

Speech for the AIMA Global Policy and Regulatory Forum – 18 May 2016, London

The Capital Markets Union, supervisory convergence and asset management

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Ladies and gentlemen,

I am delighted to be here at the AIMA Global Policy and Regulatory Forum. Over the years the Forum has become a key gathering for the alternative investment management sector and I am grateful to AIMA for giving me the opportunity to give an update on ESMA's work. Today, I will speak principally about how ESMA's work is contributing to the development of the Capital Markets Union (CMU), with a focus on asset management issues, and give you a flavour of the shift in ESMA's focus towards supervisory convergence work. I will also update you on a couple of workstreams that I'm sure will be of interest to you, namely our UCITS remuneration

guidelines and our advice on the possible extension of the AIFMD passport.

Allow me to begin by focusing my attention on the CMU initiative launched last year by the European Commission. As we have said on many occasions, ESMA is very supportive of the aims of the CMU to foster deeper and more integrated capital markets encompassing all 28 Member States of the EU. This is only natural since ESMA's main objectives, namely enhancing investor protection and promoting stable and orderly financial markets, are fully aligned with the objectives of the CMU. A European Union with open capital markets and reduced fragmentation will attract investment, boost competitiveness and strengthen Europe as a global financial sector.

In its Green Paper on the CMU and the subsequent Action Plan, the Commission made clear that new legislation would be developed only when necessary and that the focus should now be on how to make existing legislation, such as the UCITS Directive or the AIFMD, work better. The Commission also underlined the importance of developing alternative sources of funding of the real economy which, as we know, has traditionally been funded by the banking sector.

Now, let me present in more detail what ESMA has been doing with respect to CMU and asset management.

I mentioned earlier the decrease in bank lending to companies since the financial crisis and the need for alternative sources of funding. There is broad agreement that one such source could be the granting of loans by investment funds. I have the clear impression that the debate on this topic has moved on significantly over the past couple of years. Initially there seemed to be widespread misgivings about the prospect of allowing investment funds to grant loans given that, in many areas of Europe, this was seen as a banking activity. Against the background of the recent debates on shadow banking, this was an entirely understandable reaction. However, as the discussions have evolved, policymakers seem to have accepted that loan origination by funds – while still a relatively niche activity – has the potential to develop into an important alternative funding source.

This change of perspective was reflected in the Commission's Action Plan on CMU, which noted that some Member States had already introduced bespoke regimes for loan origination by funds in their national legal frameworks, leading to difficulties in carrying out business on a cross-border basis. The Commission went on to say that clarification of the treatment of loan-

originating funds in the regulatory framework could facilitate cross-border development while ensuring they are regulated appropriately from an investor protection and financial stability perspective.

Leveraging on the Action Plan, and taking into account further discussions with the Commission, ESMA started work to develop what it considered to be the key elements of a common European framework for loan origination by investment funds. This led to the opinion that we published last month. I would like to touch briefly on a few points covered in the opinion.

The first point to mention is that our work further confirmed the shift in approaches at national level in this area, as evidenced by the increasing number of jurisdictions that have introduced – or are considering introducing – a framework for loan origination. Among the more recent initiatives, it is worth noting the examples of Germany and France.

Turning to the substance of the opinion, I would like to highlight the suggestions we made for the organisational requirements that managers of loan-originating funds should have. These recommendations take account of the fact that direct lending is an activity that requires specific expertise and internal structures. While it would not be appropriate to impose exactly

the same rules as apply to banks, there are certain key elements which we believe should be in place before a fund should be able to originate loans. These include having the requisite policies, processes and procedures with respect to credit monitoring, renewal and refinancing, assessment and scoring of borrowers, and identification of problem debt management. Such requirements should help reduce the risks that could arise from liquidity and maturity transformation, as well as imprudent lending.

Another key question that we addressed in the opinion concerned the type of investor that should be able to invest in loan funds. Overall, we were cautious about opening up this market to retail investors, although we did recognise that this could depend on circumstances: for example, if loan origination accounts for a relatively small proportion of the portfolio of the fund, that would be a different situation compared to allowing a retail investor to invest in a fund that was exposed entirely to loans. This is an aspect that would need to be considered carefully in the next step of the process.

Finally, I would like to highlight our recommendations on eligible debtors of loan funds. In line with one of the overall objectives of CMU to increase funding to the real economy, we took the view that loan funds should not be able to grant credit to

financial institutions, other investment funds or the alternative investment fund manager itself.

Let me now move on to another area in which ESMA has been contributing to the CMU. The UCITS Directive has clearly been successful in establishing a passport for marketing of funds to retail investors across the EU. More recently, the AIFMD has introduced a similar model for marketing to professional investors. We regularly hear from stakeholders, however, about the practical difficulties that they face on a day-to-day basis when seeking to exercise their passporting rights. The Commission has clearly had similar feedback since the CMU Action Plan set out a specific workstream on identifying – and subsequently removing – unjustified barriers to the cross-border distribution of investment funds. These barriers could include discriminatory tax treatment, varying national requirements on the marketing of funds and fees for cross-border notifications.

I would like to make one point clear in this context – the current legislative framework, at least as far as AIFMD and UCITS are concerned, does not harmonise the rules on marketing, nor does it prohibit in our view the levying of fees by national authorities. The issue is therefore less about the interpretation of the current rules than it is about assessing the extent to which the barriers represent genuine obstacles to cross-border

business and, as such, whether the rules should be changed in order to ensure more convergent practices and a smoother passporting system.

From an ESMA perspective, we have gathered information on the practices of national competent authorities in this respect and have provided that to the Commission. The mapping that we did was very comprehensive in nature, covering not only AIFMD and UCITS but also EuSEF, EuVECA and ELTIF. Now is not the appropriate time to go into details about our findings but suffice it to say that there are indeed a wide range of national practices across the EU that merit further analysis. I would encourage you as industry representatives to engage in the consultation on this topic that the Commission is due to launch by the end of May. ESMA stands ready to provide input to the further work of the Commission in due course.

Moving on from the CMU, let me say a few words about ESMA's increased focus on supervisory convergence issues and the relevance of this to asset management. You will no doubt be aware that we have stated publicly, notably in our strategy for 2016-2020, that we see a need to move away from the single rulebook work that took up so much of our time and resource in the first five years of existence and put the spotlight more on the way in which those harmonised rules are applied in

practice. This is not an easy task: the single rulebook workstreams, while presenting significant challenges, came with clear deadlines and deliverables. Both we and the national authorities had a lot of experience in that area and we had built up the structures and expertise that allowed us to make, if I may say so, a huge contribution to the single rulebook in the past few years. Supervisory convergence, on the other hand, requires a more proactive assessment of the priorities and naturally comes with different consequences for the national regulators. The need to take into account divergences between markets and supervisory cultures becomes increasingly important and, in some cases, sensitive. Based on our experience thus far, however, I am confident that we will be able to make significant progress in this area and take steps that will lead to real change “on the ground”. Feedback from stakeholders such as those represented here today will be invaluable as we take this forward, both in identifying possible issues and assessing the extent to which our actions have achieved their aims.

Looking at asset management in particular, I would like to mention a couple of areas of supervisory convergence work that we will be carrying out this year.

The first relates to the topic of asset segregation. You may recall that we issued a public consultation on this issue back in December 2014. It's fair to say that the views from stakeholders on the two options that we set out in that paper were mixed at best. We have been considering this issue further in recent months and are now assessing in more detail the different segregation models that can be envisaged and their pros and cons. Throughout this work we have to pay close attention to the legal provisions on segregation in the AIFMD and consider the extent to which they allow the use of omnibus accounts. We also need to take into account the rules on segregation in other pieces of legislation, such as the CSDR. At this stage we have not taken a final decision on the most appropriate ESMA instrument for the outcome of this work: it may be guidelines, an opinion to national regulators or a recommendation to the EU institutions on possible legislative change. In any case, you should expect to see something being issued by the end of the year.

Another topic that will aim to further our supervisory convergence objectives relates to the powers to limit leverage under the AIFMD. Given that the powers are drawn rather broadly, stakeholders are naturally interested to know in more detail in what circumstances the powers might be used and on

what basis. We have therefore decided to develop more detailed guidance on this. As you can imagine, this topic is linked to the broader issue of the data that managers have to report periodically to their home regulators under the AIFMD, which includes information on leverage. The data is then sent on to ESMA so that it can be consolidated at EU level. We know that fund managers have had to dedicate a lot of time and resource to the establishment of the systems necessary for this exercise. Similar efforts have been required both at the level of national authorities and ESMA to put in place the appropriate infrastructure. Our focus at this stage is on ensuring the quality and consistency of the data, which is itself a challenge given the number of fields to be reported and the huge range of information covered. As part of our efforts in this respect, we will continue to update our AIFMD Q&A with respect to reporting issues. Once again, I would encourage you to flag problems or issues to us – ideally through AIMA – so that they can be considered in that context. Once we have sufficient confidence with respect to the quality, consistency and completeness of the information in our database, our priority will become the analysis of the data with a view to identifying possible trends and risks in the alternative investment fund sector.

I would like to bring my remarks to a close by updating you on two workstreams, namely the UCITS remuneration guidelines and the advice on the AIFMD passport.

I'm conscious that the audience here today has a greater interest in alternative investments than in UCITS. Nevertheless, I'm sure that you will have followed our work on the UCITS remuneration guidelines closely given the general interest in that topic and the link to our earlier guidelines under AIFMD. Much of the debate around these guidelines centred on the approach to proportionality or, to put it another way, whether it is possible to disapply certain of the remuneration rules (namely those on the pay-out process) in particular circumstances. In developing the guidelines we had to balance two elements of the Level 1 text: on the one hand, the need to align the guidelines with those under the AIFMD and, on the other, the need to cooperate closely with the European Banking Authority (EBA) on their equivalent guidelines under the Capital Requirements Directive (CRD) with a view to ensuring consistency of rules across the financial sector.

Against this background, and mindful of the information gathered from national competent authorities on different legal interpretations of the proportionality clause, in our final guidelines we decided to follow an approach which is similar to

that adopted by the EBA. Therefore, we did not include in our final guidelines any guidance on the possibility not to apply certain specific requirements on the pay-out process. We appreciate that stakeholders would have preferred to have clearer indications from ESMA that such disapplication could continue, but we took the view that legal clarity would be more usefully provided in the Directive itself. For that reason, we wrote a letter to the Commission, Council and Parliament explaining why we felt that proportionality in the application of remuneration rules was important in the asset management sector and suggesting that legal clarity would be helpful in that respect. We now await possible follow-up from the Commission on this topic.

Turning to the AIFMD passport, our assessments of non-EU countries have continued since we submitted the first advice to the institutions last July. In line with the feedback that we received from the European Commission in January, we have been looking at six new countries (Australia, Japan, Canada, Cayman Islands, Bermuda and Isle of Man). We have also been working to finalise our views on the three countries covered in our first advice for which we did not provide definitive assessments, namely Hong Kong, Singapore and the US. This is an extensive exercise involving intensive exchanges with

national authorities in the non-EU jurisdictions. An additional aspect that we have had to take into account is the assessment of the effectiveness of enforcement in each non-EU country. In that respect we see merit in relying as much as possible on the assessments carried out by the IMF for the purposes of its Financial Sector Assessment Program (FSAP), which is an internationally accepted benchmark and ensures a good level of consistency across non-EU countries. For countries that have never been subject to an FSAP, there has clearly been more work for us to do in terms of gathering and assessing information on the non-EU jurisdictions. We have made good progress on the advice and will continue to develop it further in the coming weeks. Looking beyond that, we can expect that our work will continue since there are many other non-EU jurisdictions to be assessed.

Ladies and gentlemen, I have spoken today about ESMA's contribution to the development of a Capital Markets Union. I have also explained how our work is moving towards convergence of supervisory practices at national level. I hope that you will see the clear interlinkages between these two initiatives. It is equally clear that asset management will remain a priority area for ESMA's work in the coming years and that



your continued engagement will be an important element if we are to achieve our objectives.

Thank you for your attention.