24 November 2023
ESMA34-44599010-313

The role of asset management – channelling capital into financial markets preserving financial stability and sustainability aims

EFAMA Investment Management Forum – Brussels

Verena Ross
Chair

Introduction

Good morning, Ladies and Gentlemen,

Thank you for inviting me to this edition of the EFAMA Investment Management Forum. It is always a pleasure for us, at ESMA, to interact with EFAMA and its members on what is high on the policy and regulatory agenda for the asset management sector.

There is a lot on the agenda to keep us busy, both the asset management industry and supervisory community, as we come to the end of this legislative cycle. For today's intervention, I thought it would be useful to start with a stock-take of regulatory initiatives to preserve financial stability in the non-bank financial sector, and asset management in particular.

In the second part of my speech, I would like to focus on sustainability. Bearing in mind the importance of investors' trust to foster their active participation in Europe's capital markets and the need to find a way to transition to a more sustainable economy, I would like to explain why transparency and comprehensibility of sustainability disclosures on one side, and addressing greenwashing risks on the other, remain extremely important for us at ESMA.

Finally, I hope you will allow me to share a brief comment on a topic the conference has also focused on – T+1.

Financial stability

Following the Global Financial Crisis, financial regulation has gone through an unprecedented wave of global reforms. While banking undoubtedly remains a concern for all of us when it comes to financial stability, the G20 also endorsed Financial Stability Board (FSB) recommendations to strengthen the regulation and oversight of the financial sector "beyond" banking. At the EU level, we have taken a number of key measures through regulation, as well as through enhanced data collection and risk analysis. In this respect, MiFID II and EMIR were particularly instrumental in addressing the market opacity which played such a detrimental role in the unfolding of the crisis, by moving trading to regulated markets and clearing of derivatives to central counterparty clearing houses (CCPs). As you know, an important regulatory change has been that hedge funds are now regulated under EU law by the Alternative Investment Fund Managers Directive (AIFMD), and directly supervised by national EU securities regulators. National supervisors are able to collect data on these alternative funds and to monitor their level of leverage. AIFMD and UCITS are centrepieces of a comprehensive regulatory framework also including specific rules applicable to specific type of funds, such as MMFs, ELTIFs or ETFs.

The increased data availability improves our capacity to analyse risks from a financial stability angle. Regulators and supervisors have been developing a monitoring framework, taking into account both the risks posed by the entities and their economic functions. At the global level, the FSB is publishing an annual global monitoring report on non-bank financial intermediation, which has become the landmark to analyse Non-Bank Financial Intermediation (NBFI) development since the crisis. In the EU, ESMA is publishing a risk monitor twice a year, and publishes EU market reports based on regulatory data in its remit, such as

MMFs, AIFs, derivatives markets, securities markets or CRAs, on a regular basis. ESMA is also a key contributor to the ESRB NBFI monitor, which is now a well-established product when it comes to assessing the developments in the NBFI sector and the potential risks to financial stability.

While these reforms have extended the regulatory scope since the global financial crisis, recent stress episodes have shown that financial stability risks can still be triggered. For example, we have seen the impact of the 2020 turmoil on fund liquidity, or more localised episodes, such as Archegos or the LDI turbulence, where leverage via derivatives (or repo) played a great role in risk amplification.

Over the past years, we, at ESMA, have actively contributed to the discussions at the European and international level (with the ECB, the ESRB, the FSB and IOSCO), leading to a number of concrete proposals notably in the area of investment funds with a view to strengthening the overall resilience of the financial system further. In that context, the FSB are expected to issue their new recommendations on liquidity mismatch in open-ended funds and IOSCO should issue their guidance on anti-dilution liquidity management tools – both by the end of the year. With respect to leverage risk in NBFIs, the FSB and IOSCO are also coordinating policy work to enhance the monitoring of leverage in NBFI and address outstanding financial stability risks. This work includes taking stock of the policy tools that are available to authorities to contain such risks and considering potential further measures to address them.

As you know, ensuring orderly and stable markets is at the core of ESMA's mission. In that context, leverage is one risk we have been actively monitoring in the fund sector as excessive leverage may amplify the impact of negative market movements.

It is fair to say that the end of the low interest environment has been and will remain for some time a key driver for developments in the asset management sector and the economy at large. Since the Covid-19 outbreak, a succession of shocks of different nature brought inflation to levels unseen in 40 years, up to 11.5% on an annual basis in the EU, in October 2022. Higher energy prices, reaching 10-year highs, have particularly contributed to inflation, widely increasing input and distribution costs. As a direct consequence, central banks tightened their monetary policies to reduce demand and bring inflation back down. Interest rates increased by 4.5 percentage points in the euro area (EA) over one year and 5.25 points in the US, taking yields to levels not seen in ten years. Uncertainties and risks with respect to the macro-financial environment remain high, which is reflected in subdued current growth and a GDP forecast set at 1.4% in 2024 in the EU.

I don’t need to tell you that asset managers need to adapt to this new reality, after operating for years in a low yield and low inflation environment. The asset management sector has seen rapid growth since the financial crisis, increasing four times in size. The normalisation of monetary policy led to an historical but orderly decline of EUR 2tn (-11%), mostly owing to valuation effects. However, higher interest rates also put pressure on levered funds as illustrated by the impact of the UK gilt market turmoil on leveraged Liability-Driven Investment Funds in 2022. Generally, the transition to the new environment creates challenges for funds managing assets sensitive to interest rates, especially when they are not liquid – such as real estate funds. ESMA and supervisors are monitoring the situation closely.

In that context, NCAs and ESMA conduct regular risk assessments in the investment fund management sector. ESMA published Guidelines on the implementation of Article 25 of

AIFMD to promote convergence in supervisory practices and discussion among supervisors regarding leverage. The Guidelines include a set of leverage-related risk indicators that can be measured with supervisory data. When NCAs identify funds, or group of funds, posing financial stability risks, the Guidelines define a number of principles to consider when designing, calibrating and implementing macroprudential leverage limits, such as those imposed last year by the Central Bank of Ireland on Irish real estate funds.

Focus on valuation

In addition to leverage, valuation is another risk that ESMA is monitoring in the fund sector. Indeed, exposures to assets facing liquidity issues can be hard to value, especially in case of stressed market situations. Assessing whether a fair value of these assets can still be determined and adapt the valuation without undue delay can be challenging. Since the emergence of the Covid-19 pandemic, we have identified several issues related to the valuation of assets. To name a few, these include consistent application of valuation rules, insufficient control by the management companies on the quality of external valuers and/or overreliance on external reports. This is why in 2022

ESMA has conducted a Common Supervisory Action (CSA) on valuation with NCAs with a specific focus on less liquid assets, such as Private Equity and Real Estate assets, whose nature can amplify the structural liquidity mismatches of certain types of investment funds.

The CSA provided a valuable opportunity to exchange knowledge and experiences amongst NCAs on their supervisory approaches to addressing adherence with fair value principles, both under normal and stressed market conditions. We also focused on ensuring that UCITS and open-ended AIFs implement sufficiently sound valuation policies and procedures, as well as provide appropriate disclosures on valuation-related matters to investors. This CSA aimed to ensure that both market participants and NCAs are better prepared to address valuation-related challenges in future periods of stress. It is therefore important that NCAs address the deficiencies identified in the course of the CSA exercise and keep paying close attention to potential valuation issues arising from less liquid assets. Hence, ESMA welcomes that NCAs have planned to follow-up on some of those identified deficiencies and encourages the use of enforcement where appropriate.

Sustainable finance

Given the panel just discussed the ESG regulatory framework, I thought it would be right to spend the second part of my intervention this morning to mention our work in the sustainable finance space. We are all aware of the fact that it is time for the regulatory framework to now gain some maturity and regulators are committed to helping the market get regulatory clarity and consistency. At the same time, given ESMA’s core investor protection role, we need to focus on ensuring a trusted environment to encourage sustainable investing.

On the regulatory side, I should start by saying that we welcome the Commission’s consultation on the assessment of the SFDR. It provides a good opportunity to take a step back and look holistically at what improvements can be made. The message I want to leave you with today is that to have a coherent framework that caters for the sustainable finance transition and for investor protection, there are two things we need to look at:

- First, comprehensibility. We need to empower investors with the ability to absorb the amount of available information. As you know we are about to publish our Final Report on the review of the SFDR Delegated Regulation. We have tried within the existing regime to improve the current templates by introducing language simplification and a 'dashboard', taking into account the results of consumer testing. I am the first to admit that this is only a first step towards the simplification of disclosures that should be further improved in the context of the Commission's overall assessment of SFDR;

- Second, one size may not fit all – what I mean is that we can envisage very simple disclosures for retail investors and more comprehensive information for more sophisticated investors. The key is to differentiate the information that are key for retail investors (e.g. the level of greenness disclosed in a simple and understandable manner) vs. more technical information relevant to sophisticated investors (e.g. PAI that would still be available and disclosed to provide full transparency).

ESG disclosures as ESMA USSP

From a supervisory perspective, effective and consistent supervision and enforcement of the ESG framework at both EU and national level is equally critical. This is why ESMA has decided to upgrade ESG disclosures as one of our two Union-wide strategic supervisory priorities since the beginning of this year. By doing so, ESMA is urging NCAs to implement this priority into their national supervisory work programme this year and in the years to come. By defining the topic as a top supervisory priority for NCAs the intention is twofold. On one hand, this provides us a good framework to ensure that actions are taken concertedly and in a consistent manner among NCAs pursuing the same goals.

On the other hand, we are also using this tool to approach ESG disclosures in a coordinated manner across key segments of the investment value chain (from issuers to investment managers and investment firms). As a matter of fact, among the actions taken to implement this top supervisory priority, ESMA and NCAs are actively engaged in the implementation of several ESG-related Common supervisory actions while a few more are in the pipeline. In July, ESMA and NCAs have launched a CSA on sustainability-related disclosures and the integration of sustainability risks in the investment management sector. From our experience of previous CSAs, these are a very effective tool to go beyond having common guidance and deepen the convergence of real supervisory practices. Our primary objective is to evaluate to what extent market participants adhere to sustainability related regulatory provisions and standards in practice. Of course, the conclusions of that exercise will also feed our work on greenwashing, and more generally help us identify where there is need for further supervisory intervention.

We are also revising existing guidelines to reflect ESG considerations, ensuring that investors receive accurate information and advice about products that properly reflect the product's sustainability features. These updated guidelines will help distributors consider sustainability preferences properly, giving retail investors the trust and confidence they need. At this point, I believe it is worth mentioning that ESMA, in collaboration with the other ESAs, has been working on a Financial Education factsheet on sustainable finance which will be published at the end of this month.

Furthermore, we have consulted on guidelines for investment funds using ESG or sustainability-related terms in their names. We continue to consider this a high priority to address greenwashing risks in the investment management space. Given the widespread use of SFDR disclosures as proxy labels, and the long time needed before SFDR is successfully reviewed, we believe guidelines in this area will help investors choose sustainability-related investment funds with more clarity on their real sustainability characteristics. We will shortly communicate publicly more about the next steps related to this initiative.

Our continuous efforts to address greenwashing

Effective ESG disclosures is for us one clear area which we need to tackle if we want to address the risk of greenwashing. Findings from ESMA's Greenwashing Progress report published this June show that greenwashing is driven by a multitude of structural factors including a steep learning curve for all stakeholders, scaling up the necessary skills and tools (e.g. IT) in implementing the necessary ESG governance, ESG data availability issues, an enforcement gap, and a fast-moving regulatory framework.

This is particularly relevant for funds, where we have identified several high-risk areas of greenwashing including misleading claims about real-world impact and claims about engagement with investee companies. First, we found that claims about impact are often vague and cover very different ambition levels. Moreover, we found many instances where it was unclear where a fund's impact was actually being achieved, in other words, whether the impact was attributable to the underlying investee companies held by a fund and/or to the investment strategy itself. Second, regarding engagement, our findings showed that, on the one hand, some funds doing bespoke active engagement with companies do not always provide the necessary details about how this engagement is actually carried out (e.g. intermediary milestones, how progress on engagement impacts buy or sell decisions). On the other hand, some funds reference engagement excessively, even when engagement is not a binding element of their ESG strategy.

Our progress report was meant to support a common understanding of greenwashing. It was also meant to identify points of attention for market players across the investment chain when making sustainability related claims. I want to be clear - we do expect that such claims are substantiated.

In parallel, we are working with NCAs to take stock of the supervisory response to greenwashing. In terms of what you can look forward to, ESMA, along with the other ESAs, will publish their final reports on greenwashing in May 2024.

[A note on ESG ratings

Finally, on ESG ratings, we are closely monitoring the progress of the ESG rating file and are hopeful that an agreement can be reached before the end of the European Parliament's term. ESMA has been highlighting the need for regulatory safeguards for ESG rating and data assessments since 2021 and led the work of IOSCO to deliver good practices for ESG rating and data providers. It is important to keep in mind that Europe is not alone in taking action here, and we need to be mindful of approaches taken in other jurisdictions to ensure international alignment is maintained, to the extent possible. Whatever the outcome of these discussions we are pleased to see action being taken in this area by the co-legislators and will support its implementation as needed.]

Shorter settlement cycle

As forewarned, I wanted to finally touch on one other issue that you are discussing during this conference. The EU fund management industry is directly and heavily affected by a changing post-trading landscape. Some third-country jurisdictions have already transitioned to a shorter settlement cycle. Others are considering shortening it.

Looking at our European markets, at the technology available and at the evolution of other markets outside the EU, we need to ask ourselves whether a two-day settlement cycle is still right for European markets.

This is why we launched a Call for Evidence on shortening the settlement cycle in October. The objective is to gather all the necessary feedback to assess whether settlement cycles in the Union should be shortened, and if yes, how, and when.

This assessment has to be transversal, including parameters that directly concern the funds industry, such as the functioning of securities lending or the degree of alignment between the subscription/redemption and the settlement cycles. That's why we have actively sought the input of the funds industry as part of our stakeholder engagement from the start.

We are also aware that these considerations arrive at a moment when the EU asset management industry is preparing to the move to T+1 in the U.S. by the end of May next year. There are a number of industry initiatives to address these challenges and complexities and ESMA is actively engaging with EFAMA to understand the implications for EU asset managers of different settlement cycles across the Atlantic.

ESMA is also using the call for evidence for the identification of possible regulatory changes that would smoothen the impact for EU market participants of the U.S. move, to help the competitiveness of our industry and prevent negative externalities.

I must thank EFAMA and its members for all the feedback already provided and also encourage all of you to contribute to our call for evidence.

Conclusion

Now let me conclude. Our goal is to enable retail investor to benefit from participation in sound capital markets, while at the same time promoting financial stability. This is the driver behind our work at European and international level on the remaining vulnerabilities of the investment management sector, while fostering appropriate disclosures for retail investors, including of sustainability related information.

Our regulatory framework needs to remain fit-for-purpose in this changing world. As supervisors, we continuously challenge ourselves to support the adjustment of rules and supervisory practices in light of the changing market and regulatory landscape.

I am always grateful for the invitation to address your conference, allowing me (on behalf of ESMA) to engage with you on the many important topics we are currently facing. We very much value the quality of the engagement and look forward to future discussions. I hope we will be able to assess together the progress in these areas at your 30th conference next year.

And with this, I will conclude and open the floor to questions.

Many thanks.