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Key priorities for the asset management industry in 2022: sustainable finance and systemic risk

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Ladies and Gentlemen,

I am very pleased to have been invited to address the ICI investment management conference and provide the European Securities and Markets Authority's perspective, even if only remotely as I can unfortunately not be with you in person.

Let me start by saying that ESMA is a strong supporter of international cooperation and trying to reach international consistency to the extent possible. We have regular contacts with colleagues in the US authorities including through the participation in the EU-US Regulatory Dialogue and we are keen to deepen the already strong cooperation we have in place with our US counterparts.

The asset management sector has been the focus of significant reforms at the EU level and I want to take this opportunity to share with you some thoughts about two of the key challenges ESMA will be addressing this year and going forward.

Before entering the substance of my intervention, I would just like to state that we are all still shocked by the devastating war in Ukraine and the humanitarian crisis it represents. Our thoughts are of course with the people of Ukraine in these difficult times. From a supervisory perspective, as you would expect, we are closely monitoring the impact of the Russian invasion on financial markets. In the funds' area, we have increased the frequency of exchanges with National Authorities and the collection of information, focusing on liquidity and valuation issues and the use of liquidity management tools, including on suspensions of redemptions. We have also facilitated discussions among national authorities to support the consistent implementation of EU sanctions.

We are following the developments closely and will continue to coordinate with national authorities across the different sectors based on the information received and needs identified.

I will now turn back to the two themes that I mentioned earlier and that we believe are relevant on both sides of the Atlantic: (1) the first one is developing a framework for the asset management industry to positively contribute to the climate transition and (2) the second is strengthening the resilience of investment funds to market, credit and liquidity shocks.

There is no need to remind you of the severity of climate change, the urgency to address global warming and its severe social and economic knock-on effects. Actually the question is no longer is there an issue? but what are we doing about it? Today, I am therefore going to focus on what we are doing as European regulators and how this is relevant for market participants in both Europe and the US. We have been following closely the recent developments from the SEC and welcome the recently announced disclosure proposal. At the international level, IOSCO serves as the main body where securities regulators drive forward the global sustainability agenda. We look forward to continuing our work with our international counterparts, including of course the US regulators, in delivering on the ambitious IOSCO sustainable finance work plan, to ensure a positive markets' contribution to sustainability challenges and advance on a range of issues, including addressing greenwashing.

Furthermore, with heightened volatility returning on both sides of the Atlantic, this is the right moment to remind ourselves of why we need to be vigilant to ensure that industry and supervisors play their roles in ensuring the investment fund industry is resilient and does not unduly amplify risks in the financial system. I will touch upon some of the work we are undertaking on liquidity, leverage and valuation risks, where we stand in relation to the money market funds reform and certain aspects of the review of the Alternative Investment Fund Managers Directive that is currently on the table.

The asset management industry has an important role to play in ensuring financial stability and contributing to the climate transition.

Progress and priorities in sustainable finance

Let me start with the role of asset managers in the broader sustainable finance agenda. I will try to provide you with an overview of how we are progressing with the EU rule book, what we are doing to ensure the rules are supervised in the same way across the EU and highlight our work to combat greenwashing. We are very much looking at this with the investor's interest at heart in line with our investor protection mandate.

Demand for ESG products remains strong, investors are increasing their allocation to sustainable investment products and vehicles. According to Morningstar data, the net asset value of ESG funds increased by 10 % between June and December 2021. Net inflows into ESG equity funds have amounted to EUR 200 billion over the last 3 years, compared to EUR 74 billion in their non-ESG peers.

The disclosure requirements embedded in the European sustainable finance disclosure regulation (or what we commonly refer to as ‘SFDR’), constitute a key building block of the European sustainable finance framework. They are applied since 10 March 2021. They were notably designed to enhance investor confidence and further support this market growth.

We have noted that market participants are actively preparing for the application of the detailed rules contained in the “implementing measures” of SFDR which will apply from 1 January 2023 and welcome the significant efforts made to comply with these in a market that is still evolving. We continue to discuss these disclosure requirements with the European national authorities to support a consistent interpretation of the regulatory requirements and ensure investors can truly benefit from the enhanced transparency.

Beyond the implementing measures under SFDR, the European supervisory authorities (ESMA and our sister authorities the European Banking Authority and the European Insurance and Occupational Pensions Authority) are also preparing the review of the indicators for principal adverse impacts, a key part of the SFDR disclosures. The objective is to ensure the indicators stay relevant in light of key environmental and scientific developments.

One important development we need to recognise is that although SFDR was primarily a transparency regulation, both fund managers and investors are increasingly treating the disclosures categories as product classification. More and more investment funds market themselves as either Article 8 or Article 9 SFDR - meaning products promoting environmental or social characteristics and products with sustainable investment as their objective. Out of a sample of 27,000 EU funds representing EUR 10 trillion assets under management, 30% included in their precontractual documentation an SFDR Article 8 or Article 9 statement.

As a consequence, Article 8 products, which are also called “light-green” products in SFDR, have been called out for less ambitious environmental or social characteristics. In light of this we must think ahead and consider appropriate criteria to ensure that investors who are looking for sustainability features in their financial products are offered products matching their preferences. We expect to provide technical advice to the European Commission on future initiatives in this area based on national authorities’ supervisory experience. We are also working towards publishing guidance and questions and answers on a number of stakeholder questions we have received with regard to implementation and timing of the regulation (e.g., on scope, definitions, interactions between different pieces of legislation). Our aim is to bring greater clarity to financial market participants and financial advisers as the implementing rules start applying next year.

A few words on the taxonomy regulation, which is the centrepiece of the whole EU sustainability framework. Apart from acting as a “dictionary” for what is green, the taxonomy regulation also contains crucial disclosure requirements on the “taxonomy alignment” of entities and products. The European supervisory authorities intend to play an active part in ensuring these taxonomy related disclosures are relevant for investors and valuable for the market. As supervisory authorities, we want to ensure that investors are not subject to potentially misleading disclosures by product providers regarding the level of ambition of the taxonomy alignment of products or financial market participants. Hopefully the new rules could also be seen as an opportunity for fund managers to get on the front foot in their efforts to contribute to the transition to net zero and deliver on the Paris agreement. We do acknowledge that the framework is still in the making which can create implementation challenges. The taxonomy itself is indeed evolving, with more environmental objectives being defined and other important elements, like a social taxonomy, still to be added. Against that background, in close coordination with National Authorities, we are trying to provide practical guidance wherever possible.

Overall, there is broad consensus on the direction of travel. But we are well aware of the practical challenges faced by the financial industry in implementing the ambitious set of rules, especially as the different pieces of legislation are not all finalised and will only gradually fall into place.

One key challenge is the lack of data. A legislative proposal on corporate sustainability reporting is currently being discussed in the Council and the European Parliament. Once adopted and applied, this will help reduce some of the biggest data gaps fund managers are grappling with. The work being done at the international level with the ISSB to develop common standards for corporate sustainability reporting will of course be paramount. Another important and related issue is that of ESG rating providers where ESMA has been advocating for adequate oversight to make sure there is sufficient transparency on the methodologies used and the information provided to the market is reliable and comparable.

While acknowledging the difficulties in obtaining good quality and reliable data, supervisors remain particularly concerned with the investor protection dimension and the risk of misalignment between the investment promise and what the product actually delivers.

ESMA is therefore working with national authorities to ensure consistent supervision of the sustainability disclosures. Actually tackling greenwashing and promoting transparency is one of the three overarching priorities of ESMA's recently published sustainable finance roadmap, alongside capacity building and risk monitoring. Investigating possible cases of greenwashing, reaching common views on how it may materialise, and addressing it with coordinated action across the EU, will be key to safeguarding investors interests. Investors should be confident that they are not being sold products that do not deliver the sustainability features advertised to them.

At this point, you might be asking yourself - what can the fund management industry do? Given the soaring demand for ESG products, the lack of proper data and the high risk of mismatch between the investor expectation and the product offering we expect fund managers to do their best to overcome these challenges and provide a transparent and accurate description of the product for investors to make informed decisions. Where appropriate, fund managers may also engage with investee companies to bridge some of the data gaps.

I want to take this opportunity to stress that we always welcome feedback and input from stakeholders as we seek to calibrate the sustainability disclosure framework appropriately. Please do not hesitate to share experiences and views with us as we strive to continue to provide guidance to the market.

From a more global perspective, we are pleased with the far-reaching IOSCO work plan for sustainable finance in 2022. We particularly concur with the heightened focus on combating greenwashing and enhancing the reliability of information for investors. We look forward to working with our US and other international counterparts within IOSCO to deliver on the priorities identified in the work plan.

Financial stability and the fund management industry

The volatility we have been witnessing in the markets in recent times is a reminder of the importance of monitoring risks to financial stability, which remains – and has been for a while - a key priority from a supervisory perspective.

Ensuring orderly and stable markets is at the core of ESMA’s mission. Over the past years, we have actively contributed to the discussions at the European and international level (with the ECB, the ESRB as well as the FSB and IOSCO) and made a number of concrete proposals notably in the area of investment funds with a view to strengthen the overall resilience of the financial system.

First, on money market funds. MMF play a crucial role in short-term financing and the smooth functioning of the economy. But the March 2020 market turmoil also revealed vulnerabilities, with some money market funds experiencing heightened redemption pressure while on the asset side the liquidity of commercial paper markets deteriorated quickly.

ESMA engaged extensively in the FSB and IOSCO discussions and conducted a thorough analysis based on which it formulated a series of policy proposals.

We now expect that the review of the EU MMF Regulation will be launched by the European Commission by mid-2022. ESMA will follow closely the different steps of the legislative process, but our priorities have already been made clear in our Opinion on the review, which was sent to the Commission in February 2022. I would like to mention here three of our key proposals.

The first two are intended to address threshold effects for constant NAV MMFs:

We first suggest removing the possibility to use amortized costs for Low volatility NAV MMFs (LVNAV). The rationale is that LVNAV mechanisms based on the amortised cost method imply nonlinearities (cliffs effects) and make these types of MMFs intrinsically prone to first-mover advantages.

We also suggest decoupling regulatory thresholds from suspensions, gates and redemption fees, for LVNAV, and for Constant NAV (CNAV) MMFs. This is because, as you know, as the level liquidity ratios decline towards the regulatory threshold, investors might have an incentive to pre-emptively redeem to avoid being subject to redemption fees and gates.

Finally, in order to address liquidity related issues, we also suggest increasing the daily liquid asset / weekly liquid assets ratios of Variable NAV MMFs (VNAV) and LVNAV MMFs. Requiring higher levels of liquidity buffers should ensure greater liquidity and reduced risk in MMF portfolios.

Second, the review of AIFMD which is currently taking place is an opportunity to increase the availability and harmonise the use of liquidity management tools across EU jurisdictions to have such tools available in the event of a renewed liquidity crisis.

In that context, based on recent proposals by the European Commission, ESMA might be mandated to work on guidance for managers on the use and availability of LMTs.

Furthermore, the review is a great opportunity to enhance the reporting of UCITS and Alternative investment funds (AIFs), especially with regard to leverage and valuation risk.

This is a good time to note that ESMA has issued Guidelines in liquidity stress testing and is actively monitoring liquidity risks within open-ended funds. Such risks are particularly significant in the case of leverage funds, which could amplify shocks and propagate stress across the financial system. AIFs are allowed to use leverage but must report to National Authorities. In addition, the Article 25 of the AIFM Directive provides for the possibility for National Authorities to set leverage limits to curtail the build-up of risks posed by leveraged funds. ESMA has been working on the implementation of this power by publishing Guidelines on risk monitoring and the setting up of leverage limits for AIFs or group of AIFs. ESMA and National Authorities are now performing a regular monitoring of AIFs based on a common framework and could set up leverage limits when needed to address systemic risk.

Finally, it is worth mentioning that we have just launched the so called ESMA ‘Common Supervisory Action’ on fund valuation. The exercise is conducted by national authorities to assess in their respective jurisdictions the level of compliance with valuation related provisions under UCITS and AIFM Directives, with a special focus on authorised managers investing in less liquid assets, such as unlisted equities, unrated bonds, corporate debt, real estate, high yield bonds, emerging markets, listed equities that are not actively traded, bank loans.

Conclusion

To conclude, fund managers are playing an increasingly important role in financing the climate transition and the path to net zero. With that role, the supervisory attention has grown, and we expect to see better and more precise disclosures to investors and the market. We believe sustainability considerations are profoundly transforming the global investment fund industry – it certainly is the case in the EU. We firmly believe that there needs to be extreme vigilance on the risk of greenwashing to preserve investor trust in capital markets and that the strong regulatory and supervisory framework we are building in the EU should help support the sound growth of the ESG market.

It is undeniable that the asset management industry continues to be subject to acute supervisory attention, especially when it comes to systemic risk and investor protection risks. ESMA will continue to engage in the European and international fora to ensure the framework remains fit for purpose. We will also increase our efforts in the EU in the area of supervisory convergence to ensure national authorities have the right tools and data to properly supervise those risks.

I know we can count on ICI and its members for timely contributions, inputs and data. We look forward to continuing the high quality and constructive engagement. Thank you again for the opportunity to participate. I wish you an excellent and insightful conference.

Thank you very much.