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Supervisory priorities and challenges for investment managers

EFAMA Investment Management Forum 2022

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Good morning,

Thank you for the kind words and warm introduction. It is my great pleasure to speak to you today at the EFAMA Investment Management Forum. We very much appreciate the opportunity to share ESMA's views on some of the key challenges the asset management industry is facing and to explain what concrete actions we are taking.

Today I want to focus on two of these challenges through the lens of the regulatory and supervisory community namely, the sustainable finance journey and the deteriorating macro-economic situation and heightened risks in financial markets.

In order to enable investors to make informed investment decisions in terms of sustainability and to support our transition to a sustainable economy, ESG considerations need to be fully integrated in financial regulation and our supervisory practices.

Asset managers have a key role to play in a well-functioning sustainable investment value chain, providing institutional and retail investors with access to sustainable investment products and contributing to the funding of the transition.

Workable regulation and effective, consistent supervision in this market segment are therefore key to delivering on our objectives in the field of sustainable finance.

While we are trying to address the essential transformation towards a more sustainable economy, there are also immediate risks that require our attention. The macro-economic environment has rapidly deteriorated. Liquidity, market and credit risks are all elevated. In that context, we expect the asset management industry to act with vigilance in order to monitor and manage risks appropriately, using the right tools at the right time.

A key priority of ESMA's strategy: sustainable finance

Sustainable finance is one of the key areas that will structure ESMA's work in both regulation and supervision over the medium term. For the asset management industry, the impact is profound with significant new disclosure and risk management requirements.

Today, I would like to highlight a number of specific recent or ongoing developments that are relevant for the investment management sector as we progress in the implementation of the European Sustainable Finance framework and develop further our guidance: (i) the incoming Union Strategic Supervisory Priority (USSP), (ii) the guidance we are providing to market participants and notably the new consultation on draft guidelines on the use of ESG or sustainability-related terms in fund names that we are publishing today, and finally (iii) the recently published Call for Evidence on greenwashing (CfE).

New Union Strategic Supervisory Priority

As the EU legislative framework for sustainable finance gradually kicks in, the focus will increasingly turn to supervising and enforcing the rules. In light of the importance of ensuring adequate and comprehensible ESG disclosures, and a level-playing field in the EU, ESMA recently identified the topic of “ESG disclosures” as a new USSP.

USSPs are an important tool through which ESMA coordinates supervisory action with National Competent Authorities and provides an EU structured and comprehensive response to address specific risks. NCAs then take these Priorities into account when drawing up their own work programmes.

In the case of ESG disclosures, the objective will be to take active steps to enhance transparency and comprehensibility of ESG disclosures, with a view to protecting investors and further supporting the development of a credible ESG market. Concretely, through this USSP, ESMA wishes to gradually promote increased and consistent scrutiny on ESG disclosures across the sustainable investment value chain through a number of supervisory actions which will be carried out by NCAs in parallel across the EU.

One such action of particular relevance to the Investment Management industry is the launch, in the second half of 2023, of a Common Supervisory Action (CSA), coordinated by ESMA, on sustainability risks and disclosures. The objective will be to foster NCAs' convergence regarding the application of provisions on sustainability risks and disclosures in the regulation, with a particular focus on the SFDR requirements. The CSA will also feed into ESMA's work on greenwashing.

We are also closely monitoring and contributing to the work of EFRAG and the ISSB on the standardisation of corporate sustainability reporting, which is crucial for the overall quality of information that is then available through the sustainable investment value chain, including for investment managers.

Please let me also take this opportunity to also underline the important achievements of our previous USSP on costs and performance. ESMA and NCAs will continue monitoring closely the evolution of costs as a key element for investor protection. In this respect, while no longer a USSP the topic of costs and performance of investment products will continue to be high on our dashboard of the key factors to monitor.

Coming back to sustainable finance - in parallel to this increased focus on supervision, ESMA will pursue its efforts to clarify rules where possible with the intention of making them less complex and more comprehensible.

ESMA is also attentive to capacity building within the regulatory community. Next to ESG-focused trainings, we encourage discussions of supervisory cases concerning the various segments of the investment value chain (issuers, investment firms, investment managers) to foster sharing of best practices, of expertise and ultimately further convergence.

Additional ESMA guidance to market participants under SFDR

Beyond the USSP, a tremendous amount of work has gone into providing guidance on the application of SFDR notably in the form of Q&As.

As the regulatory landscape further develops, ESMA aims to support a clear, decision-useful framework. We are conscious that as it stands, the current framework is still evolving and requires ongoing support to the industry in the practical application of the rules. This is why the three European Supervisory Authorities (ESAs) have sent several queries to the European Commission requiring Union Law interpretation and have this week published a first set of technical Q&As related to the application of the SFDR Delegated Regulation. We hope that these will support market participants in the preparation of their disclosures starting from 2023.

Supervisory briefings are another important tool in ESMA's supervisory convergence toolbox. On 31 May 2022, ESMA published a supervisory briefing on sustainability risks and disclosures in the area of investment management which aims to promote convergence with regard to how the NCAs supervise investment funds with sustainability features. ESMA continues to discuss these disclosure requirements with the national authorities across Europe to support a consistent interpretation of the regulatory requirements and ensure investors, wherever they are, can truly benefit from the enhanced transparency.

In addition today ESMA is launching a consultation paper on draft guidelines on the use in funds' names of ESG or sustainability-related terms. Many voices both in the public and private sector have expressed concerns with the misuse of article 8 and article 9 categories in the SFDR as marketing labels. We hope that through our proposal on the use of names we may address any such misuse of these categories by funds.

Fund names are a powerful marketing tool, especially for retail investors. In order not to mislead investors, ESMA believes that when ESG- or sustainability-related terms are used in a fund's name, this should be supported in a material way by evidence of sustainability characteristics or objectives that are reflected fairly and consistently in the fund's investment objectives and policy.

We are particularly seeking input on the introduction of quantitative thresholds for what would be the minimum proportion of investments to support the ESG or sustainability-related terms in funds' names. We are suggesting a threshold of 80% when ESG related terms are used and an additional threshold of 50% where sustainable or sustainability related terms are used. I encourage you to take part in this consultation, share your views, comments and suggestions. Your feedback will be essential.

These are just notable examples of guidance provided by ESMA to market participants and NCAs regarding the implementation of the Sustainable Finance regulation relevant for asset managers. ESMA will continue monitoring the application and supervision of the SFDR, engaging with the industry and regulators, to identify where more guidance is needed.

Call for evidence on Greenwashing

Building a deeper understanding of the features and drivers of greenwashing and developing an adequate policy and supervisory response is a priority for the EU supervisory community - as spelled out in our Sustainable Finance Roadmap.

We are undertaking this work with the ultimate objective of enhancing the transparency and quality of sustainability-related claims and of maintaining trust in and the integrity of ESG markets. In a context of growing demand for sustainability-related products, rapidly evolving regulatory regimes and sustainability-related product offerings, and data scarcity, greenwashing concerns have been growing and the supervisory community needs to develop a more granular understanding of the potential issues at stake and to identify which topics, market segments or financial products may be more prone to greenwashing risks.

That is why last Tuesday, the three European Supervisory Authorities (EBA, EIOPA and ESMA – ESAs) published a Call for Evidence on greenwashing. The objective is to gather input from stakeholders on how to understand the key features, the drivers and the risks associated with greenwashing and to collect examples of potential greenwashing practices. The Call looks at all sustainability-related claims across all aspects of the environment, social and governance (ESG) spectrum.

The Call seeks input from all market participants and from consumers associations, NGOs and academics. The Investment Management industry input will of course be crucial for the comprehensiveness of the replies. Feedback received will feed into our response to the EC mandate we received last May, and it will eventually help inform policy making and supervision and will help foster the reliability of sustainability-related claims. We count on your participation in this call for evidence which will close on 10 January 2023.

Next to developing our understanding of the greenwashing phenomenon through this CfE and other stakeholders outreach efforts, the European Commission has asked us to also take stock of the implementation of relevant sustainable finance legislation and to map and assess the supervisory response. We will report back on our findings in an interim report by May 2023 and in a final report by May 2024.

The goal is eventually to identify the challenges encountered by financial market participants as well as by competent authorities and to make recommendations, including where appropriate recommendations that would imply legislative changes. This work is therefore an opportunity to enhance the effectiveness and the consistency of both the regulatory framework and the supervisory response.

The macro-economic environment and money market funds

The exit from accommodative monetary policies in a context of high inflation and economic uncertainty represents a challenge for the financial sector and investment funds in particular. Recent episodes, such as the Gilt market turbulence a few weeks ago, have shown how leverage and liquidity risks can crystallise and present risks to financial stability.

Against that backdrop it is crucial to consider how the asset management industry can be made more resilient, including through macroprudential policies. The FSB published last week its progress report on enhancing the resilience of the non-bank sector, and different policies discussed in this report must raise our interest and attention. An effective and enhanced policy toolkit may reduce any identified remaining risks and vulnerabilities, and the potential for spill-over of risks from funds to other sectors. This could be achieved by building more resilience before crises materialise, allowing for strengthened risk monitoring and management, as well as increasing the preparedness of both market participants and regulatory authorities to dealing with adverse shocks.

Let me focus on two segments where work in the international fora and at the European level have identified areas for improvements : money market funds and open-ended funds.

MMFs

The vulnerabilities that surfaced during the pandemic as well as the current market conditions demonstrated that legislative changes to enhance the resilience of the money market fund sector are needed sooner rather than later. We have made a number of concrete proposals in the ESMA Opinion on the review of the MMF Regulation that we believe would strengthen the European framework.

On Constant NAVs MMFs on threshold effects

We first propose to remove the possibility to use amortised costs for LVNAV MMF (Low volatility NAV MMFs). The rationale is that LVNAV mechanisms based on the amortised cost method imply cliff effects and make LVNAV MMFs prone to first-mover advantages.

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

On liquidity related issues

To ensure greater liquidity and reduce risk in the portfolio, we propose requiring higher levels of liquidity buffers, through weekly and daily maturing assets.

On Complementary/crisis preparedness reform

We propose to enhance MMF reporting requirements, to have a more frequent reporting to be activated in stressed market conditions (e.g. daily) with a subset of key indicators and a more frequent full reporting in normal times (from quarterly to monthly).

We also suggest enhancing the MMF stress testing framework to strengthen the role of MMF stress-testing, including from a system-wide perspective

We also propose to clarify the requirements on external support, in line with the statement on this issue that ESMA published in the summer 2020.

Finally, we suggest including a disclosure requirement in the prospectus of the MMF, regarding information on the main features of the rating of the MMF (especially the conditions, including the potential use of LMTs, under which the ratings are downgraded).

In the case of MMF, and the ESMA Opinion on the review of the MMF Regulation, each MMF should put in place at least one Liquidity Management Tool, which would be clearly presented in the documentation to the investor.

These LMTs should be activated by the manager of the MMF, and not by the authorities since there is a risk that when the authorities decide to activate a tool it could actually trigger the very contagion it intended to contain.

Open-ended funds

In relation to open ended funds more generally, while policy work has been largely driven at international level, through the FSB and IOSCO, let me share the main points from an ESMA perspective.

First, it is crucial that regulators have access to detailed and timely information to perform risk monitoring. In that context, we welcome the review of the AIFM and UCITS Directives which foresees the creation of an EU-wide reporting regime for UCITS and we hope the co-legislators will keep this ambition.

Second, tools should be available to mitigate risks related to liquidity and leverage. While some of these tools should generally be in the hand of asset managers such as most liquidity management tools, regulators should provide guidance to encourage their use. Regarding leverage, explicit limits should be either enshrined in regulations for UCITS or regulators should be able to implement appropriate leverage limits as is the case for AIFs under Article 25 of AIFMD.

Third, the enhanced use of macroprudential stress tests is also warranted. While asset managers already perform a range of stress tests at fund level, regulators could consider running formal sector-wide stress test to identify pockets of vulnerabilities.

More broadly, considerations need to be given to system-wide risks as a whole, not just in respect of the risks generated by funds. It is important to account for the interconnectedness of the financial sector, and the heterogeneity of the non-banking sector through a comprehensive and effective framework. It is our role to ensure that this framework addresses identified shortcomings regarding market infrastructures, or liquidity providers, with the aim of improving liquidity supply and demand, avoiding concentration risks, and strengthening bond and short-term funding market resilience.

Conclusion

Let me conclude. We believe that there should be an increasing focus on supervision, enforcement and consistent application of the sustainable finance rules.

We know that the legislative framework is complex, in some areas it is still evolving, but fundamentally we are shifting from a space of understanding the law to applying it. ESMA and the national competent authorities are aiming to ensure that asset managers are disclosing appropriately, not misleading their investors, and that funds marketed as ESG or sustainable have sufficient sustainability features to justify doing so.

As the framework continues to evolve we will aim to pursue our efforts to provide appropriate guidance to the market. With transparency and comprehensibility of ESG disclosures now a Union strategic supervisory priority, expect to hear more from us on this topic in the future.

We believe we share a common objective to ensure adequate disclosures and combat greenwashing. We are keen to hear from you about how this can be done notably with regard to the naming of investment funds – our consultation paper launched today seeks input on different ways to ensure ESG or sustainability claims are backed up appropriate fund features. We look forward to your feedback to this consultation and our call for evidence.

At the same time, we expect asset managers to fully take into account the challenging macro-economic environment and to manage their funds prudently. We believe money market funds resilience could be strengthened via improvements to the EU MMF regulation and that open-ended funds need to pay particular attention to liquidity and leverage risk.

We are grateful to EFAMA for many fruitful exchanges we have had over the past years and I hope we can continue to rely on you for timely and constructive contributions to our work. We very much value the quality of the engagement and look forward to future discussions.

Thank you very much.