ASSET MANAGEMENT TRENDS AND POLICY IMPLICATIONS

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Asset managers' strategic role in the recovery

While we recover from the pandemic shock, asset managers must face the trends it has fueled, especially in what regards sustainability and technology, while at the same time dealing with policy and regulatory developments in respect to many pressing issues, with financial stability, passive investment, delegation, passport improvements, ESG or investor protection and engagement at the forefront.

Digital transformation, a CMU and EU priority, has been extensively accelerated by the pandemic, involving relevant risks and opportunities. Data analytics, machine learning and artificial intelligence, if properly used, may strongly contribute to foster efficiency at back office, sales and distribution levels – enabling Direct-to-Customer approaches as an alternative to Business-to-Customer; to upgrade customer experience and access to new asset classes; and to support active management decisions. Technology-enabled advice also allows for new and more efficient ways of providing wealth management. As is well known, middle and back office operations have historically been an expensive cost source for asset managers, whose competitiveness depends on their ability to offer value for money to investors.

Digitalization and technology may effectively minimize such costs in the long run, by increasing operational automation and improving the opportunities for outsourced relationships – not only related to the day-to-day operations, but also to key functions as portfolio management and investment advice. Distributed Ledger Technology will also support this movement, enabling more secure, cost effective and fully traceable flows, while opening the way for new processes and products.

Asset managers should avail the transformative times we are experiencing and make the most of it.

All these opportunities should not lead us to ignore the risks posed by digitalization to market integration – namely, excessive concentration and market power on few asset managers – and to investors – who might not be prepared to deal with the new challenges posed by digital illiteracy, behavioral distortions in digital economy and the increasing disintermediation of financial relations. Asset managers, but also policy makers and regulators, are therefore requested to find proper approaches to all these risks, preserving competition and financial stability.

At product level, investment allocation to passive products remains a trend, as investors search for low fees while broadening their market exposure. But the demand profile is changing: along with the continued growth of ETFs, we observe also an increased demand for ESG and long term investment products that meet the current demographic challenges in the advanced economies. Additionally, the inclusion of digital currencies in funds' portfolio should not be neglected as a critical challenge and source of risks to asset managers and regulators.

All in all, the asset management sector, considering all these challenges and opportunities, and being the most democratic and risk diversified savings product for investors, will have a strategic role in supporting the recovery and the transition to a sustainable economy. Its success will depend on its ability to attract retail investors and foster their confidence through fair, robust, and transparent investment options.

Ongoing policy and regulatory initiatives will hence have to acknowledge and support these trends and handle the risks therein. The ongoing AIFMD and ELTIF reviews and the implementation of the CMU proposals are already do it. But the EU retail investment strategy, planned for 2022 will be key. It will have to set up a comprehensive and integrated strategy, more than merely a sum of rules, to give EU citizens the necessary tools and confidence to allocate their savings to investment products and increase retail participation in capital markets. For such purpose, more and better investment advice, improved and consistent financial disclosure, including on PRIPPS, and improved financial literacy (of current and potential investors), alongside with reinforced intervention powers and supervisory convergence, will be paramount.

The most important factors of these initiatives will be to create strong and clear incentives and benefits for retail investors, fostering their confidence in the market through clear and comparable information, diversified products, easiness of access and avoid complex, disproportional and excessive regulation. But, of course, it is also on market participants and not only on regulators to take the responsibility to rise up to the challenge, to avail the transformative times we are experiencing and make the most of it, taking the opportunities to develop new business models, new products and new distribution channels, while putting the investors' interests first as way to build a sustainable and profitable future.

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Changes to the AIFMD can increase resilience in the non-bank sector

The development of the regulatory framework for the alternative investment sector has been important for the welfare of European investors and the development of European capital markets in general. Since its introduction in 2013, the AIFMD has supported the development of a European market for alternative investment funds, while protecting investors and improving the monitoring of potential risks to the financial system.

It is therefore important that reform of the AIFMD, UCITS and ELTIF frameworks are considered in the context of serving the needs of the European economy and the economic welfare of EU citizens, and that the sector operates fairly and in the interests of investors and consumers. The review of these frameworks has a key role to play in supporting the Capital Markets Union - whereby better facilitating investment across Member States and providing firms with a range of funding options, the non-bank sector can support the economic recovery post Covid-19. The ELTIF review represents an opportunity to enhance the funding of European long-term investments.

Since the introduction of the first UCITS directive in 1985, European capital markets have become increasingly characterised by cross-border activity. The AIFMD, particularly through the marketing passport, has further supported the removal of barriers between jurisdictions. This has helped to provide financing to the European economy and improve outcomes for investors.

The sector is evolving rapidly, however, driven by regulatory changes since the global financial crisis; initiatives such as the CMU to boost direct retail participation in capital markets; and improvements in technology. It is important that the regulatory framework and supervisory architecture keep pace with this changing environment. Continued strengthening of supervisory coordination and consistency is an important part of securing best outcomes for European investors and the EU economy, including in supporting the delivery of the Capital Markets Union, with ESMA continuing to play a key role in this area. Further enhanced coordination and consistency across EU supervision will be important in the context of securing optimal levels of integration between European and international capital markets.

The regulatory framework must keep pace with the changing environment.

When delegation arrangements, for instance, are subject to high standards and robust and consistent supervision by NCAs, investors can avail of substantial benefits. These include reductions in costs, increased operational efficiency, and a wider range of well-managed investment opportunities. To safeguard investor protection, delegation must be performed responsibly with AIFMs maintaining high quality and effective oversight of their delegates. The AIFMD must continue to ensure that fund management companies discharge their obligations in a safe and sound manner and in the best interest of investors, while maintaining the benefits of delegation.

The Covid related financial shock of 2020 brought into focus how collective responses by investors in parts of the investment fund sector-in particular the first-mover dynamic - could potentially amplify financial stress. There is therefore a need to consider how national and European authorities can develop and apply macroprudential powers to limit the build-up of systemic risk. Currently, the EU does not benefit from a complete and operational macroprudential framework for the non-bank sector, so further development is required.

One example of this is the work currently underway on operationalising Article 25 of the AIFMD. The ESMA guidelines, published last year, will help to ensure that NCAs can apply macroprudential leverage limits on AIFs or groups of AIFs in a manner that is consistent, transparent, and effective in reducing risk to the financial system.

However, improvements to the Article 25 mechanism should be considered to make it a more holistic tool for responding to the nature of the systemic risk posed by investment funds. Moving beyond this, there is a need to create a macroprudential framework for liquidity in the investment fund sector, under both AIFMD and UCITS. This would involve considering measures that align the liquidity of funds' portfolios with redemption terms (including pricing), with the objective of mitigating the systemic impacts of investors seeking to gain first mover advantage in redemptions.

Given the success of the AIFMD and UCITS regimes in supporting cross-border activities, macroprudential tools may in some cases need to be applied uniformly across jurisdictions. The current framework could be amended to provide for enhanced reciprocity between NCAs to ensure that measures are not circumvented by re-domiciling.

It is important that the opportunity of the AIFMD review is used to develop the resilience of the European non-bank sector, so that future periods of financial stress do not lead to failings in either investor protection or financial stability and undermine the potential for more effective pan-European capital markets.

JÉRÔME REBOUL
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The AMF proposals to strengthen the EU cross-border supervision of funds

AIFMD has been successful in creating an efficient internal market for Alternative Investment Funds ('AIFs') and setting out robust and competitive standards recognised internationally. The AMF does not believe a global overhaul of the directive is needed. Yet, the upcoming review of the directive is an opportunity to consider significant improvements in certain areas, taking stock after almost a decade of application of the AIFMD framework and learning from the vulnerabilities highlighted by the COVID crisis.

The AMF set out detailed proposals in a position paper published in March 2021, highlighting key issues that in our view deserve specific attention in the AIFMD review and should be addressed holistically e.g. with the necessary mirror amendments in the UCITS directive. One area of particular importance, is the supervision of funds cross-border activities: how can we enhance the supervision of funds' cross-border activities within the EU?

The AMF believes a smoother organisation of responsibilities between national competent authorities ('NCAs') would be instrumental to a more efficient supervision of the cross-border activities of alternative investment fund managers ('AIFMs') within the EU. A key challenge is the fragmentation of supervisory responsibilities amongst several NCAs in the case of AIFMs acting under the management passport and the resulting fragmentation of the information required to have a full picture of the cross-border activities of AIFMs.

The partition between rules applicable to fund managers and rules applicable to funds is indeed not always clear-cut and often generates some overlap when a fund and its manager are domiciled in different EU jurisdictions. For instance, according to AIFMD/UCITS, the NCA of the fund manager ('Manager NCA') is responsible for the supervision and enforcement of risk management, liquidity management and valuation requirements that AIFMs have to comply with. In parallel, the NCA of the fund ('Fund NCA') is also responsible for supervising and sanctioning any investment breach or valuation issues within the fund.

How can we enhance the supervision of funds' cross-border activities within the EU?

The current fragmentation in the supervision of cross-border activities means that none of the NCAs involved enjoys a comprehensive picture of the asset manager's activity, which might be detrimental when emergency supervisory actions are needed in times of crisis. For example, the Manager NCA may need access to information related to that manager's funds domiciled in other jurisdictions for the purpose of carrying out its supervisory responsibilities. Although information may be accessed through cooperation arrangements with other NCAs, experience shows that NCAs have different priorities and due to resource and time constraints, they may not be in a position to cooperate at the level and speed required by the circumstances.

In order to remedy the sub-optimal effects of fragmentation and to ensure there are no supervisory gaps, we believe one NCA should be granted a leading role and equipped with appropriate tools to monitor the activities of the asset manager across the EU. In our view this 'Lead Supervisor' role would be best awarded to the Manager NCA, who is already responsible for the supervision of the fund manager and its funds domiciled locally.

Therefore, we propose to enhance the Manager NCA supervisory responsibilities when the manager activates the management passport to operate cross-border, without adjusting downwards the responsibilities of other NCAs.

This would entail granting the Manager NCA direct access to all fund information held at the level of service providers (such as the depositary and auditor), in full transparency with the Fund NCA. This could include for example the breach reports produced by depositaries in the course of their oversight functions.

In addition, NCAs should be required to report to ESMA all notifications they receive regarding the use of the management passport, as well as all instances where portfolio or risk management is fully delegated to third parties. This would serve to complement the information on the marketing passport that will be reported to the future ESMA central database required by Article 12 of Regulation (EU) 2019/1156, thereby centralizing at ESMA level all relevant data on cross-border activities by AIFMs.

Fragmentation of supervision is a challenge for competent authorities but it is inherent to a vibrant EU internal market and we should endeavour to deal with the additional complexity in the most effective manner. It is time to seize the opportunity of the upcoming AIFMD review to fine-tune our rules and design a more effective framework for the future.

SEAN HAGERTY
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The future of asset management in Europe: shaking up traditional business models

According to the European Central Bank (ECB), household savings in the EU have reached unprecedented levels in response to Covid-19. The effect on individual savers during the Covid crisis has highlighted the opportunity to set policy that encourages long-term financial sustainability for EU citizens. Deposits in banks alone will not be able to address these needs – consumers in all wealth brackets need to have access to high quality, low-cost and broadly diversified long-term investment opportunities in order to help them achieve financial well-being.

In Europe, there is a solid savings culture to build on. But cash savings are typically less effective in the long term as a result of the erosive effect of inflation. Money put aside today is worth less in the future. As a result, going forward, the challenge for both policymakers and the industry is to help savers transition to long-term investments where there is a need for a positive long-term real return.

While the past year has brought sudden shocks and challenges to the marketplace at large, we also believe that the various learnings will accelerate changes in investment markets. At Vanguard, we believe that a long-term investment culture in Europe can be built using an investor-centric approach. The EU's Capital Markets Union (CMU) has an offer that embodies strong investor-centricity, and therefore creates the opportunity to build significant momentum towards an investment culture oriented towards the long-term.

But there are three basic steps that must be taken to boost retail participation in the markets. First, more must be done to encourage people to invest for their long-term future. Second, we need to empower European citizens by reducing barriers to investing, and ensuring rules are consistent across the EU. Finally, once people are saving, they should have access to a fair deal. This means being able to seek out appropriate financial advice, guidance, and investment products, and not being charged unreasonable fees.

Beyond macroeconomic shifts, other changes are afoot that have the potential to improve European citizens' long-term financial futures and their relationship with asset managers.

Europe has built great foundations for retail investment through patient and considered development of the UCITS fund ecosystem. As the total size of the UCITS fund market has grown, so has the opportunity for investors to benefit from economies of scale, lower costs and higher net returns.

A long-term investment culture in Europe can be built using an investor-centric approach.

The European ETF sector continues to grow steadily, helping an increasing number of European investors to benefit from low costs and broad diversification. Developments in financial technology are further helping to increase the public's access to investment opportunities, improve transparency and drive down costs. For us, one of the most exciting uses of technological advances in asset management is how technology is helping to augment human advisors in the provision of investment advice. Innovations in automation and artificial intelligence now offer firms the opportunity to provide low-cost, technology-enabled advice in order to meet the differing wants and needs of the investing public in the EU. In particular, these models appear to have been helpful in ensuring that the younger generation is engaged with their finances and can make better investment decisions.

While there is an opportunity to create an investment culture in Europe, there is also a risk that without the right policy, long-term investment in the capital market could be mistaken for, or substituted by speculation in the capital markets. Policy needs to promote long-term investing by individuals and avoid individuals mistaking investment with speculation.

The rapidly evolving ESG landscape continues to push investment companies to develop new ways by which to deliver value to investors.

However, to positively change investment culture in Europe, we also need to tackle some long-standing challenges. The total cost of investing in Europe remains too high. And potential conflicts of interest in the distribution chain continue to exist through the ongoing dominance of commission-based sales models in many parts of the EU, increasing costs and reducing choice and competition for investors.

The last year has continually shown us that while change is difficult, it is also an irrefutable force.

As policymakers contemplate a CMU to benefit retail investors, we would encourage them to design a regime that is fit for the future and not one that shies away from tackling long-standing challenges and incumbencies.

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ELTIF – White knight or a damp squib?

The ELTIF structure was launched in 2015 to satisfy a clear investment need: to facilitate investment in longer-term assets such as transport and social infrastructure projects, property and small and medium-cap companies (SMCs). Additionally, the ELTIF regime was also introduced to fulfil an equally clear investor need: to provide retail investors with the ability to invest in private markets.

The ELTIF concept was, therefore, a good one, but the implementation and subsequent industry take up has not had the desired effect. The European Commission estimates that only around 27 ELTIFs have been launched in the EU, not all of which are being marketed, with total assets under management (AuM) below €2 billion. This represents c0.03% of the €6.8 trillion EU alternative investment fund (AIF) market.

The challenge in practice is that the ELTIF regime, as currently calibrated, seeks to provide access to private markets, but at the same time significantly limits eligible assets in a way that AIFs sold to professional investors are not, for example by effectively constraining managers to invest in infrastructure projects that have a rather loosely-defined social benefit.

Although a laudable aim, in our view, the restrictions mean that it is challenging to launch an ELTIF that can either be invested practically or provide returns that are acceptable to an investor required to lock their capital up for a substantial period of time. The result is that take up of the ELTIF remains limited – the ELTIF has not turned out to be the 'White knight' the industry wanted, but rather a damp squib.

Europe needs a viable long-term investment product for all investors. The continuing decline of defined benefit (DB) pension funds, alongside the steady increase in defined contribution (DC) pension schemes and privately saved capital; combined with an aging European population illustrates the need for all investors to increase their allocations to asset classes with longer term horizons. A recalibrated ELTIF regime has the potential to fulfil this need.

Therefore, the first priority of EU policymakers in reviewing the ELTIF regime should be to substantially reduce the restrictions on eligible assets. For example, under the current regime, investment in real estate is currently restricted to *«commercial property or housing... where they are integral to, or an ancillary element of, a long-term investment project that contributes to the Union objective of smart, sustainable and inclusive growth.»*

Europe needs to improve retail investors' access to investment opportunities in private markets.

This is so restrictive as to make it almost impossible for a manager to be able to invest in this asset class. In our view, there are very few investment opportunities that would meet such criteria, and those that do tend not to provide a return on investment in line with investors' expectations. The EU's objective of smart, sustainable and inclusive growth is, of course, a good one, but placing such restrictions on ELTIFs serves only to undermine this objective, rather than support it.

A better approach would be to allow investors to decide how to encourage smart, sustainable investment. In Europe especially, sustainable investing is at the forefront of many investors' thinking, both institutional and retail, and with the introduction of the EU's Sustainable Finance Disclosure Regulation (SFDR) and taxonomy providing some guidance on how sustainable a fund is, there is a ready-made framework – an ELTIF with the freedom to invest in any real estate opportunity, but which can be classified as an Article 8 or even Article 9 product is likely to be an attractive proposition.

EU policymakers should also focus on recalibrating provisions governing ELTIF redemption policies. Currently, ELTIFs are designed to be long-term investments offering little liquidity to investors and returning capital at a defined point in the future. Here, lessons should be taken from the broader AIF market. Managers of ELTIFs should be able to include the sort of liquidity and valuation mechanisms afforded to professional investors in AIFs. These are tried and tested, and having an ELTIF regime that provides greater liquidity than is currently available would help to facilitate more retail investment in this type of product.

Other areas of the ELTIF regime that require to be made more amenable from the perspective of a retail investor include revising downwards minimum investment requirements and enhancing the proportionality of rules on marketing and suitability.

In summary, the ELTIF concept is a good one, but it needs refining in order to gain popularity and critical mass. Targeted amendments in the areas described above would significantly increase the ability of managers to create well considered and attractive investment propositions while retaining robust investor protections, improve the ability of retail investors to access investment opportunities in private markets and, ultimately, boost investment in longer-term assets such as transport and social infrastructure projects, property and SMCs.