Frankfurt am Main,
7 January 2021

BVI[1] position on the inception impact assessment of the European Commission regarding the review of EU rules on alternative investment fund managers

In the EU, a total of EUR 10.7 trillion is invested in investment funds by private and institutional investors. With assets of EUR 3,000 billion, Germany is the largest market (according to the ECB as of 30 June, 2020) with a market share of 27 percent. With an annual growth rate of 7.0 percent, Germany is the second fastest growing market followed by Luxembourg (4.6 percent), Italy (3.9 percent), followed by the Netherlands, England and France. In terms of funds issued in the EU (according to EFAMA as of 30 September, 2020), the German AIF market accounts for EUR 2,002 billion out of EUR 6,325 billion AIF in Europe, which corresponds to a share of 31.7 percent. France follows by a wide margin (EUR 1,143 billion or 18.1 percent).

In a context of continued inflows and growth of the asset management sector, financial stability bodies such as the European Systemic Risk Board (ESRB) and the European Central Bank (ECB) have called for an impact assessment of the resilience of the current framework applying for asset managers. The Policy Recommendations[2] of January 2017 published by the Financial Stability Board (FSB) have significantly rationalised the political debate. Rather than speculatively insinuating systemic risks based on mere quantitative considerations, the FSB addresses potential structural weaknesses in the existing fund regulation in a targeted manner. Accompanied by additional discussions between the roles and tasks of supervisory authorities, the current work is focused on understanding potential implications from asset management activities such as liquidity mismatch of open-ended investment funds and leverage within funds. In this general debate, a distinction will need to be made between the impact on investors to protect their interests and the impact on the financial market to protect the financial stability.

Alternative funds are more than just hedge funds. Asset managers bring together the supply of capital from investors and the demand for capital by businesses and countries around the world. In this way they provide equity capital and debt capital to businesses for growth and innovation and assist states in performing their functions. While hedge funds were the focus of the financial crisis response, the EU alternative funds universe was subsequently defined by lawmakers to be broader, including private equity and real estate funds, but also a large residual of vehicles pursuing diverse strategies mainly in bonds and equity and taken up by institutional investors as the main investors. In terms of assets, hedge funds, in fact, make up only 6 percent of the EU AIF market (at the end of 2018).[3]
Investment funds are intermediaries. They bring together money provided by millions of savers and institutional investors. The vast majority of institutional investors of investment funds are highly regulated entities such as insurance companies, banks or institutions for retirement provision. Although Germans mostly save for their retirement through life insurances or occupational pension schemes, they are indirectly investing in investment funds, as the majority of pension plans invest in specialised institutional funds, i.e. AIFs ("Spezialfonds"). Therefore, investment funds support financial market functioning and the provision of market based finance to the real economy.

---

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset Managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 113 members manage assets more than 3.6 trillion euros for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 27%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.
[2] https://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.
[3] Cf. ESMA Annual Statistical Report, EU Alternative Investment Funds 2020, 10 January 2020, ESMA50-165-1032.

BVI
Bundesverband Investment
und Asset Management e.V.

Contact
Phone +49 69 15 40 90 0
www.bvi.de

BVI Berlin
Unter den Linden 42
10117 Berlin

BVI Brussels
Rue du Trône 14–16
1000 Bruxelles

BVI Frankfurt
Bockenheimer Anlage 15
60322 Frankfurt am Main

Executive Board
Thomas Richter CEO
Rudolf Siebel MD

Existing European sector-specific rules for asset managers provide a robust framework to address investor protection and entity-specific vulnerabilities. Both the UCITS Directive and the AIFMD fully cover the activities of asset managers and provide strict rules on their authorisation, own funds requirements, operation conditions, organisational and transparency requirements, delegation of functions and reporting obligations to competent authorities. In addition, restrictive rules apply for products such as UCITS, money market funds (MMFs), European venture capital funds (EuVECAs), European social entrepreneurship funds (EuSEFs) and European long-term investment funds (ELTIFs).

The strict UCITS requirements, comprising portfolio diversification and eligibility criteria to certain types of assets, have made the product successful on European and global markets. The Eligible Assets Directive as an integral part of the UCITS framework provides the key principles concerning what financial instruments a UCITS can invest in ("eligible assets"). However, the eligibility of an asset for a UCITS must be assessed not only with regard to the Eligible Assets Directive, but also with regard to the other requirements of the UCITS Directive. This involves, in particular, strict risk management processes including liquidity management and contingency planning. Therefore, narrowing down the range of eligible assets is not a commensurate measure to address any perceived shortcomings identified in individual cases of internal and external governance failures on fulfilling the strict UCITS framework requirements as a whole. Instead, we are in favour of further strengthening the governance requirements while retaining the flexibility in terms of eligible exposures. Such an approach represents the best way forward to eliminate potential deficiencies relating to investor protection which may be threatened not by the range of eligible assets, but by inadequate treatment of related risks. In that context, we strongly support IOSCO's call[4] and the European Commission's statement[5] that the responsibility for supervising the correct application of these rules including effective and consistent implementation on liquidity risk management rests with the national competent authorities.

Management of inherent financial risks is an integral part of the internal risk control system. Investment funds are financial products which inherently involve financial risks. While asset managers are obliged to inform their investors about investment strategies and risk profiles of investment funds according to strict transparency requirements including fees, redemption terms and suspension, the decision of the investor to invest in the fund is taken according to his own assessment of risk. In order to minimise the risk of underperformance of the managed funds, strict risk management requirements including setting of limits and stress testing to the relevant financial risk of the managed funds apply. That process involves performing strict liquidity management including definition of liquidity risk limits and liquidity stress tests, in both normal and stressed market conditions, for each individual fund. It is of utmost importance that managing financial risks needs to be observed in the overall context of the individual fund's portfolio including the investment objective, the investment instrument and redemption terms. All of these issues have different effects on the riskiness of the funds' portfolio and give asset managers the flexibility to react depending on current and potential market conditions.

Liquidity management tools should be made available in all jurisdictions. Open-ended funds have at their disposal different tools for dealing with liquidity shortages, including the possibility to suspend redemptions. The wide variety of liquidity management tools across jurisdictions such as exit charges, gates, limited redemption restrictions, dilution levies, side letters which limit redemption rights or notice periods will help to reduce herding effects by the potential use of a limited range of such tools. However, legislators in various jurisdictions need to close the gap to make all liquidity tools set out in

[4] https://www.iosco.org/news/pdf/IOSCONEWS539.pdf.
[5] https://www.europarl.europa.eu/RegData/questions/reponses_qe/2019/002510/P9_RE(2019)002510_EN.pdf.

IOSCO's report[6] available to funds in instances of stressed market conditions. That involves a need for a common understanding based on general principles on EU-level on how to use such tools. In any case, it is at the discretion of the manager of the funds to decide which tools they want to use because of very different fund types and structures. Deployed appropriately, their use or possible use can create a sense of constructive ambiguity amongst individual market participants which can help to encourage better market discipline in stressed situations. As a last resort, redemption should be suspended under the precondition that no other alternative is available under the fund rules or other potential liquidity management tools are considered inappropriate.

There is a need for a common understanding on how to calculate leverage in investment funds. Leverage in investment funds means methods such as the use of derivatives, borrowing of cash or securities which might, but not necessarily increase the ratio of the fund's market exposure over its net asset value. There is a wide variety of funds and fund strategies in different jurisdictions and market structures which allow different methods to increase leverage. In this respect, the use of leverage is not a risk as such. According to the AIFMD, managers of AIFs are required to set leverage limits for the funds they manage, to monitor the leverage and to disclose information regarding the overall level of leverage employed vis-à-vis investors and competent authorities. UCITS are legally restricted in using leverage methods such as use of derivatives and borrowing agreements. In addition, national legal requirements limit the use of leverage in certain funds. Even if the acceptable methods by which the fund manager could increase the fund's exposure differ among investment funds in order to protect investors, the metric for the calculation of the market exposure should be based, in principle, on the same method for both UCITS and AIFs. Such an approach would efficiently ensure a sustainable and meaningful understanding and monitoring of leverage for financial stability purposes. However, it is important to highlight that the use of leverage by investment funds is limited within the European market, with the notable exception of hedge funds. According to a survey within our membership, the exposure of nearly all German AIFs relating to borrowing arrangements and derivative instruments (with hedging and netting) does not exceed leverage on a substantial basis (three times the fund's net asset value). Moreover, all German open-ended AIFs observe the UCITS limit on global exposure to derivative instruments.

Financial stability supervisors need to operationalise their macro-prudential toolkit. Competent authorities already facilitate analysis of the risk impact of investment funds in the European Union. In particular, information of the risk profile of alternative investment funds gathered by competent authorities are shared with ESMA and the ESRB so as to facilitate a collective analysis of the impact of the risk profile (including leverage and liquidity) 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. We therefore welcome the latest ESMA analysis of investment funds: the main finding is that the fund industry is resilient and is able to absorb economic shocks. We also welcome that ESMA has already started establishing guidance to operationalising existing tools to address risks and to identify the effect of macro-systemic shocks affecting the economy as a whole. These figures should be used by all financial stability bodies such as the ESRB and the ECB. That involves the need for country-by-country analyses and the need for further strengthening data exchange between supervisory authorities and financial stability bodies.

[6] Available under the following link: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf.

There is a need for a single regulatory reporting mechanism which will reduce operational effort and burden for asset managers as well as supervisory authorities. For a common understanding of financial stability risks and in order to avoid excessive burdens for cross border activities of asset managers, the main challenge is to agree at least on harmonised data reporting and exchange standards between the industry and supervisory bodies to enable better understanding and supervision. This important task should not be left solely to national authorities as it is currently required under the UCITS Directive. In any case, it is important that all managers of funds report such data in a uniform way. Proposals for a new harmonised reporting such as a UCITS reporting need to be analysed carefully in avoiding of double reports and in closing data gaps. The removal of regulatory obstacles which hinder the efficient functioning of the capital markets should be considered an overarching priority. For financial stability purposes it is necessary to define at least on EU level which kind of data and in which frequency national competent authorities should collect data such as data on leverage and liquidity risks. However, it could be helpful to set a reporting threshold for small-sized funds (such as funds whose assets under management do not exceed EUR 500 million) and funds with low leverage. Such a threshold would ensure that information relating to the build-up of financial stability risk is collected throughout the EU in a consistent way and provides certainty to all investment funds. However, competent authorities may request additional information where necessary for the effective monitoring of systemic risks.

Managing investment funds differs fundamentally from business models of banks or other types of financial entities such as insurance companies. Asset managers are neither banks nor insurance companies, but a separate pillar of the financial economy. They act as agents on behalf of their investors and are subject to fiduciary duties to act in the best interest of investors. They do not have custody over the assets, as these are “safe-kept” by separate depositary institutions. The fund assets are thus never part of the asset manager’s own balance sheet. Therefore, own capital of asset managers is not required to bail out struggling funds. Importantly, the investment results of investment funds – whether positive or negative – belong to the investors. Own capital is only needed to ensure that the operational and potential professional liability risks are appropriately covered either by way of own funds. That includes risks resulting from asset managers’ activities such as damage or loss caused by staff members, events resulting from negligent actions, errors or omissions, failure to prevent, by means of adequate internal control systems or fraudulent behaviour within the organisation. It is clarified under the AIFMD that losses incurred because an investment has lost value as a result of adverse market conditions should not be qualified as a potential professional liability risk and, therefore, not be covered by own capital of the asset manager. It is also required by law that money market funds shall not receive external support such as purchase by a third party of units or shares of the MMF in order to provide liquidity to the fund. With regard to the German asset management sector, our members provide us on a voluntary basis with data on losses deriving from operational risk occurrences. According to our experience based on the BVI’s Operational Risk Database statistics, operational risks materialising in our membership amount to about EUR 30,000 on average per year and company and over a period of the least five years. Therefore, the own fund requirements of the UCITS Directive and the AIFMD are already designed to cover such losses. Moreover, in a context of continued investor inflows and growth of the asset management sector, it is self-explanatory that growth of professional liability risks is continuing to be proportionate. The increase of own capital of asset managers, observed in the current practice, is therefore due to cover increased professional liability risk resulting not least because of much stricter organisational requirements for asset managers established after the financial crisis.

****