How to maximize the role of investment funds in the post-Covid recovery?

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The role of the EU Asset Management regulation in the post-Covid recovery

As the COVID19 pandemic continues to rattle the economies and financial markets across the globe, the year 2020 has proved to demonstrate the remarkable resilience of the EU investment funds sector. Looking ahead, the relative calm of the markets should not be a reason for complacency but be used as an opportunity in maximizing the value for European savers, supporting our communities, and ensuring green, smart and sustainable growth of the European economy in line with the CMU objectives.

Resilience of the EU asset management framework

While the industry has witnessed some funds redemption suspensions, predominantly in the commercial real estate sector and mainly caused by valuation-related uncertainties, the EU funds sector has functioned relatively well. Notably, the liquidity management tools functioned as they should, the investor protection rules functioned properly and the money market funds (MMFs) sector has not witnessed serious redemption suspensions, while the ESAs and the national regulators were constantly monitoring the markets to ensure their orderly functioning and prevent the markets against systemic risks.

Key challenges for the EU fund sector in the years ahead

There are always clouds on the horizon ranging from geo-political tensions and trade wars, Brexit, and the climate crisis. The EU fund industry continues to face challenges in terms of integration and competitiveness, including fragmentation, transparency and fees. The bulk of the cross-border supply of the EU funds are directed to Member States with large markets to the detriment of investors in smaller Member States and poorer choice for investors, competition, level of fees and net returns.

> *The EU Commission is focused on strengthening the CMU and promote green sustainable post-Covid 19 recovery.*

However, many of these perceived challenges could be turned into opportunities: by attracting a rising numbers of investors keen to place their savings in green or more sustainable investment options, improving the framework for investments in long-term growth and promoting sustainability and responsible business practices, by simplifying distribution, product and costs structures. By seizing these opportunities, the industry can reshape its business models and strategies and become more resilient.

Initiatives aimed at improving the competitiveness of the EU fund sector

As a constant advocate of the CMU and a strong Single Market, the Commission (EC) is focused on strengthening the CMU and promote a green sustainable post-COVID19 recovery by continuously improving the functioning of the EU investment funds market. The role of regulation is to support the implementation of these policies. The EC continues to execute on the initiatives underpinning an efficient functioning of the asset management sector, among others:

- The Commission's work on the review of the AIFMD is well underway and is seeking to identify areas for potential improvements and propose targeted legislative amendments.
- Pan-European personal pension product (PEPP) should very soon offer transparent and long-term savings solutions for consumers; EIOPA is currently about to finalise relevant rules. Once approved, first PEPP products might be launched.
- The Disclosure Regulation will apply as of March 2021.It will have considerable behavioral effects on the markets, in terms of the consideration of negative externalities caused by investments or clear explanations of how claimed sustainability of a given financial product is achieved.
- In line with the legal mandate and the recommendations of the High Level Forum for the Capital Markets Union, the Commission has started the review of the European regime for long-term investment funds with a view to identifying the areas for possible improvements and proposing legislative amendments towards Q3 2021.
- The EC also intends to open up the EU Eco-label to financial products; a number of preparatory steps necessary for the legislative change have already been taken.

While the Commission is focused on the smooth operation of the EU funds sector and removing the obstacles to the Single Market, the EU asset management legal framework continues to serve the industry and the investors as a robust, predictable and well-regulated regime. The EC is known for constructively engaging with the regulators, ESAs and the stakeholders and will continuously execute on its policies in helping the sector to unlock unrealized opportunities and speed up the post-Covid-19 recovery. ●

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Contribution of Asset Management to the post-Covid-19 economic recovery

European households own significant bank deposits, but often show limited interest in capital markets. The contribution of asset management to the post-Covid economic recovery requires a large-scale distribution of European fund products to investors, and more specifically retail investors. The following main considerations are likely to increase the attractiveness of these products:

- Focus on the adequacy of the cost-performance ratio of UCITS distributed to retail investors to manage the significant impact of costs on the final value of investments.
- Structuring the post Covid-19 world around sustainability with private actors being key to finance the green transition.
- Increasing the outreach of investment fund products to a larger investor base by way of measures already put in place under the EU Regulation on cross-border distribution of funds, like uniform rules on the publication of national provisions concerning marketing requirements and on marketing communications addressed to investors, and via setting up a framework on the marketing of funds through digital media and increasing the possible investment horizon of UCITS funds while still complying with the retail investor focus.

With the European asset management sector being expected to grow further as a result of both the European initiatives related to the Capital Markets Union and a possible contribution to the post-Covid economic recovery, a continued close monitoring of related financial stability aspects remains important. The 2017 FSB Recommendations[1], the IOSCO follow-up work[2], the 2017 Recommendation of the ESRB[3] with the related ESMA implementation work (e.g. ESMA Guidelines on Liquidity Stress Testing in UCITS and AIFs) are central policy contributions in that respect and address in particular financial stability risks related to liquidity mismatches in open-ended investment funds as well as leverage within funds.

During the recent COVID-19 crisis, outflows in investment funds and tensions in market liquidity were observed in less liquid market segments, such as high-yield and emerging market fixed income markets. Also, difficulties in the valuation of certain asset classes (e.g. real estate) and strains in some MMF segments became apparent.

In Luxembourg, the large availability of liquidity management tools revealed their particular importance under these exceptional circumstances from both an investor protection and financial stability perspective.

It will now be important to thoroughly analyze these developments and examine how the substantial policy work carried out so far addresses the tensions and whether possible gaps exist. ●

1. FSB "Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities", 2017.
2. IOSCO "Recommendations for Liquidity Risk Management for Collective Investment Schemes", 2018, "Open-ended Fund Liquidity Risk Management – Good Practices and Issues for Consideration", 2018, and "Recommendations for a Framework Assessing Leverage in Investment Funds", 2019.
3. "Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds (ESRB/2017/6)".

Gerry Cross

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Strong regulatory frameworks are the foundation of effective capital markets

The path of economic recovery from the COVID-induced shock remains unclear at this point. What is certain is that economies will need to rely on a range of sources to finance recovery, including banks and capital markets. If capital markets are to fulfil their potential, investors must be better protected and systemic risks further mitigated. A regulatory framework which prioritises these goals remains necessary to ensure the confidence that is needed for the financial system to function effectively in support of the economy.

With this in mind, regulatory authorities have long been focusing on matters related to appropriate liquidity management by fund managers, their use of leverage, and their capacity to appropriately oversee their activities and manage risk. These matters were in focus given the significantly increased role of the asset management sector following the ▶

▶ financial crisis and subsequent regulatory reforms and were given further emphasis by events relating to Woodford, H20 and GAM funds and in light of the challenges and risks of a disruptive Brexit.

The performance of capital markets generally, and the asset management sector in particular, during the recent period of significant Covid-19-related market disruption has underlined the need to enhance the regulatory approach to these matters. It appears likely that the turbulence that was experienced during this period was exacerbated by a dynamic in the asset management sector that reflected liquidity expectations that were misaligned with the underlying assets. Moreover, the degree of central bank intervention that was required to restore the normal functioning of markets indicates the need for enhanced regulatory requirements to more appropriately apportion the cost of liquidity risk.

> *It will be important to enhance the framework relating to liquidity mismatch and leverage in funds.*

In order to ensure that capital markets and the asset management sector are able to meet their full potential in supporting the economy it will be important to enhance the framework relating to liquidity mismatch and leverage in funds. It will be important to address the collective action issue whereby actions taken by funds and managers in periods of stress, while rational at the individual level, may be materially suboptimal at the systemic level. This implies the need for enhanced macroprudential rules. Work underway internationally and in Europe to address the issue of leverage in the funds sector needs to be continued and brought to an impactful conclusion.

A well-regulated asset management sector plays a significant role in supporting the functioning of the financial system and wider economy. The convergence of the next phase of work on Capital Markets Union, and the review of AIFMD, with the lessons learned from the Covid-19 crisis provides the opportunity to leverage and enhance work previously underway to deliver a better performing asset management sector more effectively supporting the economy. ●

Tim Friederich

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How to secure a sustainable recovery

The human and economic costs of the Covid-19 pandemic have refocused minds on the challenges facing societies globally. They also remind the asset management industry of our core purpose. As stewards of our clients' assets, we must help secure their future and the future of the planet – and investing responsibly will be a vital part of our collective success. In the post-Covid economic recovery, this means focusing on sustainable investing, managing risk and providing customised solutions.

Sustainable investing must be a priority

Although sustainable investing was once seen as a separate category, it is becoming an intrinsic part of many more investment strategies – a trend that is accelerating. According to Morningstar, sustainable funds attracted more than USD 20 billion in new assets in 2019, compared with USD 5.5 billion the year before.

> *...active asset management has an ever-more critical role to play...*

Institutional investors increasingly prioritise environmental, social and governance (ESG) factors in their decision-making – not just to manage risk, but to drive returns by funding opportunities with long-term potential.

We also see increased demand from a young generation of retail investors who refuse to separate investment outcomes from responsibility – a trend further fuelled by regulation.

The United Nations Sustainable Development Goals (SDGs) provide a blueprint for directing investments towards global challenges that need funding – from climate action to improving access to food and clean water – and the pandemic has only increased the urgency.

Meanwhile, private market investments will be critical for building the social, environmental and energy projects that will support the well-being of future generations.

As active asset managers, we can help structure these deals in a way that multiplies their financial and societal impact, and we can form new and innovative partnerships to deliver these results.

Risk management is critical

As the crisis crystallises investors' priorities, risk management should be at the top of the list. Today, a wide array of approaches exists, ranging from dynamic risk management to tail-risk hedging. The asset management industry must reinforce the need for a holistic risk management strategy – one that considers the entire portfolio, not just a sleeve. Only then can correlations be taken fully into consideration and managed against investors' risk budgets.

As investors push into new means of diversification, they need help understanding the implications on their portfolios' risk-return profiles. This is especially true when it comes to sustainability – investors want to know that they ▶

are achieving their goals because of their responsible investment strategy, not despite it.

At the same time, we think active asset management has an ever-more critical role to play. Passive investment strategies must, by definition, track their respective index – regardless of what the index contains. Yet this crisis has shown that investors need to be selective and choose the companies that are most able to weather unexpected storms.

Customisation is king

One common thread that links these emerging trends is the need for customisation. With the help of technology and academic research, asset managers have a greatly improved ability to optimise portfolios and investment strategies for institutional clients. Digitalisation and new developments in the areas of machine learning and artificial intelligence will allow us to bring this customisation gradually to retail channels.

What cannot be automated, however, is the first step in any successful investment strategy: understanding clients' investment goals, risk profiles and constraints.

This can be solved through education and dialogue – and a commitment from industry and regulators to work together. As the world focuses on securing a post-Covid recovery, such collaboration will be more important than ever. ●

Daniel Kapffer

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Let asset managers provide targeted services to retail clients

Currently European asset managers were managing total assets of 23 trn EUR out of which over 70 % invested in equities and corporate bonds. These numbers clearly show the importance of asset management for the financing of the economy.

7 trn EUR are managed for retail clients directly. Another 12 trn EUR are managed for pensions funds and life insurance. These numbers have to be compared with 4,7 trn EUR of corporate loans issued by European banks.

It is a general flaw in various European regulations to adapt the concept of one single group of retail investors. We see clients that want to delegate the investment decision, clients that run a monthly savings plan, mainly in one financial instrument, and retail clients doing a significant amount of transactions each year in a very self-guided manner.

The clients with a monthly savings plan will get lots of information around financial markets and various types of financial instruments. Most of it irrelevant but scarring for the investor.

The client delegating the investment decision does so knowing that managing assets is a very specialized discipline. It requires significant know how in financial markets and instruments as well as a complex infrastructure. For this client it does not make any sense to educate him – he wants to receive a service.

Finally, for the self-guided retail investor the current requirements also don't fit. The required information especially pre-trade is an obstacle for him not providing any value for his order execution.

The EU has recognized this with the quick-fix to exempt professional clients and eligible counterparties from requirements like pre-trade cost transparency. However this needs to go further. We very much support the idea of a non-professional Qualified Investor as proposed by the CMU HLF.

Four levers will further increase the contribution by investment funds to finance the European economy. The first is to develop the investment culture. Investing in capital markets needs to become an integral part to cover retail clients long term financial needs. Pension schemes will play an important role in this. However, reporting or auto-enrolment will not help. There must be private pension schemes supported by the state through tax benefits or contributions. They must have rules and risk implications that are manageable for providers in the low interest rate environment.

> *We need to provide a standardized framework to promote ESG investments.*

Secondly, the role of investment advice and investment funds needs to be strengthened. Questioning inducements repeatedly which are the basis to finance investment advice or providing clients with comparison tools go the wrong direction. If there is a perceived issue with the quality of advice, we need to address it. But we must not deteriorate the fundament it is based on. In addition, I am worried by the intensity in which retail clients are pushed into single stock investments or ETF. Both products have no active risk management component – as we have experienced again in the turmoil in March this year.

The third point – the need to increase the flexibility of the regulatory requirements has been touched upon already. Asset management in the EU is already embedded in a sound legal framework, including the UCITS Directive and AIFMD, for the benefit of market participants and investors. We support the EU in taking an ambitious approach to improve the framework but not to add even more requirements.

Lastly, we need to provide a standardized framework to promote ESG investments. Asset managers need clear standards and harmonization of rules that will support the growth of sustainable finance. ●

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How to upgrade Investment Fund regulation to benefit EU citizens and businesses?

The recent Covid crisis, which is not over yet, requires to reflect further on how to upgrade the EU fund regulation framework in the short term. And in the longer term, the Sustainability critical issue must be properly tackled by the asset management industry.

Data show that market-based finance, mainly developing through the regulated fund industry, has increased its footprint in the economy – in particular since the 2008 crisis – and therefore bears more responsibility vis-à-vis society. Through funds, citizens as savers are increasingly contributing to the financing of companies. As employees, they benefit from that easier financing of their employers. As retirees, they enjoy higher private pensions.

During the Covid crisis, the EU fund industry reacted well. From a systemic perspective, no major failure occurred – showing that the current UCITS and AIFM Directives' framework is appropriate. The only area where few issues happened was related to the lack of Liquidity Management Tools in some Member States. Apart from that lack which should be solved at EU level, we think that Europe should not take the political risk of changing a regulatory framework which has made the proof of its appropriate design, including in highly stressed conditions.

Instead, policymakers should assess how positively the fund industry could contribute to the post-Covid recovery – in the short and longer terms.

In the short term, clearly a re-designing of the ELTIF Regulation would be key. In theory, the ELTIF is an ideal tool to boost the pan-European retail financing of key EU assets which will need to recover post-Covid, such as SMEs (which are a core component of job creations) and real assets (infrastructures and real estate). But up to now, ELTIF failed to deliver due to too many constraints (too high minimum amount to be invested by retail investors, unclear eligibility of real estate assets). Integrating a clearer and consistent Sustainability criterion for eligibility of assets, in particular for real assets, would help converging between that product new design and the EU Green Deal. The first priority should be for the Commission to ensure a harmonized tax treatment, otherwise the regulatory reshaping might be done for nothing.

In the longer term, the EU fund framework must embed Sustainability more widely. AXA IM has been a strong supporter of the 2018 Action Plan and current Green Deal. This is needed from a societal perspective, for the well-being of future generations. It is also needed from a competitiveness and business perspective, if Europe wants to take benefit from its political advance vis-à-vis its main non-European competitors. For instance, regarding ESG labels for funds, we have seen Member States developing various local ones: we are now calling for a European one, both to benefit from the Single Market and develop an EU brand externally.

> *We are now calling for a European ESG label for funds, both to benefit from the Single Market and develop an EU brand externally.*

However, policymakers must remain realistic in the practical contents to be implemented. As an example, the forthcoming implementation of the Sustainability Risk assessment within management companies is highly problematic: while the ECB made clear that for banks the environment and climate risk should be assessed "at least qualitatively", and therefore not systematically quantitatively, such a clarification from the Commission for UCITS and AIF management companies is still lacking – and crucially needed. ●