

# Asset management trends and regulatory evolutions

## 1. Current state of the EU asset management market

### 1.1 Status of the single market for investment funds and overall market evolution

An official stated that an audit on the European investment funds market recently performed by the European Court of Auditors (ECA)<sup>1</sup> concluded that there is so far no true single market for investment funds likely to benefit all European citizens. Three important aspects were highlighted in this report. The first is that cross-border asset management activities and the cross-border distribution of funds remain limited within the EU. The domiciles of the funds are concentrated in four main countries, with the largest domiciles in terms of assets under management (AuM) being Luxembourg, Ireland, Germany, and France. This allows a concentration of expertise, but at the same time means that large parts of the EU are not active in the fund sector, since the cross-border distribution of funds is limited. The barriers created by different interpretations of European legislations and different domestic investor protection and taxation rules hinder the functioning of the UCITS and AIFMD passporting regimes. In some cases investor protection rules also excessively restrict access to investment fund products. In Lithuania for example there are fewer than 200 UCITS funds which can be invested in on the local market, out of 64,000 UCITS funds domiciled in the EU. The ECA recommended that the European Commission should undertake fitness checks of the gaps in terms of cross-border fund management and distribution, and propose incentives for the further development of cross-border fund activities.

Secondly, the ECA audit found that for the supervision of the fund market, ESMA sometimes relies too much on the goodwill of the national competent authorities (NCAs) and that supervisory convergence still needs improving, although progress is being made. This is mainly an organisational matter of ensuring a full scale application of existing convergence processes and tools. A third aspect highlighted by the ECA report concerned retail investment and investor protection. The audit found that the existing level of protection is generally satisfactory in Europe, but two areas need improving. The first area is inducements, for which rules vary significantly across the EU, ranging from a ban in certain member states to a fairly wide acceptance in some others. The second area is information. This includes regulatory reporting that is not sufficiently granular, particularly for alternative investment funds (AIFs) and not sufficiently harmonised, which hinders risk assessment and

macroprudential supervision. Moreover investor disclosures are not sufficiently comparable and are not adapted to digital devices. A single point of access, such as the one proposed for corporate information in the European Single Access Point (ESAP) project would also be useful for information regarding investment funds.

A second official noted that the asset management sector is significantly contributing to economic growth in the EU and supporting new evolutions such as ESG. The resilience of the sector was also demonstrated during the recent Covid crisis. The market is particularly concentrated in Luxembourg and Ireland, but it is also the materialisation of major centres of expertise in Europe. The single market needs continuous monitoring and deepening to ensure that all parts of the Union are appropriately covered. That is one of the main objectives of the Capital Markets Union (CMU) and the different projects that are part of it.

The official observed that the discussion about inducements is challenging and is being addressed by the European Commission in the context of the work on the Retail Investment Strategy (RIS). Further improving and harmonising reporting and the information provided on funds is also essential. Progress on this can be expected with the AIFMD and UCITS review proposals, which have recently been agreed. EU institutions need to move fast on the adoption of those proposals. When assessing supervision and the possible need for providing ESMA with more powers, it is necessary to take into account the ongoing actions in this area. A review of the European Supervisory Authorities' (ESA) operations has taken place providing the ESAs with additional powers, some of them only now coming into operation, such as peer reviews. These new powers and tools should first be fully implemented before adding more.

An industry representative observed that since the beginning of the pandemic there have been many changes in the market environment that have impacted the fund industry and capital market dynamics, including stresses on supply chains, the invasion of Ukraine and a significant rise in inflation. Central banks are forced to react to current inflation levels, increasing interest rates and tightening monetary policy. This is impacting fixed income markets, as well as the economic outlook of firms with expectations of reduced earnings, resulting in a negative trend in risk asset classes in general. In terms of asset classes year to date, asset managers saw inflows into equity and multi-asset products, and redemptions mainly in the money market and fixed-income markets. This is on the whole a positive evolution so far that contrasts with what was observed in past crises.

1. [https://www.eca.europa.eu/Lists/ECADocuments/SR22\\_04/SR\\_SM-for-Invest-Funds\\_EN.pdf](https://www.eca.europa.eu/Lists/ECADocuments/SR22_04/SR_SM-for-Invest-Funds_EN.pdf)

Increasing the international distribution of EU domiciled funds is a key objective, the industry speaker added. Their company, a major asset management firm based in Luxembourg, manages approximately €420 billion assets for various types of investors. Close to 40% of these assets come from non-European investors, notably from Asia and Latin America, showing the global success of the UCITS and AIFMD frameworks and the importance of the rules embedded in these legislations such as those on delegation.

### 1.2 Development of sustainable finance

An industry representative observed that sustainable investing is a major trend, with inflows into sustainable products increasing across all European markets and management companies. Significant additional capex investments will be required in order to achieve net zero targets by 2050 and support the required structural change of economies. The asset management industry is extremely well positioned to support that evolution, and has an opportunity to play a key role in the transition to a more sustainable economy, channelling investments through UCITS and AIF funds.

An official agreed that there is an increased demand for ESG products, triggered in particular by concerns about climate change. Regulation is instrumental to sustainable finance but it comes with challenges, such as completeness, timeliness and ESG data availability and reliability. The Sustainable Finance Disclosure Regulation (SFDR) is very recent but needs tweaking on some key aspects, such as the definition of investment thresholds when disclosing under Articles 8 and 9 of SFDR. The regulation currently does not provide a definition of the thresholds used, which means that different rules may be applied in different member states to address the same issue, with some member states having implemented their own rules. This may undermine investor protection and the fight against greenwashing, and hinder supervisory convergence. In terms of timeliness, the SFDR regulatory technical standards (RTS) that were adopted in July 2022 are due to enter into force on 1 January 2023, which gives little time to all stakeholders to adapt to a very complex package. Supervisors realise the magnitude and the difficulty of the task, but they need to make sure that the supervised entities are complying with the sustainability rules applicable to them, as well as avoiding greenwashing and mis-selling practices, which may be challenging in such a timing. Finally, ESG data is currently scarce. The reliability of the data still needs to be worked on, but regulatory initiatives like the Corporate Sustainability Reporting Directive (CSRD) and market practice should contribute to improving data availability.

An official stated that regulation and supervision of ESG ratings is currently non-existent. This is a gap that needs filling, because retail investors are not aware of the limited value the ESG ratings used by the green funds in which they are investing. This should be tackled in order to ensure the trust of investors and support the development of the industry.

### 1.3 Digitalisation and technology use in the asset management sector

An industry representative noted that digitalisation and information and communications technology (ICT) are having a significant impact on the asset management industry and their different activities. The potential of distributed ledger technology (DLT) in particular is being assessed by the industry. DLT may provide significant benefits in the asset management sector in two main ways. First, DLT may help to reduce transaction costs and increase efficiency notably in the post-trading space. Their company, a major asset manager, carried out experiments in 2021 with the European Investment Bank (EIB) and the Banque de France that were quite encouraging, aiming to test bond issuance on the blockchain. Secondly, DLT may facilitate the distribution of fund units and reduce distribution costs for fund managers. Cryptoassets are also progressing as an asset class, despite recent issues with some stablecoins and lending platforms. Some asset managers have started investing in this market on behalf of their clients but many are still refraining to do so, given the fiduciary duty, which requires that they invest client money with care, including for non-retail clients. There is active monitoring of developments in this area.

Asset managers are developing internal expertise in terms of digitalisation but they are also outsourcing a significant and growing part of their ICT activities, the industry representative stressed, which may give rise to new challenges, as digitalisation expands further in the sector. Imposing due diligence on tech providers for outsourced activities that the asset managers have to take responsibility for can be challenging. Additionally, there has been a permanent increase in the cost of third-party providers of ICT services and data. The terms of contracts with those providers are not always as balanced as they should be between the parties, and in many cases large providers are able to impose their terms of contract, including with large asset managers. In terms of regulation, the digital policies being developed by the Commission provide an appropriate framework for supporting on-going digitalisation efforts and addressing related challenges. The DLT pilot regime will facilitate the testing of DLT-based activities and DORA will allow critical third-party providers to be brought into the scope of oversight and will provide a common EU framework for ICT risk management in the financial sector.

## 2. Ongoing policy initiatives impacting the EU asset management sector

The panellists commented on proposals of the Capital Markets Union (CMU) initiative relevant for the asset management sector i.e. the reviews of the ELTIF, AIFMD and UCITS frameworks, the project to implement a European single access point for financial and non-financial corporate information (ESAP) and the Retail Investment Strategy, aiming to increase retail participation in the capital markets.

## 2.1 ELTIF review

An official was hopeful that the review of the ELTIF framework would foster the development of the ELTIF market, which has not been a success so far.

An industry representative emphasized the importance of the review of the ELTIF regime for supporting economic growth and developing the overall investment ecosystem in the EU. Europe needs a vehicle for long-term investing in order to increase investments, notably in renewable energy, which requires deep structural changes across the entire economy. Having a product in the AIF space such as the ELTIF that can build on the success of the UCITS regime and can potentially attract more retail investors and also international investors is a great opportunity for the European economy. ELTIFs can provide investors with higher returns, capturing the illiquidity premia offered by long term investments. However, appropriately managing illiquidity risk and educating customers about potential risks will be essential for the success of ELTIFs. It is also important to allow a broad enough diversification of investment in the shaping of ELTIF products, due to the size of many illiquid assets.

Another industry representative welcomed the proposals made in the context of the ELTIF review. The Council and the Parliament still need to agree on some final details but their positions are close now. The main remaining issue within the ELTIF framework relates to taxation across member states. While it is understandable that each member state wants to keep its own tax revenue, minimum tax transparency principles are needed to foster cross-border investment, which is necessary for achieving a sufficient level of diversification of the assets that ELTIFs invest in. Among these assets, there are real assets such as real estate, for which taxation differs across member states. Member states must agree on solutions to improve tax neutrality across European jurisdictions in order to avoid double taxation.

## 2.2 AIFMD and UCITS reviews

Several panellists welcomed the fact that the AIFMD review was targeted at specific issues. The AIFMD review also involves a review of UCITS regarding common provisions. An official noted that the fact that the AIFMD review is focused is a recognition that the regime has worked well so far, contributing to investor protection and safeguarding financial stability. An official agreed that AIFMD is a success, together with UCITS, which has become a very significant and global brand. There is no need for a fundamental review of these frameworks. The AIFMD and UCITS reviews aim to foster a further development of capital markets in the EU in the context of the CMU, but the attractiveness of Europe for capital coming from other regions must also be considered.

Specific issues were highlighted by the panellists regarding delegation arrangements, reporting, liquidity management tools and competitiveness. An official noted that the process to transpose AIFMD into national law had taken eight years. It is hoped that the recommendations of the AIFMD review will be implemented faster. Generally, regulations should be preferred to directives to ensure consistent implementation.

### 2.2.1 Delegation arrangements

An industry representative stated that the current delegation framework works extremely well and is widely accepted. Any significant changes may threaten the functioning of the EU fund market. An official agreed that current delegation arrangements should not be unpicked, because that is part of the huge success of the EU fund frameworks.

A regulator observed that some selective changes have been proposed to delegation rules in the AIFMD review, notably aiming to increase transparency. The Commission proposal takes due account that delegation of activities is currently an inherent and key future of the EU asset management industry. It has led to an ultimately positive outcome for investors, with a high degree of specialisation and the development of competence centres inside and outside the EU. A strong regulatory framework in this area with initial and ongoing due diligence in place is needed, as well as a well-functioning oversight framework. In 2018 the CSSF issued specific guidance to the asset management industry in Luxembourg laying out expectations regarding delegation, which covers not only portfolio management but also other functions like the distribution network. These guidelines provide a framework that allows market players to anticipate regulatory expectations, as well as the associated cost.

### 2.2.2 Reporting

An industry representative was concerned that the review of the common provisions of AIFMD and UCITS would require elaborating additional reporting for UCITS funds and harmonizing it at EU level. In Europe there are currently 33,000 individual UCITS funds on which reporting may potentially be needed. Since 2014, following a requirement put forward by the ECB, fund managers already have to regularly report in a number of EU countries the inventory of each of their UCITS funds to the central banks where these funds are domiciled, identifying each security held, as well as the liabilities of each fund, as far as the information is available. Central banks should agree with securities regulators in the member states concerned to pass on the information already provided by fund managers on the assets and liabilities of each fund in order to avoid significant duplication. A further issue in terms of reporting is the proposal that has been made in the European Parliament's report on the MiFID review to extend MiFID transaction reporting to each UCITS and AIF. This would mean that fund managers would have to report transactions executed by each fund under MiFID, in the same way as brokers. That addition would be excessive, the industry representative felt.

The Chair agreed with the need to avoid duplication, but observed that statistical reporting that was designed 10 years ago for central banks might not serve the objectives of the regulatory reporting envisioned in the UCITS review, which aims to enhance risk supervision. Hence, a new, regular, detailed and supervision-oriented reporting regime seems inevitable.

### 2.2.3 Liquidity management tools (LMT)

A regulator stated that Luxembourg currently has a very strong liquidity risk-management regulatory framework

in place, and Luxembourg domiciled funds probably have access to the largest range of LMTs in Europe. An assessment of LMTs that has just been published by the CSSF in collaboration with the Bank for International Settlements (BIS) based on supervisory data and experience with the use of these tools, concludes that LMTs are essential for ensuring investor protection and safeguarding financial stability. The importance of having a proper and robust liquidity risk-management framework in place was demonstrated again during the recent market turbulence.

Implementing a liquidity-management framework at EU level and providing access to LMTs is an important addition of the AIFMD review, the regulator observed and will help cement investor protection, but it is important to be mindful of several elements. In order to deliver on the objectives of such measures, the responsibility for the choice and activation of LMTs should clearly remain with fund managers. Fund managers should continue to manage liquidity appropriately, even if LMTs are more widely available. These are important aspects of the framework, which also appear in the IOSCO recommendations on liquidity-risk management. The use of LMTs by fund managers will vary, especially during crisis periods. Supervisors need to provide fund managers with sufficient flexibility so that they can have recourse to the most relevant LMTs at a given point in time.

An official agreed with the importance of LMTs for avoiding liquidity mismatches and the need to harmonise them across the euro area. LMTs are currently missing in a number of member states and are not always well understood. The essential point is that the decisions regarding LMTs remain with the fund managers, who are the experts in this regard, and not with the supervisors.

#### **2.2.4. Competitiveness**

An industry representative noted the importance of considering the impacts of the ongoing regulatory reviews on the competitiveness of EU asset managers, in order to allow the European asset management industry to develop. A competitiveness test could be introduced requiring an assessment of the impact on competitiveness of every new regulation within one or two years of its introduction. Significant impacts should lead to reconsidering the regulation. Such a test already exists for SMEs in the EU in certain areas of regulation. In the UK there is also the intention to provide regulators with a roadmap aiming to preserve not only the interests of investors, but also the competitiveness of the industry. It is important that the EU asset management industry is able to sell funds to investors outside Europe, which requires making sure that EU champions remain sufficiently competitive.

The Chair agreed that regulations should preserve the competitiveness of the sector. The challenge is granting a competitiveness mandate to a supervisor that at the same time provides authorisations or may issue a fine.

An official stated that the need for competitiveness is recognised by policy-makers, as well as the need to evaluate the impacts of regulations on costs. An adequate balance however needs to be found between competitiveness and investor protection.

### **2.3 The European Single Access Point (ESAP) initiative**

An industry representative noted that data is at the heart of developments in terms of ESG and also supports digitalisation. The EFRAG (European Financial Reporting Advisory Group) work on EU sustainability reporting standards is moving in the right direction, and cooperation with the ISSB (International Sustainability Standards Board) and the US SEC (Securities and Exchange Commission) will allow the implementation of standards that are more easily usable by asset managers and that will provide more reliable data. Cost of data has significantly grown over the last 10 years. This significantly impacts the costs and competitiveness of asset managers at a time when the need for financial and non-financial data is increasing in the industry. Asset managers are price takers in the data market and are dependent on a limited number of powerful non-EU data-providers who control the market and keep prices high. There is hope that the ESAP initiative will facilitate access to good quality financial and non-financial data provided in a comparable way by companies. This could also be an opportunity for new data providers to enter the market, which would improve both competition and prices.

An official agreed that the creation of the ESAP is essential. An additional proposal would be to have a European Single Investor Portal (ESIP) providing access to information about management companies and investment funds for investors all over Europe, including in regions such as Central Eastern Europe, where capital markets need to be further developed.