EUROPEAN
COMMISSION

Brussels, 26.6.2013
SWD(2013) 231 final

COMMISSION STAFF WORKING DOCUMENT

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

Proposal for a
REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
on

European Long-term Investment Funds

{COM(2013) 462 final}
{SWD(2013) 230 final}

1. INTRODUCTION

A consequence of the crisis has been to highlight the problem of investors' focus on short term economic gains which comes at the expense of the underlying purpose of capital markets which is to finance growth in the real economy.

There is a need to encourage investors to make longer term commitments to assets such as infrastructure projects by providing 'patient capital' rather than chasing short term gains. This kind of longer term investment may not be able to be redeemed for a number of years but can provide stable and predictable returns. This also benefits the real economy by providing finance to firms and creating employment.

Investors with longer term liabilities such as pension funds and insurers may find longer term investments attractive. But there are no readily available pooling mechanisms such as funds to facilitate this in a way that takes account of the size, scale and duration of the commitment to those long term investments that is needed. This is also acts as a barrier smaller investors such as SMEs and high net worth individuals as well as and retail investors.

This Impact Assessment (IA) looks at whether the creation of a cross border product framework for long term investments, so-called Long-Term Investment Funds (LTIF), could stimulate institutional and/or retail investor demand for such assets. This work compliments the Commission Green Paper on Long Term Financing of the European Economy.

2. PROBLEM DEFINITION

Problem drivers

Long term investment in infrastructure projects, SME financing and the like can be done through a variety of financial instruments, for example, equity participation and loans. These instruments often share the common characteristics of being non-transferable and illiquid with little or no secondary market. Investment in such assets can require very large up-front commitments of capital which can deter even major institutional investors from acting alone given the amount of money needed. Unlike the market for liquid, transferable assets such as securities, there is no standard framework for such investments. Some Member States (MS) provide national mechanisms in the form of recognised investment vehicles, others do not. This fragmentation prevents the development of a single market for investors who wish to gain exposure to long-term assets which often offer predictable returns but are illiquid by nature.

Investing in long-term assets, whether via financial instruments or in real assets, entails substantial risks when these investments are not properly managed. The first risk is that investors are misled as to the nature and risks of the assets they invest in due to the lack of a harmonized approach to these assets. Uncertainty exists over the identity of long-term assets, their risk and returns profiles and recommended holding periods. The second risk is linked to the characteristics of the assets, namely that they are illiquid in nature. The third risk is linked to the fact that funds offering access to these assets might not possess the relevant expertise in selecting and monitoring assets and tailoring a fund’s return profile to the needs of potential clients. Due to these reasons, LTI funds have not always performed according to plan and investors have sometimes been misled about the return that has been promised.

The problems

As a result there is no common, comparable cross border standard for what long term assets or investments are, who they may be suitable for and how they function. This is in contrast to the cross border market for liquid assets which benefits from the Undertakings in Collective Investments in Transferable Securities (UCITS) Directive standardisation of product rules. The EU's UCITS fund market has €6,350 billion of assets under management.

These factors have led to fragmentation in the market for long term investment vehicles across the EU. This has discouraged investors from exploring this market as unlike for UCITS there is no common, recognisable and regulated product structure they can have confidence in. The Alternative Investment Fund Managers Directive (AIFMD) will create an EU passport for managers who wish to offer non-UCITS funds across borders shortly. But the AIFMD applies to managers, not the funds they offer and so it does not create product rules or definitions for differing types of asset classes. It is therefore unlikely to address the problem identified. Smaller investors face even greater barriers as the AIFMD does not create a passport for managers to offer cross border retail investment funds so different national approaches will continue.

This has led to a range of undesirable outcomes. Costs for managers remain higher than they might otherwise be as cross border investment requires them to deal with a range of legal and product issues in different MS. Funds are smaller than they might otherwise be and so the impact of costs on any investment return or yield is proportionately higher. Retail investors are unable to access funds in other MS that they are familiar with and have confidence in. Costs remain high and the choice of funds is restricted. As a result other smaller and retail investors are unable to enjoy the diversification benefits that access to long term investments could otherwise bring.

The real economy is also affected as alternative ways of financing long term growth are restricted and so firms continue to rely primarily on bank financing which has moved its emphasis on to short term commitments. This restricts the amount of capital firms have access to from both institutional and retail investors and so acts as a brake on their ability to invest for the long term and create growth and employment for the economy.

3. ANALYSIS OF SUBSIDIARITY

Fund managers, investment targets and investors are domiciled throughout the Union. Because the asset management sector is essentially of a cross border nature, the current fragmentation of the LTI market has led this sector to operate below an efficient level. National regulatory approaches to addressing this are however inherently limited to the Member State in question. Regulating the product profile of an LTI fund at national level has led to a situation where many different fund regimes have evolved independently. National action has impeded the emergence of a Union-wide internal market for those who offer LTI funds to their investors.

The creation of a stable cross border mechanism to encourage LTI is desirable and could form part of the drive for economic recovery. Long experience with UCITS suggests that EU-wide product rules and requirements can prove to be a highly successful way of stimulating investment into the relevant assets.

Therefore action at European level to create a single market for long term investment funds is needed.

4. OBJECTIVES

The general objectives are to: (1) increase the means for long-term financing across all sectors of the economy and (2) increase the coherence of the single market. To do this requires three specific objectives are met. These are: (1) enhance economies of scale for managers of LTIF, (2) increase the choice and protection for investors interested in them and (3) increase investment flows into assets with long-term horizons.

Achieving this in turn requires two operational objectives are carried out: (1) remove the barriers to a single market for funds targeting long term assets which would expand the investor base and (2) reduce opportunities for mis-selling of LTI vehicles.

5. POLICY OPTIONS

To meet the two operational objectives the IA sets out seven policy options relating to both product rules and different types of investors. These range from taking no action to creating product rules for a cross border LTIF available to both institutional and retail investors. Each option is relevant to both operational objectives.

Option 1	No action
Option 2	Develop a 'soft' label but not a passport
Option 3	Allow UCITS, which already have a passport, some exposure to long term assets
Option 4	A new fund, the LTIF, would be created with a distinct set of portfolio rules relating to the classes of long-term assets that are eligible for investments. This new LTIF would be open to institutional investors only
Option 5	Same as option 4 but the fund would be open to High Net Worth Individuals (HNWI) as well.
Option 6	The LTIF would be open to all investors, including retail investors. This would entail stronger investor protection requirements. To match the long-term nature of the assets, there would be no redemption rights.
Option 7	The same as option 6, but including redemption rights, after an initial lock-in, for example for three years.

6. ASSESSMENT OF THE IMPACTS OF THE RETAINED OPTIONS

Option 1 of taking no action is not acceptable as it does nothing to address the issues identified.

Option 2 would involve non-legislative measures to encourage the convergence of funds targeting long term investments or marketing themselves as long term investment funds. This would most likely require the creation of a voluntary product label and code. While it would be a low cost option for managers it may only achieve traction if MS choose to amend their national rules to support it, so it is unlikely to address the problem of fragmentation.

Option 3 would allow a limited amount of assets that are both illiquid and not transferable to be held within a UCITS. This would give retail investors access to long terms assets as well as giving funds that are at least partly invested in long term assets a passport. However, it would cut across the fundamental UCITS principle that investors are able to redeem their investments at any time. This has given investors confidence in UCITS. Any change to it risks undermining its success and causing confusion about the types of assets UCITS may invest in and the risks inherent in them. A number of asset managers have also signalled their objection to such a change as they too are concerned it could undermine UCITS' success.

Option 4 would create a recognisable LTI product capable of being sold to institutional investors across the EU via a passport. The rules would be modelled on those in UCITS in relation to, for example, eligibility of assets, but would apply to assets that are illiquid and long-term in nature. This would not address the problem that smaller and retail investors will continue to be excluded from making such investments so they would not be able to diversify their portfolios accordingly or contribute to the available pool of capital.

Option 5 would allow what are often called high net worth individuals or HNWI regarded as able to accept higher levels of investment risk access to such funds. Otherwise it is the same as option 4. While it would have the effect of widening the available pool of capital and extending to availability of further diversification to more investors, it still excludes retail investors from the potential benefits of investing in such funds.

Option 6 would allow funds as defined under option 4 which do not allow redemptions to be marketed to retail investors across the EU via a passport. This would allow the widest range of investor’s access to such funds so maximising the potential pool of capital available to make such investments. To address investor protection standards needed for retail investors, the fund will be subject to product rules designed to ensure enough diversification, address conflicts of interests, increase transparency about costs, and limit the use of leverage. This inevitably implies some extra costs. Greatly improved and harmonized product rules may mitigate risks of mis-selling. This will aid institutional investors as well as retail, building confidence in long-term assets. Making the fund take a closed-ended form has the advantage of permitting investments in all types of long-term assets as the structure better matches the illiquidity profile of these assets. Such a solution has the merit of being transparent as to the long-term commitment that investing in such assets requires.

Option 7 is the same as option 6, except that it allows redemption rights. Redemption rights would be available after a set period, for instance three years, after which investors would have access to their money on a regular basis. While this would reduce the danger of retail investors being locked in against their interests it does not, given the illiquid nature of long-term assets, eliminate it altogether. It would also mean funds would have to maintain a liquidity buffer to ensure they are always able to meet redemption requests. This would reduce the proportion of illiquid long term assets held within funds, so reducing the portfolio diversification benefits they offer to investors and cutting the amount of money available for investment in long-term assets.

Retained option

On this basis, looking at options 1 to 7, option 6 appears to offer the greatest effectiveness and efficiency in creating a common definition and reducing barriers to a flourishing single market for LTIF. By including retail investors, it will open up untapped capital sources, and it will stand a stronger chance of addressing fragmentation across national markets. Further, by permitting managers to market LTIF without redemption rights, it will allow a faster and potentially deeper take up than option 7 due to its flexibility. This option mirrors the existing models that exist in the countries that allow investments of retail investors.

7. MONITORING AND EVALUATION

Evaluation of any legislative initiative is a priority for the Commission. In the case of this proposed regulation the monitoring would relate to the growth or otherwise in a market for EU-wide long term investment funds. Were such a market fail to develop after a reasonable time period then further evaluation would be needed to assess whether the regulations themselves need to change.