Anticipating the Future of The Funds Industry

Assessment of the impact of the UCITS IV Directive

The Undertaking for Collective Investment in Transferable Securities (UCITS) IV Directive, which becomes effective on 1st July 2011, is designed to facilitate the sale of funds across Europe and to support greater rationalization of the asset management industry. The UCITS IV initiative was based upon the assumption that existing regulation is a barrier to increased concentration within the European asset management industry. In 2006 the European Commission wrote in its white paper that regulation did "not allow fund managers with funds or activities in different Member States sufficient flexibility to organize or restructure businesses. These inefficiencies and constraints are reflected in higher costs and lower returns that are borne by the fund investors."

Key questions arising as a result of the UCITS IV Directive are: is the industry ready for this new directive? What impact will it really have on industry participants' businesses? What stance have they adopted in preparation?

Understanding UCITS IV and its impact on Fund Management Industry

1.The UCITS IV Directive is unlikely to achieve its objective. The European Commission has set the objective of a 3% increase in nominal investment returns as a result of the directive, but it appears that the proposed measures will not achieve this goal. Professionals surveyed confirmed this point. They mostly see this directive as offering opportunities for optimization without any major disruption of the existing market structure. They react positively to the opening of certain commercial barriers, but are just as concerned that distribution costs will skyrocket.

2. Asset managers are acknowledging this directive somewhat belatedly, and with caution. Despite their service providers offering new services to assist them with taking up the objectives of the directive, asset managers continue to take a 'wait and see' stance.

3. While the directive is a step in the right direction, the lack of provisions on the depository function and on tax matters makes its use by market players uncertain.

The potential for new distribution opportunities within Europe should not be overestimated. When existing markets and level of sophistication are looked at, there do not appear to be clear opportunities for significant growth within European markets. Local management is frequently focused on local needs, be it through local or foreign vehicles (mainly Luxembourg). In most cases, national preferences seem to prevail when determining positioning within the European market. Asset managers are not planning to use UCITS IV as a tool for reorganizing on a pan-European basis. Many are already more structured than was assumed by the European Commission. In most cases management is already heavily concentrated in one or two countries. In many cases a distribution hub is already set up, particularly in Luxembourg, with relevant know-how available.

It appears that the challenges facing the European fund industry are not primarily caused by existing UCITS regulations. There remain other regulatory barriers to cross-border distribution: investor reporting, status and constraints on fund administration. Taxation systems remain highly heterogeneous. Several business issues also limit fund distribution across Europe.

A large part of distribution remains concentrated in the hands of insurance and banking groups. Pan-European distribution platforms allow asset management companies to diversify their distribution across Europe, but costs for cross-border distribution are still high, especially for small- and medium-sized managers. A preference for own nation funds seems to prevail, especially within the retail segment.

UCITS IV only brings a partial answer. A quicker notification procedure will help to reduce time-to-market and a more understandable version of the prospectus (Key Investor Information Document or KIID) will increase transparency for the end investor, but these improvements only indirectly contribute to increased sales.

The directive does not significantly address distribution costs: KIID-specific regulation on advertising material will remain (and the KIID itself still has to be translated into the language of the country of distribution).

Potential threats to the future growth of the fund industry remain, and the directive won't address these. Market performance may not improve. Although UCITS funds can borrow and use derivatives, they are not as flexible as hedge funds in exploring emerging markets trends.

The real opportunities for further distribution only partially arise from the directive. The best way to access new distribution networks remains the takeover of a local participant to use its existing distribution facilities. This consolidation will be related as much to the financial crisis as to UCITS IV. Most likely, master-feeder structures will be helpful in this process.

Key considerations

Given the unfolding situation within Europe as a result of the directive, the key considerations for asset management companies in the years to come are:

1. Adoption of opportunistic strategies for entry into new European markets based upon maximizing re-use of existing offers, combined with light investment in new market opportunities is the most likely approach to prevail. This will help gain a better knowledge of foreign markets, and seems the safest short-term strategy.

2. Concentrate on core business – asset management and sales – and find innovative solutions for distribution. European-wide use of master-feeder funds is expected to offer sizeable opportunities for asset managers.

3. Seize the external growth opportunities that will emerge in the coming years. With an increasingly open market and rising distribution costs, mid-size organizations should gradually exit the market, as is currently the case with banks in Italy. This situation should provide investment opportunities for the leading industry players, allowing them to strengthen their position within Europe.

There is more to UCITS IV than it simply being yet another new European regulation. UCITS is viewed worldwide as a 'brand'; a guarantee of investment security. However, it is a brand that can easily be tarnished, for example as a result of losses such as those incurred on Madoff's UCITS funds. A future 'UCITS V' directive, clarifying the role of the depository in guaranteeing assets, will play an important part in preventing such things from happening again, and further bolster the UCITS brand. What cannot be disputed is that the potential benefits from getting UCITS legislation – and its implementation – right are high: close to a quarter of the investment into UCITS funds comes from the world outside Europe, and in particular Asia and Latin America.