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FINANCIAL SERVICES - EXPERT GROUP REPORTS (JULY 2006)

EFRP RESPONSE

The EFRP welcomes the European Commission's initiative to consult with the industry at large to identify priorities for action in respect of the investment fund industry. An open and transparent consultation process improves the quality of legislation and EFRP is keen to contribute to it.

EXECUTIVE SUMMARY

The EFRP has analysed with great interest the findings of the three Expert Groups because:

- the reports address issues which may have implications for other financial services operators involving asset/fund management such as those who provide services to IORPs
- investment funds will play an increasing role in providing investment opportunities for pensions savings vehicles.

Broadly we are in agreement with the conclusions of the Expert Groups:

➤ **INVESTMENT FUNDS**

Action should focus on **extending the opportunities offered under the existing legislative framework for UCITS**. UCITS should be equipped with a modern and efficient legislative framework to face the challenges of market integration. The identified inefficiencies should be addressed by improving and modernising the UCITS Directive.

➤ **ALTERNATIVE INVESTMENTS - PRIVATE EQUITY and HEDGE FUNDS**

IORPs are qualified investors and are perfectly able to assess the risk and return characteristics of hedge funds. **Additional regulation might hinder their innovative capacity** to search for additional investment returns. Private equity is an adequate asset class for IORPs to search for real investment returns. The existing degree of **self regulation and best practices** developed by the industry are sufficient.

We would also like to refer to the **EFRP response to the Green Paper on Investment Funds**¹ to complete our views as expressed about some more focussed issues in the Expert Groups reports.

A summary note of our response to the Green Paper is **attached** as Annex 1.

¹ Available on our website: www.efrp.org

I. REPORT OF THE EXPERT GROUP ON INVESTMENT FUND MARKET EFFICIENCY

The EFRP agrees that UCITS regulation could contribute to enhancing their efficiency. This is important since UCTIS will undoubtedly increase their role as long term savings – pension - products. The identified inefficiencies should be addressed by **improving and modernising the UCTIS Directive**.

The EFRP was somewhat surprised that the Expert Group expressed pessimism regarding the future of pan-European pension funds. It is simply **too early** to assess the development of pan-European pension funds. Member States are still implementing the IORP Directive and pension funds managers are assessing the possibilities of the IORP Directive.

We agree that many aspects of pensions are indeed connected to the local market but we take this as a given. It is a way to adjust the pension product to the local preferences and to fit it into the three pillar pension structure. As set out in the report, we agree that national pension structures will not be dismantled soon. Therefore any assessment of pension products should be made within the context of the three pillar pension structure.

We regret that no **representative from the IORPs** – as a wholesale, or institutional, investor – was included in the Members List of this Expert Group. This probably explains why the report mainly presents the perspective of a product provider. It may be helpful to include in future also the angle of the institutional investor.

Comments on specific issues raised:

AUTHORISATION AND NOTIFICATION RULES, P. 8

The Expert Group pointed out that authorisation and notification procedures have become in some Member States long and cumbersome procedures. The Expert Group proposed to amend the UCITS Directive to align its authorisation and notification rules among Prospectus Directive timescales.

The EFRP fully agrees with the proposal of the Expert Group. The correct interpretation of authorisation and notification rules is critical for facilitating the provision of services across border.

A **notification** procedure should **not be a time consuming** procedure and should not in any way be part of the authorisation procedure. Any Member State imposing notification as an approval process is failing to implement the provisions of the UCITS Directive.

We recommend that the EU Commission takes a clear position on these fundamental issues to safeguard the efficiencies and benefits of an EU single passport.

REVISING THE SIMPLIFIED PROSPECTUS, P. 9

The Expert Group recommends revising the simplified prospectus so that it becomes a fully and automatically recognised document containing key disclosures for investors.

It is vitally important that investors are fully informed so that they are able to make a proper evaluation of the different investment products. If UCITS are to provide products for long term savings, it is important the product characteristics are very well understood. This in particular includes full disclosure of cost and fee structure throughout the savings period.

There need **not be a legal obligation** to provide a simplified prospectus in the **language of the host country**. Market forces will dictate whether or not consumers are in need of a national language version of the simplified prospectus.

EFFICIENT MERGER OF FUNDS, P. 13-14

The Expert Group recommends expanding the UCITS Directive to include arrangements for fund mergers and to take actions to ensure that fund mergers do not give rise to adverse tax implications.

We support the recommendation of the Expert Group to facilitate cross border fund mergers. Fund mergers should have no cost or tax consequences for the investor. Tax indeed remains the most important barrier to cross border mergers of funds.

Mergers do lead to greater efficiencies, lower fixed costs, economies of scale and thus increased net investment returns. However, it is important to assess to what extent the cost savings will be passed on to the individual end investor. UCITS are operated by commercial providers and they have to manage conflicting interests (management company, shareholders and unit holders). There are some doubts as to whether individual retail investors will benefit from the realised cost savings because they do not have any negotiating power nor would they be expected to know that such benefits to them may arise. Institutional investors are more likely to benefit from the efficiencies realised.

The fund merger may have consequences on the composition of the underlying assets and on the investment policy of the investment fund. The investor should be adequately informed on all these implications.

ASSET POOLING, P. 19

The Expert Group recommends to allow the centralised management of assets owned by different funds.

We agree with the Expert Group recommendations. Asset pooling can lead to greater efficiency and significant cost savings at both production and distribution levels. However, asset pooling also involves the costs of setting up and using the pooling structure. It is not always the case that synergies will outweigh the cost of centralisation.

As with fund mergers, it is unclear to what extent the cost-savings will be passed back to the individual end investor. Pooling techniques should be clear and transparent for investors.

PENSION POOLING, P. 20

The Expert Group considered that it remains impossible to establish in Europe, a European pension fund entity containing the assets of pension funds of a large group with operations in multiple European countries.

The Expert Group recommends that CEIOPS should review Member States' transposition of the Occupational Pensions Directive to confirm that pooling is, indeed permissible.

The assessment of the Expert Group regarding pension fund pooling is incorrect.

We regret that the Expert Group failed to define the term of pooling. We agree that **liability pooling for defined benefit plans** is highly complex and that it remains doubtful whether it will be feasible to pool these liabilities in the near future, other than for defined contribution plans.

However, many multinationals have already set up pension fund entities **to pool their assets** (for example: IBM, Nestle, Unilever, Shell, etc.). Many others are for the moment assessing the different possibilities offered by the IORP Directive. Annex 2 provides more information on **Uninvest** – the pension asset pooling vehicle of Unilever.

We would like to highlight that CEIOPS is a Level 3 Lamfalussy body for supervisors in the field of insurance and occupational pensions. It has **no role to review Member States compliance with EU legislation**. There would be a conflict of interest. CEIOPS may provide factual information or make policy recommendations to the EU Commission about EU legislation, but the responsibility for assessing national compliance remains entirely with the EU Commission as guardian of the Treaties.

MANAGEMENT COMPANY PASSPORT, P. 20

The Expert Group recommends to allow fund managers to provide core management services to funds domiciled in other Member States.

The EFRP fully agrees with these recommendations. In a European market we have to promote specialisation as it leads to greater efficiencies, economies of scale and cost savings. It is outdated and in breach of EU principles to restrict the provision of certain services to national providers only.

II. REPORT OF THE ALTERNATIVE INVESTMENT EXPERT GROUP – PRIVATE EQUITY

We broadly agree with the views taken in this report. However, some points of this report are worthwhile to highlight in respect of the functioning of the European private equity market:

1. we believe that the **current mix of self imposed industry standards** (created in conjunction with major investors) and a **light-touch supervisory oversight** forms a sufficient basis; additional supervision of private equity funds would provide little additional value
2. we strongly believe that for IORPs the “**prudent person**” **concept is essential** in order to safeguard the returns necessary to provide inflation protected pensions. Arbitrary (quantitative) restrictions would imply the end of the competitive advantages of a pension product (cfr. Ph. Davis²)
3. we believe a **better cross border fund structuring for cross border investing and capital raising** will reduce costs and risks and will also make European industry more efficient and competitive.

Furthermore, we consider that private equity is an **adequate asset class** for IORPs in terms of portfolio and risk diversification aimed at enhancing investment returns necessary to provide inflation protected pensions. Our information suggests that those IORPs that invest in private equity – mainly large funds – hold between 3 and 5 % of total assets in private equity funds.

IORPs are long term vehicles whose liabilities (which are often real in nature, ie linked to inflation) stretch out over many decades and we are **concerned about the supervisory approach** which is increasingly becoming short term. The supervisors typically have a 1 to 3 years time horizon. In view of its illiquid nature and the “J-curve” return it produces, private equity is normally a long term investment that offers a real return to investors. The typical life cycle of a private equity investment with its “J curve” needs time in order to mature and generate adequate returns. A short term supervisory approach will be counterproductive and could also make private equity (because of the compensation for these risks) expensive. This in its turn will hinder the functioning of efficient national and European economies

Experience shows that private equity in the longer term is providing attractive higher returns than the risk free rate of return, to those prepared to take the long term view. It seems to be a continuing challenge to explain to supervisory authorities the **need for a long term approach to secure optimal real returns.**

Finally, we should point out that private equity investment is naturally ‘capacity strained’ since at any time there can be a shortage of investment opportunities relative to the cash commitments of investors, this further reinforces the need of

² E.P. Davis, Prudent Person rules or quantitative restrictions? The regulation of long-term institutional investor’s portfolios, in: Journal of Pension Economics and Finance 2002-2

investors to be long-term in their nature, as any rush to get such commitments invested in the short-term can lead to artificial spikes in prices.

PRUDENT PERSON RULE

The Expert Group considered that “there is a growing need for a “prudent person” concept to be applied to institutional investors across the EU. This could start with investor groupings for which such a concept already exists but which is still inconsistently applied through national implementation of the IORP Directive”.

The call of the Expert Group to extend the prudent person concept to other institutional investors than IORPs is to be supported. Should this occur, we recommend focussing on enhancing investor protection through increased **transparency and full disclosure of the investment process being undertaken, and all costs and fees.**

The report refers to the inconsistent application of investment rules under the IORP Directive at a national level. It is our view that the implementation process is not yet completed throughout the EU and that we still need some time to assess the consistency of national implementation with the EU law.

Nonetheless, we are convinced that the **prudent person concept**, combined with suitable transparency and reporting requirements should form the **cornerstone of any institutional investment process.** An investment policy, based on quantitative investment limits, is counterproductive and generates suboptimal returns. Therefore an adequate set of principles is much more valuable than a set of prescriptive investment rules.

Under the prudent person rule, the prudence of the investment process as well as the risk and return profile of the whole diversified investment portfolio are central. The risk attached to an individual investment is at a portfolio level less relevant. This distinguishes the prudent person rule from quantitative investment restrictions. Those apply generically and therefore take insufficient account of the assets and liabilities of each pension fund. To explain this to many supervisory bodies also is a challenge, but one we and our members continue to rise to.

In respect of the further development of the prudent person rule in Europe we received the suggestion to align the content of this concept with the **American Uniform Prudent Investor Act (UPIA)**. The principles set out in this act are in line with the prevailing investment theories and in this legislation a natural link is made between law and economics. Moreover, its principles are dynamic and they take into account new insights in the field of prudent asset management. Alignment with the UPIA will also contribute to a “transatlantic” or even global interpretation of the prudent person rule. EFRP is happy to provide the Commission with further details on this issue.

III. REPORT OF THE ALTERNATIVE INVESTMENT EXPERT GROUP – HEDGE FUNDS

We broadly agree with the thrust of this report. Some issues deserve specific comment:

1. the removal of unproductive legal and/or regulatory impediments is the key to the free movement of capital within the single market and to fully release growth potential;
2. hedge funds fulfill an important and sometimes under-stated role in terms of market efficiency, along with liquidity and thus market efficiency;
3. additional regulation will not accommodate the need for a sufficient level of investment freedom and would drive the hedge funds and some of its investors offshore; it would limit the funds' innovative capabilities;
4. better valuation methods and risk management practices can be developed through the best practices stemming from the industry itself.
5. we would rather limit access to hedge funds to 'qualified investors' and ensure proper supervision and regulatory requirements at the level of the management company

Since there is some difficulty in providing an appropriate definition of what constitutes a hedge fund, it also is problematic to gather data on pension fund investments in hedge funds.

We broadly estimate that those IORPs that allocate to hedge funds do so to around 5 % of their total assets. Allocations vary by country and the larger Dutch and UK funds are leaders in this area.

A particular point of concern is that although IORPs are professional investors and hence fully qualified to assess the risk/return characteristics of hedge funds, some Member States prevent them from investing in hedge funds or their access is restricted to domestically located hedge funds. Such restrictions are outdated, do not deliver any useful prudential effect and are often circumvented by using less efficient and less transparent constructions. We wonder whether the IORP Directive implementation could help to remedy this unhelpful regulation.

Specific comment

The Expert Group report argues that (p. 23) “under-funded pension funds are seeking new asset classes or investment styles offering access to equity like premium without all the associated risks. Because of their focus on absolute performance and risk control and because they offer non-linear return profiles, hedge funds are particularly useful in an asset/liability management context”.

This statement is not correct. In general hedge funds cannot generate “equity like returns without a similar level of risk. What is important though is that these risks are different from those in equities, and therefore hedge funds offer a good source of diversification to pension funds in achieving their investment objectives at a total portfolio level...For this reason, hedge funds are useful instruments to all pension

funds and not only to the under funded ones as stated in the report. For under-funded IORPs a **realistic recovery period** (in line with the duration of the liabilities and the investment horizon of the IORP) is the **most appropriate** and sensible route to take.

Under the umbrella of “hedge funds” it is possible to put together a broad range of different strategies in different asset classes. So from this point of view it is fair to say that hedge funds -depending on their strategies and underlying instruments- are able to offer diversification and attractive - risk-adjusted - returns. Some of the individual strategies may be very volatile , but when combined appropriately with other non-correlated strategies can produce an attractive risk adjusted return. One of the main attractions of hedge funds is that their returns generally rely on the “skill” of the fund managers employed, and this skill can be rewarded in both rising and falling markets, so as a result the **returns** from hedge funds will be **uncorrelated with the different asset classes** in which the pension fund otherwise invests.

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ANNEX 1 - EU COMMISSION GREEN PAPER ON THE ENHANCEMENT OF THE EU FRAMEWORK FOR INVESTMENT FUNDS

EFRP KEY MESSAGES:

- **REGULATORY DIFFERENCE IS NOT NECESSARILY MARKET DISTORTIVE**

There is and should not be competition between IORPs (= institution) and UCITS (= product).

EFRP supports the basic idea that:

- the same activity should be regulated by the same rules
- different rules which do not have equivalent effect must be justifiable either by reference to specific objective factors or to the presence of other overriding elements.

EFRP believes that in occupational pensions, the **social policy dimension** automatically limits mechanical application of competition policy

- **WORKPLACE PENSIONS ARE MORE THAN JUST LONG TERM SAVING PRODUCTS**

Workplace pensions are long term saving products with specific elements that go beyond the mere savings or investment aspects. There are objective difference between occupational pension funds and the mere asset management:

- insurance elements in the pay-in and pay-out phase
- asset liability management
- capital adequacy rules
- compliance with social and labour law
- governance

- **THE IORP DIRECTIVE SHOULD BE GIVEN TIME TO OPERATE AND TO DELIVER**

The IORP Directive must be given sufficient time to “bed down” before any amendment is proposed to it.

- **THE IORP DIRECTIVE DOES NOT EXCLUDE OTHER FINANCIAL SERVICES PROVIDERS FROM PROVIDING OCCUPATIONAL PENSIONS OR OPERATING UNDER THE IORP DIRECTIVE AS A MANAGING ENTITY**

No provision in the IORP Directive prohibits other funded financial services providers from providing occupational pensions. Each Member State remains free to choose the design of their workplace pension’s architecture.

- **FOCUS ON CORRECT TRANSPOSITION AND ENFORCEMENT OF IORP DIRECTIVE**

The focus should be on correct transposition of FSAP measures and enforcement of correct implementation. A legislative pause does not mean inactivity.

- **THE ADDED VALUE OF PENSION SCHEMES WHICH ALLOW RISK SHARING AMONG MEMBERS OF THE SAME COMPANY/INDUSTRY OR ANY OTHER CONSTITUTED GROUP SHOULD BE FULLY UNDERSTOOD BY POLICY MAKERS**

Research suggests that collective occupational pension arrangements are more cost efficient than individual occupational pension accounts. UCITS and collective investment funds in general should focus on improving transparency of their governance and policy as well as full disclosure of all costs and fees

- **PRIVATE EQUITY AND HEDGE FUNDS ARE USEFUL OPTIONS FOR PORTFOLIO DIVERSIFICATION OF PENSION FUNDS**

Pension funds would not like to see that investments in private equity and hedge funds becoming viewed as problematic and subjected to per se restrictions. Private equity and hedge funds are mainly used by qualified investors to enhance investment return.

ANNEX 2 – EXAMPLE UNIVEST – PENSION ASSET POOLING VEHICLE OF UNILEVER

Example: **Univest** - a new pension asset pooling vehicle which gives the opportunity to leverage the strengths of Unilever and its national-based pension funds³.

The pooling vehicle is a Fonds Commun de Placement (FCP), established in Luxembourg. Local Unilever pension funds retain full ownership of their assets invested in Univest, through being unit holders in a series of multi-manager regional equity sub-funds with best-in-class managers. All the sub-funds are ring-fenced from one another and enable each individual Unilever pension fund to continue to define its own geographical investment strategy.

The Management Company manages the vehicle with critical input from the Univest Investment Committee, which brings together the investment expertise from across Unilever and the participating pension funds.

³<http://www.unilever.com/ourcompany/newsandmedia/pressreleases/2005/NewUnileverpensionassetpoolingvehicle.asp>