



**Financial Services
User Group's (FSUG)**

response

**to the Consultation
on UCITS VI
long-term investments**



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Introduction and background

FSUG is pleased to submit a response to this consultation. We have focused our response on the issue of long-term investments. However, we would have included some general observations on Box 1: Questions 1-7 which covers the eligibility of assets for UCITS funds – particularly on the need for the Commission to adopt a more pragmatic, precautionary approach to financial innovation.

A modern economy and society needs an efficient, effective, accountable investment industry. Policymakers often speak of ‘systemically important financial institutions’. But the nature of the services provided by financial markets and institutions means they are also ‘socially important financial institutions’. These core financial services include: networks and systems for transmitting money around the economy; markets for allocating savings/investment capital to the real economy (theoretically, to the most productive uses or those which promote the general interest or important social goals); stock exchange functions; a means for intermediating savings/deposits to provide loans to consumers, industry, and government (the bond markets); insurance, reinsurance, and derivatives markets to allow economic actors and investors to protect against and manage risks; and, of course, financial products and services to meet the core needs of financial users.

The FSUG makes the following observations to illustrate the scale of the challenge facing policymakers and regulators if they want to create a single financial market that works for EU citizens. While FSUG recognises that there is much good in investment markets, there are a range of market failures that need to be highlighted:

- A ‘democratic deficit’ exists in the EU system of financial governance. Powerful investment institutions play an increasingly important role in society. Yet they have been allowed to become to a large degree unaccountable and ungovernable.
- The rewards for financial speculation and market manipulation were privatised, while the risks and costs were socialised with the result that taxpayers across the EU are being forced to pay a terrible price for the crisis.
- Financial services and markets, despite their much heralded and self-appointed role as enforcers of economic discipline and economic efficiency, have huge in built inefficiencies of their own wasting billions of savers and investors capital in the form of opaque, high charges.
- Savers and investors capital has been diverted away from economically productive or socially useful activities in the real economy to short-term, speculative activities and financial products of questionable social or economic value.
- Poor standards of corporate social responsibility allowed financial and legal engineering to be used by bankers and banking lawyers to systematically circumvent regulations such as tax, capital adequacy, disclosure rules in takeovers and trade embargoes, to get round regulatory control and the rule of law and involving regulators in a cat and mouse game.
- Financial institutions and financial intermediaries should have an important role to play in helping citizens make effective decisions and encouraging citizens to provide for the future (consumer inertia is a significant problem). However, aggressive institutional behaviours have resulted in a litany of misselling scandals that have left a legacy of mistrust and undermined consumer confidence in markets – again driven by short-term considerations.

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- There are now many layers of financial intermediaries between investors and capital markets extracting high fees and destroying investor value – thereby reducing the amount of capital available for investment in the real economy.
- The security of consumers' savings has been severely compromised and sub-optimal asset allocation decisions by supposedly expert investors has resulted in major value destruction in the pensions and long-term investment sector (much of which is only now coming to light). This has further undermined confidence in markets at a time when citizens are expected to provide for the future.

We are of the view that there is a clear need and mandate for fundamental reform of EU long-term investment markets. However, we are disappointed at the rather limited ambitions outlined in this consultation paper.

Response to specific questions

Box 1: Response to Questions 1-7

We are not responding to individual questions. However, we would like to comment on the general points raised in this section.

We agree there is a need to review the scope of assets and exposures eligible for UCITS funds. However, we have serious concerns about the lack of a robust 'ex-ante' regulatory model that allows reviews such as this to be undertaken in a coherent, systematic, objective way.

FSUG wants to see successful, innovative investment markets that operate in the interests of financial users. However, while we want to see effective financial markets and socially useful innovation, it is important for regulators to understand that not all innovations are necessarily beneficial for financial users – even if these innovations are commercially advantageous for product manufacturers and distributors.

UCITS has been one of the few genuinely successful innovations¹ in financial services of recent times – successful that is from the financial user perspective. It has developed a very successful brand. Therefore, it is critical that the Commission takes extreme care not to: i) damage the interests of financial users by allowing complex, risky, limited value/utility financial products/instruments to achieve a 'halo' effect by being included within the UCITS brand; and ii) in doing so, damage the UCITS 'brand'.

Therefore, it is very important that the regulatory regime is fit for the purpose of evaluating the benefits and disadvantages of market developments and financial 'innovations' from the perspective of financial users, not the perspective of the industry.

A further important point to make is that regulators should adopt a precautionary, rather than permissive, approach to regulation. A precautionary approach to regulation is appropriate for complex markets such as financial services given the evidence of history – that is, a litany of misselling and other scandals and 'innovations' that have caused major detriment to financial users.

¹ To be precise, UCITS is not actually a financial innovation, more of a regulatory and legal innovation, which further underlines the point that there have been very few genuine financial innovations in financial services.

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Regulators should not approve additional assets as eligible unless there are clear reasons to believe that this decision would produce real benefits for the users. This means that regulators should consider whether it is appropriate to remove assets as well as add assets that are deemed eligible for UCITS funds.

Unfortunately, the consultation paper provides no such evidence or regulatory model to allow us to answer the specific questions. The Commission (or the market) has not produced any evidence to justify allowing the products, instruments and techniques outlined in the consultation to be included in the UCITS brand.

Before the Commission decides whether or not to include other assets, we would urge the Commission to evaluate the proposals according to the following model. FSUG is currently in the process of producing a series of three papers on how to use financial regulation to make markets work for financial users.

The first paper, *New Model Regulation*, argues for a profound change in regulatory philosophy and proposes a new regulatory model which we believe would be more effective at understanding why markets fail and at identifying effective policy interventions to make markets work for financial services consumers. This will be followed by a second report called *Financial Supervision and Sanctions* which focuses on the practical implementation of regulation. The third report, *Financial regulation, innovation, and competition*, challenges the widely held view that regulation stifles financial innovation to the detriment of financial users. This paper also shows how regulation can be used to reward consumer-friendly and socially useful innovations. This third paper also sets out a model that allows policymakers and regulators to evaluate *ex-ante* whether certain innovations are likely to be beneficial or detrimental for financial users and therefore identify the best way to regulate innovations in the interests of financial users.

In any sector of the economy, innovation that is economically or socially useful has to fulfil certain qualifying conditions. For example, the innovation should:

- meet the needs and preferences of consumers more effectively;
- enhance market efficiency or productivity creating better value for consumers;
- result in improved functionality/social utility for consumers;
- improve safety for consumers;

Overall, for an innovation to be progressive and socially useful:

- it should enhance the economic or social welfare of consumers;
- the externalities and negative outcomes should not outweigh the benefits; and
- it should be used appropriately under properly regulated and transparent conditions.

Economic history provides numerous examples of how the creative energy of free markets resulted in progressive, economically or socially useful innovations. However, sadly, too many innovations in financial services have not met these qualifying conditions leading to major detriments for financial users and wider society – for example, destruction in asset values, introducing massive risks into the financial system (or simply concealing those risks), pushing up distribution costs and reducing investment returns for retail investors, benefiting commercial models of financial institutions rather than the interests of financial users and so on. This has resulted in a sharp decrease in the level of users' confidence in all financial products which in return harms the market.

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Therefore, it is critical that the Commission adopts a pragmatic, precautionary approach to financial regulation – particularly when it comes to financial innovation. The Commission should not assume that financial innovation is necessarily and automatically progressive and beneficial. Indeed the innovations that have most obviously benefited financial users have been either technological or legal/regulatory, not actually financial – good examples include, the ATM or UCITS itself.

Long-term investments: assessment of the potential need for measures to promote long-term investments and of the possible form of such measures (including investments in social entrepreneurship)

Box 10: Questions 1-10

The promotion of long-term investments is crucial for the wellbeing of EU citizens – all of them being current or future pensioners who have and will have to rely more and more on the performance of their long-term and pension savings. It is also crucial for the development of the EU economy and the creation of jobs. This is why we believe the solutions envisaged by the EC in this consultation are not of the magnitude required, and we have proposed measures with significantly more potential impact.

The problem is not that individuals living in the EU do not invest for the long-term. They do, but actually, they now most often no longer ‘invest’, they ‘save’ for the long term, surrendering investment decisions into underlying assets to financial intermediaries, to ‘agency’ owners who most often do not have such a long-term horizon. This growing replacement of ‘economic’ end-investors by ‘agency’ investors and their more short-term behaviour has been identified by previous reports from EuroFinuse and lately by the Kay Report in the UK as one of the key issues disconnecting long-term end-investors from long-term invested assets. Therefore the EU Authorities must not ignore in this consultation the necessary reconciliation between long-term savings and shorter term ‘packaged’ investment products.

The issue of long-term savings & investments had been rightly identified by the European Commission more than five years ago in its Green Paper on retail financial services. But the necessary framework has yet to materialise. The EU framework needs to lay strong foundations for enabling a competitive, open and effective market for long-term savings, retirement and pension solutions that meet consumers’ needs. Unfortunately, even today, the ‘PRIIPs’ Regulation proposal of the EC excludes such long-term investment products as shares, bonds and occupation-based private pension products from its scope.

1. What options do retail investors currently have when wishing to invest in long-term assets? Do retail investors have an appetite for long-term investments? Do fund managers have an appetite for developing funds that enable retail investors to make long-term investments?

Retail investors do have some options for long-term investment. However, these are limited and their benefits for the users increasingly unclear. Moreover, these options can be expensive with unnecessary layers of intermediaries in the supply chain standing between the investor and the target investments in the real economy. The supply chain is fraught with conflicts of interest.

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However, as we explain elsewhere it is not clear whether the Commission is seeking views on: i) how to promote a new asset class that invests in long-term assets; or ii) more generally wants to promote long-term investment per se.

In the view of FSUG, retail investors certainly have a need for 'fit-for-purpose' investment vehicles that provide the potential for sustainable, long-term investment returns. However, it is not clear that there is demand for long-term investment funds from the investment industry in its current state following the financial crisis and crisis of confidence and trust.

An important principle for the Commission to understand is that in financial services supply does not follow demand – rather demand tends to follow supply of products. A market for a product or service only emerges after this has been developed by providers and heavily advertised. Unfortunately, product development and 'innovation' in the investment sector has too often been for the benefit of financial institutions, fund managers and/or intermediaries.

Certain conditions would have to be met if a long-term investment market was to emerge that is fit-for-purpose. These conditions are set out below.

2. Do you see a need to create a common framework dedicated to long-term investments for retail investors? Would targeted modifications of UCITS rules or a stand-alone initiative be more appropriate?

It is difficult to answer this question because the Commission is not clear whether it is referring to i) 'long-term' investments as a new specific asset class, or ii) more importantly, the need for wider measures to promote a long-term approach to investment that would benefit financial users and the real economy.

If it is the first option, then the priority is to ensure that:

- the types of asset included within a modified UCITS regime would be suitable for the needs of retail investors and potential users of investors capital;
- retail investors and advisers understand fully the risk/reward trade-offs involved; and
- the regulatory regime including investor compensation schemes and the sales and promotions regimes are fit-for-purpose.

For example, we can see there is real merit in developing alternative sources of funding to bank lending for medium sized companies and SMEs in the real economy. In theory, investors (whether in the form of retail investors, pension funds, or policyholders) could provide the source capital – if, and only if, this could be done in a way that was safe and cost effective for both parties.

In essence, this is a question of developing the appropriate form of intermediation. But there are many outstanding issues to be addressed including how to ensure:

- the investment timeframe of investors and investee companies are aligned;
- the risk/return ratio reflects the investment timeframe, potential liquidity constraints, variability of capital, and volatility of asset values;
- a genuine market exists for assets;
- risks are properly and transparently evaluated and disclosed including investment risk, contract/charging structure risk, and liquidity risk;

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- issues around investor preference in the event of default or loss are clarified;
- investment fund sponsors are efficient and 'manufacture' funds that are of good value; and
- potential distributors/intermediaries are sufficiently professional and competent to understand risks/rewards.

Clearly, if it is the second option, then a much wider set of reforms is needed to correct the various market failures in the investment supply chain.

If the Commission wants to promote mutually beneficial long-term behaviours, this requires a range of interventions to: i) discourage destructive short-term behaviours and conflicts of interest and ii) promote long-term, mutually beneficial behaviours in the investment supply chain.

Unfortunately, most of these important interventions are not addressed in the consultation paper. Therefore, FSUG recommends that the Commission should draw up a coherent reform plan covering the following issues:

- **Efficiency:** the investment supply chain and capital markets must become more efficient – the optimum amount of resources (in the form of investors' capital) must find its way to the real economy. As we describe, there are too many layers extracting and destroying value for the retail investor/pension fund member/ordinary shareholder.
- **Utility and effectiveness:** resources/investors capital must be allocated to the most productive and sustainable economic uses.
- **Improved information:** if investors are to be able to make better long-term decisions, they need the right information to evaluate and trade-off between different short, medium and long-term investment decisions.
- **Level playing field:** end the discrimination of direct long-term investments such as shares (especially small and mid-caps) and bonds at the point of sale;
- **Agents/intermediaries:** the role and effectiveness of the various layers of agents and intermediaries in the investment supply chain must be addressed especially the potential for conflicts of interest and value extraction/destruction.
- **Alignment of interests/behaviours:** the behaviours of markets must be aligned to long-term public policy goals – this means creating a system of incentives that promote long-term sustainable investment behaviours and deterrents to discourage destructive short-term behaviours; a necessary overhaul of the incentives of manufactures (asset managers) and of distributors of 'packaged' long-term products and provision of long-term value protection.
- **Governance and accountability:** investment managers are in a position of responsibility as they generally look after 'other people's money'. Yet there is an unacceptable lack of governance, accountability and transparency relating to their operations.
- **Investor engagement:** creating sustainable, socially responsible, accountable investment markets requires genuine investor engagement with the ultimate owners of capital (whether ordinary shareholders, retail investors, pension fund members, or insurance company policyholders). Critics argue that more socially responsible, long-term investment activities involving greater investor engagement implies a higher cost of investing. This is not necessarily the case. However, the most important point to recognise here is that the embedded inefficiencies in the investment supply chain allows the industry opponents to block enhanced investor engagement and corporate responsibility. If the Commission successfully intervened to strip out the

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unnecessary oversupply, overintermediation, and overcomplexity in the investment supply chain this would result in more transparent and efficient markets leading to a significant reduction in investment supply chain costs. This would then free up resources for enhanced governance and investor engagement. It would also ensure that the investment risk is carried by those engaged in the investment rather than by the taxpayers.

- 'Fit-for-purpose' infrastructure and investment vehicles: as we explain elsewhere we are unclear as to why the Commission appears to be actively promoting the greater use of private funding for public policy areas given the inherent cost inefficiencies associated with private funding mechanisms. This is clearly a political decision not an economic decision. However, despite these serious reservations, we do think there is merit in creating long-term social purpose investment vehicles – particularly if the Commission wants to promote socially useful investments such as social investment bonds (SIBS).

3. Do you agree with the above list of possible eligible assets? What other type of asset should be included? Please provide definitions and characteristics for each type of asset.

We do not object in principle to any general class of assets being included in a new regime providing the conditions for safe and efficient intermediation can be met – see above.

As mentioned above, there is real merit in developing long-term social purpose investment vehicles such as social investment bonds (SIBs).

However, we have grave concerns about the role of long-term investments in funding public policy projects – to be precise, why the Commission is suggesting these measures in the absence of any comprehensive, objective evaluation of the benefits and disadvantages of such an approach.

It is not clear why the Commission is actively promoting the greater use of long-term investments as a way of financing infrastructure projects in public policy areas such as transportation, energy, health or education. The Commission produces no compelling evidence to justify such 'financialisation'. Facilitating such a market might benefit one group of stakeholders (that is long-term investors such as pension funds) but very likely at the expense of another group of stakeholders (other citizens including taxpayers).

There is a very strong prima facie case for the argument that the cost of funding public policy projects through private investment sources is more expensive in the long term for citizens than public funding. This is because, ceteris paribus the return on investment or yield demanded by private investment sources is by definition likely to be higher than the comparable cost of funding for governments (central or local). If private sources are genuinely willing to take on the long-term risks of funding public policy projects, they will demand a risk premium in the form of a substantially higher return. If they are willing to accept a return closer to that available on government bonds they will expect that citizens (in the form of taxpayers) will bear the long-term unforeseen risks.

We are not aware of any independent, objective macro investment models that demonstrates that, after taking into account the trade-offs between various groups of stakeholders (citizens versus private investors, current versus future generations), it is beneficial for society (or member states) at the aggregate level to promote private funding of public policy projects. It may well be that the Commission is in possession

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of such independent investment models but it has not included these models as evidence in this consultation document.

Furthermore, concerns have already been expressed by many commentators about the increased share of 'real economy' activities represented by financial activities. Pre financial crisis, allowing financial market activities to grow unchecked distorted and destabilised the real economy of member states. The Commission now seems to advocate the introduction of financial market activities into even more areas of public and economic life without producing an objective assessment of the rewards/risks of such greater financialisation. We urge the Commission to ensure that, if it insists in promoting greater financialisation, this is done in such a way that benefits the wider social and economic good and does not just create more markets for financial institutions.

Therefore, if the Commission is to actively pursue and promote greater financialisation, it must produce, as a priority, an independent, objective, and transparent ex-ante impact assessment evaluating the impact of greater financialisation on:

- the cost effectiveness of funding public policy projects through private investment funding;
- different stakeholders – private investors versus taxpayers and other citizens, current and future generations; and
- the wider economy.

It would be unwise to take this issue further without this necessary ex-ante impact assessment.

4. Should a secondary market for the assets be ensured? Should minimum liquidity constraints be introduced? Please give details.

It is difficult to see how an efficient, safe market could evolve without the necessary liquidity provided by a secondary market in some form. We do not have specific proposals at this stage.

5. What proportion of a fund's portfolio do you think should be dedicated to such assets? What would be the possible impacts?

It is not possible to say in advance what proportion of a fund's portfolio should be dedicated to such assets. The optimal asset allocation for any portfolio depends on the specific risk and reward characteristics of the individual component assets. Yet at this stage, we have no real indication of the potential risk/reward associated this new asset class.

However, an equally important point is that potential investors (including pension fund trustees) and intermediaries understand the real risks/rewards associated with such assets. We must avoid the previous mistakes made with the development of other alternative investment products such as structured products, hedge funds and so on. These funds were aggressively promoted to pension fund trustees as offering enhanced risk/reward trade-offs and potential for diversification. Of course, in reality these alternative funds were often more expensive than conventional investment funds and did not meet investor expectations – see comments above about the need for a more pragmatic, precautionary approach to claims from the investment industry about financial innovation.

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- 6. What kind of diversification rules might be needed to avoid excessive concentration risks and ensure adequate liquidity? Please give indicative figures with possible impacts.**

See above – it is not possible to give specific answers at this stage.

- 7. Should the use of leverage or financial derivative instruments be banned? If not, what specific constraints on their use might be considered?**

Yes. If these funds are intended to be socially useful and offer intermediation opportunities for the real economy there is no room for speculative financial activities in UCITS.

- 8. Should a minimum lock-up period or other restrictions on exits be allowed? How might such measures be practically implemented?**

See response to Question 2 above. These funds need to trade off the following dimensions: risk/return; investment timeframe; capital variability and liquidity; asset volatility; and contractual and pricing risk. Clearly, funds with a minimum lock-up period or restrictions on exit would benefit investee companies given the predictability of capital funding but would be required to provide investors with an enhanced return to compensate for the disadvantage of the lock up. Funds without a lock up period may only be suitable for very short-term funding requirements unless there was a very liquid, secondary market. So it is impossible to say in advance whether and to what degree a lock up period is appropriate without further work.

- 9. To ensure high standards of investor protection, should parts of the UCITS framework be used, e.g. management company rules or depositary requirements? What other parts of the UCITS framework are deemed necessary?**

Yes – we agree that the UCITS framework is appropriate.

- 10. Regarding social investments only, would you support the possibility for UCITS funds to invest in units of EuSEF? If so, under what conditions and limits?**

Yes. As we explain above, there is real merit in developing social investment bonds and other asset classes. However, as we also explain in above responses it is not possible to answer specific questions on limits at this stage without further development of the framework.

But a priority for the development of such an asset class is that there is clear labelling of investment funds so that potential investors are able to identify appropriate funds. There should be an adequate definition of the scope of social business while appropriate reporting and certification requirements for social investment funds are needed.