scientific based taxonomy that properly includes transition activities. ●

1. Europe refers to the EEA + the UK + Switzerland.
2. The Cerulli Report, Global Markets 2019, p 40.

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Recovery from COVID-19 turmoil has to be EU's top priority in financial services

EU's short-term top priority in financial services needs to be supporting the economy to sustain and recover from the coronavirus crisis. Governments, central banks and other authorities need to do whatever it takes to overcome the economic impact of the crisis. New regulatory initiatives/ requirements should be delayed to help the financial industry to recover its operations and support its customers in full.

Looking beyond the current crisis, moving towards a carbon-neutral economy is a fundamental challenge facing the EU economy the next decades. The devastating economic impact of COVID-19 pandemic will add to the challenge. Both public and private capital will be needed to achieve the transition and asset management can be a key channel to convey private investments in a sustainable way. There is growing client demand for this and also lot of regulatory action.

What asset managers need in support of this development is clear standards and harmonization that will support the growth and mainstreaming of sustainable finance. Avoiding labels and frameworks becoming too niche and hindering product development is key. Regulation needs to be meaningful, requirements clear and non-duplicative and implementation schedules realistic. Key is also to have clearer ESG data standards so asset managers can assess the investee companies properly and fulfil all the new requirements.

EU asset management regulation is very mature and successful in global comparison, especially UCITS has become a global gold standard which has to be preserved. No major overhaul is needed. The planned reviews of the UCITS and AIFMD should be evidence-based, carefully targeted and aimed only at addressing material issues that cannot otherwise be addressed through supervisory convergence.

Lot of focus has in recent years been devoted by the stability regulators on liquidity of investment funds. The COVID-19 market turmoil is now stress testing the current rules in real life. EU regulation already provides a proper toolkit for asset managers to manage the liquidity of their funds, but these tools are not evenly allowed by the national regulators. A big step forward would be ensuring that these liquidity tools are available in all EU jurisdictions.

Many EU regulatory measures have in recent years been adopted impacting indirectly asset managers, most prominently MiFID II which is having key impact on distribution models. With the review of MiFID II now commencing EU has the opportunity to correct the problems that have arisen for the industry to be able to serve its clients properly. There are certainly pressures to amend the client classification framework to create a category for semi-professional investors and to simplify the costs and charges disclosures.

EU action is needed to establish a proper framework for long-term investment for retail investors, allowing them to commit a greater part of their savings into less-liquid investments. It seems we will be in the low yield environment for long so Europe needs new kinds of products to give retail investors adequate returns. ELTIF was a laudable idea but has not been taken up by the market. We need to analyse carefully what went wrong and how to create a workable framework on less-liquid assets for retail investors to ensure they have all the means they need to achieve a proper asset allocation for their savings.

The European economy faces many short-term and long-term challenges. By working in constructive dialogue policymakers and the industry can ensure that asset management continues to help economies and citizens to overcome the challenges they face in current crisis and in the future.

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How circumstances should lead to asset management regulation adaptation?

At the time of drafting of this article, it is difficult to anticipate what the market situation will be when it is published. However, some lessons can already be drawn – possibly leading to practical actions by policy-makers and regulators.

First, the prompt spreading of a natural virus and its consequences were difficult to anticipate. Since the 2008 crisis, the work carried out by supervisors was mainly targeting the risk of re-occurrence of a similar event. The actions were not so much taking into account externalities such as sanitary risks and their impacts on finance. Probably no one can be blamed for that, as by definition a crisis occurs where you have not anticipated it.

So the point is not to anticipate any crisis for ever – which would be ▶

▶ pure utopia – but more to set the right tools to manage in practice the consequences of an unpredictable shock.

The current EU legal requirements work well. AIFM and UCITS Directives require fund managers to be licensed, monitored and if needed sanctioned by NCAs. The role of ESMA to facilitate the coordination among NCAs is also positive to facilitate convergence at EU level.

However, the current exceptional context demonstrates the insufficient requirements applicable to other players in the value chain or the uncertain application of best practices and rules among Member States.

First, regarding risk management, fund managers are currently lacking information from distributors on the detailed profiles of fund investors. ESMA identified the need for fund managers to anticipate investor behaviors, through its "Guidelines on liquidity stress testing in UCITS and AIFs" issued in September 2019. But to date, distributors do not provide on a free-cost basis for such investor profiling.

Still regarding risk management, many Member States have not introduced the complete set of fund liquidity management tools available in other Member States, e.g. swing pricing. This is regrettable as already 2 years ago, IOSCO issued a report recommending NCAs to introduce the widest range of tools: « IOSCO expects that authorities will actively promote the implementation by responsible entities of the 2018 Liquidity Recommendations".

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The fund industry reminded such issues to EU authorities in two AMIC/EFAMA public reports on fund liquidity, already in 2016 and more recently this year. We wrote: "We note that the operational tools listed, such as swing pricing, for example, while not mandatory under the AIFM or UCITS frameworks, are useful liquidity management tools for fund management companies. ESMA could encourage the NCAs in certain EU Member States to consider broadening the range of available tools, thereby ultimately contributing positively to the management of liquidity risk."

Last, the Commission should use its powers at Level 4 to ensure the application of existing EU rules across Europe. For instance, we are still lacking the first ESMA report on AIFM measures and sanctions, although required by the AIFM Directive almost ten years ago.

These practical actions by ESMA and the Commission towards Member States should be taken as top priorities, in the general interest of financial stability and investor protection – before deciding to launch any legal revision of the AIFM rules. ●