Regulating the asset management industry proportionally will help create growth and jobs

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Seven years after the financial crisis of 2007-08, the economic situation in Europe is still unsatisfactory: stagnation, high unemployment, deteriorating infrastructure and insufficient investment in R&D and education. Last but not least, inflation has hit rock bottom, with recent quarters even showing signs of deflation. These economic conditions have seen the European Central Bank (ECB) launch an unprecedented quantitative easing program worth €1,44 billion, which may even be expanded to twice this amount in the near future should conditions not improve.

Under these circumstances, it is no surprise that the European Commission (EC) and national economic and finance ministers have started to think hard about how economic growth could be reignited within Europe. On a macroeconomic level, Europe is in tremendous need of investment, in particular in the fields of energy infrastructure, transportation, and R&D in digitalization. This growth is essential for EU member states, not just to make their economies more competitive, but to stabilize their own worsening financial situations. In reality, however, most of these actions simply fall short of what is needed to rectify the situation.

One of the main reasons for this problem is a mixture of inability and unwillingness on the part of banks and insurance companies to lend to the real economy. To a large extent, this is the result of the many new regulatory requirements European lawmakers introduced following the financial crisis in order to stabilize the financial system and better protect investors. Banks are now required to hold much more capital than before and have thus embarked on a massive deleveraging process that has seen their balance sheets be substantially reduced in order to improve their capital ratios and satisfy the new regulatory requirements. At the same time, (life) insurance companies are also being compelled to retain a much higher percentage of capital against any long-term investment (e.g. such as investment in infrastructure projects).

The substantial amount of newly introduced legislation may have created unintended consequences. It is therefore not surprising that the European Commission recently launched a "call for evidence" to evaluate the overall impact of the "Barnier era" (the former European commissioner for internal markets and services). However, this is clearly not meant as an initiative to deregulate the financial sector, as not too many concrete changes to the existing level 1 legislation are expected. Rather, it is the intention of the European Commission to focus on the more technical, so-called level 2 measures. Amidst all these challenges, it is encouraging to see that the new Commission under Lord Hill has identified the asset management industry as a key player for change.

The first spark for this massive undertaking is to be provided by the so-called "Juncker plan", which foresees investments of around €315 billion, the first tranche of €21 billion being bankrolled by the EU budget and the European Investment Bank, the rest being bankrolled by the private sector. In a low-interest environment such as the current one, private and institutional investors share the same interest in ensuring a reasonable yield on their investments; thus, they could find it very attractive to participate in long-term projects promoted by the EC, but only if the conditions are right.

By this we mean:

First and foremost, the EU needs a single European code of regulation. The fragmentation of the European market is bigger today than before the crisis. Member States have become used to gold-plating (i.e. adding their own national requirements on top of EU legislation); therefore, from a pan-European perspective, regulatory details have introduced another layer of costly and burdensome bureaucracy.

Secondly, the principle of proportionality has not been respected as promised, and especially tedious and overlapping reporting requirements to supervisors have become an immense operational burden on many industry participants. In addition, many legislative files have been introduced as directives, not as regulations, leaving a lot of room for national specificities that are inconsistent with each other.

One issue, in particular, that the asset management industry is constantly being faced with is that it is confused with the banking sector and not perceived for what it is: an agency business. As such, its business model is different from other financial services firms and its business proposition is to help clients reach their investment objectives. The responsibility of these agents is fiduciary by nature. As agents for their clients, they must place their clients' interests ahead of their own. In contrast to banks and insurance companies, an asset manager's clients are the asset owners. As such, the risk stays with the clients, not the asset managers. The performance of the asset portfolio is attributed to the client; thus, he or she takes the profit or loss.

This clearly demonstrates that the current trend towards regulating all financial services companies in the same way is questionable. Asset management is a business sui generis and should be addressed as such. What is important is that asset managers can work in a true single European market without national barriers. Only then will the huge differences that still exist within the investment fund sectors of the various Member States gradually disappear. Currently, funds face a number of impediments when attempting to do business across borders: the UCITS passport does not work as well as intended, registration fees differ, some countries require local paying agents, and prospectuses for shares, bonds and funds are still far from a maximum level of harmonization.

There are, of course, also new business developments to take note of: so far, asset managers have not provided credit to individuals or corporations. They do not tend to work with borrowed money either. Hence, there is no risk of an asset-liability mismatch on an asset manager's balance sheet. However, many market segments where asset managers have been active show an alarmingly low level of liquidity. There have been instances of funds lending to businesses in Ireland and Germany. Some national supervisors have introduced regulatory standards to deal with this situation. It seems obvious that an asset management company will have to respect the same regulatory demands as other financial services companies, if it offers the same service. It will be very interesting to monitor these future developments closely.

When taking a closer look at the important regulatory initiatives, four directives will have to be recalibrated in particular:

- Shareholder Rights Directive II (SRD II)
- Banking Structural Reform (BSR)
- MiFID II
- Capital Requirements Directive IV (CRD IV)

The objective of SRD II is to strengthen the commitment of shareholders and create incentives for institutional investors and asset managers to invest long term. Today, shareholders still do not have the possibility to vote easily across borders. SRD II attempts to alleviate this situation. However, fund companies may be forced to publish their investment strategy. This would make the acquisition of institutional clients much more difficult, since they want the asset manager to design and follow a client-specific strategy that is not widely known. Putting resources and know-how to work would no longer give the asset manager "the first mover advantage". The best-in-class principle would be worthless—a major disadvantage for the asset management company, particularly in view of the very thin operational margins.

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One aspect of the banking structural reform currently being discussed is to decouple it completely, splitting the deposit taking and investment activities of the largest European banks. One suggestion that is being proposed by the Commission is to also prohibit the institutions from involvement with any type of alternative investment funds (AIFs). However, the AIF category comprises many different funds and the one-size-fits-all approach is not useful. Hedge funds can be risky, particularly if they are heavily leveraged. In contrast, special funds (Spezialfonds in Germany) try to avoid or at least diversify risks, are not leveraged, and try to ensure a certain level of liquidity. Therefore, instead of banning all trading activities in AIFs, a more differentiated approach based on leverage should be followed. MiFID II is at risk of increasing the patchwork situation in the EU. The inducement regime under MiFID II will generate very different approaches across Europe. The planned ban of using dealing commissions to pay for research activities will turn out to be a major disadvantage. This ban does not exist outside the EU. For example, IOSCO does not intend to introduce such a ban either.

The EU risks introducing unilateral changes that are neither in the interest of the asset management industry nor the investors.

Finally, the remuneration laws, as laid down in CRD IV, should be based on the principle of mitigating risk. It at least looks as if the supervisory authorities EBA and ESMA are showing willingness to consider this aspect when detailing the implementing measures.

If an asset management company is part of a bank or insurance company, their remuneration rules should not apply without proper identification of the risk takers when constructing the remuneration policy. Since the asset management company has quite a different risk profile to the mother company, blanket rules should not be applied to the identified risk-taker positions, but nuances of country specifics and product specifics should be taken into account.

A group policy should serve as a code of conduct that creates a standard across the group for the various categories of risk taker or risky person (sales, asset managers, management board) identified, as well as those that come into contact with customers (customer service advisors, relationship managers, etc.).

Conclusion:

The asset management industry is well-suited to fill the financing gap for important European projects. New vehicles like ELTIFs, designed and proposed by the European Commission, could turn out to be ideal in helping the asset management industry make a much-needed, important contribution to the European economy and at the same time offer its clients a financial yield which is satisfactory and much more stable than could be found elsewhere.

Hopefully, in this regard, the regulators will thoroughly consult the industry and design the products and respective regulations correctly, so as to make them work properly and achieve the best results; this does not seem to have always been the case with products and regulations in the past.