Speaking note EFAMA (24th November 2023)

Asset management in turbulent times: challenges and opportunities

- *Will turbulent times be an opportunity for the asset managers to show the added value of active asset management?*
- *The need to monitor vulnerabilities of the asset management sector in the field of liquidity and leverage.*

Over the last 3 years, there has not been a lack of challenges for asset managers.

The global geopolitical framework can be seen as a succession of crises, whether health, political or war-related, all against the backdrop of the climate change and the increase of its perceptible consequences.

In term of macro-economic developments, the return of the inflation and the subsequent rise in interest rates by central banks mark the end of a long period of low rates.

The question is: "Will turbulent times be an opportunity for the asset managers to show the added value of active asset management?"

Among the challenges that are reshaping the world and the asset management industry, active asset managers are facing additional significant headwinds in the form of the rise of passive investment strategies and the renewed attention to the structural vulnerabilities that are the liquidity and leverage risks.

As Chairman of IOSCO, I would like to emphasize, not only the challenges, but also the opportunities active investment manager are facing in these turbulent times.

Rise of Passive investment strategies

The shares of both ETFs and index funds in the total net asset value of European funds have more than doubled between 2012 and 2022 to reach 11% and 9%, respectively[1].

ETFs and index funds have become increasingly popular with a wide range of market participants, both retail and institutional.

Against this background, the RIS proposal introduces moreover some safeguards to improve the quality of advice. It does so by further substantiating the obligation for all investment firms to act in the best interest of their clients. Investment firms should, according to the proposal, recommend the most cost-efficient financial product from the range of suitable financial products, and offer at least one financial product without additional features which are not necessary to the achievement of the client's investment objectives and that give rise to additional costs.

[1] EFAMA, Fact Book 2023_lowres.pdf (efama.org)

This trend of growth raises certain questions about investor understanding of ETFs, and their impact on the broader marketplace, including under stressed market situations.

In this context, the role of IOSCO has been to foster the international dialogue between national competent authorities. Through IOSCO and its publications, the global industry of ETFs benefits from a consistent regulatory approach.

It is important to understand the drivers of the growth in passive investing. Low costs for a comparable performance are undoubtedly a big driver of flows and are one of the explanations of the success of passive investment strategies. It is true that management fees (and commercialization costs) are lower than for other investment products and often beneficial for investors.

Yet, we can acknowledge that the management fees do not reflect all costs for the investors. In addition, this general statement of lower cost may not be valid for all passive investment strategy, in particular for the most complex ETFs (and certainly not for the so-called active managed ETF’s).

Other considerations such as the risk/return ratio of the investment strategy and other features of investments remain equally important.

It is, however, the responsibility of active investment managers to show their advantages compared to passive investment strategies.

These turbulent times are definitely a threat for the economy and the society in general. Yet, it is paradoxically a moment where the active asset managers could show their competitive advantages to the public and the authorities.

When markets are more unpredictable and volatile, dislocations and mispricing are providing opportunities for active investment managers to capitalize on under-evaluated assets. Active management allow a more hands-on approach to seize those opportunities as they arise. At the same time, active management allows to apprehend risk by repositioning portfolio and to take defensive measure to protect against potential losses. Those opportunistic abilities are a direct consequence of their adaptability, their ability to adjust portfolios in response to changes in market conditions.

The question of the “value for money” is central to the Retail Investment Package. The current succession of crises could be seen as an opportunity for active investment managers to demonstrate the value for money they deliver to the investors amid the appeal of passive investing.

Active investment managers could also reduce the appeal for passive investment by demonstrating the key role they could play in steering the global transition towards a net-zero carbon emission world.

In the face of climate change, investors wield substantial influence in allocating capital towards sustainable and environmentally responsible initiatives.

Unlike passive investment strategies, active management allows for dynamic decision-making, enabling investors to identify and support companies actively contributing to the transition.

Allow me to indicate in this repect that having data on and of the issuers is necessary for the decision-making by active asset managers. Moreover, the publication of these data by the issuers also constitutes an opportunity as this supports issuers credible and comparable disclosure on their net zero commitments.

Furthermore, active management enables investors to seize opportunities arising from the transition. As industries evolve to meet sustainability targets, active managers can identify innovative companies poised for growth within the green economy. This not only supports the transition but also generates returns for investors.

So far, the succession of crises has not reversed the upward trend in passive versus active management[2] … It is with the greatest interest that we will observe future developments in this area.

Two structural vulnerabilities: leverage and liquidity

Another significant headwind active - but also passive - investment managers are facing is the renewed attention, in this volatile environment, to the structural vulnerabilities that are the liquidity and leverage risks. The monitoring of these risks is since a few years at the

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[2] EFAMA, Fact Book 2023 lowres.pdf (efama.org)

heart of the actions taken by IOSCO and should stay a priority for investment managers.

Liquidity

Speaking of open-ended funds, the liquidity risk is inherent to their very nature.. Effective liquidity risk management is important to safeguard the interests of investors, to maintain the orderliness and robustness of open-ended funds and markets, and to reduce systemic risks. Effective liquidity management therefore contributes to financial stability.

IOSCO has always played an active role in promoting effective liquidity risk management. A key milestone was the publication of IOSCO's Recommendations on Liquidity Risk Management for Collective Investment Schemes and the accompanying Best Practices in 2018.

Last year, we reviewed the implementation of our 2018 Recommendations. We found that larger jurisdictions show a high degree of implementation of regulatory requirements consistent with the objectives of the Recommendations, while asset managers have a high degree of implementation at the level of their policies and practices.

The FSB' assessment of the effectiveness of its 2017 Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-ended Funds were partially based on the findings of IOSCO's review. The FSB concluded that authorities had made meaningful progress in implementing the 2017 FSB Recommendations, while certain policy enhancements would strengthen the current framework and open-ended funds liquidity management practices.

These policy enhancements included, among others, first, providing a clearer and more specific articulation of the intended outcome of policies to reduce structural liquidity mismatch in open-ended funds; and, second, ensuring that investors bear the costs of liquidity associated with fund subscriptions and redemptions, and enhancing the use, and the consistency of use, of LMTs by fund managers.

As a result of these findings, IOSCO and the FSB undertook follow-up work this year, which is now near completion. During summer, IOSCO and the FSB simultaneously consulted on two related pieces of work to address these concerns:

1) The first is a Detailed Guidance by IOSCO on the design and use of anti-dilution liquidity management tools ;
2) The second is a targeted revision to the FSB's 2017 Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-ended Funds.

We thank EFAMA and their members for their valuable feedback to these consultations. Your input is indispensable to arrive at ambitious and workable outcomes.

With respect to IOSCO's Guidance, we noted your agreement with the overall principles and goals of the proposed framework. Based on the feedback received to our consultation, we believe that, in general, there is broad support for the objective of expanding the use of anti-dilution liquidity management tools. At the same time, we also received useful comments and suggestions, which have been considered by IOSCO.

Taking the European perspective, we also share your enthusiasm for the newly agreed AIFMD & UCITS rules that will provide asset managers with a wide range of liquidity management tools at their disposal.

As the Chairman of the Belgian FSMA, I am also happy to share that in the Belgian public fund sector, all funds within the supervision of the FSMA have implemented at least one liquidity management tool where relevant. [I can add that this feature of the Belgian funds was also highly appreciated by the IMF representatives who conducted an elaborate liquidity stress testing exercise on the Belgian funds during the last FSAP.]

Leverage

With the FSB and IOSCO having now nearly completed the work on liquidity mismatch in open-ended funds, the focus of the NBFI work is rightly moving on to non-bank leverage.

As part of its NBFI work program, the FSB recently issued an analytical report on the financial stability implications of leverage in NBFI.

It is now time to undertake policy work to improve our ability to identify, monitor and contain systemic risk arising from leverage in NBFI within the FSB. This work will be co-lead by a member of the IOSCO ecosystem, alongside a representative from a central bank, to ensure the views and expertise of securities regulators are well accounted for.

Addressing risks stemming from leverage is about facing the common denominator between the relics of last year's Gilt crisis and the fall of Archegos. This work on leverage in the non-bank sector goes beyond the asset management sector.

With respect to the asset management sector, work on monitoring and assessing financial stability risks from leverage has already progressed during previous years. IOSCO issued its Recommendations for a Framework Assessing Leverage in Investment Funds in 2019. IOSCO has also been publishing its annual Investment Fund Statistics Report, which includes global data on leverage, since 2022.

In Europe, Article 25 of the AIFMD provides competent authorities with a mandate to assess and mitigate the systemic risks that the use of leverage by alternative investment funds managers could entail.

Conclusion

Major crises such as those we experience since 2020 are undoubtedly harmful for the society. For active investment managers, it is however an opportunity to demonstrate that they always have the liquidity and leverage risks under control and the value proposition of active management amid the appeal of passive investment strategies.