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A single market for investment funds – ensuring investor protection and financial stability

February 2021

In the EU, financial services are increasingly provided through “non-bank financial intermediation” (NBFi). By asset value, investment funds are the most important sector of NBFi. They help to ensure the efficient and cost-effective allocation of capital to businesses and provide consumers and investors with a large variety of potentially highly rewarding investment opportunities.

The EU has gradually been stepping up its regulation of the investment funds sector, and increasingly so since the 2008 financial crisis. The EU aims to provide an effective level playing field for investment funds, based on strong consumer and investor protection, whilst ensuring financial stability.

EU bodies are responsible for creating a set of common rules, fostering supervisory convergence and assessing the risks to investors, markets and financial stability, and for coordinating efforts to mitigate systemic risks.

However, since EU law in this area largely takes the form of directives, many of the detailed rules governing investment funds are determined at Member State level. Thus, there may still be significant regulatory differences from one Member State to the next. Moreover, the day-to-day supervision of investment funds remains a national competence.

The European Court of Auditors has launched an audit of the EU’s progress towards creating a single market for investment funds. As well as addressing the suitability and effectiveness of the evolving regulatory framework, we intend to examine whether it has promoted supervisory convergence among Member States.

This is the latest in a series of audits in which we focus on supervision in the EU’s financial sector, as we have previously done in relation to banking and insurance.

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Contents

Investment funds	4
Legal framework	8
Roles and responsibilities	8
A sector facing various challenges	9
Focus of the audit	11

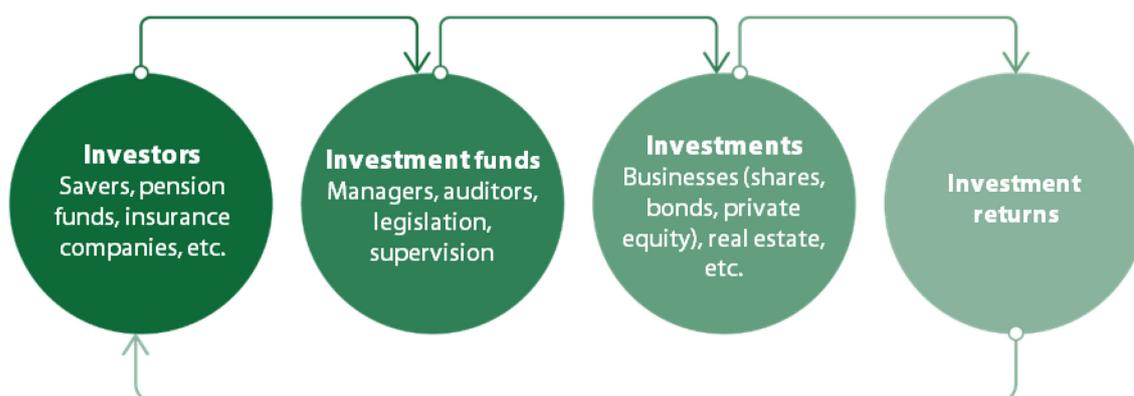
Investment funds

Investment funds play an important role for both businesses and investors

Investment funds are products created with the purpose of pooling investors' capital and investing it collectively through a portfolio of assets such as stocks, bonds and real estate.

Investment funds are important to the business sector, where they provide an efficient and cost-effective means of raising capital and finance for expansion and innovation. They are also essential to private and corporate investors seeking returns above bank rates (see [Figure 1](#)).

Figure 1 – Investment cycle and key actors



Source: ECA.

UCITs and AIFs

Investment funds can be broken down into **two main categories**:

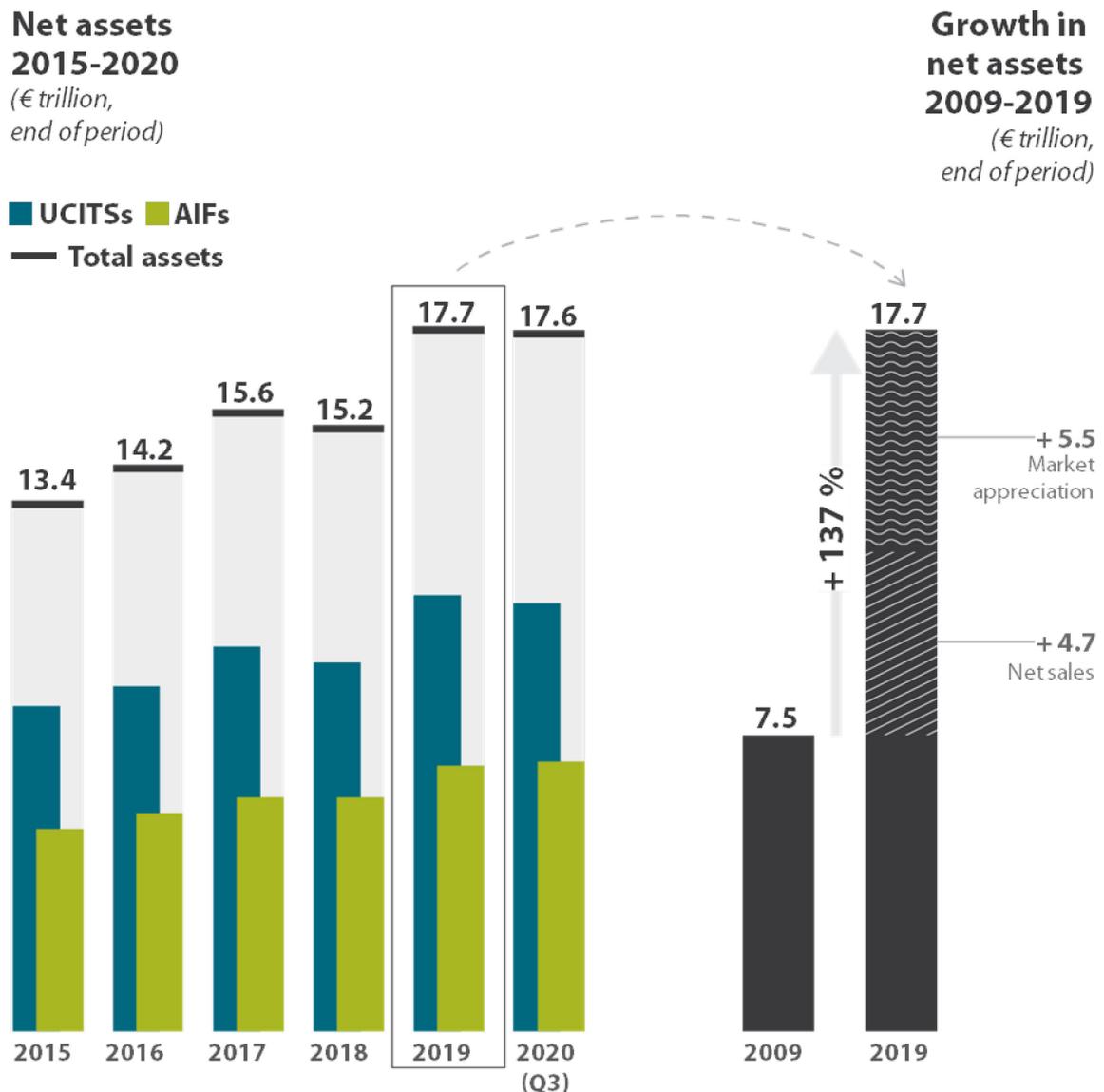
- Funds targeting retail investors, known as **undertakings for collective investment in transferable securities** (UCITs). These include bond funds, equity funds, certain money market funds, mixed funds and most exchange-traded funds.
- **Alternative investment funds (AIFs) for professional investors**. These include all funds that do not meet the UCITs requirements: real estate investment funds, private equity funds, certain money market funds, hedge funds, funds of non-UCITs funds and a large miscellaneous category of “other funds”.

European investment funds have been steadily growing in recent years

At the end of September 2020, the net asset value of the approximately 64 000 investment funds domiciled in Europe amounted to around €17.6 trillion¹ (see [Figure 2](#)).

That value has soared in the last decade, growing by more than €10 trillion since 2009. About half of the growth has been fuelled by higher valuations and retained profits from existing assets, the other half by new sales of investment funds. Globally, the European investment fund market² remains second in value only to that of the USA.

Figure 2 – Net assets of European investment funds (2015-2020) and growth in net assets (2009-2019)



Source: ECA, based on data of EFAMA.

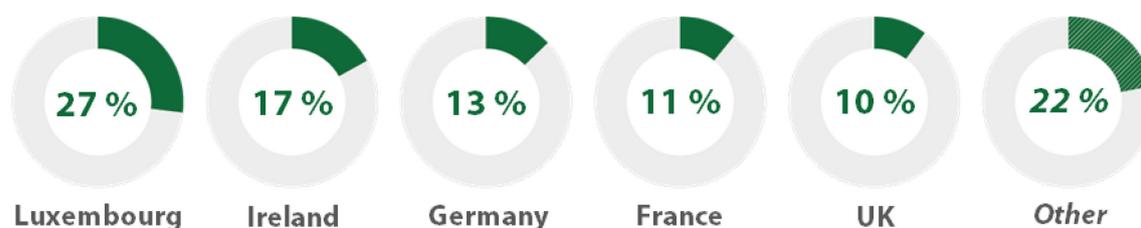
The split between UCITSs and AIFs by net assets is roughly 60/40. At the end of September 2020, the average net asset value of individual funds in Europe was €316 million for UCITSs, and €230 million for AIFs³.

The increasing role of investment funds brings benefits in terms of diversification, but may also pose challenges to financial stability in the EU.

The investment fund industry is concentrated in a few European countries

The vast majority of European investment funds are domiciled in just a handful of countries (see [Figure 3](#)).

Figure 3 – Breakdown of net assets by domicile in 2019 (EU and the UK)



Source: ECA, based on data of EFAMA.

In 2020, almost 80 % of all net assets under management were held in Luxembourg (€4.70 trillion), Ireland (€3.08 trillion), Germany (€2.39 trillion), France (€1.97 trillion) and the UK (€1.60 trillion)⁴. In the case of UCITSs, more than half of all net assets are domiciled in Luxembourg or Ireland.

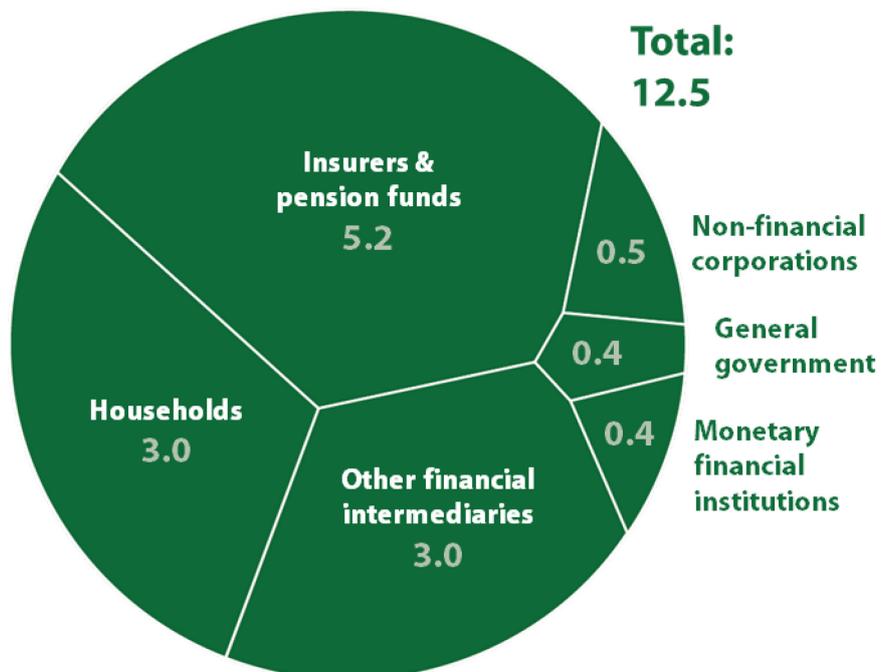
As of 2021, investment funds domiciled in the United Kingdom have to request authorisation from national authorities, in the same way as any other non-EU domiciled funds, so that they can operate in the EU. ESMA has issued guidance to ensure convergent supervisory practices on relocating investment funds in the context of the UK's withdrawal from the EU⁵.

Despite efforts to further develop the EU single market for investment funds, as recently as 2018 some 70 % of all assets under management in the EU were held by funds authorised or registered for distribution in just one Member State. By numbers of funds, only 37 % of UCITSs and just 3 % of AIFs were registered for distribution in more than three Member States⁶.

Two thirds of investment funds are directly or indirectly owned by households

Currently, more than 40 % of investment funds are owned by insurers and pension funds, and 24 % by other financial intermediaries (see [Figure 4](#)). Another 24 % are directly owned by households⁷. Indirectly, however, through insurance contracts and pension funds, households own almost two thirds of the total net assets of all EU investment funds, which demonstrates the importance of consumer (i.e. investor) protection in this area.

**Figure 4 – Direct ownership of EU investment funds
(€ trillion, end of Q2 2020)**



Source: ECA, based on data of EFAMA.

Common principles relating to fees and charges

As part of its 2015 Capital Markets Union (CMU) action plan⁸, the Commission enacted legislation to facilitate the cross-border distribution of collective investment funds by removing regulatory barriers. The new uniform rules, adopted in 2019⁹, include common principles relating to the fees and charges of funds operating across borders, and provide for the establishment of a new central database with information on cross-border marketing.

While the new rules promote fee transparency, the EU investment fund market is still segmented. As a result, EU investors continue to pay higher fees than their counterparts in the USA: on average, exchange-traded funds in the USA are 25 % cheaper than in Europe¹⁰.

In September 2020, the Commission adopted a new action plan on the CMU¹¹. The new plan focuses on the core aim of the CMU, to get investment and savings flowing across the EU, benefitting citizens, investors and companies, regardless of where they are located.

Legal framework

Investment funds domiciled in the EU are mainly governed by one of two directives:

- the **UCITS Directive** (adopted 2009)¹²;
- the **AIFM¹³ Directive** (adopted 2011)¹⁴.

The most recent amendments to the UCITS and AIFM directives are contained in **Directive (EU) 2019/1160¹⁵**, which focuses on removing regulatory barriers to the cross-border distribution of investment funds by coordinating the rules applicable to fund managers.

Roles and responsibilities

While each Member State has competence for the day-to-day supervision of investment funds in its territory, EU bodies are responsible for the underlying legislative and coordination work.

National competent authorities (NCAs)

NCAs are the Member State bodies responsible for the regulation and micro-prudential supervision of investment funds.

DG FISMA (Commission)

The **Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA)** is responsible for regulation of the financial sector, which includes

proposing directives and regulations. It also adopts or rejects regulatory and implementing technical standards proposed by the three European supervisory authorities, which are the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). DG FISMA is assisted in its work by the European Securities Committee, a high-level body of Member State representatives chaired by the Commission.

Other specialised supervisory EU bodies

The **European Securities and Markets Authority (ESMA)** is an independent body charged with enhancing investor protection and promoting stable and orderly financial markets. It relies on the NCAs of the EU and European Economic Area countries, drawing on their resources and expertise. As well as coordinating the implementation of the EU legislation on investment funds (through a joint supervisory handbook, guidelines and implementing standards), it acts as a central repository of information and statistics on all EU funds.

The **European Systemic Risk Board (ESRB)** is responsible for macro-prudential oversight of the EU financial system. By collecting and analysing information, identifying and prioritising systemic risks and issuing warnings and recommendations, it seeks to prevent or mitigate any disruption to financial stability within the EU. It works closely with ESMA, which is required to provide the ESRB with information essential to its work and, like the Commission, to act on ESRB recommendations.

A sector facing various challenges

Creating a level playing field for investment funds in the EU

The EU is responsible for regulating investment funds to guarantee the conditions for financial and economic stability, as well as consumer and investor protection.

The EU's legislative process aims to ensure a "level playing field" for investment fund managers, investor protection and the market's financial stability. EU regulations also aim to create a single competitive market for fund management companies across the EU, thus giving investors a wider choice of products they can trust and reducing the fees they have to pay.

One aspect of achieving this goal was the introduction of a "European passport", which allows UCITs and AIFMs to provide their services and/or market their activities across

the EU. The first UCITS passports were issued in 1985, and a similar scheme began for AIFMs in 2011. Nowadays, both UCITSs and AIFs domiciled in the EU benefit from the European passport, allowing them to be marketed in all EU Member States. In principle, only UCITSs can be marketed to retail investors, but NCAs can also authorise AIFMs to market units or shares of AIFs to retail investors in their territory.

Since EU law in this area still largely takes the form of directives, many of the detailed rules governing investment funds are determined at Member State level. Thus, there may still be significant regulatory differences from one Member State to the next. Moreover, the supervision of investment funds remains a national competence.

Potential risks to financial stability due to COVID-19

In 2020, the ESRB identified various risks and areas of potential vulnerability in the investment funds sector¹⁶. For example, the ESRB considers insufficient cash positions to be a key risk, as they reduce a fund's capacity to absorb large outflows of the kind experienced in March 2020, in the context of the COVID-19 pandemic (see [Figure 5](#)).

**Figure 5 – Monthly net sales of investment funds
(December 2019 – May 2020; € billion)**



Source: ECA, based on data of EFAMA.

Other key risks identified by the ESRB include the high indebtedness of some hedge funds, which can amplify shocks, and credit risk, which has increased due because of low interest rates and the resulting search for higher returns. The ESRB and ESMA have also highlighted that, despite improvements in national data collection, gaps in accessible data and standardisation prevent a full risk assessment.

Risks arising from regulatory and supervisory arrangements

Investment fund managers can delegate certain tasks and responsibilities (e.g. portfolio management services) to other entities as a way of increasing efficiency and accessing external expertise. According to ESMA, however, such delegation arrangements may also increase operational and supervisory risks, in particular where the other party is established in another Member State or outside the EU¹⁷.

ESMA's main objective is to promote supervisory convergence in the EU's investment fund industry. However, supervisory competence is still largely a national matter. It can be complicated for NCAs to obtain access to supervisory information and exercise their supervisory powers where investment fund managers set up branches or delegate tasks in other EU Member States. In its contribution to the Commission's consultation on the mid-term review of the Capital Markets Union, the ECB argued that, in the longer term, a well-functioning CMU will require the way rules are implemented and enforced to be strengthened, and will warrant an appropriate supervisory architecture.

Focus of the audit

In the EU, financial services are increasingly provided through “non-bank financial intermediation” (NBFI). NBFI is attractive to businesses as an efficient means of raising capital, and to investors because of its variety and potentially high rewards. By asset value, investment funds are the most important sector of NBFI.

Investment funds also play an important role in the CMU.

This audit will assess **the effectiveness of the EU's efforts to set up a single market for investment funds to better ensure investor protection and financial stability.**

To that end, we will examine whether the regulatory framework is appropriate, whether the EU's work has promoted supervisory convergence among Member States, and whether the EU has assessed and effectively mitigated the risk to investors, markets and financial stability throughout the EU.

We will focus on the activities of DG FISMA and ESMA in relation to the regulation and supervision of investment funds marketed in the EU to both retail and professional investors. The audit will therefore cover all types of investment funds.

This is the latest in a series of audits in which we focus on supervision in the EU's financial sector (see [Box 1](#)).

Box 1: ECA special reports on banking, insurance and capital markets

- Special report 5/2014: European banking supervision taking shape – EBA and its changing context
- Special report 22/2015: EU supervision of credit rating agencies – well established but not yet fully effective
- Special report 29/2016: Single Supervisory Mechanism – Good start but further improvements needed
- Special report 2/2018: The operational efficiency of the ECB's crisis management for banks
- Special report 29/2018: EIOPA made an important contribution to supervision and stability in the insurance sector, but significant challenges remain
- Special report 10/2019: EU-wide stress tests for banks: unparalleled amount of information on banks provided but greater coordination and focus on risks needed
- Review 5/2020: How the EU took account of lessons learned from the 2008-2012 financial and sovereign debt crises
- Special report 25/2020: Capital Markets Union – Slow start towards an ambitious goal.

ABOUT ECA SPECIAL REPORTS AND AUDIT PREVIEWS

The ECA's special reports set out the results of its audits of EU policies and programmes or management topics related to specific budgetary areas.

Audit previews provide information in relation to an ongoing audit task. Since we identified the issues underlying these areas of enquiry before the audit work commenced, they should not be regarded as audit observations, conclusions or recommendations. They are based on preparatory work undertaken before the start of the audit and are intended as a source of information for those interested in the policy and/or programme being audited.

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- 1 European Fund and Asset Management Association (EFAMA), Quarterly Statistical Release, No 83, December 2020.
 - 2 EFAMA statistics, covering all EU countries except Estonia, Latvia and Lithuania, and also covering the following non-EU countries: Liechtenstein, Norway, Switzerland, Turkey and the UK.
 - 3 EFAMA, Quarterly Statistical Release, No 83, December 2020.
 - 4 EFAMA, *ibid.*
 - 5 ESMA, Opinion 35-43-762 on supporting supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union.
 - 6 See European Commission: Explanatory memorandum to the Proposal for a Directive amending Directive 2009/65/EC of the European Parliament and of the Council and Directive 2011/61/EU of the European Parliament and of the Council with regard to cross-border distribution of collective investment funds, COM(2018) 92 final, 12.3.2018.
 - 7 EFAMA, Quarterly Statistical Release, No 83, December 2020.
 - 8 European Commission, “Action Plan on Building a Capital Markets Union”, COM(2015) 468 final, 30.9.2015.
 - 9 Regulation (EU) 2019/1156 on facilitating cross-border distribution of collective investment undertakings, OJ L 188, 12.7.2019, pp. 55-66.
 - 10 European Commission, “Distribution systems of retail investment products across the European Union”, Final report, 2018.
 - 11 European Commission, “A Capital Markets Union for people and businesses – new action plan”, COM(2020) 590 final, 24.9.2020.
 - 12 Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302, 17.11.2009, pp. 32-96.
 - 13 AIFM stands for “alternative investment fund managers”.
 - 14 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010; OJ L 174, 1.7.2011, pp. 1-73.
 - 15 Directive (EU) 2019/1160 of the European Parliament and of the Council of 20 June 2019 amending Directives 2009/65/EC and 2011/61/EU with regard to cross-border distribution of collective investment undertakings; OJ L 188, 12.7.2019, pp. 106-115.

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- ¹⁶ European Systemic Risk Board (ESRB), Non-bank Financial Intermediation Risk Monitor (NFI) Monitor, No 5, October 2020.
- ¹⁷ ESMA, Letter to the European Commission on the Review of the Alternative Investment Fund Managers Directive, 18 August 2020.

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