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The Capital Markets Union, Asset Management and Stability

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Ladies and gentlemen,

I am delighted to be here at the 26th Annual Conference of the International Bar Association on the Globalisation of Investment Funds. Today, I will first talk about the Capital Markets Union (CMU) and the role that asset management has to play in it. I will focus the second part of my remarks on another topical issue in the world of financial regulation, namely asset management and financial stability. These are the two hot topics in asset management regulation and supervision which, as I will explain shortly, are very much related.

Let me begin by focusing my attention on the CMU initiative launched by the European Commission. ESMA fully supports the aims of the CMU to foster deeper and more integrated capital markets encompassing all 28 Member States of the EU. Indeed, ESMA's main objectives and activities are fully aligned with the envisaged CMU.

For example, to attract more investors to capital markets, a high level of investor protection is essential, and to further reduce barriers between national capital markets, supervisory convergence needs to progress substantially. A European Union with open capital markets and reduced fragmentation where investors are well-protected will attract investment, and strengthen Europe as a global financial sector.

In its green paper on the CMU, the European Commission made clear that new legislation would be developed only when necessary and that the focus should now be on how to make existing legislation, such as the UCITS Directive or the AIFMD, work better. The Commission also underlined the importance of developing alternative sources of funding of the real economy of the EU which, as we know, has traditionally been funded by the banking sector.

This means that, in the years to come, the asset management industry should, in principle, expect less new legislation. But let me be clear: this does not mean that the asset management industry will not be under close scrutiny by regulators. Firstly, as you are fully aware, policy makers and regulators, including many without a direct responsibility for the regulation or supervision of asset management, are increasingly focussing on stability risks of the industry.

Secondly, a successful CMU project will imply bigger and more interconnected EU capital markets. Without ensuring their financial stability, the efforts of legislators to make EU capital markets stronger, fostering cross-border activities and developing the emergence of new funding sources, will be in vain. Later in my contribution I will talk more extensively about asset management and stability.

Now, let me explain why, in my view, the asset management industry can play a major role in the success of the CMU. First, you could argue that the CMU is somehow already a reality for the asset management industry in Europe. Indeed, the UCITS Directive introduced the marketing passport for retail investor funds more than 25 years ago. There are now around 36,000 UCITS funds representing almost €8 trillion of assets under management. These are impressive numbers which, taken together with the success of UCITS outside the EU, should make EU policymakers proud. The UCITS framework has been further developed in recent years through the introduction of the management company passport and measures to facilitate cross-border fund mergers and master-feeder structures. The AIFMD extended the regulatory net to capture alternative investment funds, leading to a comprehensive coverage of investment funds in the EU.

I think you will all agree with me that the European asset management industry benefits from a strong and robust regulatory framework. This has been a major factor in its success, including beyond the EU as I just mentioned. Notwithstanding this success, it is important to identify steps and measures that could further strengthen the effectiveness and efficiency of the sector. Let me touch upon some concrete ideas which I believe could contribute to the further development of a successful pan-European investment fund sector. The objective of these ideas is to increase the transparency of funds towards investors, stimulate competition, and reduce cross-border hurdles:

(i) Today, investors already benefit from a detailed set of rules on remuneration and cost disclosures via the UCITS Key Investor Information Document (KIID). However, we need more than transparency alone. There are still widely varying practices on the substance of what are common costs and expenses of retail investment products for investors across the EU. Hence, further harmonisation of those costs and expenses should be considered;

(ii) Experience has shown the difficulties of disclosing comprehensive and relevant information on costs in a table or a summary cost indicator, and technology can help us. I think it would be in the industry's interest to complement the information on cost disclosure by setting up reliable on-line calculators or central databases on the costs of these funds;

(iii) We have seen national authorities introducing additional requirements for UCITS and AIFs; this clearly hampers their cross-border marketing and passporting. We need to specify the types of add-ons that national regulators can introduce, if any. We should also clarify the division of competencies with regard to the rules of conduct for UCITS management companies that have established branches in a host Member State to manage UCITS; and

(iv) Finally, we can take another step to improve cross-border marketing of funds. UCITS IV simplified successfully the procedure for cross-border marketing by introducing regulator-to-regulator notifications and clarifying the role of each national

regulator. Today, any updates to the document provided to the national regulator of the host Member State at the time of the notification have to be communicated by the UCITS itself. I believe that the notification procedure would be even more efficient if regulators were to share the updates to the documents between themselves.

I have just outlined a few ideas for how the asset management industry can contribute to the CMU. At the same time we should not forget that several new initiatives have been introduced within the EU in recent years with a view to ensuring that the asset management industry can play an even bigger role in the financing of companies. I have in mind in particular the Regulations on Social Entrepreneurship Funds (EuSEF), Venture Capital Funds (EuVECA) and Long-term Investment Funds (ELTIF). While these Regulations represent an important step forward, I strongly believe that more can be done. Since funds authorised under these Regulations have to respect specific requirements in terms of eligible investments, it may be the case that companies that need finance cannot benefit from these alternative funding sources.

Being radical is not the natural mind-set for a regulator but in this context it is appropriate to be, at the very least, ambitious in our thinking. Let us take as a concrete example the practice of loan origination by investment funds. In some Member States, such as Ireland, measures have been put in place to allow funds that are not authorised under the EuSEF, EuVECA and ELTIF Regulations to grant loans to a large spectrum of companies. Only a few weeks ago the German authority announced that it was moving in a similar direction. The legislation governing these

activities varies among Member States, which could act as a barrier to the development of a pan-European market for such activities.

Mindful of financial stability issues, ESMA believes that the development of harmonised rules should be explored with the aim of creating more favourable conditions for the cross-border marketing of these funds in Europe, while ensuring at the same time an appropriate level of investor protection and mitigating risks to financial stability.

Let me now move on from the topic of CMU and discuss the issue of financial stability and asset management. When I became the Chair of ESMA in 2011, the AIFMD had just been adopted after a period of intense negotiations. The aim of this legislation was to ensure a better regulation and supervision of alternative investment fund managers following the start of the financial crisis in 2008. This legislation is a concrete example of how policymakers started to focus on potential financial stability issues in the context of the asset management industry.

Also in 2011, G20 leaders agreed to strengthen the regulation and supervision of the shadow banking system and the Financial Stability Board (FSB) issued its initial eleven recommendations. Since then, at both global and EU level a broad range of measures have been adopted. On the one hand, through sectorial legislation like AIFMD and the upcoming one on MMFs, more entities are subject to strict regulation and supervision. On the other hand, nearly every new piece of post-crisis securities markets legislation includes the collection of data, thus progressively bridging the gaps that were identified or, in other words, casting light on any shadows that may have existed. In this respect, the

latest move under way is to introduce specific rules to improve the transparency of securities financing transactions (SFTs).

Notwithstanding the significant reforms introduced in recent years or that are due in the immediate future, the financial stability of asset management is attracting particular attention these days. This trend is partly fuelled by the fact that the current low-yield environment has created unprecedented challenges for asset managers. There are growing concerns that the alleged search-for-yield behaviour, coupled with ample market liquidity, leads to mispriced risk and overvaluation of some asset classes. In certain circumstances, significant sales by asset managers could depress asset valuations, thereby transmitting stress to other institutions, which may in turn be forced to sell assets.

But what are the triggers through which asset managers might play a role in downward spirals in stressed markets?

- Firstly, liquidity risk, especially for open-ended vehicles, can arise if investors wish to have shares redeemed, but the cash amount in the fund is not sufficient, and assets cannot be sold on short notice. In other words, there is a potential mismatch between the liquidity of fund assets and the liquidity for investors. This can create run risks for the fund in stressed market conditions and asset sales in response to redemptions can in turn spread stress to other portfolio market segments;
- Secondly, leverage, through borrowing or derivatives, is a potential driver of fire sales and may force funds to sell assets at depressed prices when facing higher haircuts or margin calls from creditors;

- Thirdly, their sheer size – more than €11 trillion for investment funds in the EU – and an active role in day-to-day trading could make them important actors in scenarios of herded trading; and
- Finally, asset managers are interconnected with the rest of the financial system, through direct investments or through financial intermediation, such as securities financing transactions (e.g. repos and securities lending) or over-the-counter financial derivative transactions. In particular, the re-use of collateral received by funds creates a network of linkages between financial institutions across different markets segments, including banks and non-bank financial institutions. Distress at the level of a fund or a group of funds thus may generate substantial risk for its counterparties, and have a broader impact on market liquidity and risk aversion.

As I pointed out earlier on, liquidity risk can have very adverse consequences for funds and ultimately for financial stability and investors. However – and I would like to stress this point – it would not be fair to say that liquidity risk within the asset management sector is not regulated at all. Indeed, from a regulatory perspective, both the UCITS Directive and the AIFMD have various requirements in relation to liquidity management which are designed to mitigate this risk. The UCITS requirements are the most prescriptive, reflecting the fact that UCITS can be sold cross-border to retail investors on the basis of a passport. The UCITS Directive provides that UCITS funds have to be invested in liquid assets and sets out specific rules for the eligibility of transferable securities, money market instruments and financial derivative instruments. Where appropriate they are also required to carry out stress tests as part of their risk management.

As far as the AIFMD is concerned, there are obligations on the fund manager to put in place liquidity management requirements and stress tests, especially if they manage open-ended or leveraged funds. The results of the stress tests must then be reported to national competent authorities. These results will be ultimately passed on to ESMA.

With respect to the network of linkages created by the re-use of collateral, I would like to stress that ESMA has already taken important steps. The ESMA guidelines on ETFs and other UCITS issues put strict limits on the extent to which UCITS are able to reinvest cash collateral received in the context of repo transactions and OTC financial derivative transactions.

Leverage is another important issue addressed by regulation. UCITS are subject to strict rules on the extent to which they may use financial derivative instruments to increase their exposure. Under the AIFMD there is no hard limit but managers must report information on leverage to their national competent authorities. Moreover, the AIFMD foresees the possibility for national competent authorities and ESMA to limit the leverage employed by a manager. In particular, ESMA can issue advice to national competent authorities to limit the use of leverage by a manager or group of managers in their jurisdiction. If a national competent authority takes action contrary to ESMA's advice, ESMA can publish the fact that the authority is not compliant.

As stated earlier, with all of these new regulations, securities regulators will also benefit from unprecedented data collection that can be used for financial stability purposes. I have already mentioned the information on leverage that managers will have to report under the AIFMD. Actually,

the data set to be reported is much broader. In order to facilitate the collection and monitoring of this information, national regulators will send all the data they receive under the AIFMD to ESMA via a dedicated IT system. We expect this system to be up and running in the coming weeks. The added value of all this data collection will depend in large part on the willingness of the asset management industry to provide regulators with good quality data. Therefore, while I have the floor I strongly invite the European community of asset managers to give regulators all the information they need to assess, and respond to, stability risks in financial markets.

During its first four years of existence ESMA has focused its efforts on putting in place the single rulebook: this was also reflected in our work on the asset management sector. As we are moving from legislation to implementation, I am convinced that it is now time for ESMA to work further on enhancing its understanding of the risks involved in asset management activities, and their interconnectedness with the rest of the financial system.

The information received under the AIFMD, as well as under legislation such as EMIR and MIFID II, will clearly improve the capacity of ESMA to analyse risks to financial stability and this is one of the key priorities for ESMA in the years to come. Going forward, I believe these efforts should be guided by four principles:

- Thorough risk identification. Non-banks are non-banks because they are not banks! While we can draw on the important experience that banking authorities have collected in the past years on macro prudential regulation, we need to fully take into account

that asset management is a sector in its own right, with a specific business model and risk profile.

- Risk-adequate tools and instruments. It logically follows that the policy responses we develop must be tailor-made to the specific risk profile of the asset management sector.
- Institutional cooperation. The market players we are dealing with are highly interconnected. This reality needs to be reflected in the way we as public authorities work together on this important topic. Banking authorities and market regulators have unique insights, and we can only benefit from bringing those to the table and following a joint approach.
- Promoting an international approach. We are not alone in the EU. The stability issues I have touched upon today are very similar to those discussed elsewhere in the world. Given the global nature of the markets and market participants we are dealing with, this is natural and necessary at the same time.

Ladies and gentlemen, let me conclude by restating that in my view the CMU and stable financial markets go hand in hand. The asset management sector should play an important role in the CMU. In the past decades, successful steps have been taken to integrate the EU asset management sector and to increase its importance as a source of funding. Further steps should be taken to achieve a truly pan-European sector, which is transparent towards its investors and competitive. However, a bigger and more interconnected asset management sector will also require enhanced supervision, including of its stability risks. We

need to achieve a comprehensive view of these risks, fully taking into account the specific characteristics of asset management. The regulatory reform of the asset management sector provides a solid basis to reach that goal. However, this is still work under construction on which we all need to work together.

Thank you for your attention.