Frankfurt am Main,
17 March 2016

BVI Position on the consultative document of the Basel Committee on Banking Supervision: Identification and measurement of step-in risk

BVI[1] gladly takes the opportunity to present its views on the proposed conceptual framework for banks on identifying, assessing and addressing step-in risk. We would like to focus our comments on the proposals for asset management activities and funds under management presented under section 5.4 of the consultation paper and discussed with regard to question 7.

I. No need for a new framework in the asset management area

In general, we welcome the approach to review the scope of application of the prudential framework for risks of banks potentially embedded in their relationships with shadow banking and other entities. However, we strongly disagree with the conclusion that there is a need for a new framework with the general aim of avoiding or minimising risks such as step-in risk in the field of asset management activities and funds under management. As we understand the proposal presented in the consultation paper, only those activities of a bank should be part of the proposed framework and should be identified as step-in risk which provide financial support to asset managers or their managed funds in times of market stress, beyond or in absence of any contractual obligation to do so.

We would like to draw the BCBS' attention to the fact that, as a consequence of the financial crisis, very strict legal requirements in the asset management sector have already been implemented or are under discussion. These requirements are intended to enhance the prudential resilience of asset managers and their funds under management, thereby materially reducing or excluding the possibility of any of them encountering serious financial difficulties. After applying these relevant regulatory requirements, step-in risk measured as probability of a bank's intervention as a last consequence to avoid reputational damage will not occur or is considerably minimised. The consultation paper is short of detail in this respect. In particular, we miss a comprehensive assessment of the regulatory framework and the market development in the asset management area after the financial crisis. Therefore, we generally reject the proposals with regard to asset management activities and funds under management presented under section 5.4 of the consultation paper. Otherwise, we see a great danger of an unjustified over-regulation which is not commensurate with risks potentially arising from asset management activities and funds under management.

II. Individual cases do not allow conclusions to be drawn for the entire asset management area.

We would like to highlight that the examples of certain types of funds presented in the consultation paper where step-in of banks during the financial crisis occurred are not representative for the whole asset management sector and funds under management. These individual cases do not allow at all a final conclusion regarding whether there are comparable step-in risks in the whole asset management area

[1] BVI represents the interests of the German investment fund and asset management industry. Its 95 members manage assets of some EUR 2.6 trillion in UCITS, AIFs and assets outside investment funds. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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which should be mitigated by a new framework. Hence, experience during the financial crisis has shown that the following historical examples were only exceptional cases of step-in by banks:

- **Money market funds (MMFs):** As a starting point for a new regulatory framework in avoiding step-in risk, the consultation paper refers to an example of certain types of money market funds (MMFs) such as institutional prime funds in the U.S. and similar types in Europe. In fact, some so-called "Constant Net Asset Value" (CNAV) MMFs were supported by banks to preserve their net asset values in cases of credit losses, credit transitions or liquidity constraints during the financial crises. In this context, we would like to highlight that MMFs remain a very unique product category which is explicitly marketed as short-term investments and therefore cannot be considered representative for other products of the asset management industry. It should also be taken into account that only a relatively small proportion of retail investment funds are MMFs, let alone CNAV MMFs (please see the attached overview of asset classes of retail funds in Europe, **Annex**).

  However, as already described in the consultation paper, we would like to point to the existing framework for MMFs since 2008 in the EU and in other jurisdictions around the world, including the SEC reform in the U.S. market. In particular, the EU regulator has adopted in May 2010 "CESR's Guidelines on a common definition of European money market funds"[2] supplemented by an ESMA Q&A[3] in February 2013. In order to make MMFs more resilient to future financial crises and to secure their financing role for the economy, the European Commission proposed a new Regulation on Money Market Funds (MMFR) in September 2013. In particular, the new framework provides further restrictions on portfolio concentration, weighted average maturity and weighted average life of the portfolio assets, rigorous stress testing and valuation rules. Moreover, the European Parliament's amendments to this proposal of April 2015 contain specific elements to address the issue of sponsor support. Therefore, this framework is already meant to mitigate step-in risk for MMFs. Moreover, the MMFR also covers retail MMFs. Any concerns described in the consultation paper that the potential for a bank to step-in remains for retail MMFs is already addressed through the anticipated MMFR.

- **Retail property funds in Germany:** As another example, we observed individual measures of step-in taken by banks to support open-ended retail property funds during the financial crisis in Germany. Property assets are illiquid assets and considered as long-term investments but the open-ended structure of retail property funds enabled investors to redeem fund units at any time and without notice. Therefore, with the beginning of the global financial crisis in 2008, some investors of such open-ended retail property funds used their right of daily redemptions extensively with the effect that some property funds were not able to fulfil requests of redemption to all investors because of the lack of liquidity. As a consequence, a very small number of retail open-ended property funds were supported by banks with liquidity to avoid the risk of suspension of redemptions. The majority of property funds which were affected by liquidity shortage only used the legal possibility to suspend redemptions of units allowed in unusual circumstances in which a suspension appears necessary to protect the interests of investors.

  In response to these circumstances, the German legislator has already adopted a new investment regulation (implemented by the "Investor Protection and Capital Markets Improvement Act, AnsFuG, and the Capital Investment Act, KAGB) which is to help German retail open-ended proper-

[2] Cf. Ref. CESR/10-049.
[3] Cf. Ref. ESMA/2012/113.

ty funds limit excessively high short-term outflows of liquidity and to support the character of open-end funds as long-term investment. Investors of open-ended retail property funds are no longer allowed to redeem their units on short notice. In particular, a minimum holding period of 24 months and a cancellation period of twelve months for investors apply. A *de minimis* redemption threshold without notice period of 30,000 Euro per half-year has been abolished by recent legislation. All in all, we can say that German open-ended retail property funds have left the turbulences of the past behind towards a more stabilized and transparent framework which is also designed to avoid any step-in risks for banks.

Moreover, we would like to point out that the cases described under paragraph 87 (the first two sub-items) are clearly lacking practical relevance. In general, we cannot think of any financial or reputational incentive for providing additional financial support to fund investors (as a defined step-in risk) in the case where the bank (or a third party) has already provided limited guarantees or commitments to investors on a contractual basis. Furthermore, with regard to the last sub-item of paragraph 87, relevant investments in funds or loans to the funds made by banks are already covered by the current capital requirements of the Basel framework implemented in the EU Capital Requirement Directive (CRD) and the EU Capital Requirements Regulation (CRR). On the basis of the sophisticated legal framework applicable to asset managers and funds as described above, we do not see any potential for step-in risk on the part of banks beyond the scope of their contractual commitments.

III. The European legislator has already done his homework.

In the meantime, the European legislator has already adopted new legal requirements for asset managers which are intended to avoid or mitigate any historically realised or furtherly feared step-in risks. In particular, following the two rounds of amendments to the UCITS Directive after the financial crisis (the so called UCITS IV Directive of 2009 and the UCITS V Directive of 2014) and the adoption of the new AIFMD in 2011, strong legal requirements for asset managers with focus on protection of the interests of investors apply in Europe.

- **Acting in the best interest of investors:** Asset managers manage funds or assets outside investment funds on behalf of investors and – as a crucial requirement – in the best interest of investors. In their fiduciary role, they are obliged to act in accordance with the investment objectives and guidelines for a given risk/return level. Managers also do not have custody over the assets, as these are held – or more appropriately, “safe-kept” – by separate depositary institutions (usually a credit institution, but with a specific licence). Here the fund assets are kept segregated and are thus never part of the asset manager’s own balance sheet. Importantly, the investment results - whether positive or negative - belong to the investors. Moreover, while asset managers are obliged to inform their investors about the investment strategies and the risk profile of the investment funds, the investment decision is taken by the investor according to his own assessment of risk.

- **Asset managers are subject to strict standards of risk management including stress tests:** In order to minimise the risk of underperformance of the managed funds and to fulfil the general obligation to act in the interest of investors, strict risk management requirements including setting of limits and stress tests to the relevant financial risk of the managed funds apply. [4]

[4] Cf. Article 15 of the AIFMD and Article 38-45 of the Delegated Regulation (EU) No 231/2013 with regard to AIFM or Article 51 of the UCITS Directive and Article 38-43 of the Implementing Directive 2010/43/EU with regard to UCITS managers.

- **Asset managers are subject to strict standards of liquidity management:** Asset managers are required to perform strict liquidity management including definition of liquidity risk limits and liquidity stress tests for each individual fund.[5] Moreover, open-ended funds have at their disposal adequate tools to deal with liquidity shortages, including the possibility to suspend redemptions.

- **Asset managers set leverage limits:** According to the AIFMD, alternative investment fund manager are required to set leverage limits for all managed funds and to disclose information regarding the overall level of leverage employed vis-à-vis investors and competent authorities. Leverage in the asset management sector means any method by which the manager increases the exposure of an investment fund it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means. Therefore, leverage of all investment funds is expressed as the ratio between the exposure of a fund and its net asset value. The main difference between AIF and UCITS is the opportunity to use methods by which the fund manager could increase the exposure of a fund it manages. In principle, the AIF manager can use methods in an unlimited manner, where allowed under national law[6], such as borrowing of cash or securities, or leverage embedded in derivative positions or by any other means. In contrast, the manager of a UCITS is limited in using such methods. In particular, a UCITS is authorised to borrow cash only on a temporary basis (basically in order to account for temporary lack of liquidity) and with a limit of 10 percent of the value of the fund. Moreover, EU member states may authorise UCITS to employ techniques and instruments relating to transferable securities and money market instruments (such as borrowing of securities) under strict conditions and within the limits which they lay down provided that such techniques and instruments are used for the purposes of efficient portfolio management. However, in each case, the UCITS manager is obliged to ensure that the UCITS' global exposure does not exceed the total net value of its portfolio (the so called "200 percent threshold").

- **Competent authorities facilitate analysis of the risk impact of investment funds in the European Union:** According to the AIFMD and the UCITS Directive, information of the risk profile of funds gathered by competent authorities should be shared with other authorities in the Union, with ESMA and with the European Systemic Risk Board (ESRB) so as to facilitate a collective analysis of the impact of the risk profile (including leverage) of investment funds on the financial system in the Union, as well as a common response to potential risks. These measures ensure that competent authorities are able to quickly intervene on a case by case basis in case of identified potential risks to financial stability or to the functioning of financial markets.

IV. The SEC is continuing the overhaul of the U.S. regulatory framework.

While risk and liquidity management including stress testing have been included in the requirements for AIFs and UCITS at EU level, recent calls for comparable requirements for asset managers in other jurisdictions around the world have been advocated, most prominently by the International Monetary

[5] Cf. Article. 48 and 49 of the Delegated Regulation (EU) No 231/2013 with regard to AIFM. In addition, Box 10 of CESR's Risk management principles for UCITS (CESR/09-178) of February 2009 (available under: https://www.esma.europa.eu/sites/default/files/library/2015/11/09_178.pdf) also requires the UCITS management company to provide a system of risk limits to monitor and control the relevant risks (including liquidity risks) for each managed UCITS, as approved by the Board of Directors and found to be consistent with the risk profile of the fund; Box 7 and the relevant explanations under paragraphs 41-43 require the UCITS management company to perform stress tests. The Germen legislator requires the same approach of liquidity management for UCITS managers.

[6] In Germany, all retail AIFs are restricted in using leverage (e.g. by legal investment limits for borrowing of cash or securities or investments in derivatives which are in principle comparable with the restrictions under the UCITS Directive). This also applies for the special funds (AIF) for institutional investors (without hedge funds).

Fund. Therefore, the US Securities and Exchange Commission (SEC) is currently discussing the following new rules which are in principle comparable with the EU requirements for investment funds:

- As an enhanced data reporting initiative, in particular, amendments to the forms used by open-end and closed-end registered investment companies to report information about fund operations and portfolio holdings
- Adequate stress testing methodologies for large asset managers that are mandated to implement stress tests by US law
- Use of derivatives by registered investment companies and business development companies (including proposals for portfolio limitations and risk management programs for derivative transactions)
- Open-ended fund liquidity risk management programs; swing pricing; re-opening of comment period for investment company reporting modernisation release

V. The development of the regulatory framework at international level for the asset management sector is ongoing.

At the end of 2015, the International Organisation of Securities Commissions (IOSCO) published a report[7] on liquidity management tools for collective investment schemes that maps the existing liquidity management frameworks in 26 jurisdictions with a particular focus on tools to help dealing with exceptional situations (e.g. significant redemption pressure). This report sets out clearly, for a large number of jurisdictions, the various frameworks and policy tools currently at the disposal of asset managers and the scope of funds to which they apply. According to the media release[8] published by IOSCO, the report highlights the following observations:

- Many liquidity management tools are available to jurisdictions, some of which are specifically tailored to the features and nature of the funds considered (e.g., money market funds, real estate funds, hedge funds). In particular, most jurisdictions clearly distinguish open-ended schemes from closed-ended ones;

- The most common tools are: redemptions fees; redemptions gates; redemptions in kind; side pockets; and suspension of redemptions. Suspension of redemptions is available in all responding jurisdictions, with the power to activate, in exceptional circumstances, in both the hands of the fund/asset manager and regulator;

- Funds are generally required to have appropriate risk management and internal quality controls to ensure that all material risks are properly identified, assessed, monitored and controlled;

- Open-ended funds are generally subject to additional regulatory requirements dealing with fund leverage, asset concentration, investor concentration, restrictions on illiquid asset investment and short-term borrowings; and

- Historically, many of the liquidity management tools outlined in the report have been activated within individual jurisdictions, with the recent financial crisis being a particularly rich source of recent case studies.

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[7] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf.
[8] Ref. IOSCO/MR/49/2015.

As a future step, IOSCO is conducting work on enhancing collection of data about asset management activities and is considering developing guidance on liquidity risk management beyond its 2013 principles, including on stress testing.

Moreover, for large asset management entities, IOSCO also considers that a full review of asset management activities and products in the broader global financial context should be the immediate focus of international efforts to identify potential systemic risks and vulnerabilities. This review is now ongoing under the auspices of the FSB, with one major workstream focusing on the issue of liquidity mismatch in funds and its potential systemic vulnerabilities. IOSCO and FSB are commonly working on policy recommendations in this area which shall be due for public consultation in the second half of 2016.[9]

VI. The proposed specific approach to asset management entities and funds does not warrant a commensurate response to the declared objective of developing a risk-sensitive and proportional framework.

Regardless of the previous remarks, we strongly disagree with the proposed specific approach under paragraph 88 of the consultation paper that unconsolidated asset management companies should be consolidated or stronger capital requirements with a new conversion approach in relation to the total assets of the fund should apply to banks.

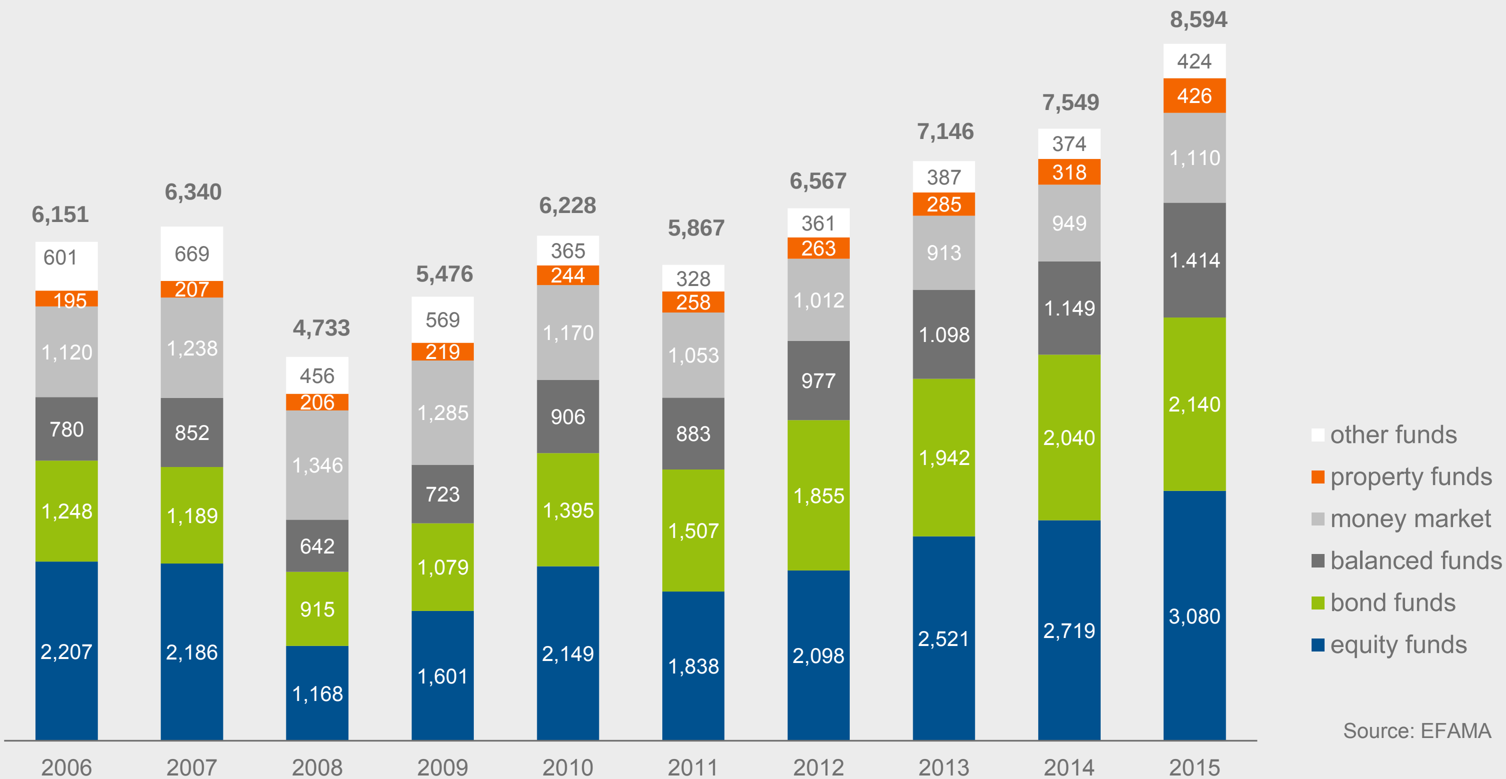
With focus on unconsolidated asset management companies, we would like to draw the attention to the EBA report[10] on investment firms such as certain asset managers. According to this report, the EBA recommends that a more limited set of prudential requirements should apply for non-systemic firms such as asset managers. The reason for this is the EBA analysis that the current prudential requirements do not clearly reflect the lower risks associated with providing investment services by such firms. Developing stricter rules in this field would run counter to the results of the EBA analysis.

With regard to the proposed stronger capital requirements, we would like to highlight that this approach is not in line with the proposed Principle 3 that the new framework should be risk-sensitive and proportional. In particular, a conversion approach with a figure in relation to the total assets of the fund does not consider the special risk situation of asset managers and their managed funds and the negligible potential for step-in by the parent bank (see above). Moreover, we see the great danger that the effects created by such an approach would be disproportionate to the intended objective. In particular, any additional capital requirement could limit asset management activities in a banking group. We see this as an intervention of the legislator with a potentially negative impact of the asset management sector which is already subject to sector-specific high quality prudential rules.

[9] Cf. FSB Chair's Letter to G20 Ministers and Governors on Financial Reforms – Progress on the Work Plan for the Hangzhou Summit dated 27 February 2016 (http://www.fsb.org/wp-content/uploads/FSB-Chair-letter-to-G20-Ministers-and-Governors-February-2016.pdf).
[10] Cf. Ref. EBA/Op/2015/20.

ASSET CLASSES OF RETAIL FUNDS IN EUROPE

Assets under Management of retail funds (in EUR Billion)



Source: EFAMA