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Evert van Walsum
Head of Investors and Issuers Department, ESMA

Good afternoon Ladies and Gentlemen,

It’s a great pleasure for me to be here at the Swedish Investment Fund Association's Annual Conference and I would like to thank the organisers for inviting me today.

The key themes of my speech concern a number of ESMA’s current priorities which – I believe – are relevant also for the Swedish capital market and investors. I will cover sustainable finance, costs and fees borne by investors buying funds and investor protection more generally, with a focus on disclosure-related issues.

Sustainable Finance

Beginning with the important topic of sustainable finance, which is a key priority for the EU. Following the adoption of the 2016 Paris agreement on climate change and the United Nations 2030 Agenda for Sustainable Development, in May 2018 the European Commission has expressed, in the ‘Action Plan: Financing Sustainable Growth’, its intention to clarify fiduciary duties and increase transparency in the field of sustainability risks and sustainable investment opportunities.

To address these goals, on 24 May 2018 the Commission launched a package of measures on Sustainable Finance. This included proposals aimed at:

(1) establishing a unified EU classification system of sustainable economic activities, the so called "taxonomy";

(2) improving disclosure requirements on how institutional investors integrate environmental, social and governance factors in their risk processes; and

(3) creating a new category of benchmarks which will help investors compare the carbon footprint of their investments.

The co-legislators have agreed on two of the three proposals, disclosure and benchmarks, and the three European Supervisory Authorities – EBA, EIOPA and ESMA (ESAs) – are starting to work on the mandated technical standards on disclosure.

Before I move to the Sustainable Finance Disclosure Regulation, I would like to mention that last summer the Commission asked ESMA and EIOPA to provide technical advice to supplement the initial package of proposals and to assist it on amending delegated acts under the UCITS Directive, Solvency II Directive, AIFMD, MiFID II and UCITS with regard to the integration of sustainability risks and sustainability factors. In line with the mandate, at the end of April ESMA submitted its technical advice on integrating sustainability risks and factors in (1) MiFID II and (2) in the

UCITS Directive and AIFMD. Today I will focus on the UCITS and AIFMD advice which should be mostly of interest to this audience.

Technical advice on integrating sustainability risks and factors

ESMA's advice recommends changes to the UCITS and AIFMD Level 2 legislation with respect to organisational requirements, operating conditions and risk management.

On organisational requirements, ESMA recommends that the Commission amends relevant requirements to ensure that all UCITS management companies and AIFMs take into account sustainability risks in their processes, systems and controls, devote sufficient resources to the integration of sustainability risks and ensure that senior management is responsible for the integration of sustainability risks.

In relation to operating conditions, our advice recommends changes to the legislative texts to ensure that fund managers take into account sustainability risks in their due diligence processes and consider conflicts of interests that may arise in relation to the integration of sustainability risks.

Similarly, on risk management we recommended the Commission include sustainability risks in the list of material risks to be managed by UCITS Management Companies and AIFMs.

I would like to highlight that throughout this process, ESMA coordinated its work with EIOPA to ensure cross-sectoral consistency. Following the delivery of the technical advice by both ESMA and EIOPA, the Commission will now consider it and decide on the legislative amendments to be made to ensure the integration of sustainability risks and factors in the relevant legislation.

Forthcoming rules on disclosures

Moving to one of the proposals mentioned earlier, in March this year the co-legislators found a political compromise in relation to a new Regulation on Disclosures. This Regulation sets out ESG disclosure requirements for a broad range of financial market participants (including UCITS management companies, AIFMs and MiFID investment firms) and financial products. The aim of this Regulation is to strengthen protection for end-investors and improve disclosures to them.

EBA, EIOPA and ESMA have been empowered by the Disclosure Regulation to deliver through the Joint Committee a significant number of draft Technical Standards.

Broadly summarised, these relate to:

- Public disclosure of so-called “principal adverse impacts” of investment decisions on sustainability factors, such as environmental and social matters (which apply to market participants on a comply or explain basis, except for companies with more than 500 employees for which the obligation is mandatory);
- Pre-contractual disclosures showing how products meet environmental or social characteristics or sustainable investment objectives;
- Public disclosure of how relevant products meet environmental or social characteristics or sustainable investment objectives;
- Periodic reporting requirements on how financial products meet their

environmental or social characteristics and the overall sustainability-related impact of products with sustainable investment objectives; and
- The standard presentation of the promotion of environmental or social characteristics and sustainable investments in marketing communications.

The ESAs will coordinate producing the requested draft technical standards. The timeline is very tight as the vast majority of them must be delivered within 12 months of entry into force of the Regulation, which is expected during or just after the summer.

To conclude on Sustainable Finance, we believe that the forthcoming changes to the delegated acts on integrating sustainability risks and factors by asset managers and investment firms, and the new Sustainable Finance disclosure rules, will have a lasting impact on investor behaviour in the EU. ESMA will continue monitoring relevant developments in this area and stands ready to engage with stakeholders in relation to the disclosure standards to be developed together with the other ESAs.

Fund fees

Sustainability issues are a key topic for stakeholders. When it comes to funds' investing there are also other specific issues that matter to investors. One of these is the fees that they pay out of their invested assets and more generally the cost of their investments. This is why I would like to focus the second part of my speech on these aspects.

ESMA's first Annual Report on Performance and Costs of Retail Investment Products

ESMA's first annual statistical report on costs and performance of retail investment products covers UCITS, retail alternative investment funds (retail AIFs) and structured retail products (SRPs) and was published on 10 January 2019.

The report documents the significant impact of costs on the final returns that investors make on their investments, with a specific focus on UCITS, distinguishing the performance and costs of various time horizons, asset classes, retail and institutional investors, and actively and passively managed funds. The report complements ESMA's investor protection work and contributes to the Commission's Capital Markets Union Action Plan: To achieve stronger participation of retail investors in capital markets, clear, comprehensive and comparable information on retail investment products is key.

Among the main findings, the report highlights that, taken all together, charges on UCITS funds impact their gross returns by one quarter on average, thus representing a significant drain on fund performance. This is particularly true for retail investors as they are impacted to a much higher extent than institutional investors and pay, on average, twice as much, depending on asset classes.

To make this more concrete, let me provide you with a practical example on the value of an investment for a retail investor, as shown by the results of the report. Let's assume a retail investor makes an investment of 15,000 EUR over 10Y in an equity fund. Based on the report we assume an annual gross return of around 7.3%. The impact of costs relative to gross return for retail investors stands around 27% on average over 10 years. As a result the retail investor will get over 30,000 EUR at a gross level.

Accounting for costs or, in other words, having net returns of 5.4%, we will obtain just over 25,000 EUR. This means almost 5,000 EUR after costs, which clearly shows the substantial impact on investors in the longer term.

In terms of management strategies, the report shows different results if we compare active to passive strategies. One of the main outcomes is that active equity UCITS only slightly outperform passive over the 1-year and 3-year horizons, while costs are significantly higher for actively managed funds. As a consequence, net annual returns are similar across management types, at 1-year and 3-year horizons, while they are higher for passively managed UCITS at longer time horizons. This result, again, shows the relevance of the level of costs on performance in the longer term.

In light of these preliminary results, ESMA decided to further investigate the performance of active versus passive funds. This analysis includes performances of active equity funds against their prospectus benchmarks, further insight into the performance of the specific class of equity ETFs, as well as reporting on the distribution of cost and performance within active funds.

So far, we have observed a slightly higher variability of active versus passive funds compared to the EU average, both in terms of gross and net performances. Focusing on top 25% active and top 25% passive performers we observe significantly better gross and net performance of actively managed funds over one year (2017). This result is in line with expectations: while on average active does not outperform passive, at least some active strategies should outperform passive strategies, also after taking costs into consideration. However, this phenomenon needs more in-depth analysis and we will report on this in more detail in the next version of the ESMA annual statistical report.

For retail AIFs and SRPs, the report provides an overview of the respective markets as, for those type of products, market transparency is particularly limited and up-to-date data on costs and performance are not available.

Finally, another interesting finding touches upon the on-going costs such as management fees, which constitute over 80% of the total cost paid by customers, whilst entry and exit fees have a less significant impact.

ESMA's work on performance fees

While mentioning costs, I would like to say a few words on the topic of performance fees, as this is also relevant to what the end-investor pays and the impact on the overall investment performance.

It is part of ESMA's role to enhance cost transparency of retail investment products in the EU and, to this end, we identified performance fee structures and payments – especially for funds marketed to retail investors – as an area on which increase supervisory convergence across the EU.

It has come to our attention that national practices on performance fees are not always consistent – not only in terms of disclosure, but also on the way performance fees are calculated. In particular, some performance fee models are permitted in some Member States but not in others, including different frequencies for performance fees computation and payments. This creates the risk of different levels of protection for the retail investor depending on where the fund is domiciled, while we believe that the cross-border nature of the EU fund market calls for investors to be treated fairly wherever they live and regardless of the fund’s location.

That is why we are of the view that supervisory convergence on this issue is essential to ensure a level playing field in the European Union, especially in light of the extent to which UCITS are distributed cross-border in the internal market.

Against this background, we’re currently working on some common principles that could help harmonise the way EU regulators approach performance fees and the way they allow asset managers to structure them while creating funds. The overall objective of this work should be setting high-level convergence principles on some key areas, such as:

- the frequency for computation and payment of performance fees; ensuring consistency between the performance fee model and investment objective of the fund; and
- enhancing disclosure to retail investors, for whom the impact of performance fees on the overall return of the investment can be difficult to assess.

We will continue this work in order to prevent the risk of regulatory arbitrage and inconsistent levels of investor protection for retail investors. The cross-border nature of the EU fund market requires that investors are treated fairly wherever they live and regardless of where the fund itself is domiciled.

Consumer protection

Now moving to the related, but broader dimension of consumer protection – and more specifically its disclosure component – I would like to mention a couple of files that are particularly relevant to ESMA: PRIIPs and closet indexing.

PRIIPs

As I mentioned earlier, ESMA's first annual costs and performance report on retail investment products clearly confirms that, in the case of UCITS, the total costs of a fund present a significant drain on fund performance. I believe that what is true for UCITS is also true for other types of investment funds, and more generally for most types of investment products marketed to retail investors, whether these products are funds, structured products or insurance contracts: costs are a key factor determining performance.

The new PRIIPs disclosure framework has of course an important role to play in this respect. This is because it should help the retail investor to be aware of the costs embedded in the investment product he or she is about to buy. This is not to forget that some improvements to this framework will be warranted in light of first application experiences. However, we believe that, thanks to the PRIIPs KID, investors should now have a better picture of the costs of the investment product they are buying in a comparable format.

At the same time, we need to ensure that this new disclosure framework is equally appropriate for all types of PRIIPs, allowing retail investors to compare the features of the products they will buy before they take their investment decision, but also allowing retail investors to clearly understand the costs they will pay. This is a challenging task, given the heterogeneity of the products, and their cost structures, in the scope of the PRIIPs Regulation.

In this context, we have initiated work on a broad review of the PRIIPs Delegated Regulation during 2019. We expect to hold a public consultation in Q3 this year, and look forward to receiving input from the various stakeholders.

This review will first of all include proposals to review the performance scenarios section of the PRIIPs KID, which proved to show over-optimistic results in certain cases. But it will also cover cost related issues, such as the presentation and calculation of costs.

This review will be complemented by a consumer testing exercise carried out by the Commission on the different possible amendments to be made to the presentation of performance scenarios. The results of this exercise will be known by the end of the year. The proposal of the ESAs on the changes to the PRIIPs level 2 should then be sent to the Commission at the beginning of next year.

Closet indexing

Now moving to my last topic, I would like to emphasise that it is a key part of ESMA's role to enhance consumer protection. This is the reason why we undertook various initiatives aimed at tackling closet indexing, also known as index hugging, which refers to the practice of fund managers claiming to manage portfolios actively when in reality the fund stays close to a benchmark.

The practice of closet indexing is highly detrimental not only to investors, but also to the overall industry, as it jeopardises the competitiveness of the market as well as efforts to reach a full transparency on fee structures. The consequences of index hugging are exacerbated at the EU level, especially in a single market where cross-border distribution of funds is widespread.

Since the publication of the statement on closet indexing, in February 2016, ESMA's work focused on both the supervisory convergence and the policy side.

In this context, a pivotal aspect in tackling closet indexing was considered to be the active role of national competent authorities. This is why, over recent years, ESMA liaised with national supervisors to get a comprehensive picture of the outcome of their work at national level. From this standpoint, we supported the work done by many authorities at national level and welcomed initiatives of those of them which included closet indexing among the priority areas where consumer protection in the financial market needs strengthening.[1]

As we acknowledge that statistical analysis can only give an overall indication of the existence of closet indexing activity, we decided to complement this supervisory effort with specific policy work to ensure consistent and enhanced benchmark disclosures in the UCITS KIID.

The new ESMA Q&As on benchmark disclosure underline the importance for all UCITS funds to disclose clearly whether the fund is managed actively or passively.

The Q&As also clarify that a 'benchmark referencing' UCITS is one where the benchmark plays a role in its portfolio composition and/or performance

[1] See Finansinspektionen,, Consumer protection on the financial market, https://www.fi.se/contentassets/9791b37d1d074ed4a3fc193786d449f6/konsumentrapp_2015engny.pdf

objectives and measures. To this regard, we believe that the adoption of a broad definition of ‘benchmark referencing’ UCITS will reduce the level of discretion allowed to fund managers in terms of past performance benchmark disclosure, thus reducing the possibilities of adopting closet indexing strategies. Furthermore, the obligation to show past performance of the benchmark should allow investors to better evaluate investment strategies, such as active funds against passive funds.

We expect that this work will bring a consistent interpretation of the provisions on benchmark disclosures across Member States, providing NCAs with diverse tools in order to better assess the extent to which a fund is adopting an index hugging strategy and enhancing investors’ protection.

Conclusion

Ladies and Gentlemen, today I gave you an overview of three key priorities in the investment management area for ESMA. I believe that a common theme is the urgency with which the underlying issues should be tackled. The world cannot wait to tackle sustainability issues – I think that you will agree that this is obvious. Equally, investors have a pressing need both to be treated fairly (in particular when setting the costs that they bear) and to understand the products that they’re investing in – what is at stake is the credibility of the financial sector and ultimately the effective channelling of private money into financial markets.

I hope that you share my views on the need to tackle these issues and support ESMA’s continued commitment to promote retail investor participation in capital markets through enhanced investor protection.

Thank you for your attention.