SESSION SUMMARY - BERLIN SEPTEMBER 2020

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

1. The role of investment funds in the economy

A policy maker stated that the EU asset management sector remains crucial for building the Capital Markets Union (CMU) and more generally the single market. Asset management will also be essential for the post Covid recovery, because it provides citizens and businesses with much needed access to market based finance in a cost-efficient way and within a well regulated environment.

An industry speaker emphasised the role played by the asset management industry in connecting businesses with investors willing to provide capital, making it a crucial tool for the financing of the economy and the recovery in the context of the Covid crisis.

An official mentioned that the sector also has an important role to play in terms of financial stability, because it supports a diversification of funding and investment, which enhances shock absorption.

The industry speaker added that risk management is a frequent topic of discussion between investors and asset managers. When assessing risks, it is important to consider the risk of the overall portfolio, rather than that of individual products or securities. Otherwise, the opportunity cost to investors will be higher. In this context, it is also important to understand the role of derivatives in managing risk. Derivatives are often associated with speculation, but most investors use them as a risk management tool.

2. Current market trends in the asset management sector

2.1 Sustainability

An industry speaker emphasized the general movement towards sustainability. Sustainability means investing according to ESG criteria but also investing in a sustainable way from a capital perspective. For example, for large institutional investors seeking long term returns, asset managers are endeavouring to provide sustainable returns rather than annual returns and to connect these investors with projects or entrepreneurs that have a long term perspective such as sustainable infrastructure projects, for which there is increasing demand. This also means that in the broader sense, the financial community must evolve beyond traditional return on investment metrics towards the inclusion of sustainability criteria in its assessment of investments and reporting.

Another industry representative added that the Covid crisis has confirmed the need for the industry to enhance its action on sustainability. Beyond Europe, sustainability is also being tackled by several countries in Asia, most notably China, Japan as well as Hong Kong. A committee of the CFTC in the US has also raised climate risk as an area of concern for the US financial industry, although this is still a minority view in the US.

A regulator agreed on the importance of ESG and sustainable finance and the role that investment funds can play in this regard, noting that their regulatory body endorses these objectives and encourages the creation of sustainable investment products by the asset management sector. An official also agreed on the importance of sustainability, adding that this is a complex objective to address that requires a real change in how the industry operates.

2.2 Customisation and new technologies

An industry speaker suggested that customisation is a second major trend in the fund sector, with investment vehicles increasingly being adapted to the needs of specific investors. This approach has been present in the institutional space for a long time and is now also extending to the retail space with the adoption of artificial intelligence and machine learning, allowing the mass-customisation of products to the needs of different groups of customers. This trend, which will drive the development of new products and is particularly relevant in relation to ESG, is due to grow exponentially over the coming years, the speaker believed. Ultimately asset managers may be able to treat each investor in a tailored way, as is the case at present for institutional investors. This however requires understanding precisely the needs of each investor and customising solutions for them with the use of technology.

Another industry representative agreed that technology and digitalisation are due to play an increasing role. The fund industry should also seek to benefit from these evolutions for the marketing of funds.

3. Key challenges facing the fund sector

3.1 Lessons learned from the Covid crisis

Several speakers stressed that the asset management sector demonstrated its resilience through the first stages of the Covid crisis. A policy maker noted that the pandemic created major disruptions in a number of key segments of the European economy, but the financial markets have functioned in an orderly fashion notably thanks to an effective supervisory coordination at the EU level. An industry representative added that the limited number of market issues concerning investment funds in the EU observed during the first months of the Covid crisis demonstrated the relevance of the risk-management features of the AIFMD and UCITS frameworks.

A regulator highlighted the fact that assets under management are currently at their highest ever levels, which means that the market has returned to its pre crisis level, following a substantial drop in March. The role of the asset management industry in the economy has not changed following the Covid crisis; if anything, it is now more important. One great difference compared with the financial crisis is that in 2008 finance and banks in particular were at the centre of the crisis. Today, there is no suggestion that banks or asset managers are the source of the problem; rather, they are contributors to the solution. The regulator however cautioned the audience regarding the risk posed by the current disconnect between financial markets and the real economy, which is due to remain. Additionally, markets have not yet returned to their normal volatility, which is still more than double its normal level, though this varies across asset classes.

An official provided a different perspective, emphasizing liquidity mismatch and leverage issues observed in the funds sector during the first weeks of the Covid turbulence. The need to implement a range of financial stability measures in the funds sector, in particular with enhanced liquidity and leverage rules, had been identified before the Covid outbreak and was confirmed by the events of March and April. These issues will need to be addressed in the coming months to ensure there is a strong confidence in the sector, which is needed for it to fulfil its potential to support the European economy.

Liquidity mismatch, which happens when the redemption period of a fund is misaligned with the liquidity of the underlying assets, remains a major issue to be addressed, the official felt, particularly during periods of stress. In 2019, ESMA's STRESI stress simulation for investment funds indicated the existence of potential liquidity issues, notably concerning high yield bond funds, which were confirmed during the period of turbulence in March / April 2020. As a result of liquidity mismatches, asset sales by funds may have increased asset price pressures and played a role in amplifying the stress being experienced. The overall pattern of redemptions was moreover consistent with the presence of first mover advantage dynamics among investors, which in some cases amplified redemption pressures.

Concerning leverage, the official described the analysis provided by the BIS on the role of leveraged hedge funds in the dislocation of government bond markets during the March / April period, which shows how leverage can create an impetus for earlier sales. The official thus encouraged the EU authorities to conclude the work underway on Article 25 of AIFMD and on leverage in the investment fund sector more generally. ESMA is considering these issues in a number of pieces of work. A policy-maker mentioned that a review of AIFMD is also planned.

A regulator echoed the remarks made by the previous speaker about the exposure of high yield bonds to the crisis. However, other asset classes have behaved differently. Money market funds (MMFs) have seen quite a positive evolution and some substantial net inflows during the crisis for example..

3.2 Challenges related to the international geopolitical context and Brexit

The official also emphasized the challenge of maintaining the benefits for investors and the EU economy of the EU fund sector's close integration with international financial markets, in the current uncertain geopolitical context. Issues include growing protectionism, pandemic induced concerns about dispersed supply chains or the disruptions caused by Brexit. It is important to avoid creating new barriers to the greatest extent possible. Regarding Brexit, a key question is how to ensure that linkages remain strong with the City while addressing the financial stability and regulatory concerns emerging from the new Brexit configuration.

In terms of future policy developments, the official felt that the EU should continue to lead the way in regulating fund markets so the standards it adopts are seen as benchmarks for regulation globally. Significant work is also being performed by ESMA on the Brexit relocation process, bringing together senior supervisors from affected EU jurisdictions to discuss issues such as substantive presence and its potential impacts on the fund industry and its outcomes for investors.

4. Policy measures proposed for enhancing the role of investment funds in the economic recovery

4.1 Risk management tools

An official was in favour of enhancing rules concerning liquidity mismatch and implementing a robust macroprudential framework for tackling remaining liquidity and leverage risks in the asset management sector. Although asset managers might be acting individually in the appropriate way for their own risk profile, what emerges collectively may not be in the interest of financial stability, of the wider economy or of the sector. An example of this would be market participants selling assets all at the same time and creating stability concerns as a result. Such a macroprudential approach has been implemented for the banking sector with new capital buffers and liquidity measures, following the observation during the financial crisis that despite existing regulations, banks were not always acting in the interests of citizens and the wider economy. The same goes for the asset management sector. Despite the measures already in place for mitigating financial stability risk, more progress is needed on tools to manage the problems stemming from suboptimal collective action. In other words, if central banks are required to intervene in certain cases, this means that collective liquidity has been outsourced to the wider community. As in banking, it is important to strike the correct balance between having central banks as ultimate backstops and ensuring that financial stability risks are appropriately internalised by actors.

An industry representative stressed that many liquidity management tools are already available in different EU countries for mitigating the liquidity risks associated with asset management activities. In addition, the EU regulatory framework of AIFMD and UCITS supports the resilience of the sector, as was demonstrated during the first months of the Covid crisis. Concerning liquidity mismatch, an essential element for mitigating this risk is providing investors with the appropriate assets. Regulators have a responsibility in this regard, together with the industry, in making sure that a fund submitted for authorisation has a profile that is appropriate and likely to deliver positive outcomes for investors, and subsequently ensuring that market players apply fund rules adequately.

A regulator agreed that regarding liquidity management tools there is no need to 'reinvent the wheel'. The basic work on this topic was completed by the FSB and IOSCO at the international level. Moreover EU jurisdictions have many tools at their disposal, including swing pricing and gating, which were successfully used in the last few months, resulting in very few fund suspensions. The issues that regulators in the EU are facing relate more to the better use of existing liquidity management tools and their harmonisation across the EU, rather than the creation of new ones.

4.2 Additional areas of improvement for enhancing the economic role of the EU fund industry

4.2.1 ESG policies

A regulator emphasized the need for a regulatory framework supporting the evolution towards more sustainability. Positive work is being carried out by the European Commission, ESMA and many private firms in this area, notably concerning ESG disclosure. An industry representative was in favour of developing EU level ESG funds. At this stage, Europe is among the few leaders on sustainability due to the European Commission's action plan. A practical way for enhancing this position would be to implement an ESG label for EU based funds. This could be a significant contribution to the real economy and to ensuring the competitiveness of the EU fund industry.

4.2.2 ELTIF review

The industry representative suggested that reviewing the ELTIF framework would also be beneficial. This review, aiming to make ELTIFs more flexible and usable has been pending for over a year. Further harmonising the taxation regime of ELTIFs at EU level is however necessary for these funds to develop in the retail area. A policy-maker was pessimistic about the possibility of addressing this taxation issue at EU level, because that would necessitate the unanimity of member states.

4.2.3 Rules for retail investors

A regulator stressed the importance of increasing the participation of retail investors in capital markets and investments. There are many retail funds, but a substantial proportion of their investors are professionals. Further developing retail investment requires enhancing investor trust, with appropriate investor protection, and also increasing the scale of fund distribution across the EU in order to reach a greater number of investors. Marketing rules need to be further harmonised, because there is still significant divergence between national regimes. Second, it is important to consider how digitalisation may facilitate cross-border distribution and to establish a framework for marketing funds through digital channels.

4.2.4 Equity research

The industry representative suggested that the MiFID research regime is another area that could enhance the contribution of investment funds to the financing of the economy. The current MiFID research regime has many unintended consequences. The Commission is consulting on this currently. Moving towards a dual-regime, with the re bundling of some parts of research would be challenging to handle for large players since it would mean managing two different regimes within the same portfolios. In addition that may be confusing for investors. Instead, the industry representative suggested promoting an issuer sponsored research regime at EU level that could come into play and support liquidity when there is no external research available, e.g. in micro, small and mid cap capital markets. ■