EUROPEAN CAPITAL MARKETS INSTITUTE

Research Report | April 2016

ASSET MANAGEMENT IN THE EU: which way forward?

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Overcoming market fragmentation in the EU

The European asset management industry has witnessed a solid growth in recent years, reaching an estimated €19 trillion in assets under management (AuM) at the end of 2014, divided almost equally between discretionary mandates (largely serving institutional investors) and investment funds. Notwithstanding the significant steps taken in the past decade (UCITS, AIFMD, PRIPS and KIID), the European asset management sector remains highly fragmented, resulting in suboptimal size of funds and higher costs for investors. Much more needs to be done in order to achieve a truly pan-European market that is competitive, attractive and transparent vis-á-vis its investors (in particular the retail segment). This is also one of the priorities listed in the Commission's Action Plan on Building a Capital Markets Union, but is awaiting further clarification.

Which barriers currently hamper cross-border competition among product developers and distributors? Does the future of retail distribution lie in open architecture, i.e. online platforms? Or will banks and insurers remain the main distribution channels? Also, what role will independent financial advisors play? What are best practices in terms of disclosing comprehensive and relevant information on the cost of

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investment funds across the EU? Does the KIID work? How can new technologies help consolidate the market and increase cross-border access to products and markets?

Data on the so-called 'pure-play' cross-border funds (BroadRidge) showed a 17% CAGR of 'accessible' assets since 2008. There is a need to focus on the issue of competition and the extent to which it exists outside the referred to the need area of 'captive' retail assets. The distribution channels for third-party providers of funds are different across national markets. Based on data sourced from interviews with Europe's major distributors, the United Kingdom, Germany and the Netherlands are more open to third-party providers of funds. Despite the still very high number of funds in Europe, this has decreased at a steady rate in the last 4-5 years (closing down, merging or being acquired). The commercial pressures are encouraging the asset management groups to rationalise their investment products range. Regulatory developments (either at national or EU level) and pricing (especially the growth of passive funds or the creation of clean share class) will remain the main drivers of industry change in the coming years.

The European households have a very small share of their financial savings invested directly in investment funds (around 7%). Their holdings are mostly through wrapped financial products such as unit-linked insurance contracts or pension products (up to 32 %). Concerns remain over the proliferation of funds in the EU, which in turn leads to suboptimal size of funds and higher costs for investors. Contrary to the popular belief, retail participation in the UCITS market is quite limited. In practice, there are a large number of non-UCITs funds (or the so-called "AIFs") sold to EU households, e.g. in France. The lack of comparable data on historical performance and fees for retail investment products was signalled as a major problem. The public letter by Better Finance on the RTS for the PRIIPs Regulation by the ESMA SMSG advocates for maintaining the disclosure of past performance in the KID and not replacing it by future performance scenarios.

According to industry representatives, the debate around improving transparency in the asset management industry should not be about whether to disclose or not but about how to disclose meaningful and consistent data in a more effective manner. Such disclosure should facilitate informed decision-making, by or on behalf the savers and investors. The UCITS KIID format is one that worth continuing and applying more broadly in the market. The ongoing charges figure (subject to regulatory guidance on the detailed calculation) should be maintained separately from the transaction costs. While the aggregation approach under the PRIIP KID and for MiFID distribution is potentially a useful indicator of overall economic experience, it is equally important to maintain an appropriate level of granularity with respect to different components in the wider value chain, i.e. fund manufacturer, manager, distributor, advice.

As outlined by policy makers, MiFID 2 will challenge the current distribution model in a number of national markets. At present, the differences in the general notification procedure, registration fees, local paying agent requirements, marketing material review by national regulators, additional obligations around investor disclosure and information and even different tax treatment of foreign vs local funds simply make it more burdensome and ultimately more costly for providers to distribute UCITS funds on a cross-border basis. When it comes to AIFMD, there are certain things that can be improved with respect to the divergence across EU in private placement regimes. Changes in the

distribution channels will also be triggered from the end-users' side, in particular the millennials. They are very tech savvy, the self-research element in investment is far more dominant, much more ready to make use of robo-advisors and online platforms.

The Commission will gather evidence on the main barriers to the cross-border distribution of investment funds, including marketing requirements, fees, and other administrative arrangements imposed by host countries. If warranted, the Commission will seek to eliminate such barriers through legislative means. ESMA was tasked with the mapping of the main differences across the EU in the local rules that are currently affecting cross-border distribution. This will feed into a public consultation, which will be launched by mid-2016 in order to obtain very detailed insights from various stakeholders. Most importantly, the Retail Distribution Review will be conducted throughout 2018. It will aim at investigating whether the current distribution channels are fit for purpose and investors offered the products they need. It will also examine whether incentives for new channels, business models, to emerge are in place, e.g. online platforms. It is important that regulation doesn't stifle innovation or make it economically not viable to achieve scale.

Business and regulatory challenges for the asset management industry

The growth of the asset management sector has directed policy-makers' attention towards the industry's business model and the different risks involved, whether risks to the system, risks to individual institutions or risks faced by clients. As dealer/investment banks exit fundamental areas of the financial system, such as securities borrowing/lending and provision of market liquidity, the asset management industry is expected to respond and potentially even to change the way financial markets work. Asset managers are also facing unprecedented challenges in meeting investors' ever-rising expectations against a prolonged low-yield environment. At a systemic risk level, the understanding of the interconnectedness of asset management activities with the rest of the financial system is still developing. This may result in a revision of the current prudential framework.

Are the concerns about potential financial stability risks in the asset management sector well founded? In which ways an asset manager could contribute to systemic risk? What changes in the business models of asset managers are being driven by the need to adapt to the new financial landscape? What are the critical factors that are going to influence the balance in asset allocations (equity, fixed income, alternatives) and the investment strategies (active or passive) in the coming years? Is there a need to strengthen or revise the oversight of the sector, e.g additional micro-prudential tools and include them in a broader macro-prudential framework?

In the academia, there are a number of arguments pro and against macro-prudential rules and NBNI G-SIFI designation for asset managers. AMCs are to a large extent bankruptcy remote due to the segregation of client accounts, do not have sizeable balance sheets like banks and are not particularly highly leveraged. Even very big fund managers have failed without major disruptions to the markets. Nonetheless, the growth of fund management industry and its increased global interconnection deserves additional attention. Some funds do use substantial leverage and maturity mismatch. Even without leverage, there still may be a problem of herding and fire sale externality. AMCs are not insolvency immune. The failure of an AMC could provoke a withdrawal of investors in the funds they

manage either because in bankruptcy a critical liquidity provision function is lost or simply driven by investor fear.

Supervisors describe a series of potential financial stability risks posed by the asset management sector. The low headline figures on leverage do not reflect the full picture. Disclosure rules are too lax and supervisory practices to deal with leverage ratios are diverse. 90% of euro area investment funds are open-ended; this can trigger liquidity spirals and amplify market wide shocks. It's not the size of asset manager that should be a concern as such but the fire sale externality and a potentially larger herding behaviour. The buffers of liquid assets have fallen from 40% in 2009 to 32% in 2015 and the portfolios shifted towards risker assets. One should also see how the liquidity risk management under UCITS and AIFMD would work in times of stress. The (in) direct links with the banking sector needs to be monitored. Only 4 out of the 26 largest asset managers in the euro area are not directly affiliated with banks and insurers. Euro area banks hold EUR 2.5 tn of their assets and the asset management industry holds about 10% of bank debt. As to the effect on the wider economy, asset managers are also holding more and more of the NFC debt, the share went from 18% to 25%.

Industry representatives argue that the asset managers' business model is fundamentally very simple, i.e. an agency business in which the risk is taken by the clients, within a very carefully protected framework. The assets are not held on the balance sheet but held by 3rd parties. In the event of an asset manager failing, the assets are still safe. Nonetheless, an individual asset manager does face operational (system and valuation failures) and reputational risks. The rules currently applicable to asset managers are much more related to conduct of business rather than prudential rules. The regulatory spill overs from the banking sector to the asset management sector must be avoided. The Report published by EBA in late 2015 calls for a proportionate prudential regime for investment firms under CRD/CRR, based on appropriate risk analysis and a new categorisation of firms. Also, managers of open-ended funds are very familiar with liquidity management and have responsibilities to ongoing unitholders as much as to those coming into or going out of the fund. This doesn't mean, however, that asset managers will actually step in and provide liquidity.

The respective roles of asset owners and asset managers should not be conflated. Asset owners are responsible for the strategic asset allocation; they can decide to manage their assets in house or outsource part of or the entire portfolio. The asset manager is then in charge of the tactical asset allocation, within the tight parameters of the investment strategy. As a result of QE, asset managers are receiving greater flows from asset owners into mandates and funds with higher risk/return investment objectives. This is not because asset owners are 'chasing yield' without consideration of the risks but because many are forced to incur greater risk to meet their yield obligations given the low yield environment. The proposal of labelling asset managers as systemically important financial institutions is ill conceived, according to the industry. Leverage and liquidity risks should be analysed on a market wide basis rather than looking at a number of asset managers and/or funds in isolation. Liquidity stress testing is common across the market place. However, there is room for greater consistency and supervisory convergence in the definition and reporting of leverage and liquidity risk management

Some policy makers disagree with the proposal of introducing equivalent prudential requirements for asset managers due to the induced pro-cyclicality. It would lead to forced withdrawals of liquid assets,

decreasing returns on investments and expand further the search for yields by asset managers to be able to comply with their contractual requirements. Nonetheless, in the transition towards a more market-based financing, an effective oversight is very much needed for a crisis in the capital markets to be avoided/properly handled. This surely requires a continuous interaction between regulators and the industry in order to identify where are the risks building up, to design an effective toolbox and put in place an enabling regulation. The asset management sector should be looked at as a part of the entire financial ecosystem; the focus should not be on entities but on their riskiness in behaviour and the various activities. The AIFMD and UCITS Review represents a good opportunity to investigate whether the current requirements are still valid, or further tweaks are necessary.

Conclusions

The European asset management sector remains highly fragmented, resulting in a suboptimal size of funds and higher costs for investors. As underlined in the discussions among the participants, much more needs to be done in order to achieve a truly pan-European market that is competitive, attractive and transparent vis-á-vis its investors (in particular the retail segment).

In this context, the Retail Distribution Review, scheduled to be conducted at EU level throughout 2018, aims to investigate whether the current distribution channels are fit for purpose. It will also examine whether adequate incentives have been put in place to induce new business models to emerge, e.g. cross-border online platforms. At present, the differences in the general notification procedure, registration fees, local paying agent requirements, review of marketing materials by national regulators, additional obligations around investor disclosure and even different tax treatment of foreign vs local funds simply make it more burdensome and ultimately more costly for providers to distribute funds on a cross-border basis.

The growth of the asset management sector has also drawn the attention of policymakers towards the industry’s business model and the different risks involved, including risks to the system, to individual institutions and to clients. The rules currently applicable to asset managers are much more related to conduct of business rather than micro- and macro-prudential rules. Steps should be taken to avoid regulatory spill overs from the banking sector to the asset management sector. Nevertheless, the existing links between asset managers and banks need to be analysed much more carefully. Increased information on liquidity and leverage risk across asset managers will provide an essential tool for understanding the risks posed to financial stability by the asset management sector.

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