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Challenges to collective investment products

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Abstract

Challenges to collective investment products[1]

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The financial and banking crisis is changing the financial world in many significant ways. Changes do not only affect the banking world, but also the area of collective investments, here understood in a broad sense as referring to all products where investors' interests are managed collectively.

The very low interest rates, likely to last for a long period of time, are changing many the fundamental assumptions on which collective investment structures and decisions have been based. The most striking example is that of the life insurance but applies to the private pension provision as well. At least in the cases where a fixed return on investment has been promised – what happens frequently for life insurance products, but for some pension products as well - the low interest rates – and now even the negative rates - make it almost impossible to achieve the longer term objectives that were proposed to the investors, or future pensioners. Increasing the risk profile in order to achieve higher returns is not an option: it is prevented by regulation – eg for including more equity in their portfolios – or is more risky eg by including more private sector bonds, although this is probably the last good solution, but deteriorating the risk profile. For some more years, these firms may be able to continue to weather the storm, but at the end they risk becoming more like a Ponzi scheme, the last investors leaving the scheme taking all the losses.

Although the issue has been known for some time, there is an urgent need to have it openly discussed, first with a view of solving the difficulties of the two aforementioned businesses, but also in a more wider sense as down the road these changes are likely to affect the social balances on which our Western European societies have been based. If the extremely low interest rates would continue over a prolonged period of time, it is not unlikely that it will result in significant stress on the employers to the extent that under DB and mixed schemes they have to offer the final backstop for any shortfall in retirement provisions. The annual accounts of these employers will receive a hit the amount of which is unpredictable, but might over time become quite considerable. Old age provision by life insurance contracts will also come under threat, although the fixed duration of the older insurance contracts may have allowed to better cover the risk. New contracts should be offered at a much lower return, and will be quite difficult to sell.

If these market conditions would last for a longer period of time, the social dialogue will come under stress, as the conditions for financial retirement will have to be re-discussed. Reducing some of the relative retirement benefits is already on the table in same places, but ultimately the entire system may have to be revised. Oddly enough, the regime of the state funded pensions might reappear as the primary retirement regime and not as a backstop, as is now often the case. Future pensioners, but also taxpayers will not like this perspective.

[1] Published in Alfi bulletin, Special issue, Sept 2012

Turning now to the investment fund segment of the market, the concerns are different as the portfolio risks are ultimately born by the investors, leading to a clearer allocation of risks. But there remain some other concerns.

One sees money market funds closing for lack of return due to the low interest rate environment. The banks are confronted with a comparable issue as their deposits at the central banks are interest free, and in fact bear a negative yield, what is already triggering a reduction of their deposits at the ECB. This raises the question where investors will have to address themselves to find a safe, equally liquid and reliable counterparty. They cannot go directly to the central banks, what is not allowed under the present framework. Or they can invest in government bonds, not an attractive proposition as some governments are now offering bonds with a negative interest rate, while others present a definite risk. The yield on high quality private sector bonds may also be driven down while in the opposite direction a real estate bubble as is feared in some European states may build up. At the end and oddly enough, the only safe investment remaining may indeed be central bank notes! But would that be a desirable outcome? And would that be risk free?

In the longer segment of the investment fund business, say the UCITS or the AIFs, these portfolios have shown volatility, with considerable outflows in some periods, inflows in others. AIFs – eg hedge funds – are sometimes known for their erratic returns, making investors rich one day, poor the other. Investors in AIFs are often contractually obliged to stay on board, allowing managers to make good in a subsequent period. In the UCITS field investors can exit any time. This often leads asset managers to simply emulate the benchmark, and in any case results in the investors bearing the liquidity risk. The last investor to exit will have to bear the "portfolio" risk, any shortfalls but especially the lack of diversification falling on his head. One should raise the question whether this business model is well conceived and at least should be considered the exclusive model. The question is the more appropriate as in the AIF space, risks are distributed quite differently, and investors being committed to remain in the fund for an extended period of time, while in some cases the manager can prevent individual exits. Should one not consider a similar approach for UCITS, whereby at the option of the investors, UCITS could be offered with a clause that would oblige investors to stay in the fund for a longer period of time, whether for a predetermined period, or after giving notice? An alternative might consist of having the fund shares traded on an organised market – Exchange, MTF or OTF – allowing investors to exit without touching the investment portfolio itself. Experience in the US with closed ended investment funds indicate that this would not necessarily result in a discount, and in some cases rather the opposite. As has been tried in some states and is the case with ETFs, exit from the fund may go along with exiting through the market. It would be useful to research how much this has reduced the trading in portfolio securities.

This longer-term approach will engage investors and fund managers to become less fixed on the day-to-day price movements, and therefore will reduce the pressure on the markets and their volatility. A different business model may emerge, whereby more attention is paid to the long-term growth of the portfolio securities, and to factors influencing long-term price movements, among which improvements in corporate governance are often cited. Investment funds, provided they are not exposed to the present short-term redemption requirement, could play an active role in delivering long term capital to firms. It seem clear that a change in approach would have far going consequences for both the investment activity of these funds, the markets where these securities are traded, the financing of the investees and finally the overall economy where these investments are made. I would like to open the debate about this issue that may considerably affect the structure of the investment business.

The UCITS formula has been very successful in many parts of the world. It was the remarkable achievement of the joint effort of the industry, of the financial specialists and asset managers, supported by the European and national regulators and supervisors. It has combined clarity in purpose and structure, reliability in management and disclosure, adequate supervision and recently proposed changes – UCITS V- would even strengthen the protection investors enjoy. In two respects however, questions can be raised. The first relates to the quality of management: many funds essentially have the ambition to match the benchmark, and only a few outperform it. I do not underestimate the difficulty to outperform, but this nevertheless raises the question whether it is not simpler to invest directly in the benchmark through an ETF, the more so as ETFs as less expensive, both in terms of access and of management. Moreover, is it so that in these difficult times, investors necessarily pursue outperformance, as for many it would already be satisfactory if the value of their investment can be maintained? Unfortunately most funds do not include maintaining value as their stated objective. The second weakness of the UCITS as presently offered is their cost, both at entry and exit and for managing the portfolio. It is clear that in this respect the ETF constitute a considerable challenge, to which the classic funds are only slowly responding.

A few words about the Alternative Investment Funds, and their managers. European rules are now being implemented and it is too early to analyse the effect of the directive on the market. But one can expect as the AIFs – especially the hedge funds- will have received official status, the national markets, - including the retail markets – will be opened to at least some types of hedge funds. Over time there will be a need to identify the more risky funds from those that are fit for being offered to different classes of retail investors.

This directive has been severely criticized. It is far from perfect, but one should not loose out of sight that this directive is one of the responses to the financial crisis and mainly aimed at giving an answer to the concerns, very active in some jurisdictions about the destabilising effects of the hedge funds. Macro-prudential objectives are at the core of the AIFMD. Whether hedge funds have contributed to the present crisis or not is not worthwhile to be discussed now that the rules are in place, but explain some of the characteristics of this regulation, that fund managers consider too burdensome from their point of view.

Distribution of investment funds is also an interesting topic, especially if viewed from a comprehensive view of the distribution of different types of collective investment instruments. Investment fund distribution taken places through different channels presenting some marked differences between the continent and the UK. On the continent most funds are distributed through the banking system, meaning that often in-house funds are privileged. Investors complain that they are offered funds that serve the interest of the bank, or of its employees, but not necessarily of the client. Rules have been adopted in the Mifid, about suitability and adequacy, but should apply across the board to all investment products. Some banks have opened websites where funds are offered in open architecture, offering a wide choice to investors, but often without adequate information about the funds on offer. This system generally applies to ETFs, where information is often even more difficult to come by, leading to regulatory concerns about their risk structure. Regulation would reduce the investors ‘ access to direct sales, by qualifying some of these funds that contain derivatives as “complex products”, to excluded from direct investor access, and as a consequence be subject to additional requirements. However “complex” is not necessarily more risky and the reverse is equally true: are equity funds although non complex less risky? On the European continent and differently from eg the US, direct sales by the investment fund manager are rare, what may contribute to increase the distribution cost. Competition between the distribution channels therefore is often limited.

Distribution in the insurance field is different in the sense that some products are offered directly by the insurance company, acting through its own staff. Simultaneously there may be distribution by a related bank, or by a third party through independent brokers. The disclosure and remuneration conditions are quite different, and a recent initiative tabled by the European Commission illustrates the need to strengthen the investor protection provisions applicable to these financial products. In the future, information to investors will be similar to the one practised in the securities field, and be based on the KIID, a short form prospectus, adapted to the needs of the normal investor and updated on a regular basis. Also the pre-contractual obligations will be clarified, especially as to the suitability of the investment to the client's needs. Finally, and most importantly, clarity will be offered on the fees that are retained from the investment and in the past were often not made apparent before investment. These reforms, often designated as Prips, will not only restore the level playing fields between comparable financial instruments, but more importantly introduce a higher level of investor protection across the board.

A more fundamental issue concerns the role of disclosure for purposes of investor protection. In the future, this question may play an important role in the offer of investment products. For many years the regulation in all countries I know of considered that disclosure of all relevant facts was the right way to protect investors. Investors should be able to fend for themselves, and disclosure should be true, fair and comprehensive, so that the investor can assess his risks. Ultimately as no one knows what is a good, a proper investment, it is up to the investors themselves to decide how much risk they want to take: this was the old doctrine of "buyer beware", or "caveat emptor". Is had many advantages: it obliges the offeror to submit full, relevant information, it obliges the investor to do his "homework" and does not restrict the types of products to be offered, thereby contributing to innovation. From the supervisory side, it reduces the risk of the supervisor to be held liable for allowing "unsuitable" products.

Recently proposed European regulation now takes another stand: investors should be prevented from being offered products that are too risky, that are not appropriate for their risk profile. Therefore the financial supervisors – at least in the field of securities, but not in insurance – have the right to suspend or restrict the offering of certain instruments or instruments with certain features, or a financial activity or practice provided that they constitute a "threat to investor protection or to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union"[2] This power belongs to ESMA and to national supervisors alike. Further implementing regulation will have to specify criteria and factors to be taken into account by ESMA in determining when the threats to investor protection or to the orderly functioning and integrity" have to be taken into account.

It has been a question for debate whether protection should exclusively be ensured by disclosure, or by more substantive, "merit" – some will say "paternalistic" supervision, excluding some investors from some of the more sophisticated products and protect them

[2] art 31 Mifid 2; a similar provision with a more restricted ambit is part of the ESMA regulation, art.9.

even against their will. The European regulation seems more and more to go in the second direction, an evolution that is probably due to the increasing wealth of the population and the interest of retail investors for all sorts of increasingly sophisticated investment products. Another factor might be the changed attitude of the representatives of the financial groups, that do not act anymore as the investor's person of confidence but as a salesmen, essentially interested in selling the product for his employer and ultimately in his fee on the transaction. One can therefore understand that the legislator concerned about the numerous cases of misselling, wanted to better protect investors. But whether this will effectively be achieved by prohibiting certain investment products or services is at least debatable. Indeed, what distinguishes a good from a bad product? When is the risk too high for retail investors: is an equity portfolio less risky than investing in a structured product? Much, if not all depends on the characteristics of the product, of the capacity of analysis of the investors and finally of the way the investment advisor acts. A point of concern might also be whether this type of intervention will be ex ante, or only ex post, as in the former case it might constitute a serious threat to innovation. One can only hope that the authorities in charge of this provision will make a moderate use of these powers and only act with respect to blatant cases of abuse.

Financial Law Institute

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