UCITS Symposium May 2013

Speech by Sharon Bowles MEP

Thank you for inviting me to do this keynote speech.

UCITS is something that is quite rare - an EU home grown product harmonisation that has been an EU export, that appeals to other jurisdictions, especially in Asia, and which brings international investment into the EU. These are things to cherish especially in difficult economic times, with bank deleveraging, when creating the confidence for investors to commit capital into the economy is more vital than ever.

Against that background, there are already some UCITS V revisions underway and some more are potentially lined up.

The Parliament is in the process of finalising its position on UCITS V, with an aim to negotiate with the Council should they be ready. Many of you will have scrutinised the ECON vote outcome more closely even than I have. You may also know that we agreed to avail ourselves of some refinements in a plenary vote in June. The intended procedure in June is not to take the final vote, so it leaves us with the possibility of a first reading agreement and then return to plenary with the trialogue amendments in order to take a final vote.

On the substance of amendments in plenary, it looks like the outcome will be very similar to the one voted in committee. Currently the majority still favour the notion of capping remuneration aligned with the CRD4 outcome and there may be changes to the performance fee structures as there is a very strong German lobby in particular to remove them.

I am well aware of the concerns that this brings in the context of the success and internationalising of the UCITS brand.

On performance related fees and bonuses – and I think this principle is widely shared in the Parliament even if the details are not – there should be elements of symmetry or in other words relationship to performance over the cycle – if there is reward for good years this has to be balanced out for the poor years.

Further it should be performance against benchmarks not just good market conditions.

I would have preferred that we had kept to the bonuses argument that banks were different, for example due to the inbuilt subsidy of central bank liquidity, and dealt with fees and remuneration as a package. However neither I, nor anyone else, has yet formulated a proposal that satisfies the rapporteur, EPP and Socialists and left of the House, and time is ticking by.

On the Council side they may therefore choosing perhaps between accepting the popularity of bonus caps, which they say is toxic when it comes to upcoming elections, or maintaining the international investment, unless they can come up with the holy grail formula that has eluded me.

Of course we are dealing with the fees issue and transparency in PRIPS and MiFID too. There we need to ensure that investors see the full cost of all the fee layers in both products and distribution.

Looking beyond the current proposals, there is the issue of more substantive review following the Commission consultation, so I thought I too would say a few things on key issues in that.

As I said at the start UCITS has been a success so we should attach importance to keeping a successful European brand, to keeping it up to date, and finding solutions in those areas where there may be challenges.

I have five overarching concepts.

First, where it isn't broke, don't fix it – it is essential not to undermine the international UCITS reputation

Look at areas where there are new interactions, such as with EMIR

Deal with the UCITS side of Money Market Funds – noting that interaction with banks is for banking regulation

Look at derivatives, and I do not think vanilla/exotic is the right definition of division

Consider whether there have to be 'categories' within UCITS and maybe that feeds into pensions and long term investments.

I will start with the last point – categories – and while I understand some reluctance to subdivide, if UCITS is opened up to general revision then it may end up being the only pragmatic solution that satisfies both the original safe and simple objectives for the simple retail investor, and also produces funds that cater for those with a greater risk appetite and those taking advice. It may also turn out to be a way to deal with long term investment products, to introduce pension products and SME funds, which may be better than over-reliance on securitisation which is in focus at the moment.

In the 'not broken' category comes much of the scope. However I would back looking at derivatives because we should reduce complex investment instruments in general and seriously ask whether any should be allowed at all, never mind in UCITS, that fall into what I call the category of 'explosive derivatives'. By an explosive derivative I mean one that may look like it is a small percentage risk but is capable of hugely non-linear behaviour once a less than usual event occurs. These were events that actually happened in the financial crisis and we should not be going there again. Thus there should be no exposure either directly or indirectly to those explosive derivative products that are highly leveraged.

A consequence of such a clamp down on derivatives is that the 10% investment in non-eligible assets needs refining because an explosive derivative is not rendered safe by the 10% limit – that is the problem with highly non-linear behaviour.

I do recall the debate at the time of the revision to the original UCITS assets. However that extension was done just as we were going into, or before, the financial crisis and it is perhaps timely to look at it again in the light of what has been learned. It is certainly the case that some MEPs are of the view that there should not be any investment allowed beyond the eligibility criteria, some that consider the criteria themselves have been overly weakened and others that are of the view that the more sophisticated investor and institutional investors need to be catered for along with an eye on returns is necessary.

Clearly not all of these views can be satisfied and that is why I said the question has to be put whether there should be categorisation within UCITS as the only way to square the circle that I see looming ahead.

Coming to some technical issues there are questions of interaction with EMIR, and indeed FTT wherever that ends up. The posting of collateral with CCPs means that funds may need to engage in more repos in order to obtain the necessary type of collateral, and information on that impact is something I would wish to see before changing repo limits within UCITS. Also we are, or soon will be, in the process of collecting information on repo and securities lending in general, courtesy of some work I did on CRD4, and that should also inform future actions.

Reverse repos are used as a cash management tool and are a way to avoid bank counterparty risk, hence limits may not be needed. But in all instances the repos and reverse repos should be governed by whatever general rules are forthcoming for repo markets so as to avoid any inappropriate use and there have been instances of inappopriate uses.

If FTT applies to the repo and reverse repo transactions then this will be an added cost to investors, in addition to the EMIR clearing costs, and could influence investor and hedging behaviour in a way that is not advantageous.

Securities lending and re-hypothecation is more generally under the spotlight. We are probably again in the zone of some good some bad. From my perspective the bad part is repeated lending where the chain is long and hard to track down. Horizontal rules may be forthcoming but the principle that will appeal to Parliamentarians is that retail investors should not be exposed to a long chain of a re-hypothecation merry-go-round. Rules concerning what can be invested in, or not, are also appropriate. And another general principle, not just for UCITS, such as re-hypothecation is that it must always be done for the financial benefit of the investor not as a profit on the side venture for fund managers.

Another issue that faces us as a consequence of EMIR is counterparty limits with respect to CCPs. However we should not aim to redo in UCITS what has already been done in EMIR by layering on additional OTC conditions.

Since the financial crisis a lot more attention has focussed on liquidity, but this does not need to be on a highly granular individual asset level – indeed the net end effect of that would be lack of diversity which in itself is another risk. Therefore liquidity management is best done at the fund level and taking account of the life-cycle of a fund. This probably points more to guidelines and principles that are applied, and supervised, rather than rigid rules, or at least must allow for the life-cycle changes such as whether a fund is primarily in building up or repaying phase. For secondary markets I do not see a need for liquidity rules that superimpose on the liquidity rules of exchanges, but I wait to see what happens there.

Depository passports raises fears with some. In principle, in a single market, I feel that they should exist and we should not raise as fears or barriers that supervision might be in another country! For heavens sake, this is the single market with a single supervisory rulebook! Do we believe in it or not, or only when convenient.

Well, there are some leaks over where we are going on Money Market Funds. I do not take the view that money market funds are a bad or a systemic problem of themselves. Excessive exposure in the banking sector, collectively, should be resolved through large exposure controls for banks and moves in that direction have been started in CRD4 at least in terms of collecting information.

I am not wholly convinced about whether C-NAVS are such a bad thing - sorry ESRB - but did they fail? There are tax and accounting reasons for investor preferences between C-NAV and V-NAV, and in the absence of those elements being harmonised flexibility for the investor is a valid consideration.

Capital buffers look like a compromise but in reality I think it is really a way of forcing closure or conversion to V-NAV, especially squeezing out smaller market players. I am looking for some hard evidence here - after all haven't we just been through the worst imaginable stress test and what happened? The same applies to gates - some seem to say that they would accelerate runs not stop them, but they are in current UCITS so what is the evidence of their use?

Anti-dilution safeguards on the other hand look both sensible and fair - although the devil may be in the detail, but we know how some of these could work.

Valuation methodologies other than mark-to-market should be allowed but there needs to be some common understanding of how these operate. With regard to liquidity and redemptions some constraints such as the US rules of

10% overnight and 30% within 7 days seem reasonable, and the current ability of a UCITS fund to restrict redemptions to 10% a day in certain circumstances also seems a good place to stick.

Finally a general word I would like to say on fund management and securitisation. This is all the more relevant given the recent rebirth of CLOs – heralded by many, yet laced with warnings from structured credit experts that 'they would not buy them'. My view is to heed those warnings and I ask regulators to talk to some of the real experts – like those who gave warnings.

Also, as I have said before, I know that article 122a of CRD2, retention of 5%, is being circumvented due to the difficulty of identification of issuer/originator and some dodgy interpretation of EBA rules on 'second set of eyes'. So the 5% ends up in an SPV and is then sold on.

So, first point, under CRD4 the corresponding sections have binding technical standards which will not be so easily circumvented nor able to be ignored as guidelines can be. I'm already on the job on this with the EBA.

Second, it should be made absolutely clear in legislation that funds are not permitted to purchase such retention SPVs or be exposed to them.

I sense that there has been weakening among some regulators to let the banks off the hook in the interests of bank stability. That is simply not good enough and no way to deal with the legislature. We will strike back.

Thank you.