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ECMI Policy Brief

Brexit and the Asset Management Industry

by Karel Lannoo

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Brexit and the Asset Management Industry

Karel Lannoo*

ECMI Policy Brief No. 23, February 2017

A sset management businesses tend to concentrate in financial centres because of the proximity of service providers, access to talent and the availability of financial infrastructures. In an EU context, the UK – and the City in particular – has specialised in asset management as part of its emergence as Europe’s financial centre over the last few decades. Assets under management (AuM) in the UK have tripled since the early 2000s, a trend that was unaffected by the financial crisis, and they increased their share of total European AuM from over 20% to 40%. Whereas in the past government regulation often constrained assets to a great degree in the home country, market liberalisation and integration seem to have had their intended effects.

Regulation of the asset management industry is fragmented over several different regimes. The applicable rules depend upon the particular license that the financial institution in question possesses, which may be as a provider of services and/or for a particular investment product. Under EU rules, an entity can be authorised as a fund management company, bank, insurance undertaking, pension fund or broker, and require services from clearing and settlement entities. The degree of market integration will vary according to the degree of liberalisation achieved within the sector or value chain.

Brexit will have a big impact on the asset management industry for three reasons: 1) the passport will disappear for UK-licensed companies, which will stop or certainly seriously hinder the trend of concentration towards the UK; 2) the equivalence regime, the basis for third-country access to the EU, is unevenly developed across the different segments of asset management; and 3) the value chains in asset management will be affected, with implications for supporting firms or infrastructures.

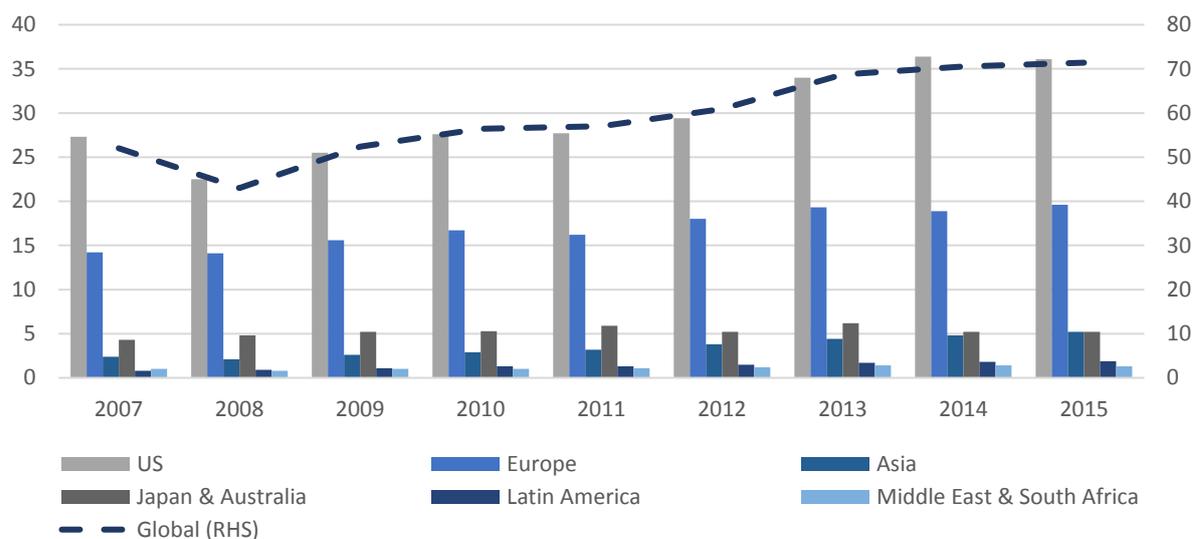
We start with a review of trends in the asset management industry. This is followed by an overview of the UK asset management industry from a European perspective. The third section discusses the EU rules applicable, the equivalence regime and the impact of Brexit.

Trends in the asset management industry

Over the past decade, the asset management industry has experienced strong growth reaching over \$75 trillion global AuM at the end of 2015, with the US and Europe managing about 80% of the assets (FSB, 2017). At the same time, a certain degree of concentration started to emerge in a sector that was hitherto highly fragmented along sectors and countries. The growth of the sector was not much affected by the global financial crisis, registering only a limited decline in 2008.

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Figure 1. Assets under Management (\$ trillions)



Source: Author's calculations based on data from BCG Global Asset Management Market-Sizing Databases.

Hallmarks indicative of the concentration in the sector are its performance and reach, which required vertical integration and exploitation of scale economies. Most investors have grown their in-house asset management capacities, and with it the control of the underlying value chain. Large investors need to have a global reach over a variety of asset classes and regions, managed actively or through indexes, for a differentiated set of clients. The problem is that integration can lead to conflicts of interest in the fiduciary duties of managers, an issue that has been addressed by policy-makers in recent years.

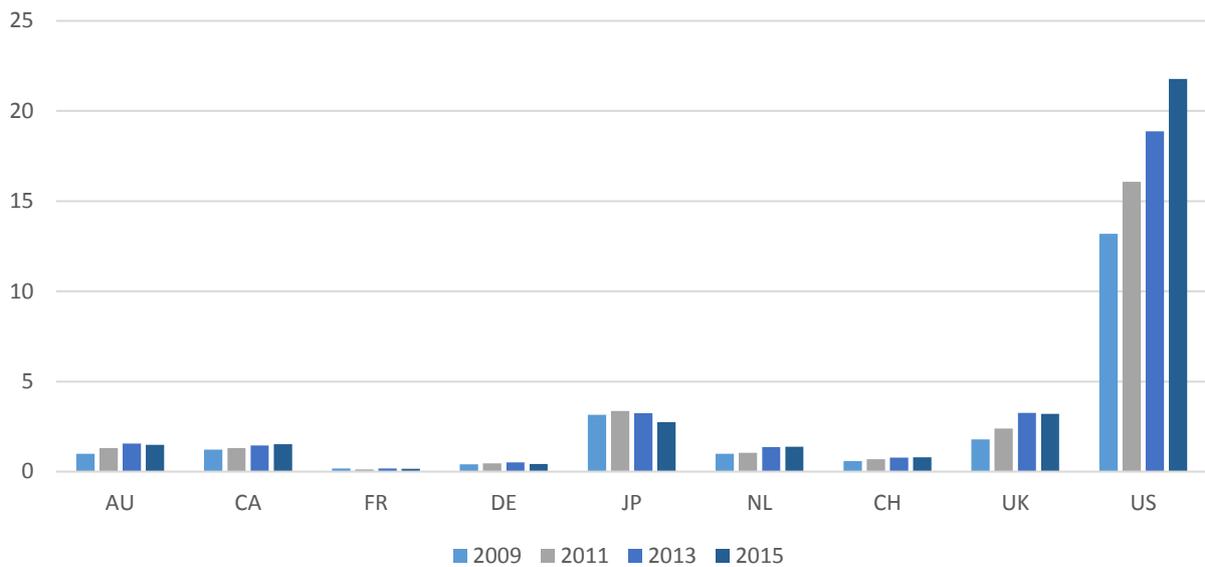
Technology has become a vital instrument for controlling the value chain in asset management, as it has been in other parts of the financial services industry. From a back-office function, with dematerialisation and integration of securities services, settlement and custody, technology has become a front-office function as well, with client data analysis and electronic distribution through fund platforms and robo-advice. Sophisticated technological responses are also required for compliance with the growing complexity of regulation, as well for prudential and conduct of business reasons.

The concentration in the sector is a source of concern among policy-makers, most notably in the Financial Stability Board (FSB). Analogous with the work on the global SIFI's (significantly important financial institutions), the FSB wanted to develop a list of systemically important firms in asset management. The concern however was not the threat of systemic effects of the failure of a firm for the global financial system, but rather the operational risks resulting from the size of the assets under management in the large firms, and the dominance of their risk analysis model (see for example The Economist, 2013). Most asset management companies are agency business and do not use their balance sheet to engage in the conduct of their activities.

The UK asset management industry in a European perspective

The UK has a large home-grown asset management industry. As one of the few countries in the EU with a fully funded occupational pension system, the UK has a large pension fund sector, which ranks third globally after the US and Japan in assets under management. The fund management expertise helped the UK to acquire foreign clients, which today account for about 40% of the assets (18% EU and 21% other), according to the FCA (2016a).

Figure 2. Pension Funds' Assets under Management (\$trillions)



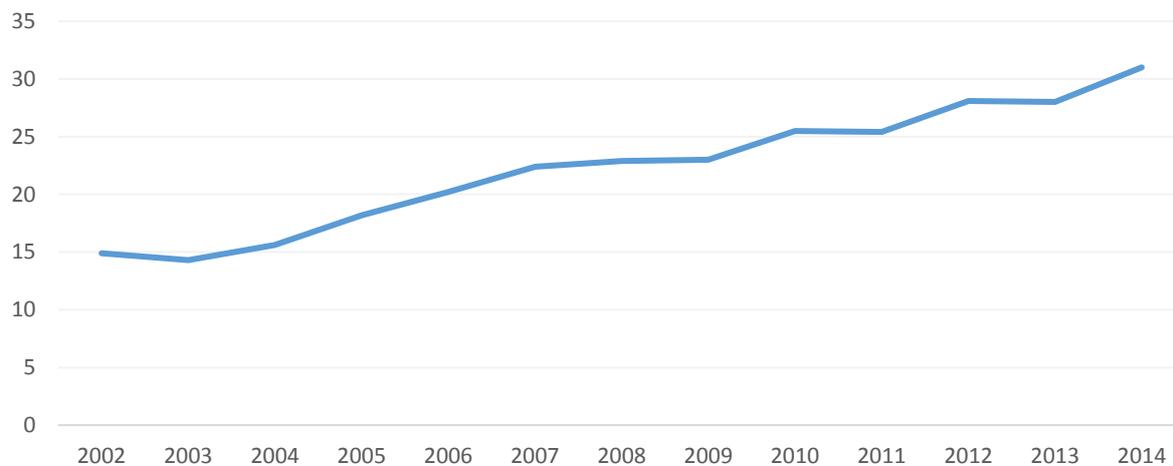
Source: Author's calculations based on data from Willis Towers Watson Global Pensions Asset Studies.

Overall the entire UK asset management industry is the largest in Europe and second only to the US globally. The sector contributes significantly to the UK economy, both in terms of employment and tax revenue. In 2015 the UK asset management industry earned around £17 billion in revenues and generated about 1% of UK GDP. The UK industry is not particularly concentrated, with the 10 largest asset management firms operating in the UK accounting for around 55% of total AuM. The number of asset management firms currently authorised in the UK stands at 1,840 (FCA, 2016a).

The UK's asset management sector has not been without its problems over the years, which have not necessarily been confined within the UK's borders. There were several single high-profile scandals, such as the Maxwell fraud, or the expropriation of fund assets, or the Equitable Life scandal, involving the inadequate provisioning for guaranteed life insurance products. But there have also been the problems with fund management fees and the conflict of interest in investment advice that led to national and EU-wide regulatory initiatives, discussed below.

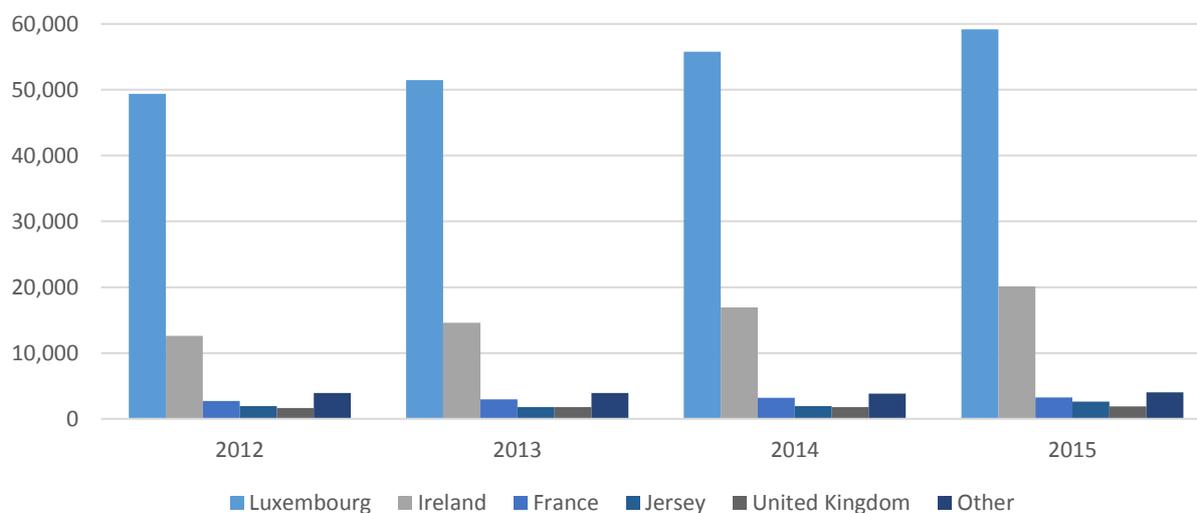
According to FCA data (2016a), the outbound activity of the sector, was above all developed in the sector of private wealth management under MiFID and for alternative funds under the AIFMD, with each time a significant number of UK passports to provide services in other EU countries (see Table 1). The use of UCITS on a cross-border basis has grown significantly (see Figure 3), but cross-border funds are mainly registered in Luxembourg and Ireland (see Figure 4), but managed elsewhere by delegation. The sector thus clearly benefitted from the EU's market integration initiatives, and adapted its business models, with fund registration, asset management and asset servicing spread over different jurisdictions within the same group, or over different firms. It should be added that the EU passport for pension funds was insufficiently single or practical, as pension funds could not be set up on a European level for tax and labour law reasons, which has led to the revision of the IORP Directive.

Figure 3. Share of cross-border investment funds
(% of the net assets of UCITS and non-UCITS)



Source: EFAMA Fact Book 2015, excluding round-trip funds.

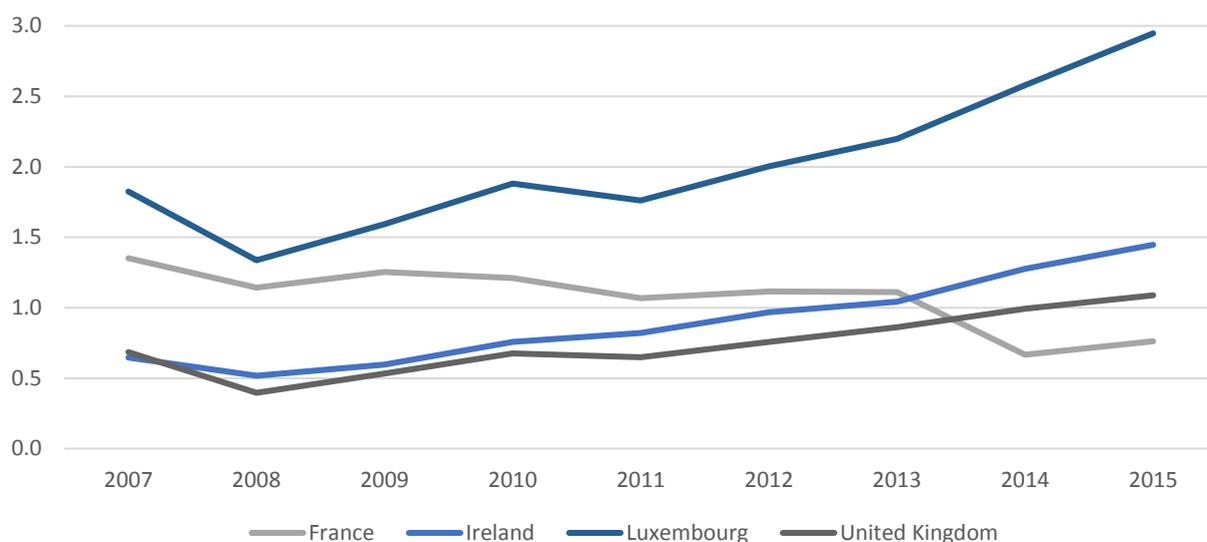
Figure 4. Cross-border UCITS registrations, top 5 domiciles (thousands)



Notes: Only true cross-border funds were taken into account (i.e. funds distributed in at least three countries, including their domicile).

Source: Author's own calculations based on data from Lipper LIM and PwC.

Figure 5. UCITS Net Assets of the top 4 Domiciles (€ trillions)



Notes: The large change for France is due to change in EFAMA’s methodology that took place in Q4 2014. Source: 2016 ECMI Statistical Package.

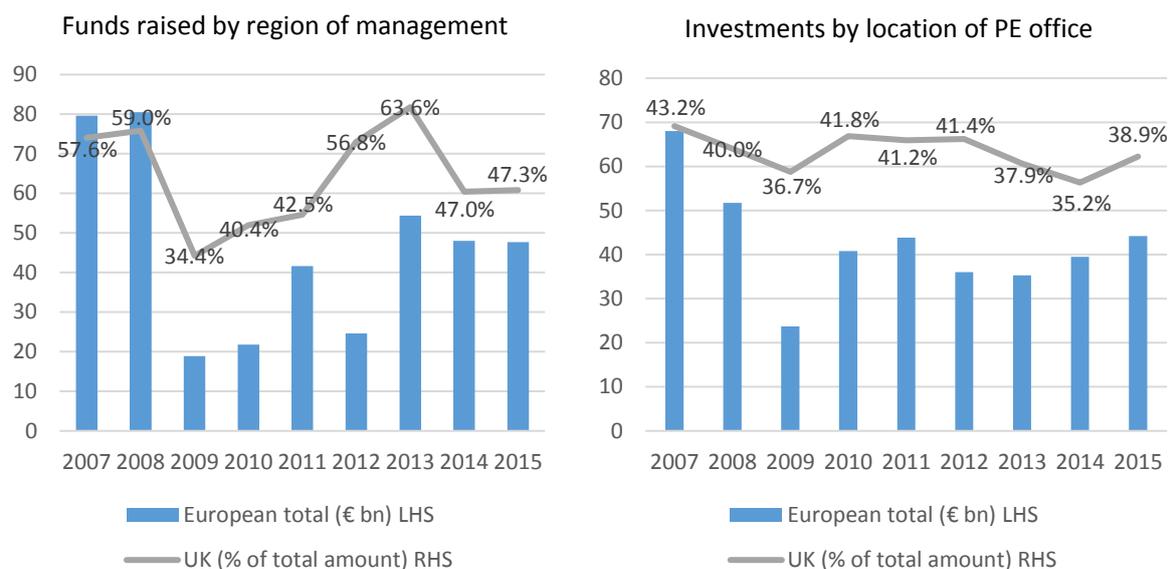
Table 1. Single market passports in the UK for investment providers: Number of firms with at least one passport

Directive/Passports	Outbound	Inbound
MiFID (investment services)	2250	988
AIFMD (alternative funds)	212	45

Source: FCA (2016b).

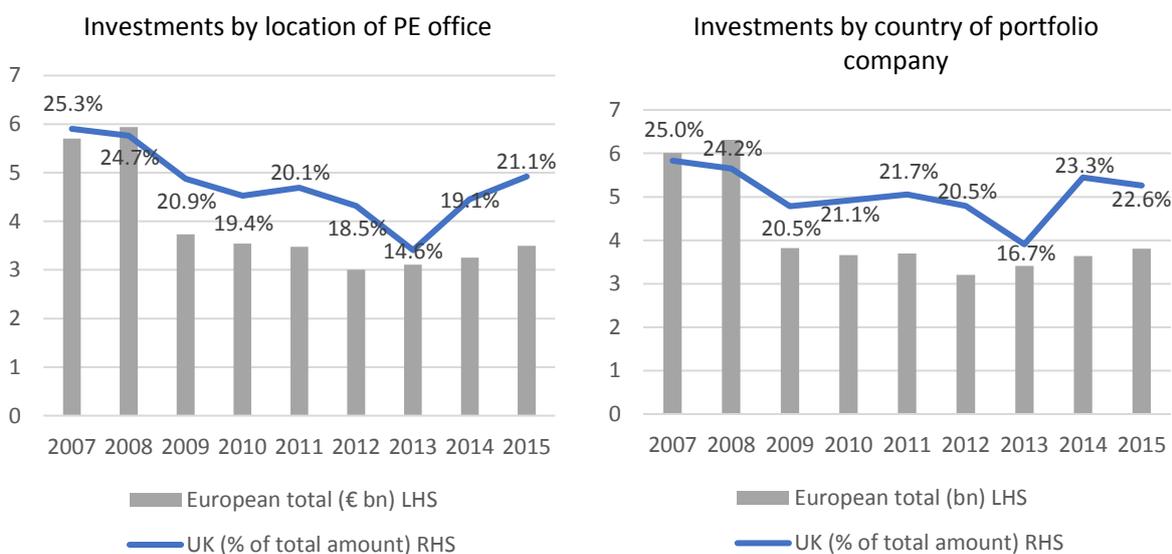
The UK is strong in specific segments of the asset management industry such as hedge funds, private equity and venture capital. In private equity, for example, almost half of the funds are raised in the UK, whereas about 40% of the managers are located in the UK (see Figure 6). Comparable numbers for venture capital are 20% (Figure 7).

Figure 6. All private equity



Source: Author's calculations based on data from Invest Europe/PEREP Analytics.

Figure 7. Venture Capital



Source: Author's calculations based on data from Invest Europe/PEREP_Analytics.

The EU rules, equivalence and the impact of Brexit

Brexit poses four main risks to the UK asset management sector: the loss of the passport, the constraints by EU supervisors on outsourcing of core activities to third countries, the limitations on the management of EU assets from the UK for EU and third countries, and the impact on financial infrastructures. But it will also possibly limit the access to the UK market by EU-based firms.

As the sector is complex and spread over different layers, there are a multiplicity of EU rules governing asset management, and they were considerably expanded as a result of the financial crisis. The rules

set the single passport for services providers: brokers and investment services, insurers, pension funds and alternative funds and investment products (UCITS and ELTIFs). EU rules also define the conditions for financial infrastructures, such as for clearing and settlement, which are consequential given the importance of vertical integration in the sector (see Lannoo, 2015).

The expected 'hard Brexit', or the termination of EU membership two years after the invocation of Art. 50 of the Treaty (TFEU) without a clear new trade regime, will relegate the UK to a third country under EU law. The basis for access to the EU's single market is the equivalence assessment, which determines that a third country's regulatory and supervisory framework should achieve the same results as the corresponding provisions in EU law. This requires, however, that the relevant EU harmonising directives and regulations have set the parameters for such an equivalence assessment. Equivalence decisions are taken unilaterally by the European Commission, within the framework foreseen by the relevant measures, and can be revoked at any time. They are prepared on the advice of the European Supervisory Authorities (ESAs). EU regulations foresee that certain functions can be delegated to non-EU managers, subject to certain conditions being satisfied, including among others the existence of an equivalence decision.

Comparing the different rules in place, there is no overall third-country regime in the EU's financial services, but rather a spectrum of regimes, going from no to very extensive provisions. As regards the asset management industry, the most important provisions are discussed below, and are subdivided between the front- and the back-office functions.

At the front-office level, three asset management activities are expected to be the most affected by Brexit: the cross-border marketing and distribution of mutual fund products under the UCITS Directive by UK and EU27 based firms and similar for alternative funds under the AIFMD, and the brokerage and portfolio management under MiFID II (MiFIR). Solvency II, covering insurance companies, and the related Insurance Distribution Directive (IDD), have no specific third country regimes, hence there is no market access for third countries, apart from freedom of establishment.

The cross-border distribution of UCITS will end for the UK with Brexit, although certain asset management functions can continue to be performed in the UK. UCITS IV, adopted in April 2009, allows for the pooling of assets across borders in the EU and introduced the concept of the management company. Management companies may delegate functions to third-country undertakings, but it cannot delegate the totality of its functions to one or more third parties, and this cannot hinder effective supervision over the management company (Recital 16, Art. 13). Management companies can be based in another country than the UCITS home country and also in third countries, on the condition that appropriate procedures exist for the exchange of information among supervisors and effective supervision.

The same will apply for asset servicing under UCITS, i.e. the cross-border provision of asset servicing will become more difficult for UK based firms. Under UCITS V, adopted in the wake of the Maddoff scandal, a strict separation is in place between the management company and the custodian, and the delegation of the safekeeping of assets. In case safekeeping is delegated to a third party, which can be in a third country, effective supervision must be in place.

The AIFMD has the most developed third-country regime, as many alternative funds are incorporated outside the EU. The regime foresees that until 2018, a non-EEA manager has to be authorised as a manager in the EEA by the EEA regulator in its "member state of reference", which only delivers a national passport. But starting from 2016, an EU passport co-exists with the national passport. This EU passport can be extended to non-EU managers, further to an assessment by ESMA (see e.g. Majoor,

2016). For the UK-based hedge funds, this means that an EU passport decision on the extension of the passport will be needed to the UK after Brexit, or a national authorisation in an EU member state will be required. But Brexit may also facilitate the management of non-EU funds in the UK over time, when UK rules get loosened as compared to the EU27.

The regulation of investment services providers and markets is contained in MiFID II and MiFIR. Access for third countries is based on an equivalence assessment as well for markets and investment services providers, but for the latter, it includes only eligible counterparties and professional clients, meaning that a base within the EU is required for providing services to retail clients. MiFID II also significantly updates the conduct of business regime for asset managers, and requires a distinction between paid and unpaid investment advice, following the Retail Distribution Review in the UK.

Table 2. Third country provisions in EU asset management legislation

MiFID II (brokers and trading venues)	<ul style="list-style-type: none"> • Commission to adopt equivalence assessment, but this is for investment services limited to eligible counterparties and professional clients • ESMA to register third-country firms (from equivalent jurisdiction) • ESMA to establish cooperation arrangements • Member states can licence third-country service provider, but only within their territory, no Single Market access • Equivalence assessment of third-country markets (Art. 25.4)
UCITS (investment funds)	<ul style="list-style-type: none"> • No specific third-country regime • Equivalence assessment for third countries' supervisory system of management companies of UCITS (Art. 7.1) (see Art. 14 MiFID) • Delegation of tasks to third country undertaking depends on existence of equivalence agreement and appropriate exchange of information (Art. 13)
AIFMD (managers of non-UCITS funds)	<ul style="list-style-type: none"> • Until 2018: Non-EEA manager has to be authorised as a manager in the EEA by the EEA regulator in its "member state of reference" • From 2016: EU passport co-exists with national passport • ESMA to propose standards of conditions of equivalence of third countries (Art. 37) and the extension of the passport, annual peer review by ESMA of supervision of third country AIFMs (Art. 38)

From a **back-office perspective**, the core piece of regulation is the central securities depositories Regulation (CSDR), which has a regime very similar to what was already in place in EMIR, governing central counterparties (CCPs). Both regulations harmonise the operating conditions for financial infrastructures in the EU, and allow for cross-border competition and interoperability. They set extensive procedures for the recognition of third-country infrastructures in which ESMA is to recognise third-country CSDs and CCPs after an equivalence decision by the Commission. But once this is obtained, access for third-country infrastructures is much less constrained than for front-office activities.

Table 3. Third country provisions in EU financial infrastructure legislation

CSDR	<ul style="list-style-type: none"> • Equivalence of third-country supervisory regime, subject to Commission Implementing Act • ESMA to recognise third-country CSDs and establish cooperation arrangements
EMIR (CCPs)	<ul style="list-style-type: none"> • Equivalence of third-country supervisory regime, subject to Commission Implementing Act • Third-country CCPs can provide clearing services after equivalence assessment by ESMA (Art. 25) • Cooperation arrangements between supervisors

The problem is that, in case of non-equivalence, capital charges for banks' exposures to CCP's in derivatives clearing may increase multi-fold, further to the capital requirements regulation (CRR). EU27 banks are significant users of UK CCPs and vice-versa, but the UK is by far the dominant centre for clearing. Derivative instruments are used in capital guaranteed fund products but also by asset managers to reduce risk in portfolio management.

Remuneration policies and constraints have become a common feature of any EU post-crisis rules covering financial services providers in general and asset managers in particular. They are designed to constrain risk-taking by managers, or to ensure that it protects the interests of the asset holders. The UK has been fairly outspoken against these limitations, and challenged the rules governing bankers, as contained in the CRDIV, before the Court of Justice of the European Union. In its assessment on third country regimes for alternative investment funds for extension of the passport, ESMA also assessed the remuneration rules, for example (ESMA, 2016). They may therefore become an important stumbling block in any equivalence discussions.

Large asset management groups will, dependent upon their business model, combine different licences and passports under one roof. They may be more front office and distribution oriented, and have many different UCITS product licences, a UCITS management company, an AIFMD or MiFID passport. They may be more back-office or asset servicing oriented, combining a bank and a financial infrastructure (CSDR) licence. Asset management firms that centralised in the UK with multiple passports will see their model affected and will have to fragment operations to other EU countries. This however is dependent on the interpretation on the delegation of functions to third countries by local supervisory authorities.

Conclusions

In the process of developing into a global financial centre in Europe, the UK, and London in particular, has specialised in asset management activities, for both wholesale as well as private clients in Europe and the rest of the world. Further growth of this segment, as well as other segments of financial services, is likely to be negatively affected by the loss of the single market passport, for both EU and foreign clients, and the limitations of equivalence assessment for third-countries' access to the EU market under EU law. Letterbox asset management companies in the EU27 for large UK-based firms are unlikely to be tolerated by EU supervisors in the post-crisis context, as delegation is conditioned by the equivalence assessment, and supervisors will be worried about their liability.

The impact of the loss of the passport will be most deeply felt by large groups, which often group different passports under one roof. As the trend towards concentration is also pronounced in the asset

management business, it will also affect the capacity of the City and the UK to attract and retain its status as the European home country of large asset management companies, many of which are of American parentage.

But the departure of the UK out of the single market will also render access by EU based asset managers to financial services providers more difficult. Asset managers need access to a variety of specialised financial services providers for portfolio and treasury management, such as the use of derivative financial instruments and repurchase agreements (repo's) of assets, which are traditionally available in large financial centres.

Leaving the EU could on the other hand provide some scope for regulatory competition for the UK, but this will mostly be limited to the new entrants and fintech firms in the asset management domain. The UK is likely to adopt the 'regulatory sandbox' approach also in this field, which the EU will not necessarily be capable of doing, because of the single market and the level playing field between 27 member states.

Given the special status of the UK as a financial centre, it would be advisable to have a more comprehensive equivalence agreement, covering all the different regulations and directives, rather than taking the current third-country regime as the base. This should be part of a bilateral procedure between the UK and the European Commission. As it looks now, Brexit will be fairly abrupt, leaving asset managers limited time in which to adapt their value chains. This will be disruptive for the entire European industry.

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