Frankfurt am Main,
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BVI's comments in relation to the Peer Review on implementation of the FSB policy framework for shadow banking entities

BVI[1] welcomes the opportunity to contribute its views to the peer review on implementation of the FSB policy framework for other shadow banking entities. Since the initiation of the shadow banking debate by the G20 leaders in November 2010, BVI has been closely following the various initiatives led by the FSB and has been engaged in illuminating the specificities of regulatory frameworks applicable to the European fund management sector.

The European Banking Authority EBA recently conducted a consultation on limitation of credit institutions' exposures to shadow banking entities[2]. As regards the scope of application, the EBA has taken a very formal approach by proposing that any EU fund which is not UCITS shall be considered shadow banking entity. This approach results in a sweeping treatment of all alternative investment funds (AIFs) in Europe as shadow banking entities regardless of their level of regulation, the economic function performed by those funds or the related potential for systemic risk and thus, is inconsistent with the economic-function based framework developed by the FSB. BVI has been actively engaging in the consultation process by arguing in favour of a differentiated treatment of EU AIFs. Our relevant arguments are presented in the annex to this reply.

As pointed out in our comments to the FSB consultation from November 2012, shadow banking risk in European investment funds is very limited. Especially, the risk of bank funding through investment funds in exchange for illiquid assets (economic function 5) can be basically excluded for most European ETFs which generally obey the strict UCITS rules for high quality collateral and limits to counterparty risk. Therefore, we would like to focus our subsequent remarks on the treatment of funds with features that make them susceptible to runs (economic function 1) and facilitation of credit creation (economic function 4) as well as the corresponding information needs of the authorities.

1. Collective investment vehicles susceptible to runs

In light of the general FSB approach to shadow banking, we understand that only collective investment vehicles (CIVs) engaging in some way in credit intermediation e.g. by investing their client's money in sovereign or corporate bonds can be possibly caught by the "wide net" defined as a first step of the FSB approach to shadow banking. Under this interpretation, CIVs focusing on investments in equities or real assets such as real estate would be excluded from the consideration since their investment activities do not involve credit intermediation of any kind.

Even though it is difficult to grasp in a positive manner which types of relevant CIVs are susceptible to runs, we can certainly exclude large parts of the European fund spectrum by considering the amplifying

[1] BVI represents the interests of the German investment fund and asset management industry. Its 90 members manage assets in excess of 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.

[2] Draft EBA Guidelines on limits to exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 para. 2 Regulation (EU) No. 575/2013 dated 19 March 2015, accessible under: http://www.eba.europa.eu/documents/10180/1019894/EBA+CP+2015+06+%28CP+on+GL+on+shadow+Banking%29.pdf

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factors specified in the FSB report[3]. In particular, run risk should be generally not present in European UCITS since the UCITS framework prohibits excessive leverage and imposes strict standards on risk diversification which prevent concentration in terms of issuers or counterparties. Moreover, as UCITS invest in transferable securities traded on exchanges or other organised markets, liquidity of UCITS portfolio assets is generally ensured.

In our view, run risk should also be denied for CIVs issued exclusively for one or a few institutional investors. In Germany, this fund category is represented by the so-called "Spezialfonds" which are regulated CIVs dedicated to institutional investors such as insurance companies or pension funds. Due to their close relations to investors, "Spezialfonds" are able to duly anticipate and to take steps in order to serve the individual redemption needs.

The illustrating examples provided by the FSB suggest that CIVs with very low investment objectives (so-called near-money-market funds) might be considered as being susceptible to runs. In this regard, we would like to point to the pending EU legislative procedure for a Regulation on Money Market Funds (MMFR) [4]. This new EU framework is meant to cover all funds which invest in short term assets and have the objectives of offering returns in line with money market rates or preserving the value of the investment[5]. Therefore, it can be anticipated that any EU fund with investment objectives at the level of money market rates will be in future considered a money market fund and fall into the scope of the new Regulation which provides i.a. for further restrictions on portfolio concentration, weighted average maturity and weighted average life of the portfolio assets, rigorous stress testing and valuation rules. In this vein, the MMFR confirms the delineation between money market funds and short-term bond funds introduced by ESMA's predecessor CESR in 2010[6]. Moreover, the EU legislators are determined to prevent circumvention of the new rules by stipulating that the objective of offering returns in line with money market rates shall be understood in a broad sense meaning that an objective to outperform those rates by a slight margin shall not take a fund outside the scope of the EU Regulation[7].

2. Facilitation of credit creation by investment funds

A new development in the EU regulatory environment for investment funds pertains to the so-called credit funds, i.e. funds entitled to issue loans to third parties. According to the prevailing interpretation by EU institutions, the Alternative Investment Fund Managers Directive (AIFMD) adopted in 2011 in response to the financial crisis does not prevent granting of loans by AIFs.

Against this background, the German supervisory authority BaFin and subsequently the German Ministry of Finance were prompted to regulate credit issuance by investment funds precisely in order to mitigate potential shadow banking risk associated with these activities[8]. Under the new rules, credit granting funds in Germany ("credit funds") can be launched only as closed-ended CIVs dedicated to institutional investors ("Spezialfonds, cf. section 1 above) and thus are neither exposed to the risk of maturity or liquidity transformation nor prone to investors' runs. Leverage in credit funds is limited to 30% of a fund's aggregated provided and committed capital which represents a very low level basically

[3] Cf. Strengthening Oversight and Regulation of Shadow Banking, final report by the FSB dated 29 August 2013, page 7.
[4] The EU Parlament reached an agreement on the EU Regulation for Money Market Funds on 29 April 2015. Further negotiations will take place after the adoption of a common position by the Council.
[5] Cf. the definition of money market funds in Article 1 para. 1 of the draft EU Regulation (Parliament's version as of 29 April 2015).
[6] CESR's Guidelines on a common definition of European money market funds dated 19 May 2010 (CESR/10-049).
[7] Recital 15 of the draft EU Regulation (Parliament's version as of 29 April 2015).
[8] In the explanatory memorandum to the relevant draft statute (UCITS V Implementing Act), the German Ministry of Finance refers specifically to the regulatory arbitrage, procyclicality, run risk, risk of spillover and excessive leverage which need to be tackled by regulatory measures, cf. page 74-75 of the ministerial draft.

removing the risk of spillover to credit institutions and procyclicality risks. Credit funds in Germany are neither allowed to issue loans to consumers nor to take deposits from the public. Commensurable provisions in terms of loan origination by AIFs have been introduced also in other EU jurisdictions, i.e. Ireland regarding qualified investor AIFs.

Furthermore, similar safeguards are in place for European Long-Term Investment Funds (ELTIFs) representing a new category of European AIFs investing in long-term projects and in this context, also entitled to grant loans to qualifying portfolio undertakings. Like the German credit funds, ELTIFs are generally of a closed-ended nature[9]. Provision of loans by ELTIFs cannot be financed by way of borrowing which is otherwise limited to 30% of the fund's capital value[10].

Consequently, it is our understanding that the new regulatory standards for credit funds in Germany alongside the EU ELTIF framework will eliminate the potential for systemic risk which might justify classification of loan originating funds as "other shadow banking entities".

3. Regulatory reporting and public disclosure

European investment funds, both UCITS and alternative investment funds (AIFs), already provide comprehensive information to the authorities and the public. Regulatory reporting under AIFMD is mandatory for most funds on a quarterly basis and encompasses extensive details on portfolio composition, principal exposures and most important concentrations, liquidity management and risk profile[11]. The AIFMD reporting is also meant to provide helpful data for assessing the interconnectedness between banks and other financial institutions as it requires identification of the top five counterparties to which a fund has the greatest credit exposure and which have the greatest credit exposure to the fund respectively for each individual AIF[12]. These requirements have been developed with the dedicated aim of enabling supervisory authorities to effectively monitor systemic risk associated with AIF management[13]. Nonetheless, and despite their level of detail, they do not fully provide for the availability of data on maturity and liquidity transformation requested by the FSB.

In addition, AIFs facilitate extensive disclosure to investors both before investing and on regular basis. The periodical information to investors comprises in particular any new arrangements for liquidity management, current risk profile and description of the risk management systems in place and in case of leveraged AIFs any changes to the maximum level of leverage an AIF may employ as well as the actually employed level of leverage[14].

The regulatory reporting under AIFMD applies independently and in addition to the individual transaction reporting for derivative transactions required under EMIR and for other financial instruments under the future MiFIR framework. Further reporting regimes targeted at asset managers are already underway at the EU level under the EU Regulation on Securities Financing Transactions and the Money Market Fund Regulation mentioned above.

Therefore, we deem it absolutely crucial that any new reporting items potentially resulting from the FSB work on other shadow banking entities be integrated into the existing reporting systems for investment funds and no separate reporting procedures be established for these

[9] Cf. Article 18 of Regulation (EU) 2015/760 of 29 April 2015 on European long-term investment funds (ELTIF Regulation).
[10] Cf. Article 16 para. 1 (b) of the ELTIF Regulation.
[11] Cf. Annex IV to the Delegated Regulation (EU) 231/2013 (AIFMD Delegated Regulation).
[12] Cf. Annex IV to the AIFMD Delegated Regulation, reporting item 17.
[13] Cf. Article 24 especially para. 5 and recital 49 of Directive 2011/61/EU (AIFMD).
[14] Cf. Article 23(1),(2),(3) and (4) of AIFMD.

purposes. In terms of the AIFMD regime, this should prompt a refinement or possibly modification of the focal points of reporting with a clear view to avoiding excessive costs and operating burdens for the industry.

The regulatory focus should be rather placed on proper aggregation and analysis of data which is already or will be shortly available to the global regulatory community though specific investment fund or general transaction reporting. In the short term, data aggregation could be improved through mandating the use of standardised trade and product identifiers (UPI, UTI, LEI). In this respect, we welcome the ongoing work by IOSCO, the FSB and GLEIF. Going forward regulatory support and enforcement of globally agreed common data standards and data dictionaries in transaction reporting are necessary in order to make full use of the wealth of information stored by trade repositories for the identification and management of local, regional, and global systemic risk. BVI is continuously committed to supporting these initiatives.

ANNEX: Arguments pro differentiated consideration of shadow banking risks imminent in European AIFs

The proposal to treat all European AIFs as shadow banking entities (a) contradicts the recommendations of the FSB WS3 on shadow banking, (b) overstates the potential risks associated with fund activities, (c) disregards the existing regulation of AIFs at the EU and national level and (d) is inconsistent with other streams of EU regulation.

a. Contradiction with FSB recommendations

As indicated in our preliminary remarks, the FSB recommends to categorise non-bank financial entities "not by *legal forms* or *names* but by *economic function* or *activities*, and (to) provide international consistency in assessing their risks"[15]. Seen from that angle, the universe of AIFs cannot be associated with a specific economic function or activity. The EBA should recognise that the term "AIF" or alternative investment fund comprises any collective investment vehicle in worldwide terms that is not UCITS. Hence, AIFs are per se all third country funds and EU vehicles managed by authorised or registered AIFM. EU AIFs also cannot be perceived as a uniform fund category. On the contrary, the variety of fund solutions formally classified as AIFs is very broad and ranges basically from retail funds regulated and supervised in a UCITS-equivalent manner, but with a somewhat different investment focus (e.g. on real estate) to highly leveraged hedge funds or specialised closed-ended funds investing e.g. in infrastructure or private equity. In Germany, a lion's share of the open-ended AIF market[16] is attributable to "Spezialfonds" which are regulated and supervised investment vehicles dedicated to professional investors. Not only the degree of AIF regulation at national level, but also the markets in which AIFs invest and the investment strategies they pursue/investment techniques they employ display considerable differences. **Hence, it is clear that under the FSB approach, AIFs must not be submitted to a blanket treatment in terms of their shadow banking risk.**

Moreover, an assessment of AIFs based on the five economic functions endorsed by the FSB can only result in AIFs following very specific investment strategies being classified as shadow banks. This might pertain in particular to "MMF-like" AIFs with very low risk investment objectives or to AIFs investing in long-term/complex illiquid instruments which are redeemable upon demand or within short time frames, since such vehicles feature a liquidity/maturity mismatch relevant from the systemic perspective[17]. However, also in this regard, it must be noted that the FSB recommends targeted policy tools to be applied to such vehicles in order to mitigate potential shadow banking risks. Such tools comprising i.e. measures for managing redemption pressures in stressed market conditions (redemption fees, gates, suspension of redemptions), general management of liquidity risk and limits on leverage[18] are already present in many AIFs to the extent matching a fund's investor profile and liquidity needs. In our understanding, AIFs featuring such adequate tools which suppress the relevant shadow banking concerns should be no longer considered shadow banking entities.

b. Potential systemic risks by AIFs are fundamentally overstated

In explaining the rationale for limiting shadow banking exposures, the EBA states that "shadow banks are generally not subject to prudential regulation, do not provide access to deposit guarantee schemes

[15] The FSB Report, page 6.
[16] Roughly 92 % as of 31 March 2015; source: BVI statistics.
[17] Cf. section 2.1 on page 6-7 of the FSB Report.
[18] Cf. section 3.2.1 on page 14 to 17 of the FSB Report.

to investors and do not have access to central bank liquidity"[19]. All these features are not relevant for EU AIFs and other investment funds for the following reasons:

- Prudential regulation: AIFs and other investment funds do not need capital requirements at the vehicle level, since they are fully funded by the own capital of their investors. Investments by AIFs are subject to clear limits on leverage imposed either by national regulation or by the fund rules[20]. In this context, it should be noted that AIFs are already considered to apply leverage on a substantial basis if the exposure to market risk exceeds 300% of the fund's NAV according to the commitment approach[21]. In addition, the competent NCA is entitled to impose limits on the level of leverage employed by AIFs or other restrictions in terms of AIF management if deemed necessary for systemic reasons[22]. Other elements of a prudential framework are fully reflected in the regulation of the fund manager under the AIFMD and frequently also in the national fund rules (cf. our comments below).

- Access to deposit guarantee schemes: The portfolio assets of AIFs are segregated from the manager's assets and held in custody by the appointed depositary. AIF's cash must be booked on accounts held with an entity subject to adequate regulation and supervision. The depositary is responsible for overseeing the AIF's cashflows and verifying the ownership rights in relation to assets not subject to the custody obligation (e.g. titles resulting from derivative contracts or real assets)[23]. As a result, AIFs are fully shielded from the manager's insolvency and hence feature NO issuer risk which might justify coverage by deposit guarantee schemes.

- Access to central bank liquidity: Central bank liquidity is not requisite for AIF operations. AIF's liabilities towards counterparties and investors are monitored on an ongoing basis and dealt with as part of the internal liquidity and risk management. In particular, AIF must ensure coherence between the adopted investment strategy, the liquidity profile and the redemption policy of the fund[24]. In this respect, AIFs can employ a range of tools such as redemption fees, gates or even suspend redemptions in accordance with the relevant national law.

In addition, we disagree with the EBA's interpretation of the potential systemic risks associated with AIFs. Against the backdrop of the EU and national frameworks governing the AIF business, such risks as depicted in section 3.1.1. of the consultation paper appear to be materially overstated. Specifically, we would like to note the following:

- Run risk and/or liquidity problems: AIFs are subject to strict standards of liquidity management including definition of qualitative and quantitative risk limits and liquidity stress tests[25]. Moreover, open-ended AIFs have at their disposal adequate tools to deal with liquidity shortages, including the possibility to suspend redemptions. AIFs are also not marketed as substitutes to bank deposits, but targeted at investors with longer investment horizons consistent with the fund's investment objectives. In Germany, regulated professional AIFs ("Spezialfonds") are often set up for one/a few investors and hence are able to duly anticipate and to take steps in order to serve the individual redemption needs.

[19] Cf. para. 23 of the consultation paper.
[20] Cf. Article 15(4), 23(5), 25(3) of the AIFMD.
[21] Article 111(1) of Regulation (EU) 231/2013 (AIFMD Implementing Regulation).
[22] Cf. Article 25(3) of the AIFMD.
[23] Cf. Articles 85-90 of the AIFMD Implementing Regulation.
[24] Article 16(2) AIFMD, Article 49 of AIFMD Implementing Regulation.
[25] Cf. Article 48 and 49 of AIFMD Implementing Regulation.

- Interconnectivity and spillovers: Many AIFs are subject to diversification rules equivalent to the UCITS regime stemming from national regulation. In Germany, this pertains also to “Spezialfonds” set up for professional investors[26] which are generally bound by the UCITS provisions on eligible assets and investment limits[27]. “Spezialfonds” are also subject to the UCITS counterparty risk limits and the relevant collateral requirements[28]. Hence, the risk of spillover to the banking sector inherent in AIFs is in many instances comparable to the situation under the UCITS Directive.

- Excessive leverage and procyclicality: It is true that there is no regulatory limit on AIF leverage at the EU level. However, as stated above, all AIFs are under the obligation to define the maximum level of leverage which must be appropriate and observed at all times, and to report on its implementation to investors and competent authorities. AIFs employing leverage on a substantial basis, i.e. exceeding 300% of the fund’s NAV, are submitted to enhanced reporting requirements and . In addition, regulatory leverage limits may apply under the applicable national law. In Germany, many “Spezialfonds” observe the exposure limit of 200% applicable to UCITS which is then enshrined in the fund rules.

- Opaqueness and complexity: The AIFM business being management of AIFs is extensively regulated in accordance with sector-specific prudential principles and subject to authorisation and supervision by the authorities. In particular, the ownership structure and the composition of the governing bodies form part of the AIFM scrutiny during the authorisation process. Furthermore, the AIFMD regime provides for comprehensive regulatory reporting in terms of both AIFM and AIF which encompasses details on employed strategies and portfolio concentrations as well as individual positions and risks of each managed AIF[29]. In fact, the reporting requirements are so sophisticated that almost two years after entry into force of the AIFMD, ESMA is still not in the position to receive and process reports submitted by AIFMs. In addition, AIFs facilitate extensive disclosure to investors both before investing and on regular basis. The periodical information to investors comprises in particular any new arrangements for liquidity management, current risk profile and description of the risk management systems in place and in case of leveraged AIFs any changes to the maximum level of leverage an AIF may employ as well as the actually employed level of leverage[30].

c. Effects of EU and national AIF regulation are disregarded

It is nearly ironic to claim that the activities of European AIFs are inadequately regulated. The AIF manager – AIFM – is an authorised entity[31] subject to regulation and supervision fully equivalent to the UCITS Directive. In this context, it should be recognised that the regulatory regime for AIFM already comprises the decisive elements of a sound fund framework. This pertains in particular to the requirements concerning the AIF risk and liquidity management, AIF valuation as well as rules on AIF depositary.

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[26] Spezialfonds mit festen Anlagebedingungen („Spezialfonds“ with defined fund terms).
[27] Modifications are only allowable subject to investors‘ consent, cf. § 284 para. 2 (1) of the German Capital Investment Code (Kapitalanlagegesetzbuch – KAGB).
[28] Cf. § 27 para. 7 and 8 of the German Derivative Ordinance (Derivateverordnung).
[29] Cf. Article 110 and in particular Annex IV of the AIFMD Implementing Regulation.
[30] Cf. Article 23(1),(2),(3) and (4) of AIFMD.
[31] With the exception of small AIFM (managing unleveraged closed-ended AIFs with aggregated AuM not exceeding EUR 500 Million) and AIFM managing solely group-owned assets not exceeding EUR 100 Million which are only subject to registration with the authorities, cf. Article 3(2) and (3) of AIFMD.

The missing EU regulation of investment assets and limits to be observed by AIFs is often replaced by national rules and may vary between different types of AIFs. In Germany, rules governing AIFs and AIFMs are part of the Capital Investment Code (KAGB) which represents an integrated legal framework for investment funds covering also UCITS. Under the KAGB, open-ended retail AIFs are submitted to UCITS-equivalent rules on investment restrictions and diversification of assets. “Spezialfonds” mentioned above are also an essential part of the German fund market with currently 1,310 billion AuM[32]. “Spezialfonds” are regulated investment funds traditionally targeted at institutional investors which are subject to the supervision by BaFin and have been in existence long before the AIFMD entered into force. As already explained, open-ended “Spezialfonds” are generally required by regulation to comply with the UCITS framework concerning eligible assets and investment limits, unless investors request specific modifications due to their particular needs. A large portion of “Spezialfonds” sticks to the UCITS rules in their product set-up.

d. Inconsistency with other regulatory work at EU level

The general treatment of AIFs as shadow banks contradicts with other workstreams at EU level which impact the relations between credit institutions and investment funds:

- Large exposure regime: According to Article 7 of the Delegated Regulation 1187/2014, AIFs as investment vehicles are deemed not to constitute additional exposure if their legal and operational structure prevents the manager from redirecting any cash flows to third parties and if institutions receive only payments from the AIF’s underlying assets. These conditions apply to a broad range of AIFs, including German open-ended “Spezialfonds”. In particular, the mandatory appointment of a depositary under rules equivalent to the UCITS regime warrants protection of AIF’s cash flows. In addition, payment titles of AIF investors are generally confined to redemptions out of the fund assets. As a consequence, credit institutions are allowed to disregard such AIFs for the purpose of applying large exposure rules. The proposals in the consultation paper at hand run counter to this equal treatment of AIFs and UCITS with regard to risk aspects under the large exposure regime. In fact, the approach under Article 7 might be altogether jeopardised if banks were required to implement exposure limits and specific risk management processes in terms of their exposure to AIFs. As a result, exposure from AIFs would be accounted for twice: in relation to the underlying assets under the large exposure rules and in relation to the investment vehicle under the consulted guidelines.

- Capital Requirements Regulation: The CRR defines items associated with particularly high risk. In this context, AIFs are considered as exposures with particularly high risk, except where the AIF’s mandate does not allow for taking up of leverage in excess of the level admitted under the UCITS Directive (total exposure not exceeding 200% of a fund’s NAV)[33]. As a consequence, institutions are required to assign a 150 % risk weight to AIF exposures which do not qualify for the exemption. Exempted AIF exposures are treated with the regular risk weight.

- Banking structural reform: It can be anticipated from the Council negotiations that the blanket ban on credit institutions in terms of acquiring or retaining investments in AIFs as proposed by the Commission in Article 6(1)(b) will be replaced by a more differentiated approach. The latest compromise proposals by the Latvian Presidency uphold such ban only in terms of AIFs employing leverage on a substantial basis. In accordance with Article 111(1) of the AIFMD Implementing

[32] By 31 March 2015, source: BVI statistics.
[33] Cf. Article 128(2)(b) of Regulation (EU) 575/2013.

Regulation, leverage in an AIF is deemed to be substantial if the AIF exposure calculated under the commitment method exceeds three times its net asset value. Discussions in the EU Parliament seem to move in a similar direction.