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Time for a risk-based UCITS

Jean-Pierre Casey[1]

As the European Commission undertakes to publish its White Paper on the enhancement of the EU framework for investment funds (scheduled for November 2006), now is a good time to reflect on whether the UCITS framework needs a radical overhaul if the regulatory landscape is going to adapt itself to the reality of market evolutions. There is no doubt that over the past twenty years UCITS has been a successful instrument for facilitating cross-border investments in authorised collective investment schemes while at the same time providing a high level of investor protection. Nevertheless, the limitations of the UCITS Directive as it currently stands are becoming readily more apparent. The most obvious of these is the outdated product approach, by which the UCITS regulatory architecture rests on the certification of specific products that are deemed eligible for investments of UCITS.

There are two crucial flaws inherent to the product approach. First, defining the asset classes that are eligible for inclusion in a UCITS portfolio is a laborious and time-consuming exercise, to which the existing institutional setting is ill-suited. That UCITS adequately accommodates the increasing multiplication and accelerating proliferation of asset classes is therefore increasingly in doubt. Second, the product approach does not take account of the lessons of modern portfolio theory (MPT).

According to MPT, considering the riskiness of an individual asset makes little sense from the perspective of portfolio construction. More important a consideration is how adding the asset contributes to overall portfolio diversification. Paradoxically, adding an asset that is individually riskier can lower the risk of the overall portfolio. The wholesale exclusion of certain asset classes from UCITS eligibility fails to take account of this reality. It is well possible that a portfolio including an exotic, non-UCITS-eligible asset outperform a UCITS portfolio not only in terms of absolute return (higher yield), but also in terms of absolute risk (lower return volatility) and efficiency (higher return for a given level of risk). In other words, there are clearly cases when the UCITS Directive's restrictions on asset choice can adversely impact the welfare of the unit-holder.

Tight restrictions on investment policies – another cornerstone of the UCITS Directive – are dangerous because they give retail investors a false sense of security. Since risk is intrinsic to the financial system, one has to wonder to what extent legislative measures aimed at 'removing' risk – or, at the least, drawing an upper bound on an 'acceptable' level of risk for a given product, such as a UCITS – are truly effective. Investment restrictions are never foolproof.

[1] Jean-Pierre Casey is Head of Research at the European Capital Markets Institute and Research Fellow at the Centre for European Policy Studies. This commentary was first published in the Financial Times' weekly Fund Management insert on 18 September 2006.

In addition, defining eligible assets, setting investment limits and regulating investment strategies does not in any way guarantee the quality of investment management. In the hands of an inept portfolio manager, what may appear to be a 'safe' portfolio can in fact turn out to be a riskier prospect than a portfolio including exotic instruments in the hands of a well-informed and skilful manager. Legislating to circumscribe investment risk is therefore a false promise. Rather, investment risk should be addressed by industry standards/best practices regarding risk management, by licensing requirements or industry certifications to ensure portfolio manager qualifications and competence, and by enforcing incentive-based safeguards that align the interests of the unit-holder and fund manager.

We do not advocate a reworking of the entire UCITS framework. A number of safeguards imbedded in the UCITS Directive ought to remain at the heart of the EU's architecture for retail investor protection in collective investment schemes, since these measures have guaranteed the success of UCITS and inspired investor confidence in financial markets. These provisions include strict rules on: prospectus approval; fund governance; conflicts of interest; information disclosure; regulatory/third-party oversight; fund manager competence and honesty.

Nevertheless, it is time to do away with the UCITS Directive's restrictions on asset choice and investment policies. They simply amount to an imperfect substitute for more disclosure and better alignment of managers' incentives with the investors' best interests. Given the Directive's strict provisions on reducing agency risk, the aforementioned restrictions are redundant: even if a 'prudent man' approach were adopted, controls would still remain in place to ensure that fund managers do not take on excessive risk. Fund depositaries and supervisory authorities alike would continue to be mandated by the UCITS Directive to maintain a close eye on portfolio managers to ensure that their investment policies match those presented in the fund prospectus.

As long as the product approach stays in place, the regulatory environment will continue to be out of sync with the lessons of modern portfolio theory.

See: "Eligible Assets, Investment Strategies and Investor Protection in Light of Modern Portfolio Theory: Towards a Risk-Based Approach for UCITS?" By Jean-Pierre Casey, Head of Research at the European Capital Markets Institute, an independent research body managed by the Brussels-based Centre for European Policy Studies.