

The dangers of regulation without impact assessment

Written by

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Regulation inevitably involves trade-offs but regulators must understand the full effects their activities will have before signing anything into law

The decade that has followed the global financial crisis has, perhaps unsurprisingly, seen a lot of regulatory activity around financial institutions – and investment funds have felt the full brunt of those efforts. While safeguarding measures are certainly laudable, it is important their effects are assessed in an empirical and rigorous fashion, taking note of potential trade-offs.

[UCITS](#) (Undertakings for the Collective Investment of Transferable Securities) is a European Commission regulatory framework for the management of mutual funds. The framework is characterised (distinct from that governing hedge funds) by a clear set of requirements.

Tight net asset reporting requirements are in place to ensure transparency and to protect investors from misreporting. There are strict rules around operational and internal controls, and for conflicts of interest. UCITs-compliant funds are also

required to have a separate risk management function, and leverage and value-at-risk limits apply. There are restrictions on eligible assets and on short selling. And there are very strict rules around liquidity, with funds required to provide biweekly liquidity to investors.

Higher liquidity means lower returns; this will have an effect on wealth accumulation, and pensions further down the line

It is this last aspect on which we are going to focus here. This may seem, on paper, a sensible thing to ask of funds; a way to protect investors from rogue schemes that allow no way out. But it is not quite so simple. Tight liquidity requirements can have a negative effect on returns, as a study conducted by [Juha Joenväärä](#) and myself discovered.

This empirical study served an important function, one that is essential during any regulatory process that strives to be considered and accurate: it offered a period of measured and precise observation, after which potential revisions can be considered based on whether the observed trade-offs are desirable. The FSA commissioning an impact assessment of its AIFM Directive in 2009 was a good example of due diligence.

Higher liquidity, lower returns

What are the trade-offs in this case? While liquidity requirements for hedge funds are considerably laxer, annual risk-adjusted returns for UCITs funds were around two per cent lower than for hedge funds, for which liquidity requirements are considerably laxer. This is because tighter regulations mean UCITs funds can't earn the same liquidity premiums. In short, you can't have everything. Higher liquidity means lower returns; this will have an effect on wealth accumulation, and pensions further down the line. Perhaps for some regulators and investors this seems worthwhile, but it is important this is explicitly acknowledged.

When investors have the ability to liquidate quickly, they will do so when the portfolio experiences losses. It's not a great idea though, as investors are often not very good with market timings

There will also be an effect on the types of investment strategy that can be pursued by the fund. If you have to be certain you can liquidate in two weeks, you will not be able to invest in anything that takes longer than that. Some corporate bond funds, for example, trade infrequently. This will eat into the risk premium that comes with trading in illiquid, harder to sell assets. Some distressed debts and event-driven strategies will also be closed off to the fund.

This will be a deal breaker for firms who have built long-term strategies that are not compatible with these high liquidity requirements

At least liquidity serves as a protection mechanism for investors though, right? Well, again, it's not that simple. One of the misconceptions around liquidity is that it is something you can give to investors to protect themselves. There's a lot of evidence that shows that, when investors have the ability to liquidate quickly, they will do so when the portfolio experiences losses. It's not a great idea though, as investors are often not very good with market timings – at timing inflows and outflows. The results may end up being more damaging.

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Evidential and precise

Regulation of any kind must be evidence based. There are certainly trade-offs that are worth making, but they need to be carefully planned. Before anything, there should be a consultation period, during which evidence can be submitted. A meta-analysis of other studies can be supplemented by an independent internal study if the regulator has the resources available to them. This applies to climate change regulation as much as it does to financial, and to everything else in between and beyond.

While we found an adverse performance impact related UCITs liquidity requirements, this does not apply to the entire set of regulations – indeed, our very point is that we need to be precise. Net asset value reporting has a positive impact on the reliability of returns, for example.

When regulating any sort of market, it's important to fully understand the dynamics involved. Regulatory processes must understand the incentives and risks involved, and quantify trade-offs. If this is not the case, there could well be unintended

consequences.

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Robert Kosowski is a Professor in the Finance Group of Imperial Business School, Imperial London. He is also a research fellow at the Centre for Economic Policy Research (CEPR) and an associate member of the Oxford-Man Institute of Quantitative Finance at Oxford University. Robert is on the editorial board of the Journal of Alternative Investments and a member of AIMA's research committee.

Professor Kosowski holds a BA and MA in Economics from Trinity College, Cambridge University, and a MSc in Economics and PhD from the London School of Economics. His research interests include asset management, risk management, hedge funds, mutual funds, performance measurement, business cycles, derivative trading strategies and economic forecasting. Robert's research has been published in top peer-reviewed finance journals such as The Journal of Finance, The Journal of

Financial Economics and the Review of Financial Studies. His book Principles of Financial Engineering (co-authored with Salih Neftci) was published in 2014.

Professor Kosowski has consulted for private and public sector organisations in the areas of asset and risk management including Goldman Sachs, the Boston Consulting Group and Deutsche Bank. His policy related advisory work includes: Specialist Adviser to UK House of Lords (2009-2010), Expert Technical Consultant (International Monetary Fund, 2008, 2016).

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