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Systemic risks and current policies in the EU fund industry – Can asset managers be too big to fail?

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Introduction

Ladies and Gentlemen,

I am delighted to have been invited by the International Bar Association (IBA) to speak at this conference. It is a pleasure for me to be with you today and to share with you few of our thoughts on asset management and financial stability in the EU. In addition, I will give an update on current policy developments.

ESMA, as you know, has a strong interest in this topic. Promoting financial stability in the EU is at the core of our mandate, and asset managers – whether mutual or alternative funds – are a key part of our work in terms of regulation and supervisory convergence. The importance of asset management in and for the EU can hardly be overstated. The Union is home to more than 3,000 asset management companies with funds worth ten trillion euros under management, making it the second largest fund market worldwide. The industry has prospered not least because the EU provides an important condition: a vast internal market based on a single regulatory framework promoting open competition.

The crisis has without doubt transformed the business, as well as our own work as regulators and supervisors. In order to enhance stability and investor protection, the EU has refined the UCITS framework and provided new rules for previously unregulated market activities. From the conference programme I am glad to see that you already had an opportunity to discuss the implementation of the AIFMD.

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And the reform work is continuing. One key question which we are in the process of discussing is the systemic importance of non-bank financial sectors, and this includes the asset management industry.

Commitment to address systemic risks

Addressing systemic risks in the financial sector is one of the most important tasks in the wake of the crisis.

Let us recall: in banking, we have truly come a long way since Alan Greenspan said about banks "[...] if they are too big to fail, they are too big." Mandated by the G20 Leaders, the FSB now designates systemically important banks, not just on the basis of size, but also considering their interconnectedness, substitutability, global activity and their complexity. Once designated, banks are earmarked for additional capital buffers and enhanced supervision, including cross-border cooperation, but also enhanced recovery and resolution regimes.

The G20 political commitment goes far beyond the banking sector. It rather concerns all financial institutions. Indeed the International Association of Insurance Supervisors (IAIS) published a first list of global systemically important insurers in 2013. The Committee on Payment and Settlement Systems and IOSCO are jointly working on systemically important financial market infrastructures, such as Central Counter Parties and Securities Depositories.

Most relevant for the asset management industry, the FSB, in consultation with IOSCO, has commenced its work on a methodology to identify systemic entities, with respect to market intermediaries, finance companies and investment funds.

This initiative marks an important first step towards global rules for systemically relevant asset management activities: Existing regulatory frameworks, including the EU's UCITS and AIFMD, have improved the functioning of markets, their transparency and ultimately the protection of investors. Now we have to complement these regulations with an efficient framework to address systemic risks. We have seen in the past that the failure of one single large financial institution can generate risks for the entire financial system. Although it is the responsibility of market participants to control these risks, and, when they still materialise, have credible recovery and

resolution plans, public authorities must ensure coordinated crisis management with regard to failing financial market participants.

Systemic risks in asset management: towards an activity-based approach

The challenge, of course is – and I am sure that you concur with this – to find an approach to systemic risks which adequately addresses the specific business of the asset management industry.

Asset management differs significantly from banking and insurance activities. Asset management firms manage assets on behalf of their clients, who agree to bear losses and gains. On the contrary, banks and insurance companies typically act as principals: Accepting deposits with a liability of redemption at par and on demand, or assuming specified liabilities with respect to policy holders. One more difference is that, as institutions, asset managers generally do not suffer as much from declining assets prices, as a bank would.

Nevertheless, asset management companies can still be vulnerable to shocks and propagate systemic risk to other financial institutions and markets.

The first reason is because they are interconnected with the rest of the financial system, through direct investments or through financial intermediation, such as securities financing transactions. Distress at an asset manager may thus generate substantial risk for its counterparts, and have a broader impact on market liquidity and risk aversion.

Another channel of contagion relates to their effects on assets prices. In particular, significant sales by asset managers can depress asset valuations, thereby transmitting stress to other institutions which may in turn be forced to sell assets. Cascading effects from fire sales can ultimately amplify deterioration of market confidence and deepen a crisis. Adverse financial market dynamics are more likely to arise due to some potential characteristics of asset managers:

- *Mimetic behavior*, i.e. the tendency of asset managers to buy or sell the same assets at the same time. Such behavior can be explained by common incentives, psychological factors or, in the case of fire-sales, by a first mover advantage. Mimetic behaviors are likely to add exuberance during the upswing and stress during the downswing;

- *Group-thinking* can exacerbate this herding behavior, when some models for pricing assets or assessing risks become dominant among asset managers. In addition, and regardless of the quality of the model, it can expose the industry to model risk;

- *Excessive leverage*, either through borrowing or derivatives, may force funds to sell assets at depressed prices when facing higher haircuts or margin calls from creditors; and

- Finally funds are also *exposed to runs*, especially for open-ended vehicles. In a stressed market environment, asset sales in response to redemptions can also spread stress from certain types of portfolio assets to other portfolio assets and market segments.

At the very centre of the debate is also the "too big to fail" criterion**.** Although the action, or the failure, of a large fund can generate instability, it can be difficult to designate a fund based on its size.

In terms of total assets, the size of the largest asset management companies can be compared to the size of the systemic banks. However, this similarity should be put in context. Indeed, within an asset management company, the difficulties affecting one fund should in principle not spread to another fund of the same company since their management and assets are separated. This does not mean that they are immune to default. Rather, that they may be more vulnerable to operational and reputational risk than to market risk.

And if we look at the individual level, funds are much smaller than banks. For example, the threshold proposed by the FSB/IOSCO in its current methodology (USD 100bn) is likely to capture only a few funds, none of them being European. In addition, unlike banks, there are very few historical examples of a single failing fund creating systemic distress requiring a public intervention.

Looking at individual institutions alone may, therefore, unnecessarily limit our understanding of systemic risks in and around the asset management industry. Instead, we believe that the analysis focusing on individual institutions in the industry can greatly benefit from a broader approach. More precisely, we should include our understanding of the business activities in the calculation.

Let me give two examples of activities whose impact on financial stability may need to be specifically addressed.

Money market funds (MMFs) can be systemically relevant, due to their size but also to the nature of their activity that leads to an increased interconnectedness with the money market and the banking sector in particular. In consequence, their disorderly failure can cause broader consequences, such as contagion to the real economy and bail-out risks for their sponsor and, ultimately, public authorities. These problems can have repercussions across the European Union, since both investments in MMFs and investments by MMFs are largely performed across borders. During stressed market conditions, as in 2007 and 2008 constant Net Asset Value (NAV) MMFs were not always able to maintain their constant NAV and were susceptible to runs by investors. That is why the Commission proposed new rules for MMFs, such as strengthened liquidity rules and a 3% capital buffer for constant NAV funds.

Securities financing transactions can also be a source of contagion and procyclicality during a financial crisis. They play an important role by providing market liquidity, facilitating funding of market participants, supporting price discovery of tradable assets and enabling monetary financing operations of central banks. However, they also allow market participants to build large exposures to each other. When confidence in the value of assets, or the solvency of the counterparties, disappears it can create wholesale market runs leading to contagion between market participants.

Therefore, it seems important, during the designation process of systemic entities, to also identify the activities that can foster directional market moves and contagion. While we should not rule out that individual asset managers can be systematically relevant, considering the specific characteristics of the asset management sector, systemic risks might well be the result of certain activities conducted by a group of asset management firms. The example just given of securities financing transactions illustrates how an activity can increase the risk of contagion within the asset management sector and with other parts of the financial sector. The policy response in such a case, for example increasing the transparency on such activities, is focused on the activity and not on individual institutions.

Data on asset management

On another subject, it is important to mention that data is of the essence when it comes to designating, monitoring and supervising systemic entities or activities.

The different FSB initiatives towards systemic institutions have increased the information available on the bilateral linkages between such institutions, or on their common exposures and liabilities to financial sectors and national markets. This information is needed to identify risk concentrations and the build-up of systemic risks. In the EU, the implementation of EMIR and AIFMD will increase significantly the harmonized data available to regulators, especially regarding OTC derivatives and alternative funds. Such information could, for example, allow the identification of the potential "super spreaders" of financial contagion, characterised as the most interconnected participants. It will provide some crucial information on hedge funds and their impact on the market, such as their use of synthetic leverage.

As one goes along, we need to assess whether there are still unknown areas in the system that need more regulatory insight and bridge the remaining data gaps. In that context, I very much support the recent proposal by the European Commission to enhance regulators' and investors' understanding of securities financing transactions.

Policy developments

I have devoted the first part of my speech to a discussion on the systemic importance of the asset management sector. I will now move on to consider some of ESMA's policy work streams and initiatives that are relevant to asset management.

Developments in Brussels are clearly a key driver with respect to the regulatory framework for securities markets, and this is equally the case for the asset management sphere. In that respect we are currently in something of a transitional period, with the recent elections to the European Parliament to be followed shortly by a new Commission. Regarding the Council, the Greek Presidency will in the coming weeks hand over the reins to the Italians for the remaining six months of this year. Against this background we can expect a slight lull in the legislative activity at EU level in the short term. Nevertheless, there are a number of files on which political

agreement was reached before the Parliament broke up which are of relevance to this audience. I will mention MiFID 2, PRIIPs, UCITS V and AIFMD.

Regarding MiFID 2 first of all, you will no doubt have seen the lengthy discussion paper and consultation paper that were published on our website last month. We are keen to receive feedback from stakeholders, including asset managers, by the deadline of 1 August. There will also be three open hearings on the different aspects of MiFID 2 in early July, as well as our frequent contacts with stakeholders and the important role of ESMA's Securities and Markets Stakeholder Group. I hope it is clear to you that we are making our best efforts to ensure that interested parties have the opportunity to provide their views on the proposals that we have set out.

One topic that has been the focus of much attention in MiFID 2, both in the discussions on the legislation and in the context of our technical advice, is inducements. Our key concern in this context is investor protection. We know that average investors often rely on recommendations from banks and investment firms when deciding how to allocate and select their investments. MiFID 2 tackles one of the root causes of unsuitable advice by regulating the conditions for the receipt by intermediaries of payments from third parties, including by banning such payments in certain cases (independent advice and discretionary portfolio management). In those cases where inducements are allowed, they need to be enhancing the quality of advice provided to consumers. We have set out in the consultation paper the criteria that we believe should be taken into account when assessing the *quality enhancement* criterion. We look forward to your feedback on these proposals.

Moving on to PRIIPs, we were very pleased to see that the Council and the Parliament were able to reach a political agreement on this important piece of legislation. I have remarked in the past on the importance of establishing consistent and high-quality disclosures for retail investors across the financial services sector. Indeed, the average consumer does not care what legal form a product takes and is interested only in the economic features of the investment. The work on PRIIPs is being carried out jointly with the other two European Supervisory Authorities (EBA and EIOPA) under the Joint Committee, which is appropriate given the cross-sectoral nature of this legislation. Although the final deadline for the delivery of the relevant technical standards to the Commission has not yet been set, we expect to publish a discussion paper towards the end of this year setting out our initial proposals. The key topics will be the risk and reward information

and the information on costs, as well as the treatment of products with a range of underlying investment options. A crucial element to be taken into account in the PRIIPs work will be the consumer testing exercise organized by the European Commission, which will run in parallel to the work of the three ESAs. A similar testing exercise was run in the context of the development of the UCITS KID and it proved invaluable in helping make the final policy choices.

I will now say a few words on UCITS V. Although this version of the Directive covers a relatively limited range of topics, it is nonetheless an important step forward in terms of strengthening further the UCITS framework, which, I should stress, is already of a very high standard. The requirements on depositaries ensure that there will be consistency in the rules that apply to alternative funds and UCITS, and ESMA will keep such consistency very much in mind when providing technical advice to the European Commission in this area. Similarly, the UCITS V agreement means that fund managers will soon be subject to common rules on remuneration. A particular challenge for ESMA in this context will be the development of guidelines on how different sectoral remuneration principles, such as those in the AIFMD and the CRD, are to be applied where staff members perform services subject to different sectoral remuneration principles. We are aware that staff within asset managers do not necessarily wear only one hat, and that there are operational challenges when similar, yet not identical, rules and principles have to be applied to the same person or group of persons. ESMA will work closely with EBA in developing that guidance, and stakeholder input will be crucial as always.

Last but not least, I will touch briefly on the latest developments on the AIFMD. We are very conscious that the transitional period comes to an end next month and that both industry and regulators are working hard to ensure that the necessary authorisations have been granted in a timely manner. At ESMA we have three current priorities in this area. The first is the development of a Q&A document that will help ensure a common understanding and application of the key elements of the Directive. It is clear that the legislation and implementing measures, even when complemented by ESMA guidelines, still leave room for divergent interpretation in some important areas. Our Q&A is already helping address those potential points of divergence, and we would be happy to receive your suggestions for any further topics that you would like to see included. Secondly, we have begun the preparatory work in view of the opinion and advice that we must deliver to the EU institutions in July 2015 regarding the possible extension of the passport to non-EU funds and managers. EU authorities are already providing us with information on the functioning of the EU passport and the national private placement regimes.

We will also look to gather feedback from external stakeholders as we develop our recommendations to the institutions on this issue. Thirdly, we are continuing our efforts to clarify the reporting obligations on AIFMs and, at the same time, building an IT system that will facilitate the centralization of the data that is reported. As I mentioned earlier in my speech, these reports will be a very valuable source in helping us to have a better understanding of the alternative fund sector.

Conclusions

Ladies and gentlemen, let me conclude by underlining our commitment to promote optimal conditions for asset management in the EU. Financial stability and investor confidence are at the core of our motivation in this regard. Addressing potential systemic risks in asset management will be an important part of our work going forward. As we develop our insights into the risks in the industry, it is clear that asset management has a specific profile that sets it apart from banking and other financial activities. This implies that the lens through which we see stability risks in banking and insurance, might not be the right one for asset management. Our proposal in this debate, therefore, is that in addition to looking at individual institutions, we must include in our analysis the very different types of activities of the asset management sector and their interdependence with systemic risks in the wider financial market.

Our work in this important area, to be sure, is only at a starting point. As regulators, we need to continue working decisively on enhancing our understanding of the systemic implications of asset management activities in all its varieties, and their interconnectedness with the rest of the financial system. Based on the important insights we have from regulators and market practitioners around the world, I am confident that we will succeed in setting an optimal framework for addressing systemic risks in EU asset management.

Thank you for your attention.