

How the asset management industry can contribute to the Capital Markets Union and the climate transition

EFAMA Investment Management Forum 2021

Natasha Cazenave
Executive Director

Ladies and Gentlemen,

It gives me great pleasure to have been invited to address the EFAMA Investment Management Forum this year in my new capacity as ESMA's Executive Director. This conference is always a great opportunity to engage on the key issues for the Asset Management industry and given the agenda no doubt this year's event will be no exception.

As our economies recover from the crisis and we all try to step up to the imperative of the transition to a more sustainable economy, we must continue to adapt as regulators and as industry to a rapidly changing landscape.

I want to take this opportunity to share with you some thoughts on how the asset management industry can contribute to meeting some the challenges we're facing in Europe. In particular, how the industry can contribute to the Capital Markets Union (CMU) and the climate transition.

The asset management sector plays a very important role in the CMU as it is one of the main channels for both retail and institutional investors to

participate in financial markets. It is key to the CMU's success as it helps diversify the sources of funding beyond the banking sector.

Given the soaring demand for “sustainable” or “ESG” investment products and the significant need for private capital to finance the transition, investment funds are also an important component of the sustainable finance agenda.

Looking at the issues through the lens of the regulator, I would like to consider today (1) what could be done at the level of the regulatory framework for it to be fit for purpose; (2) how effective and convergent supervision can support the CMU objective and (3) looking ahead at the challenges we are facing to ensure credible sustainability disclosures.

A regulatory framework fit for purpose

If we want to achieve a capital markets union that supports the economic recovery post-COVID-19, and facilitates investments and savings flowing across the EU, asset managers must take on a greater role. And we need to ensure the regulatory framework remains fit for purpose.

From that perspective, we are at an interesting moment as we are expecting a number of legislative proposals from the European Commission as soon as next week.

Capital markets funding of the real economy, especially unlisted and listed equity funding, has grown from 34 to 39 per cent since the crisis, while bank loans' share has decreased from 24 to 21 per cent. Equally, the evidence shows that debt securities and listed shares issued by non-

financial companies are mainly held by non-bank financial institutions (funds and insurers), with a smaller share held by banks.

From ESMA's perspective, it is essential that the resilience of this source of funding is strengthened as it becomes more prominent. It is vital for companies to have a stable source of non-bank funding and for investors to have a diversified range of savings products.

The regulatory framework should cater for different investment vehicles responding to the various financing needs while capturing the relevant investor protection and financial stability risks.

One way ESMA believes regulation can support this objective is to introduce a specific framework for loan origination and loan participation in the imminent review of the AIFMD. Such a framework should contain common criteria for loan originating and loan participating funds, while also protecting investors by limiting such funds to closed-ended structures and ensuring they can only be sold to professional or semi-professional investors.

Another way ESMA sees a stronger role for regulation to support asset managers' role in the CMU is in the review of the ELTIF Regulation. The original framework could be improved by making it a more attractive investment vehicle for professional investors while providing a valuable savings' alternative to retail investors. These vehicles can further improve SMEs access to funding.

Another extremely important area where ESMA expects strengthening of the existing framework is in the area of *financial stability*. This aspect is

even more important as asset managers play an increasingly important role in European capital markets.

If we look back at the period since the global financial crisis it is evident that the asset management sector has grown considerably. Assets under management have grown significantly in the EU reaching above EUR 20 trillion¹ today. This growth is the result of both investment flows, which represents 47 per cent of the growth, and valuation effects, representing 53 per cent of the growth. The persistent low interest rate environment has contributed to the growth of the asset management industry notably as a result of investors seeking investment opportunities.

With that growth comes greater responsibilities for the industry and unsurprisingly heightened scrutiny.

This increased footprint was recognised in particular by the ESRB's 2017 Recommendations on leverage and liquidity in investment funds². Many of the ESRB's recommended measures have now been adopted, including ESMA's liquidity stress testing guidelines and guidance with regard to excessive leverage build-up by AIFs under Article 25 of AIFMD.

The March 2020 turmoil however demonstrated that there were still vulnerabilities in the investment fund sector, particularly in the MMF sector. As volatility surged, investors rushed to raise cash which resulted in some segments of the EU MMF industry being subject to acute stress. Central bank interventions in the US and euro area restored confidence, but ESMA

¹ EFAMA Quarterly Statistical Release September 2021 No 86 [Quarterly Statistical Release Q2 2021_1.pdf \(efama.org\)](#)

² ESRB/2017/6

believes the episode calls for further reflection on the vulnerabilities in the MMF sector.

At international level, extensive work was conducted to assess the situation faced by MMFs during the crisis, and the different policy options to address the issues observed and any remaining vulnerabilities. At ESMA, this work has focused on the identification of the specific issues faced by MMFs in the EU. We are still discussing the feedback received through our consultation earlier this year – and thank you to EFAMA for your valuable input. We aim to finalise our suggestions to the European Commission on the way to address these issues, in the context of the review of the MMF Regulation later this year or early next year.

March 2020 also saw evidence of significant redemptions from investment funds investing in corporate debt and real estate. The ESRB issued a Recommendation in May 2020 on liquidity risk in investment funds³, highlighting the stresses observed and the potential measures to be taken. ESMA's report from November 2020⁴ responded to this Recommendation and concluded that while only 0.4% of affected funds had to suspend redemptions or subscriptions, there were some weaknesses in liquidity risk management and valuation practices across funds in the EU.

In response to the challenges in MMFs and investment funds facing redemption requests, ESMA has strengthened its coordination role by organising frequent exchanges with the national competent authorities (NCAs) on the use of liquidity risk management. Liquidity management tools (LMTs) play a crucial role for financial stability of the asset

³ ESRB/2020/4

⁴ ESMA34-39-1119

management sector. There is a strong need to increase the availability of LMTs across EU jurisdictions to have the right tools available in the event of renewed liquidity crisis episodes. We understand this point should be part of the Commission's proposals in the AIFMD review, which would be most welcome. Moreover, management companies valuation procedures should cover all market situations including valuation approaches for stressed market conditions, particularly in case of less liquid assets.

Finally, enhanced reporting by UCITS and AIFs to NCAs, especially on liquidity and leverage, is essential to improve our capacity to monitor risks effectively. The AIFMD review provides the right opportunity to explore appropriate measures in both AIFMD and the UCITS Directive to enhance liquidity risk and leverage reporting.

From a financial stability perspective, ESMA considers that the above priority areas, aimed at reducing the liquidity and valuation risks at the level of the investment fund, should reduce the risk of the fund industry amplifying a shock on the financial system.

Finally one last aspect that is critical for the framework to support the CMU objective is to look at investors outcomes. *Investor protection* remains at the forefront of regulators' concerns as asset management takes a greater share of savers' funds. Here the disclosure to the end investor is crucial, especially regarding costs. Ensuring greater convergence in the supervision of costs is an integral part of ESMA's broader efforts on the cost of retail investment products. Costs and performance, including importantly in relation to costs and fees charged by fund managers, was identified as a Union Strategic Supervisory Priority. Costs are a

determining element in investors' net returns and the topic is considered to be a key aspect in the investor protection framework.

ESMA's Annual Statistical Report⁵ on performance and costs of EU Retail Investment Products showed the impact of high costs on returns to investors and high heterogeneity of fees charged across UCITS funds. We believe that transparency in general, not only on costs, is key to allowing investors to make informed investment decisions about their savings products.

The pivotal role of supervision to support the single market in the funds' sector

Supervision is a key element that supports a stronger single market where investors have confidence in the investment products provided by the asset management industry. ESMA's role has grown considerably in this area since its establishment in 2011. In its early years ESMA focused almost exclusively on creating a single rulebook. In the asset management space, ESMA played an integral part in setting up the basic structures of the AIFMD framework and developing the UCITS framework.

In recent years, ESMA has significantly stepped up its efforts to promote further supervisory convergence. This holds true of course in the area of investment management. This was particularly supported by the enhanced supervisory convergence tasks given to ESMA in the review of the ESMA Regulation, which started applying from 1 January 2020.

⁵ ESMA50-65-1710

Two examples of ESMA's new activities with a strong supervisory component that I would like to mention in this context are our recent work on the 2020 ESRB recommendation on liquidity risks in investment funds that I mentioned earlier and the common supervisory actions (CSAs) in the investment funds' area. The ESRB recommendation mandated a specific supervisory exercise where ESMA played a coordinating and steering role of the supervisory activities led by the NCAs with regard to investment funds having significant exposures to corporate debt and real estate assets. The aim was to assess their preparedness to potential future adverse shocks. While the concrete supervisory work obviously stood with national supervisors, the identification of the relevant thresholds for the funds to be assessed as well as the areas of focus and methodology for the actual supervisory work were agreed at ESMA level. This was a very informative exercise which contributes to a better understanding of the situation on the ground.

The CSA is another key tool in ESMA's arsenal to ensure supervisory convergence. In 2020 ESMA conducted a CSA on how UCITS managers perform liquidity risk management in compliance with the applicable UCITS requirements. In 2021 ESMA is conducting a CSA on costs and fees of UCITS, to assess the compliance of investment funds with the relevant UCITS rules and the obligation not to charge investors undue costs, also covering entities employing Efficient Portfolio Management techniques. This work aims at promoting supervisory convergence in how NCAs supervise cost-related issues, and ultimately enhancing the protection of investors across the EU. For 2022 ESMA is planning to conduct a CSA on valuation issues in investment funds. All these exercises focus on key supervisory risks identified together with NCAs and

are prime examples of how ESMA can play a very concrete role in promoting coordinated supervisory action on the field across the EU and support the development of the single market.

Credible sustainability disclosures

Looking at an imminent challenge, it is clear that the asset management sector can play a key role in financing the sustainability transition. The European Commission calculated in 2019 that the “green investment gap” is EUR 260bn per year until 2030.

Evidence shows that investments in sustainable products continue to grow rapidly in 2021. Global sustainable bond issuance reached EUR 667bn in the first nine months of 2021⁶. The EU has issued its first-ever green bond as part of its pandemic recovery plan. The auction size was EUR 12bn, making it the largest green bond debut so far, and attracted more than EUR 135bn of orders. Meanwhile, flows in ESG equity funds reached EUR 71bn in the first half of the year, compared with EUR 69bn for non-ESG peers. Additionally, EU ESG ETFs, while still small in size, showed a substantial growth rate of more than 200% in the first half of 2021, compared with 27% for non-ESG ETFs⁷. Overall according to Morningstar data, total assets under management of publicly marketed EU ESG funds have increased 20% since late 2020, to €1.5 trillion taking the share of ESG funds in the total assets of publicly marketed EU funds reported to Morningstar (€8.5 trillion) to 18%.

⁶ [Global sustainable bonds see record issuance in Jan-Sept 2021 | Reuters](#)

⁷ [esma50-165-1842_trv2-2021.pdf \(europa.eu\)](#). ESG funds are identified using Morningstar's definition of 'Sustainable investment'. ETF data is also retrieved from Morningstar.

While we welcome these shifts in investment and savings towards sustainability, the speed and size of the shift pave the way for potential greenwashing risk. And there is clearly a growing concern in the regulatory community on the potential impact on investors of such a risk materialising. It is clear that if there is a discrepancy between the investor's understanding of the investment promise and what the product can actually deliver, there is a risk of a breach of investor trust and potential misallocation of capital. If left unchecked, these issues might lead investors to stay away from sustainable investing.

Hopefully the EU taxonomy and the supportive disclosures in the Sustainable Finance Disclosure Regulation (SFDR) and the Corporate Sustainability Reporting Directive (CSRD) will help guide the increasing demand for sustainable investment. Regulation is clearly one of the ways in which the EU tries to both support the shift to sustainable investment and to combat the risk of greenwashing. The disclosures required by the SFDR and the Taxonomy Regulation are designed to enhance investor protection, bringing transparency about sustainable investment and supporting confidence in sustainability products offered to savers.

That being said, we fully recognise that there are challenges particularly with the current legislative framework, where not all rules are in place and where in some instance there are consistency and sequencing issues. It's still very much work in progress. In the specific case of taxonomy-alignment disclosures for example, we acknowledge the challenges arising from the misalignment between the product disclosures and the entity disclosures. The data required for the product disclosures on taxonomy-alignment will not be available for fund managers from

underlying investee companies until 2023, while the product disclosures on taxonomy-alignment becomes applicable for the first two taxonomy objectives start applying already on 1 January 2022.

Europe is home to largest ESG fund market, reflecting a shift in European investor preferences towards sustainable investments. To consolidate their lead, European asset managers need to ensure that investors trust that their expectations in terms of the environmental or social impact of their investments are fully aligned with the reality. This will require greater transparency and cautious communication by fund managers.

There is indeed growing evidence that investors are paying closer attention to potential greenwashing instances, which can lead to reputational issues with a material financial impact. We can by way of example note the DWS 13% share drop following reports of supervisory investigations into possible misrepresentation of how ESG metrics are used to analyse companies.

We acknowledge that complying with the ambitious sustainability disclosures in SFDR is not an easy task and are aware of the significant requirements placed on asset managers to provide meaningful transparency on sustainability at both entity and product levels.

Nevertheless, it is important to stress that we expect the provisions of the Level 1 texts to be complied with, both for the core SFDR disclosures since 10 March 2021 and the additional taxonomy-related product disclosures starting from 1 January 2022.

It is essential that investor confidence in the growing share of sustainable savings products is not adversely affected by misleading disclosures about

the sustainability characteristics of investment funds. Once the additional detail provided by the RTS becomes applicable then we expect that the harmonised templates will markedly increase transparency and comparability for investors in these products.

In order to help you with this effort, the ESAs are preparing Level 3 guidance in the form of Q&A on key issues related to the practical application of the rules. More questions on the interpretation of the legal texts will also be forwarded to the European Commission.

ESMA will also work with national competent authorities to promote convergence in supervisory approaches in order to foster consistency of supervisory checks performed at national level on asset managers' disclosures. Not only is supervisory convergence a priority for ESMA, it is also a clear priority for the national competent authorities on our board. We will bring a greater focus on the supervisory challenges related to sustainability disclosures in 2022, exploring all the tools available to ESMA to bring greater clarity and coherence to this situation. This can range from Q&As, guidelines, or thematic reviews. This will be crucial in supporting our key objective and priority of combating greenwashing.

Conclusion

Let me conclude by stressing that with a greater role in the EU capital markets come greater responsibilities for the asset management industry. It is undeniable that with a greater footprint in companies' financing and savers' investments there come more supervisory attention, especially when it comes to systemic risk and investor protection risks. In sustainable finance in particular asset managers have an important role to play to



ensure investors maintain trust in the system. We expect asset managers to step up to the task.

ESMA will continue to engage with all stakeholders and publish guidance to support a strong and consistent regulatory and supervisory framework. We will specially focus on increasing our efforts in supervisory convergence to ensure NCAs have the right tools to play their role in supervising those risks.

Thank you for your attention