Regulations in Investment Management – An EU Perspective

Abstract

The UK's decision to leave the European Union (EU) will have a profound impact on the financial regulations that are being formulated currently. There are uncertainties around how these might evolve for the UK and the EU, pending agreement on key terms and policies.

In the investment management space, regulatory focus revolves around stability, capital requirements, liquidity, distribution, retirement, and taxation. Firms, on the other hand, focus on costs, fees, product governance, transparency and disclosure, new technologies, and effective risk management. This article explores the various regulations proposed in the EU, their potential impact on business models, and technology adoption as well as automation.

Introduction

Ensuring investor protection and global financial stability form the main agenda of regulators today. The focus of regulations has therefore shifted to fund management charges, research fees, product governance, 'passporting' rights, digital channels, and so on. In complying with these regulations, financial firms have to carefully assess the impact on key operational areas spanning data management, technology adoption, process automation, and so on. Let's take a look at the key regulations for each of the focus areas of a financial ecosystem, and understand their impact on financial services firms.

Financial Ecosystem Stability

Financial Stability Board's (FSB's) 14 policy recommendations[1]: These recommendations have been formulated to address financial stability risks due to structural vulnerabilities inherent to asset management activities. These recommendations aim to address vulnerabilities created by liquidity mismatch between fund investment assets and redemptions, liquidity risk, operational risk, securities lending activities, and leverage within funds. As per the recommendations, banks are required to collect the liquidity profile of funds, ensure appropriate disclosures to investors, address gaps in liquidity management, and ensure adequacy of liquidity risk management tools. Banks must also conduct system-wide stress tests, monitor and collect data on leverage in funds, adopt robust risk management frameworks, and monitor the risk associated with security lending activities.

European Market Infrastructure Regulation (EMIR) and Central Counterparty (CCP) resilience[2]: The clearing of derivative trades through a central infrastructure needs to be rolled out for different derivative products by 2019, which implies increased margin and collateral requirements, stronger risk management practices, and so on. The European Commission (EC) has also proposed recovery and resolution measures to safeguard financial stability in case of CCP failure. As a result, firms will need to modify fund strategies and strengthen the liquidity and risk management practices (such as stress tests, 'What-if' scenarios, business continuity and recovery plans, contingency plans). They will also need to invest in robust data management systems to facilitate data aggregation across departments and jurisdictions for regulatory reporting, as well as build analytics solutions for effective risk and liquidity management.

Capital Requirements

Simple, Transparent, Standardized Securitization (STS)[3]: The EU Capital Markets Union (CMU) has proposed common rules for securitization and a regulatory framework for simple, transparent, and standardized securitization, due to be implemented in 2019. These include increase in risk retention by raising capital requirements from 5% to 20%, setting up of European Securitization Data Repository (ESDR) for storing various deal documents, STS notifications and reporting forms, disclosures by originators, lenders and others through ESDR. The proposed securitization regulation introduces a single, unified regulatory framework for all institutional investors like investment firms, alternative investment fund managers, Undertakings for Collective Investment in Transferable Securities (UCITS) management companies, and internally managed UCITS. As a result, several financial firms have started building new legal frameworks to meet the requirements of enhanced reporting and rigorous due diligence by investors, as well as to cover the changes in risk retention ratios.

Revamp of regulations around Venture Capital Funds and Social Enterprises: This is an initiative to expand venture capital funds and social enterprises into cross-border markets outside the EU and extend their management to larger fund managers with AUM of over 500 million Euros. These regulations will bring asset-backed securities, investments, and pension funds under intense scrutiny. The investment model could potentially shift toward off-balance sheet synthetic products as they provide more leverage and do not come under the regulatory ambit. Capital access for larger fund managers would increase due to cross-border accessibility to European Venture Capital Funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF). These extended rules are aimed at providing economies of scale, simplifying the registration process for large fund managers, while providing more diversification possibilities for investors.

Transparency, Investor Protection, and Liquidity

Markets in Financial Instruments Directive II (MiFID II)[4]: This will require asset management firms to introduce pre- and post-trade transparency requirements for non-equity instruments like Exchange Traded Funds (ETFs), fixed income, and structured finance products and derivatives; introduce additional disclosure requirements for portfolio managers to ensure best execution; and mandate new transaction reporting requirements. Asset management firms must recognize that the MiFID II will increase operational costs, which could potentially run into billions. Compliance will require huge technology investments in data lake tools to meet reporting requirements, and sales and CRM tools to enhance customer analytics and improve product-profiling mechanisms.

Shareholder Rights Directive II (SRD): Due to be implemented in 2019, this directive will require insurers, pension funds, and asset managers to make their shareholder engagement policy, equity investment strategy, other investment policies, and strategies more transparent to their institutional clients. For this, financial firms must enhance the transparency of their reporting policies, which can be achieved by issuing public disclosures of the policies on shareholder engagement, providing insights into the company's medium- and long-term investment strategy, publishing detailed remuneration reports, and so on.

Distribution of Assets

MiFID II: This regulation will require retail and institutional investors, distributors, and wealth and asset managers to ensure that the risk profiles of investors and investment portfolios are captured by distributors at the point of sale. Unbundling of the research and execution costs will be mandatory, while the focus on product complexity and their suitability to meet client requirements will increase. Other areas of heightened activity include product design, coordination between manufacturers and distributors, and execution-only platforms in the retail investor market for non-complex financial instruments. In addition, considerable impact on inducements to independent investment advisers as well as discretionary advice is also in the offing.

Cross border distribution and asset segregation (UCITS V/AIFMD)[5]: The EC and the European Securities and Markets Authority (ESMA) proposed various reforms to the UCITS fund regime in 2016. The proposed guideline on asset segregation and custody services envisages holding client assets in completely different accounts, in their own name, throughout the entire custodial chain, instead of single collective accounts for all clients. The European Commission has released a consultation document seeking feedback on barriers to the cross-border distribution of investment funds like UCITS and AIFs. The aspects covered include costs, fund registration, tax, administration, and marketing. The commission is also looking at further consolidation to enable a single EU market for investment funds. More clarity on the cross-border regulations is expected in the coming months.

In anticipation of the guideline, some firms are opening Research Payment Accounts with the consent of clients, which would be charged back to the clients. Firms are also working on new fee and commission models (for instance, distribution analytics is taking precedence where the most profitable and loyal channels are given incentives) while distribution channels like robo-advisors are gaining traction. Other potential investments for firms are providing passive funds, increased automation, and change in product preferences of distribution partners and investment firms, and the use of blockchain technology in areas like private equity and fund administration.

Looking Ahead

The next two years are crucial for investment management firms in the EU, as new regulations evolve. Compliance will entail changes to business models, and significantly impact costs, risk management, operations, and technology frameworks. As a result, the spend on risk analytics, sales and marketing, technology automation for better client connect, and sound risk management strategies will increase. Firms will look at new technologies like blockchain for better connect with the various industry stakeholders and to address industry-wide challenges in areas like custody, fund accounting, and client onboarding. Unbundling of research and execution costs will demand increased investment on in-house research, and the use of emerging technologies like machine learning to explore market data and events and other data sources for crucial investment insights. Firms will intensify middle- and back-office automation to achieve operational efficiencies, adopt new distribution channels like automated advisors, and shift to alternative investments like real estate and private equity.

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