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Keynote Address : ESMA viewpoint – Priorities for 2018

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Steven Maijoor
ESMA Chair

Ladies and Gentlemen,

I am delighted to be here in Brussels at this important event and am grateful to EFAMA for their kind invitation.

When I look at the current environment for securities markets and the relevant regulatory developments at national, EU and international level, it is clear that there is no shortage of topics that I could deal with in my speech today. However, I would like to focus my remarks on three key issues. First, I will talk about costs and charges of investment funds, on which ESMA is active on several fronts. Secondly, I will talk about investment fund stress testing, which is high on the agenda of many policymakers at the moment. Finally, I will spend some time recalling the work that we have done on supervisory convergence in the context of the UK's withdrawal from the EU, and outline what else ESMA is doing to minimise risks to its objectives from Brexit.

<u>Costs and charges</u>

Allow me to turn first to the topic of costs and charges.

A key goal of the Capital Markets Union (CMU) is to increase the attractiveness of long-term savings products for retail investors. Transparency of costs and performance of these products is a key element to achieving this goal. In this context, the European Commission has asked ESMA, together with the other ESAs, to issue recurring reports on the cost and past performance of the main categories of retail investment, insurance and pension products. Within the ESMA remit, the request covers UCITS and retail AIFs, as well as structured products. We very much welcome this request, as cost and performance transparency for investment products is a key element of fostering investor protection within the EU financial markets.

We have started to work on our part of the mandate and are currently analysing the impact of costs, including explicit and implicit fees and charges levied by the fund industry, but also the implicit effect of inflation, on the returns of investors in EU UCITS.

We published first findings of this work in the latest edition of ESMA's semi-annual report on Trends, Risks and Vulnerabilities (TRV No. 2 / 2017). For these preliminary findings, we looked at the three-year horizon from 2013 to 2015. During this period, funds and charges reduced the investment return of the average EU investor by about 2.5% per annum. In relative terms, this means that, on average, nearly 30% of the gross fund return was eaten up by ongoing fees, one-off charges and inflation. It is important to note that this varies quite significantly between countries and asset classes. Moreover, retail investors and investors in actively managed funds are more affected than institutional investors and investors in passive products. It is equally noteworthy – and concerning – that the majority of the evidence available indicates that investors do not react to the level of the costs of their investment funds at all.

Our findings certainly underline the relevance of cost and performance transparency and ESMA will continue to monitor and assess the situation. In line with the Commission mandate, we will first deepen our analysis on UCITS funds. We expect to complete this important work by late 2018 for the purposes of the first edition of reporting on cost and performance of the main retail investment, insurance and pension products requested by the Commission.

In the longer run, ESMA will extend the analysis to EU alternative investment funds (AIFs) and structured products, such as structured deposits and structured notes. These future efforts will further contribute to enhancing cost transparency throughout the entire universe of retail investment products in the EU. In particular, they will also complement the improvements in transparency anticipated from the entry into force of MiFID II on 3 January 2018

While on the subject of MiFID II, I would like to say a few words on the issue of investment research, as this is also relevant to the costs that the end-investor pays for the service that he or she receives.

In accordance with MiFID II, inducements are banned for independent advice and portfolio management. For other services, inducements are permitted if they (amongst other things) improve services provided to individual clients. With regard to research, the legislation clarifies that the receipt of research by portfolio managers from any third-party entities (and in particular brokers) would not constitute an inducement provided that portfolio managers pay for research in one of two ways: they can either pay directly from their own resources, or from a separate research payment account controlled by the portfolio manager and funded by a specific research charge to the client. Some issues have been raised by market participants regarding the implementation of these new measures and ESMA has provided guidance in order to facilitate a common understanding and convergent supervision on the main aspects of the new framework.

I believe that the new model of payments for research (versus payments for execution) will push portfolio managers to identify more clearly the research they need and the value it adds in informing their investment decisions. This should help ensure better use of the research budget instead of firms (and ultimately their clients) paying for low-quality, duplicative research. Managers will thus be able to use more efficiently and wisely the funds allocated to research. Also, the new rules should provide better opportunities for independent research providers to compete on the quality of the research provided and should prompt portfolio managers to acquire research from a wider variety of research providers.

I would also like to mention one issue that emerged recently on the application of MiFID II rules by EU portfolio managers dealing with third-country broker-dealers and sub-advisors. The US Securities and Exchange Commission, the European Commission and ESMA have been involved in some positive discussions on this topic and I was pleased to see that the SEC was able to adopt some no-action letters on this topic a few weeks ago, which should address industry concerns in this area.

I would now like to explain some of the other work that we have done or are planning to do on costs of investment funds.

Closet indexing is a phenomenon that generated a significant amount of discussion among stakeholders when it came to the attention of commentators and regulators a couple of years ago. I should stress first of all that there are two key points of concern that arise from closet indexing activity: funds that are closet indexers are not only likely to be charging unduly high fees, but they are also failing to deliver the service to which they committed themselves in their offering documents. Efforts by supervisors to tackle closet indexing should address these two aspects.

At the ESMA level we immediately saw the potential importance of this issue from an investor protection perspective and decided to analyse it further. This led to the publication of a statement in February of last year. The outcome of our analysis was that there might be a small, but not insignificant number of funds in the EU equity fund sector that may be closet index trackers. Although it generated headlines at the time, we were very deliberate in formulating a cautious conclusion in our statement. This is due to the fact that statistical analysis can only give an overall indication of the existence of closet indexing activity. We agreed, therefore, that national competent authorities (NCAs) would pick up the baton and look into the matter further within their domestic markets. Since publication of the statement a significant amount of work has been carried out at national level by the NCAs, some of which has already been disclosed to stakeholders. This is a good example of where ESMA can contribute to strengthening investor protection by giving additional profile to an issue at EU level and then coordinating follow-up work at national level.

In terms of next steps, we are now liaising with NCAs to get a comprehensive picture of the outcome of their national initiatives. From our perspective, our objective is to ensure that NCAs are taking convergent approaches to situations where deficiencies are identified. We recognise, of course, that supervisors have a range of options in their toolkit and each situation needs to be assessed on its merits. However, in a single market where cross-border distribution of funds is widespread, we believe it is a key part of ESMA's role to try to ensure that investors are treated fairly across all Member States.

I have already explained in some detail the work that we have started to analyse costs and returns in the context of the CMU. That work is broad in scope as the intention is that it will ultimately cover UCITS, other types of investment funds and even structured products. We support this broad approach as it is important to capture those products in which retail investors place their money. As a complementary exercise, however, we intend to carry out more detailed analysis of the performance of active and passive funds.

The active versus passive debate is not a new one and we are well aware of the sensitivities that it creates. We do not enter this sphere lightly, aware as we are that a number of methodological challenges need to be overcome. I will not mention them all here today but just to touch on a few of them. First, cost structures for passively and actively managed funds differ substantially, with subsequent effects for the performance of respective fund products as experienced by investors. Secondly, and despite significant regulatory efforts in recent years, transparency on fee structures still leaves much to be desired. We are confident that the introduction of MiFID II and PRIIPs will raise the bar significantly in this respect but, in the meantime, we will need to overcome these challenges in order to deliver sound analysis. Finally, we have seen that the provisions on benchmark disclosure under UCITS may have been interpreted differently across Member States, leading to a situation in which there are some variations in the availability of benchmark data across the EU. This difference of practice is also relevant to the issue of closet indexing, and it may be the subject of follow-up policy work in that context.

As we take this analysis forward, we will benefit from the significant work of the UK FCA in the context of its recent Market Study, which touched on some similar issues.

Finally, on the issue of costs, I would like to draw your attention to a workstream that we will soon launch under our supervisory convergence agenda. This relates to performance fees.

It has come to our attention that national practices on performance fees are not always consistent. In particular, some performance fee models are permitted in one Member State but not in another. The overall objective should be to ensure that performance fee models are fair and consistent with the investment policy of the fund. To take one specific example of where there may be some room for improvement in the regulatory framework, some Member States require funds that follow a total or absolute return strategy to adopt the so-called high watermark mechanism. This mechanism allows the fund manager to charge a performance fee only where the net asset value (NAV) at the end of the period is higher than the NAV of the last period when the performance fee was charged. Where such a safeguard is not in place – and indeed there is nothing in the EU regulatory framework requiring a high watermark mechanism to be used – you can imagine that there is scope for investors to feel that they are being charged a performance fee that is not justified.

As I suggested earlier, the cross-border nature of the EU fund market calls for investors to be treated fairly wherever they live and regardless of where the fund itself is domiciled. Improvements to disclosure can only achieve so much and we should not expect that the average retail investor will always read the small print. That is why we believe it is appropriate to look closely at the performance fee structures that are currently allowed and test them against the reasonable expectations that investors have about when such a fee will be levied by the fund management company. We will take this work forward in the course of 2018 with a view to promoting greater convergence in national practices and better overall outcomes for investors across the EU. In doing so, we will have due regard to the valuable work carried out by IOSCO that led to the publication last year of good practices on fees and expenses.

I hope you will agree that the package of measures I have just outlined will be key in supporting the goal of the CMU to foster the participation of retail investors in capital markets. As I have stated before, it is only by instilling confidence in retail investors that we can expect to see them making greater use of the EU securities markets.

Stress testing

Please allow me to move now to the important topic of investment fund stress testing.

Stress testing has been identified as one instrument for funds and supervisors to monitor resilience in light of severe but plausible shocks. An important building block in this context are the existing stress testing practices at individual fund level, which are legally required for AIFs but also widely applied by UCITS. In addition to this, industry-wide macro stress simulations are increasingly being discussed in national and international fora as an instrument for supervisors that can contribute to the monitoring of market and systemic risks.

Over the past years, the growth of the investment fund sector has supported the development of a more balanced and stable financial system. The low interest rate environment and the ongoing structural changes in the EU financial system are accelerating the transition towards a more market-based structure. A bigger and more interconnected “non-bank sector” will also require enhanced supervision, including of its stability risks.

However, risks in the investment fund sector are characterised by major uncertainties regarding the nature of the risk, the scenarios, the type of entities that could trigger or amplify a shock and the contagion effects to investors and financial entities. Supervisory stress tests are one tool that could help identify those risks, and thereby focus supervisory resources in the most effective way. In its Recommendations on Structural Vulnerabilities of January this year, the Financial Stability Board (FSB) especially considers that authorities should consider system-wide stress testing in order to assess risks stemming from fire sales at system level.

The thinking around regulatory stress simulations is of recent date. It is nevertheless progressing rapidly thanks to academic research, the development of methodologies by regulators and operational exercises such as the IMF Financial Sector Assessment Programme. In the EU, ESMA is working on developing an operational framework for the identification and quantification of potential industry risks to be used in stress simulations.

Securities market regulators will benefit from the experience acquired with the Money Market Funds Regulation. In addition to the definition of common reference parameters – more on which in a moment – the stress tests will include a macro-economic shock, thus allowing supervisors to design macro scenarios in order to capture system-wide events.

The work on macro stress simulations is not the only example of where we are active in the area of stress testing. There are two other work streams that I would like to mention in this context.

First, we will publish very soon a package of measures in the context of the Money Market Funds (MMF) Regulation. This has been a significant work stream for ESMA over the past nine months or so and we are pleased to deliver technical advice, implementing technical standards and guidelines in a timely manner, all of which should help to facilitate the smooth implementation of the Regulation.

The MMF Regulation obliges each MMF to have in place sound stress testing processes that allow the identification of possible events or future changes in economic conditions which could have unfavourable effects on the MMF. The manager of the fund has to assess the potential impact that those events or changes could have, and must conduct regular stress tests in order to do so. The Regulation obliges ESMA to issue guidelines with a view to establishing common reference parameters of the scenarios to be used in the stress tests. The Level 1 text is already quite specific about the factors that need to be taken into account but it is not exhaustive, so we have been able to develop what we believe to be useful guidance on each of these factors. Stakeholders broadly welcomed the approach that we had set out for consultation but noted the difficulties in giving precise figures on the calibration of the different criteria given the constant changes in market conditions and the diversity of participants in the sector.

Therefore, in the final guidelines we decided not to specify the reference parameters at this stage but we will aim to make progress on this when we issue the next iteration of the guidelines. Indeed, the Regulation specifies that the guidelines have to be updated every year taking into account the latest market developments, so we have already started work with the objective of issuing updated guidelines by the end of next year. We will consult stakeholders as part of the process of updating the guidelines.

As a complement to ESMA's work on the macro stress scenarios and the specific framework for stress testing under the MMF Regulation, we are also planning to provide more general guidance on stress testing practices covering both UCITS and AIFs.

This comes in the context of the financial stability work in the asset management space by the FSB and European Systemic Risk Board (ESRB), one of the outputs of which has been to suggest guidance be provided with the objective of increasing supervisory convergence. You will also no doubt be aware of the two recent consultations by the International Organization of Securities Commissions (IOSCO) on its fund liquidity risk management guidance, which also seek to enhance practices in this area and to which EFAMA has provided feedback.

ESMA will be consulting with the industry in producing its guidance on this topic in 2018, with a view to publication by 2019.

Supervisory convergence work on Brexit

The last topic that I will cover today is our work on supervisory convergence in the context of the UK's withdrawal from the European Union. This is a situation which presents particular challenges to ESMA's objectives and this has been reflected in the amount of time we have been dedicating, and continue to dedicate, to this topic.

Following the referendum result last year and in light of the stated intention of the UK Government to withdraw not only from the EU but also the Single Market, it quickly became clear that there was potential for a significant shift of entities and activities from the UK to the EU27 as firms sought to secure their passporting rights. This gave rise to some concerns about the risk of regulatory arbitrage between the EU27 Member States seeking to attract this business. It was important for us to act quickly as we knew that the industry would be drawing up, and even implementing, contingency plans in the near future. We issued one general Opinion in May and three sector-specific ones in July for investment firms, secondary markets and asset management, and tackled key aspects of outsourcing and delegation to third countries.

We recognise that there will be a number of factors that firms look at when deciding where to establish themselves – or strengthen existing operations – in the EU27. These can range from marketing and distribution considerations through to particular human resource needs or transport connections. What we as ESMA are striving to avoid is that firms choose where to locate themselves for reasons of regulatory arbitrage. In other words, the EU Member States should apply the same rules in the same way.

There are three important points that I would like to emphasise in relation to our opinions.

The first is that we consider them to be fully in line with the existing Level 1 requirements. It is natural that in a supervisory convergence tool of this nature, we have developed the more general requirements in Level 1 and Level 2 further. Indeed, it is precisely in the nature of Level 3 guidance to take the existing framework and elaborate on it, in order to give a clearer picture of what firms are expected to do in order to comply.

The second is that the opinions in no way undermine the freedom of establishment that is provided by the relevant EU legislation. The passporting framework allows a firm to be based in one Member State and to provide its services throughout the Union, and we are not challenging that fundamental principle. Our key objective is rather to ensure that national regulators are consistent in the decisions they take with respect to entities relocating from the UK and that regulatory arbitrage cannot be a driver for the choice of a particular location.

Thirdly, much has been said about the impact of our opinions on the use of delegation in the fund industry. Let me be clear: we recognise that delegation plays a key role in the current industry set-up and that it has contributed to the success of EU funds, particularly the UCITS label, across the globe. We also recognise that delegation of key functions – including to non-EU countries – is expressly foreseen by the UCITS Directive and the AIFMD. Our opinions do not call into question the delegation model. Rather, they aim to provide clarity on such elements as the appropriate substantive presence in the home Member State, the importance of oversight arrangements and the role and status of non-EU branches.

We are confident that these opinions provide a sound basis with which to promote supervisory convergence as the securities markets industry adjusts to the UK's withdrawal. However, they are by no means the end of ESMA's work in this context. As a complementary measure to the opinions, we have established within ESMA a Supervisory Coordination Network. This network, chaired by ESMA's Executive Director, Verena Ross, brings together experts from a broad range of competent authorities who table "live" cases that they are facing involving UK entities looking to move to the EU27. All information is provided in an anonymised manner. It is the first time that competent authorities have discussed actual cases in this manner 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.

A further element to our work on Brexit is our analysis of the possible cliff effects if the UK were to withdraw from the Union without any political agreement having been reached. This analytical work is particularly relevant when you consider our financial stability and investor protection objectives. We will continue this work in the coming months with a view to identifying possible mitigating actions, within the boundaries of the political negotiations at EU level.

Today I have focused on three key aspects of ESMA's work in the area of investment management: costs and charges, stress testing and supervisory convergence in the context of Brexit. I hope that this has given you a good understanding of how we are pursuing our objectives of investor protection, financial stability and supervisory convergence across a broad range of topics.

Thank you for your attention.