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Keynote Address

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Ladies and gentlemen,

I am delighted to be here at the 7th Annual Cross-Border Distribution Conference in Luxembourg and first and foremost, I would like to thank the organisers - Deloitte Luxembourg, Elvinger Hoss Prussen and the Financial Times Live - for inviting me to speak today.

When I look at the current environment for asset managers and the relevant regulatory developments at national, EU and international level, there is no shortage of topics to speak about today. However I will spare you with detailed regulation and will instead focus my remarks on three key issues. Firstly, I will talk about a topic of ongoing importance to regulators, namely the role of investment funds in systemic risks. Secondly, I will talk you through ESMA's first annual costs and performance report on retail products, which focused extensively on costs of investment funds. Finally, I would like to also tackle the elephant in the room: Brexit – I will talk about key issues arising from it and how ESMA is preparing for it.

Investment funds and systemic risks

Allow me to first turn to investment funds and systemic risks.

The asset management sector has seen rapid growth since the financial crisis, contributing to the diversification of funding sources in the EU, which is one of the key objectives of the Capital Markets Union. So far, evidence suggests that most open-ended funds have been generally resilient, with the exception of some money market funds. However, we cannot be complacent – the sheer size and importance of the sector could make it potentially impactful in systemic ways. There are some concerns about the risks posed by the so-called 'liquidity mismatch', a situation in which some investment funds allow investors to redeem their holdings in a shorter timeframe than that in which the fund could reasonably liquidate assets, and I'll expand on our own look at this a little later on. It should not therefore come as a surprise that the increasing role of investment funds in financial intermediation caught the eye of international bodies and regulators both on a global and regional scale. This is also why in 2017 the FSB issued 14

policy recommendations to address structural vulnerabilities from asset management activities, followed by the ESRB's publication of its own recommendations last year. Both bodies highlighted that the two key areas of concern in the sector are leverage and liquidity.

ESMA has been doing its own analysis on leverage and liquidity in alternative funds, and we will shortly publish a report on EU AIFs using data collected under AIFMD – the first time we have done so. The report will provide a comprehensive overview of the EU AIF market, with some 5 trillion euros of assets under management.

We looked into the issue of liquidity mismatch and the report will outline that for most AIFs, we do not come across causes of concern. In general the liquidity of assets in the portfolio is aligned with the frequency investors may redeem their holdings. Real estate funds tend to be the exception here, and given direct retail investors make up a relatively high share of investors in these funds – around a quarter – the finding merits further analysis and review to ensure that liquidity mismatches are sufficiently mitigated.

On leverage, first of all it is important to emphasise that leverage as such is not a 'bad thing' as long as investors understand the risks of its use and that we can be sure that any potential risk of contagion is duly mitigated.

Our upcoming report on the alternative funds market will outline that leverage across EU AIFs is overall limited, with the exception of hedge funds who typically magnify their exposure through the use of derivatives. In a broader sense our report will demonstrate that mitigating any potential risks of contagion from leveraged funds requires good data to measure its use, both regionally and globally. However, methods related to its measurement vary across jurisdictions around the world, due to the fact that leverage is difficult to measure. In that regard, I welcome the recent consultation by IOSCO in response to the FSB recommendation to come up with consistent measures of leverage in funds, to enhance their comparability at a global level. The consultation paper is aiming for a balanced approach between achieving precise measures of leverage and simple, comparable metrics that can be applied in a consistent manner to a wide range of funds in different jurisdictions. I look forward to the final report, which will contribute greatly to any future ESMA guidance on leverage limits for alternative funds in the EU.

Moving to liquidity management issues, ensuring EU investment funds' liquidity management is robust is of key importance to both matters of investor protection and financial stability. The impact of previous cases of liquidity stress in funds has largely been contained, an example from the recent past being the distress experienced by some real estate AIFs. However, that is not to downplay the potential impact on both investors and the financial system of a broader liquidity stress experienced by funds. For this reason, it is essential that funds are adequately prepared for both normal and stressed liquidity conditions.

Liquidity stress testing has been identified as one instrument for funds and supervisors to monitor funds' resilience in the face of severe but plausible shocks. Existing stress testing practices at individual fund level, which are legally required for AIFs but also widely applied by UCITS, contribute greatly to this.

Additionally, industry-wide macro stress simulations are increasingly being discussed in national and international fora as an instrument for supervisors which could contribute to the monitoring of market and systemic risks.

In the EU, the ESRB published a set of recommendations to address liquidity and leverage risk in investment funds, which build upon the ongoing debate at international level that I mentioned earlier. Amongst others, one recommendation is that ESMA develop guidance on the practices to be followed by managers for the stress testing of liquidity in individual AIFs and UCITS. Earlier this month, ESMA opened a public consultation on its Guidelines for asset managers undertaking these tests.

The proposed Guidelines seek to ensure that asset managers across the EU undertake liquidity stress testing following a set of minimum standards. In doing so, the proposed Guidelines aim to foster robust and convergent practices of fund liquidity stress testing across the EU, ultimately benefitting both investors and the stability and resilience of the wider financial system. We very much look forward to receiving your comments on our proposals.

Similarly, the Money Market Fund Regulation obliges each MMF to have in place sound stress testing processes that allow the identification of possible events or changes in economic conditions which could have unfavourable effects on the MMF. The MMFR obliges us to develop guidance on common reference parameters of the stress test scenarios to be included in the stress tests and to update it annually to consider the latest market developments. The public consultation, which closed at the end of last year, was the first step in developing detailed specifications for these stress tests. We proposed common parameters and scenarios which take into account the hypothetical risk factors, including among other redemptions and macro-economic shocks. We expect to produce a final report by the second quarter of this year. This is another contribution from us to the efforts being made at the level of both the industry and regulators to increase the resilience of the asset management sector.

Finally on the topic of liquidity, I would also like to briefly touch on exchange traded funds, which have seen sharp growth due to their high liquidity, great diversification and comparatively low costs. It has come to our attention that some concerns have been raised in relation to ETFs that seem to be increasingly used to gain exposure to less-liquid assets. While empirical evidence does not give grounds for immediate concerns, some issues warrant further attention. This is especially the case for the role of authorised participants in the arbitrage mechanism and their provision of liquidity in time of stress. There is currently an effort from regulators, at EU and global level, to assess any potential risk that could accompany the development of this market.

Costs and performance

Now moving on from financial stability to ESMA's first annual statistical report on costs and performance of retail investment products published in January 2019. Our report covers UCITS, retail alternative investment funds (retail AIFs) and structured retail products (SRPs).

This report is related to ESMA's investor protection mandate and our role in financial market surveillance. Past performance and cost of investment products have a major impact on the outcome of individuals' investment decisions. Clear, comprehensive and comparable information on retail investment products is fundamental for retail investors to assess benefits and risks related to investing in funds and other investment products.

The report contributes to one of the key objectives of the Capital Markets Union, increased participation of retail investors in capital markets supporting the diversification of funding sources in the EU. For investors to have trust in the EU capital markets and to make informed choices about where to put their money, consistent EU-wide information on cost and performance of investment products is key. This is why the Commission has asked ESMA and the other two ESAs to produce these reports.

Whilst we are confident our results are robust, we are aware that there are challenges associated with the availability, quality, and comparability of cost and past performance data, which can inhibit assessment of retail investment products. This is something we will work on in future editions of the annual report.

Let me highlight some of the main findings.

First, for UCITS we found the total cost of a fund presents a significant drain on fund performance, impacting retail investors to a much higher extent than institutional investors. On average, fees for retail investors are nearly twice as high as fees for institutional investors. On-going costs such as management fees constitute over 80% of the total cost paid by customers, whilst entry and exit fees have a less significant impact. In terms of overall returns after costs, passive equity funds consistently outperform active equity funds. This is due to significantly higher costs for actively managed equity funds. Moreover, the report finds significant variation in costs and gross performance across Member States. For retail AIFs and SRPs there is a lack of available and usable cost and performance data. This is a significant issue from an investor protection perspective. We are considering the implications of the report findings for further policy work within our investor protection mandate.

The legislative changes already made to the investor protection framework that came into force over last year or two are crucial to enhance retail investor experience. We are convinced they are fundamental to build the necessary trust in the entities producing and distributing investment products, by providing important information about the products themselves and the services rendered. Among the changes, I think the obligation to disclose the expected costs prior to the provision of service, the obligation to unbundle charges, the ban on inducements under certain conditions and the production of the PRIIPs KID stand out in terms of increasing transparency and ultimately they should help to improve the outcomes for retail investors.

The new PRIIPs framework represents another important breakthrough in improving cost disclosure. Thanks to the PRIIPs KID, investors now have a complete picture of the costs of the investment product they are buying in a comparable format. I am convinced that this will lead to healthier competition among financial institutions and perhaps also to a reduction in costs for the end-investor in the long run.

You may have seen that we have recently published a report on targeted amendments to the PRIIPs Level 2. In this report, we have reviewed the feedback provided to the earlier consultation, and we have also taken into account the latest information regarding discussions between the European co-legislators on the application of the KID by UCITS and the timing of a review of PRIIPs.

Based on this feedback and these developments, we have decided that it is not appropriate to propose substantive amendments to the PRIIPs Level 2 at this time. Instead, we have initiated work to provide input to a review of PRIIPs Delegated Regulation during 2019. The feedback received from this public consultation will be used to inform this upcoming work.

At the same time, we think an immediate supervisory response is needed in relation to the issues concerning the expectations that the performance scenarios may provide to retail investors and the current practices to address this issue. This is why we have published a clear Supervisory Statement on this issue.

In the past year there has been much debate about the specific issue of transaction costs, whether such costs should be included in the disclosure, and subsequently how to calculate them. I hope the message we have been relaying is clear. According to MIFID II and PRIIPs there really should be no cost, whether explicit or implicit, that can escape disclosure.

Brexit

Let me now, last but by no means least, address Brexit. It is difficult to have a discussion these days without touching on this topic. I would like to start by saying that we are conscious of the numerous challenges Brexit poses to the industry and that it has been on the top of our list of priorities since the referendum, and will continue to be going forward.

Within our supervisory convergence powers, we have been focusing on the risk of letterbox entities. We aim to prevent possible regulatory arbitrage situations in the context of some entities and activities relocating from the UK to the EU27. EU regulations are clear that there should be sufficient substance in the entity established in a Member State. In our published opinions on this topic, published in the summer of 2017, we clarified what this means in practice for the asset management industry and what factors must be considered when assessing whether there is sufficient substance.

However, in order to ensure a true and fair level playing field across the EU, further supervisory convergence work was required. We, therefore, decided to set up a Supervisory Coordination Network, which I personally chair. This network is a forum that allows authorisation and supervision experts from the national competent authorities to discuss cases that they are managing involving UK entities looking to move to the EU27. I can personally testify to the added value that this network brings through information-sharing and promotion of convergent practices. It is the first time that competent authorities have discussed cases in this manner consistently and in 'real time' and we see it as a further step in the natural evolution of ESMA's role. While the national regulators ultimately retain their full responsibility for authorisation

decisions, the new forum is an important means of information-sharing and promotion of convergent practices.

We are aware of the uncertainty which Brexit brings in general, and for the asset management sector and for its investor base in particular. There are immediate consequences in case of a ‘no-deal’ or ‘hard Brexit’ scenario. A key consequence is that delegation of investment and risk management activities to UK entities would not be permitted unless cooperation agreements between the EU27 NCAs and the FCA are concluded. The MoUs are essential also for the EU securities regulators so that they may exchange supervisory information and thus continue to meet their mandates regarding investor protection, orderly markets, and stability. Given the potential significant impact on the current business models of the asset management industry should there be no transitional arrangements in place, the MoUs have been an absolute priority for us.

This is why we recently announced that ESMA and European securities regulators have agreed MoUs with the FCA, and also in the context of CCPs and CSDs with the Bank of England. These MoUs would only take effect in the event of a no-deal Brexit scenario. They are similar to those already concluded on the exchange of information with many third country supervisory authorities. The MoUs cover supervisory cooperation, enforcement and information exchange between individual regulators and the FCA, and will allow them to share information relating to, amongst others, asset management activities. This, in turn, will allow certain activities, such as investment management delegation, to continue to be carried out by UK based entities on behalf of counterparties based in the EEA in case of a no-deal scenario occurring.

Even with this key issue having been dealt with, I would like to emphasise again that thorough contingency planning by everyone single one of you remains key, given the multi-faceted risks that a no-deal scenario would bring.

Conclusion

To conclude, today I have focused on four key aspects of ESMA’s activities in the area of investment management: financial stability, costs and performances, sustainable finance as well as cliff effects and supervisory convergence in the context of Brexit.

I’m sure you’ll agree it is a packed agenda, and one we think is imperative to maintain during a very important period for the European Union. The European asset management industry is a vital one for individual investors and the wider European economy alike.

It is essential to maintain investors’ confidence that the sector is working for them and that investors are protected no matter where they are based in the EU. This is where our measures to promote investor protection and supervisory convergence are crucial. Furthermore, the asset management sector plays, and will continue to play, a key role ensuring a stable financial system and sustainable growth in the European Union. As a result, our efforts to mitigate risks arising from liquidity and leverage, and to support asset management’s efforts to support sustainable finance are, we believe, pivotal to creating a stable and sustainable European

economy. Finally, we have been working intensively to address the variety of challenges presented by Brexit, with the aim of upholding financial stability and the protection of investors across the European Union.

Thank you for your attention and thanks again to the organisers for inviting me to speak here today.