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Investment funds: how to reduce fragmentation in the EU investment funds market?

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Objectives of the session

The objective of this roundtable was to discuss the key remaining areas of fragmentation of the EU investment fund market, their impacts for investors and the industry as well as the solutions that could be proposed at the EU level to reduce this fragmentation.

Executive Summary

The EU investment fund market remained fragmented despite the implementation of European product, distribution and investor protection regulations

Investment funds were key to making the CMU a reality and helping to reduce banking finance, and increase capital market finance in Europe. Funds had grown in the EU, but there was a question of whether investors got the best value for their investments and whether the cross-border penetration of funds was sufficient.

At first glance the European fund industry appeared successful. UCITS and AIFMD were appropriate frameworks allowing the passporting of investment funds across Europe. Many actions had also been undertaken to facilitate cross-border investment. This was the case with MiFID II, PRIIPs and the KID that had many provisions aiming to harmonise client information and investor protection across Member States but also across different types of investment products. The objective of these measures was to facilitate investors' access to information, also on a cross-border basis, and to simplify the process of comparing investment products. Service providers were also facilitating the access of their clients to a broad range of markets and supporting them with reporting requirements.

The EU investment fund sector however remained quite fragmented.

Some Member States had very few foreign funds; the domestication of funds was striking. As a result, the EU had three times as many funds as the US; around 30,000. The average size of EU funds was one fifth of the size of those in the US, and the costs of managing EU funds were consequently 50% higher.

The large number of small funds increased the regulatory burden for management companies and thus the cost of managing funds, which impacted investor returns. That was an important problem to address to make the CMU a reality.

The levels of fragmentation were however not the same across Europe a panellist emphasized, because some European funds, such as those domiciled in Luxembourg are well passported across Europe and outside Europe.

The EU fund sector was fragmented for various reasons. Only a small amount of the higher fragmentation of the EU market compared to the US could be attributed to different currencies.

Differing implementation across Member States of European legislations related to funds and domestic rules were a major source of fragmentation. First were the additional disclosures required by domestic regulators on the marketing side. Second were high registration fees. Third was the requirement of local paying or facilities agents forcing UCITS to have a physical presence in a host

Member State. Fourth, there were inconsistent definitions in AIFMD of who were the return investors and the professional investors which limited the extent to which AIFs could be distributed. Many of these barriers were due to the mistrust between regulators and to differences in the way directives had been implemented. Differences in taxation were another issue.

Another source of fragmentation were the inconsistent requirements across regulations affecting investment funds, for example regarding reporting, which made cross border distribution and compliance with each set of regulation increasingly more difficult; new regulatory developments such as MiFID II and PRIIPs would add to the complexity. The risk was that the demands of regulation could eventually become insurmountable for smaller players and new entrants, potentially reducing competition.

A further source of fragmentation was the structure of distribution channels in most of Europe and the vertical integration or banks selling their own funds, some panellists considered, which was at odds with creating a single market. Private and retail banks were still the largest distributor channels in Europe, owning a 75% share of the total fund distribution. This part of the market was largely excluded from competition between funds. Moreover, certain well intended regulatory measures, such as the requirements related to the oversight of distributors in MiIFD II could favour the move towards more vertical integration. This could affect the level playing field in the market and hinder competition that were needed for service to clients to improve and prices to fall.

Different solutions were discussed during the roundtable to reduce fragmentation in the EU fund marke

A more coordinated and proactive approach to regulation and supervision at the EU level was first needed.

When MiFID II, KID and PRIIPs were in place, regulators should be able to agree that there was little or no scope left for national gold plating. In passporting, the rules that applied should be those of the EU frameworks (i.e. MiFID II, AIFMD, UCITS…) and nothing else. There should be no possibility to add fees, to impose local agents or to have extra marketing rules. That was what the maximum harmonisation of regulation was about.

A central European registration of funds was proposed. The passporting regime in place indeed mainly focused on the sale of investment funds and did not deal with marketing requirements. Once an investment fund was registered and had met the requirements in one Member State, it should be possible to use that authorisation for more than selling the fund. This would give more power to ESMA and was considered by some speakers to be a positive step towards reaching a CMU. A concern one panellist expressed was that ESMA did not carry out sufficient peer reviews on the implementation of legislation with domestic regulators. However, that was disputed. ESMA had a strategic plan for 2016 2020 on the single rulebook and supervisory convergence, amongst other initiatives and this was a priority for the authority.

It was felt that national authorities needed a mechanism whereby they could work together towards a European goal; however, some felt that that was already possible, but prevented by a lack of willing on behalf of participants. Some suggested that the EU Commission could play a more proactive role by taking out infringement procedures. If barriers to cross border fund distribution were not tackled, retail investors would suffer the most. They needed greater convergence amongst supervisors, which was currently easier than it historically had been thanks to technological developments.

A single rule book for investment funds and a streamlining of regulations was also proposed.

Several panellists stressed that further harmonisation and a streamlining of existing rules affecting EU investment funds was needed rather than additional layers of legislation. A single rule book already existed to a large extent with passports, the notification procedure, the KID, provisions regarding master feeder structures and fund mergers but the implementation of these rules differed across Member States. It was difficult to anticipate how initiatives like MiFID II would impact the industry; they needed to see how they applied and how distribution models would evolve before considering whether or not additional rules were needed. It was further recommended that superfluous parts of regulation should be removed. There would be an EU Commission consultation in Q2 of 2016 on these issues.

Better cooperation between regulators and the industry was also necessary, some suggested. Regulators needed to talk to the industry more and to understand market practices better. This would allow them to understand what level of regulation they needed to apply whilst also bearing in mind the need for consumer protection. The process should start with understanding the market before moving to legislation. Moreover the industry was encouraged to collaborate on creating industry wide templates for information exchange and communication with distributors when MiFID II was totally implemented.

New technology could also be used for various improvements, the streamlining of processes and the improvement of distribution. Although, it was noted that accessing optimal technology could then become a problem for small and medium asset managers. The prospect of new digital entrants reducing costs and challenging traditional methods of handling investment funds was welcomed by some panellists. It could only be good for both consumers and the industry as a whole.

The industry also needed to look into products that would encourage retail investors, who only had 7% of their investments in funds, to move investments from low interest rate bank accounts and into funds. Another reason why retail investors were put off cross border investments within the EU was the concern over double taxation, which needed to be tackled, a speaker believed.

Detailed Summary

1. The EU investment fund market remains fragmented despite the implementation of European product, distribution and investor protection regulations

1.1. Many rules have been implemented in order to create a single market for investment funds

At first glance the European fund industry looked successful, a market observer believed. The UCITS brand was respected across Europe, Asia and South America, and UCITS funds had developed well since the first UCITS directive. The proportion of funds in investments had grown, the fund ownership of equities had more than doubled to 20%, and the level of automation in cross border distribution levels had surpassed 80%; that was a good sign.

The next step in the fund regulation had been establishing the AIFMD which allowed the passporting of alternative investment fund management companies and enabled alternative funds to be distributed cross border in Europe. New fund categories were currently being introduced aiming at developing the sector, namely the European Social Entrepreneurship Fund (EuSEF) and the European Venture Capital Fund (EuVECA). They had not had a major impact so far however.

The European Long Term Investment Fund (ELTIF) was supposed to play a major role when it came to the Capital Markets Union (CMU). The objective of ELTIFs was to move savings into investments, particularly in the infrastructure sector and SMEs.

The backdrop of this was that there was not enough investment in Europe and thus not enough growth. The unemployment level remained at an unacceptable 11%, and was alarmingly high with young people. That was a reason why Euroscepticism was increasing and this had to be tackled. He hoped that the Euroscepticism would not have a major impact on the 23 June UK referendum.

An industry representative agreed that many measures had been implemented to create a single market for investment funds, especially to facilitate their cross-border distribution. Many actions had also been undertaken to facilitate access to cross-border funds for investors. This was the case with MiFID II that had many provisions regarding client information and would be a way for clients to get more information about investment funds. There was also the PRIIPs regulation with the extension of the KID to a wide range of investment products, which would also be a source of information for end investors that would simplify the process of comparing different types of products. These provisions would also help to harmonise investor protection across the EU, which would help to reduce fragmentation. If there was the same level of protection in all EU member states, then it would encourage investors to invest in places outside their own jurisdiction.

A great deal had also been done by service providers. There were many situations where they assisted their clients because they had both global and local expertise, which was a way to facilitate access to a huge number of markets. They helped their clients by providing a single point of entry in many situations. Reporting requirements were one area where they could definitely help their clients.

1.2. The EU investment fund sector however remained quite fragmented

Although UCITS was a good development, and AIFMD was reasonably good so far, there were problems with the implementation of these frameworks when it came to cross border distribution, and therefore talk of fragmentation, a market observer emphasized. This was not the only sector of financial services concerned by fragmentation in the EU however.

A public representative emphasised the importance of reflecting on the major developments that had occurred since the last Eurofi meeting (September 2015). The worsening refugee crisis, risks of the Chinese economy, the decreasing value of bank shares, and the situation in Greece had all impacted the financial sector. They all knew that investment funds were key to making the CMU a reality and helping to reduce banking finance and increase capital market finance. Funds had grown, which was positive, but the question was of whether investors got the best value for their investments. That was not certain.

They were not close to achieving a “total” CMU and the European regulatory framework was implemented in a very fragmented way. That was problematic; they had a framework for UCITS and

AIFMD, but there was still a clear lack of cross border penetration. That was not a theoretical problem. There were too many funds in the EU, compared to the US and there had to be some rationalisation. However, what that really meant for retail investors was that the fees were too high and the rules were not very transparent.

The sector also needed reform because there were conflicts of interest in the industry and retail distribution. They had to address the issue that when investors went to banks, the banks tended to favour their own funds and promote them to clients. Private and retail banks were indeed still the largest distributor channels in Europe, owning a 75% share of the total fund distribution.

The problem of whether investors received good value on their investments was also important to address in order to make the CMU a reality. Hedge funds were having their worst quarter because investors had taken out some $15 billion. The main reason was the high cost, and so the industry had to find a way to address it.

A market observer stated that the EU had three times as many funds as the US; around 30,000. The average size of EU funds was one fifth of the size of those in the US, and the costs of managing EU funds were consequently 50% higher. That needed to change.

A regulator confirmed these statistics on the fragmentation of the fund industry in Europe; they had more funds that were smaller and had higher fees than in the US. Some Member States had very few foreign funds; the domestication of funds was striking. They were talking about a €12 trillion market, and so it needed to be addressed if they wanted any chance of achieving a Capital Markets Union.

A regulator outlined that high costs impacted investor returns. The abundance of small funds increased the cost of complying with regulation. However, the precise impact of costs on returns compared to performance was still unclear.

An industry representative considered that the levels of fragmentation were not the same across Europe because there are some countries where it is more interesting to domicile funds. Therefore some European funds, such as those domiciled in Luxembourg were well passported across Europe and outside Europe.

1.3. Different sources of fragmentation needed to be addressed

A market observer highlighted that the fund sector was fragmented for various reasons. They had barriers because of different taxes; favourable treatment of domestic versus cross border funds; different definitions e.g. of investors in different Member States; and the same directives being implemented differently in different places, which had also been seen in other areas of financial services. That made cross border distribution difficult, and was one of the reasons why they did not exploit the potential scalability. He acknowledged that Europe did not create miracles overnight, but advised that gradual progress should be made over the coming years.

A regulator emphasised several sources of fragmentation due to domestic regulation; and where European regulators could make progress. First was with the additional disclosures required by domestic regulators on the marketing side. Excessive marketing documentation for on-boarding, and then further reporting requirements could become onerous. That created friction in every market where regulators added their own national rules. Second were fees. A number of countries had high fees, and there was a debate to be had on how that was compatible with passporting, as high fees negated the economic case for it. Third was on the requirement of local paying or facilities agents. They may have made sense when they were introduced in 1985, but there was currently less of a case for forcing UCITS to have a physical presence in a host Member State. Fourth, there were inconsistent definitions in AIFMD of who were the return investors and the professional investors. AIFMD followed the MiFID approach and said that if you were not a professional client under MiFID, then you were not one under AIFMD. That limited the extent to which AIFs could be distributed and in fact there were different definitions in the EuVECA and EuSEF regulations with a far-broader category of non-retail investors. They needed a unified definition of retail investors and professional investors that worked across the funds.

A regulator stressed that the situation had to be considered at two different levels. At the regulatory level, there was clear mistrust between regulators. Barriers had stifled cross border activity, which was at odds with a single market. At the micro level they saw fragmentation in the implementation of directives. They needed a proper single rulebook.

Several panellists stressed that distribution channels were another source of fragmentation besides regulation. An industry speaker considered that the vertical integration of fund distribution was a further source of fragmentation and that certain regulatory measures which had been well intended, favoured the move towards more vertical integration. Of the higher fragmentation of the EU market over the US, only a small percentage could be attributed to different currencies. A large part of the rest was due to vertical integration or banks selling their own funds, which was obviously at odds with creating one market. If every bank were to create a silo with their own proprietary products, then the number of funds would continue to grow, and continue to push in the opposite direction of a single market.

The UK market had been the most open and was characterised by a total separation between production and distribution, but it was rapidly becoming vertically integrated and arguably giving clients less transparency, choice, and benefit on cost. Parts of MiFID II, such as the requirements related to the oversight of distributors could also result in a similar trend. The requirement for manufacturers to determine a “target market” i.e. target clients prior to the distribution of products could be a further step in the wrong direction because the additional reporting requirements would deter certain participants.
Furthermore, if they were not careful with the way the last piece of MiFID II was implemented, it could create a natural fit for the vertically integrated model. It would be difficult to have total control on funds that were distributed if the management company and distributing bank were not the same; and that went in the opposite direction of what was wanted.

A regulator agreed that the UK was an interesting example, but there was also divergence across Europe because the UK had a fully fledged asset management industry, which was not the case of many other European countries. Europe was essentially controlled by the banks and small practitioners were being edged out, and so that was where costs increased.

An industry representative suggested that there were probably other new sources of fragmentation related to regulation, beyond those which had been mentioned. One was that complying with increasing regulation, especially in asset management, was becoming more challenging than it already had been. Reporting requirements were a nightmare to comply with, and MiFID II would bring additional requirements regarding the oversight of distributors. Asset managers would likely exit some jurisdictions due to the cost. Thus there were new sources to consider in addition to the traditional sources of fragmentation.

Another industry speaker agreed that new regulations could provide further difficulties. This was the case of reporting which was becoming increasingly complex. Because of certain tax advantages, a fund wrapped into a unit-linked policy was required to provide additional reporting because of Solvency II. And PRIIPs and the KID would add an extra level of complexity than what exists at present. He feared that further regulation coming from different directives and supervised by different regulatory authorities would continue to make matters worse.

An industry representative noted that tax was another issue. There were certain jurisdictions where local funds had minor advantages, such as Denmark and Holland. However those were dwarfed by the tax advantages that other products benefitted from, which were colossal. Those tax benefits always resulted in higher costs to clients for those products at the expense of lower revenues for treasuries.

2. Different solutions were discussed during the roundtable to reduce fragmentation in the EU fund market

A more coordinated and proactive approach to regulation and supervision at the EU level

A market observer noted that a reason for fragmentation was that the same legislation was being implemented differently across Member States for investor protection reasons. He also asked if regulators would be prepared to accept a central European registration of funds.

A regulator agreed that differences in the way EU regulations were implemented were an issue. He argued that there needed to be a trade off as new regulations were being implemented. When they had MiFID II, PRIIPs and the KID in place, they should then be able to agree that there was little or no scope left for national gold plating. In passporting for example, the reporting rules that applied would be MiFID II, AIFMD, UCITS and nothing else. There should normally be no possibility to add fees, to impose local agents or to have extra marketing rules. That was the principle of a maximum harmonisation of regulation.

A proposal had been to go one step further and have one place to approve marketing material. A central registration would give more power to ESMA, which he had always been in favour of. He noted that they had a banking union with a single supervisor, a single resolution authority, and suggested that if they wanted to go far in a Capital Markets Union, then they needed to go in that direction and decisively change the mandate of ESMA.

A public representative added that the passporting regime in place did not deal with all aspects and notably does not deal with marketing. The passport was only about selling. Having a single point of registration might be useful. Once an investment fund was registered and had met the requirements in one Member State, it should be possible to use that authorisation for more than selling. Regulators needed to have greater trust amongst each other, but also had to broaden their views on investor protection beyond protecting their own consumers.

Another regulator highlighted that there were still some areas missing in the present EU regulatory and supervisory set up. The first was that he had not seen ESMA and others carry out any peer reviews to ensure that legislation was properly applied, while this was normally an obligation. Peer reviews by regulators were missing, and should be a start towards clearing up fragmentation.

A regulator disagreed that peer reviews were insufficient. He said that ESMA regularly conducted peer reviews along with other ESAs and took them very seriously. The results of those reviews were published, and regulators challenged each other on passporting and other issues. ESMA also had a new strategic plan for 2016 2020. Within the plan was the completion of the single rulebook as well as a chapter on supervisory convergence. Behind the plan they had dozens of people allocated with detailed work programmes for the next four years. They were working on supervisory convergence and applying the single rulebook in a consistent manner throughout Europe. This was a clear priority for ESMA.

A public representative thought that it would help if there was a more proactive approach from the Commission and if infringement procedures were taken out. It would also help if ESMA issued guidelines that could be easily understood. One of the problems was that ESMA did not have many mediation powers, and so it was difficult to know who resolved problems. They needed to find a mechanism where national authorities could find trust and confidence to work with each other towards a European objective. Another speaker agreed, but said that there was a lack of willingness to move in that direction. If domestic regulators wanted to work constructively together, they could, without ESMA being empowered and forcing them. The public representative agreed, but said that it did not happen, and that if they did not have infringement issuing from the Commission, there was no reason for them to.

A single rule book and a streamlining of regulations

A regulator stated that they needed a single rulebook. As they then converged, they would end up with a single register, which he also agreed with. One speaker responded that if they had a single rulebook, there would still be the chance that the implementation would differ. The motive of national specificities was often a pretext for shutting off the market. A regulator stressed that peer reviews were what was missing in that case, as mentioned earlier.

An industry representative suggested that they already had the single rulebook to a large extent with passports, the notification procedure, the KID, provisions regarding master feeder structures and fund mergers. This was in theory a large toolbox available at the EU level to facilitate cross-border distribution, but the single rulebook was not a reality yet at the implementation level. Moreover the industry needed to digest all of the new regulatory initiatives, which was a challenge. A market observer agreed that regulators should not consider new legislation or regulatory measures until what was on the table had been fully implemented. More difficult rules would come with MiFID II and PRIIPs and add to the complexity. The industry representative noted that there were still questions on how to calculate the various indicators that would be published in the KID. MiFID II was a challenge and there were many aspects that still required clarification. It was still difficult to know how MiFID II would impact the asset management industry. They would probably see new distribution platforms and global evolution of distribution models, so they needed to see how the rules would apply, how they would impact the different market participants; and then they could consider whether they needed additional rules.
A public representative wanted effective and consistent implementation of regulation, rather than additional regulation. Having that would have a significant impact on investment funds. Getting a proper implementation of MiFID was key with notably the setting up independent fund platforms.

A regulator responded that there was an open consultation by the EU Commission on whether some parts of regulation that were no longer needed should be removed. It was for the Commission to reflect on the information it received and make proposals. He advised that local payment agents should be removed and that uniformity should be brought to definitions of retail and professional investors and SMEs.

On reporting and data requirements, the regulator added that inconsistent data requirements were appearing everywhere (EMIR, MiFIR, MiFID II). This was a mess for the industry but also for ESMA and the supervisors. Appendix IV of AIFMD was not satisfactory either. They should take the opportunity of this consultation to recommend having one place that brought consistent data and reporting requirements. The answer was not to do more, but to do things more consistently.

A public representative referred to the Commission undertaking a consultation on fund cross-border distribution in Quarter 2 of 2016. Whether they would need more legislation depended on what came out of that consultation and it was important that the sector responded to the outcomes.

Better cooperation between regulators and the industry

One public authority speaker argued that in order to move forward, they had to first go backwards. Regulators needed to talk to the industry more and to understand market practices better, and they could then find a compromise in terms of the best solution. Legislators needed to understand what level of regulation they needed to apply based on market practices whilst also bearing in mind the need for consumer protection. The process should start with understanding the market before moving to legislation.

An industry representative felt that regulators and the industry could work together to create templates for information exchange. He suggested that they should work towards industry wide templates when it came to communicating with distributors, when MiFID II was totally implemented.

Addressing taxation issues

One reason that retail investors were put off cross border investments was the concern over double taxation, which was something that they needed to address, a public representative believed. The different tax regimes were an obstacle. Another step forward for the sector was to stop setting up tax friendly constructions in offshore havens.

A regulator disagreed that tax havens being on- or off-shore had any effect on the situation. The OECD were reviewing situations around taxation of funds, and there was also the Savings Directive, which applied to individuals independent of where the structure was set up; and so tax was being paid.

Developing technology

One industry representative thought that the solution would come from new technologies and not regulators. New technology could be used for various improvements, the streamlining of processes and the improvement of distribution. This is where the industry could identify new opportunities. Access to that technology would not be an issue for large players, but could be difficult for small and medium asset managers.

A public representative agreed that in some circumstances the increasing regulatory burden could be addressed with technology. The EU Commission consultation on tackling fragmentation needed to tackle barriers to cross border fund distribution; if it did not, the retail investors would suffer the most. In order to do that they needed more convergence amongst supervisors, which was currently easier than it had been thanks to technological developments and the digital revolution. The prospect of new digital entrants reducing costs and challenging traditional methods of handling investment funds was welcomed. It could only be good for both consumers and the industry as a whole.

Improving retail investment products

A public representative wanted the industry to address why they only had 7% of retail investors investing in funds. Banks were currently offering near nothing in interest rates and yet people were not finding new products to put their money into. They needed to look at products that would get retail investors investing in funds. They had an ageing and cash rich society, which they needed to address.

Developing competition

An industry representative stated that asset managers wanted to be able to compete more with each other, but if 70% of the market were excluded from competition, because of vertical integration, they could only reduce costs and improve investor experience to a degree. Moreover coping with the different regulators was feasible for large players, but would simply prove too much for smaller players. Competition would keep the industry on its toes by aggressive and innovative market entrants, but they were seeing the opposite because regulatory entry barriers were simply too high. They wanted a level playing field and more competition. If there was more competition, service to clients would improve and prices would fall.