Comment by

Union Asset Management Holding AG

on the

Consultative Document

“Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions”

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Volksbanken Raiffeisenbanken
cooperative financial group

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Dear Sirs and Madams,

Union Investment welcomes the opportunity to comment on the joint Consultative Document on "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" of the Financial Stability Board (FSB) in consultation with the International Organization of Securities Commissions (IOSCO).

We are one of the leading asset manager in Germany and asset manager of the German Cooperative Banking Network holding more than EUR 200 billion assets under management for more than 4.3 million retail and institutional clients.

Please find our specific comments to the questions below.

Yours sincerely

Schindler

Dr. Zubrod

Operational framework for NBNI G-SIFI methodologies

Q3-2. In your view, are the above proposed materiality thresholds (including the level) for the NBNI financial entity types appropriate for providing an initial filter of the NBNI financial universe and limiting the pool of firms for which more detailed data will be collected and to which the sector-specific methodology will be applied? If not, please provide alternative proposals for a more appropriate initial filter (with quantitative data to back-up such proposals).

Yes. The proposed materiality thresholds (including the level) are appropriate for providing an initial filter whether deeming an entity NBNI G-SIFI.

<u>In contrary to the proposed assessment process we suggest the materiality threshold as a hard requirement for determining the assessment pool at "Stage 1". The materiality threshold should be a minimum requirement for assessing an entity as NBNI G-SIFI.</u> That said, national authorities should not be allowed to add on the list "Stage 1" other NBNI financial entities that are below the materiality thresholds in order to streamline the assessment process on one hard fact, making the assessment process more operational and doing so minimizing the risk of inconsistency of implementation across jurisdictions and avoiding regulatory arbitrage. Additionally, of course, the materiality threshold should be accompanied with individual indicators <u>on top</u> due to sector-specific methodologies in order to broaden the basis for assessing NBNI SIFI`s.

Q3-5. Do you think that it would be beneficial to set additional materiality thresholds based on "global activity"? If so, please explain the possible indicator and the level on which materiality thresholds should be set (with reasons for selecting such indicator, the level and any practical challenges).

Yes. As the document consults on proposals for specific methodologies for the identification of global systemically important financial institutions a threshold on global activities should be implemented to meet the principle of proportionality within the assessment as a *global* systemically important financial institution.

The additional materiality "global activity" threshold should cover the number of jurisdictions in which the NBNI G-SIFI renders its products and services because only a widespread distribution network indicates that there might be a larger global impact in times of unusual market conditions. <u>We propose a cumulation of two hard characteristics: (a) number of continents: at least 2 and additional (b) number of jurisdictions: at least 15[1].</u>

[1] See Lipper LIM and PwC analysis 'Distribution footprint', 31 December 2012

Sector-specific methodologies (3): Investment funds

Q6-1. In your view, does the proposed definition of investment funds provide a practical basis for applying the specific methodology (i.e. indicators) to assess the systemic importance of NBNI financial entities that fall under the definition?

Yes.

Q6-2. Does the above description of systemic importance of asset management entities adequately capture potential systemic risks associated with their financial distress or disorderly failure at the global level?

No.

Regarding the transmission channel "Exposures / Counterparty channel": If the potential failure or distress of investment funds could lead to risks for financial institutions such as banks or insurance companies the arising question is whether financial institutions as counterparties should be allowed to build up large exposures against investment funds and under which circumstances (risk management techniques etc.). The problem's source is not the investment fund but rather the counterparty and the regulations governing its behavior. FSB and IOSCO should consider that there are different regulations on EU level to prevent market participants from heavy losses as a result of extended financing to a fund or through direct linkages, e.g. CRR I and Solvency II. CRR I (Regulation 575/2013/EU, implementing the Basel III accord) is already put in place. The CRR I contains the maximum leverage ratio of 3 % and rules regarding the liquidity with explicit requirements to adequately address the counterparty risks as well as detailed provisions on large exposures and own fund requirements for EU credit institutions. Solvency II (Directive 2009/138/EC) codifies and harmonises the EU insurance regulation. Primarily this concerns the amount of capital that EU insurance companies must hold to reduce the risk of insolvency and doing so it reflects new risk management practices to define required capital and manage risks.

The transmission channel "Asset liquidation/market channel" is described as the indirect impact of distress or a failure of an investment fund on other market participants, e.g. may individual funds be a significant investor and/or provider of liquidity. Here, ones again, EU regulation with the UCITS Directive[2] and AIFM Directive[3] provide already strict requirements for the management of risks:

UCITS[4]: Generally, UCITS - Asset Manager do not have a global systemically relevance due to the fact that it is not permissible to trade on own accounts with investor's capital[5] and given that the balance sheet is small compared to those one's

[2] Directive 2009/65/EC
[3] Directive 2011/61/EU
[4] Directive 2009/65/EC
[5] Article 6 para. (3) Directive 2009/65/EC

of financial institutions. The European Commission has already stated that UCITS do not cause a systemic risk[6]. In particular there are strict requirements of risk diversification and segregation of assets and protection against insolvency.

- Definition of eligible assets, Art. 50
- Determination of issuer concentration limits, Art. 52
- Restrictions concerning borrowing, Art. 83 (2)
- Restrictions referring to the use of derivatives, Art. 51 (3)
- Safekeeping principle to be ensured by depository, Art. 22 ff.
- Segregation of the investor's assets from the management company‘s own assets, Art. 32 ff.
- Protection of the Investor's units against insolvency in case of the bankruptcy of the asset management company

AIF[7]: Generally, AIF - Asset Manager in Europe do not have a global systemic relevance. In particular there are strict requirements of risk diversification and segregation of assets and protection against insolvency.

- Establishment of a separate risk management, Art. 15 (1)
- Establishment of a liquidity management, Art. 16 (1)
- Close collaboration with authorities and restrictions concerning the use of leverage, Art. 25
- Safekeeping principle to be ensured by depository, Art. 21
- Segregation of investor's assets from the management company‘s own assets, Art. 21 (8).
- Protection of the Investor's units against insolvency in case of bankruptcy of the asset management company

<u>In conclusion the description of systemic importance of asset manager associated with their financial distress or disorderly failure does not reflect the prospective effect of regulation for UCITS managers and AIF managers for financial entities and markets at least in the EU.</u> The business model of asset management companies does not correspond to that of systemically important credit institutions and other types of investment firms. All asset managers' dealings are performed on agency basis: no dealing on own account is permitted. Asset Manager of UCITS and AIFs are limited to the core functions and secondary activities set out in the UCITS Directive and AIFM-Directive. For asset manager of UCITS this comprises the collective investment in transferable securities[8], management of portfolios of investments, investment advice and safekeeping / administration[9]. For asset manager of AIFs this comprises the management of AIFs[10], the management of portfolios of

[6] See, Consultation paper on the UCITS Depositary function and on the UCITS Managers` Remuneration dated 14 December 2010 (Market/G4D (2010) 950800), section 2.3 where the Commission states: “The UCITS asset management sector was not one of the root causes the financial crises, and the new regulatory framework for UCITS should place significant limits on the degree and nature of risk that a UCITS might take on, thereby also limiting the extent to which misaligned incentives might lead to wider systemic problems.”
[7] Directive 2009/65/EC
[8] Art. 1 para 2 of Directive 2009/65/EC
[9] Art. 6 para 2 of Directive 2009/65/EC
[10] Art. 6 para. 1, 2 of Directive 2011/61/EC

investments, investment advice and safekeeping and administration and reception and transmission of orders[11]. Furthermore assets inside a fund are assets which have to be segregated from the assets of the management company and the assets of the depositary (legal and physical separation). In doing so all fund assets are ring-fenced and held by a separate custodian. Hence a possible failure born on a company level won't have any impact/effects on the client's assets inside the funds. Given that asset management companies usually manage the funds on behalf of their clients but do not own them, their own balance sheet is comparably small. Therefore market risks related to investing on own account – akin to the trading book for banks – do not apply. Furthermore the size of EUR 9,531 billion[12] of fund assets managed on behalf of clients are split between about 3,200 management companies[13] and 55,277 investment funds[14]. This in return ensures a broad range of (unique) tailor made services allowing for a minimization of cluster risks which in return might be present referring to certain banks or non-banks.

Q6-3. Which of the following four levels of focus is appropriate for assessing the systemic importance of asset management entities: (i) individual investment funds; (ii) family of funds; (iii) asset managers on a stand-alone entity basis; and (iv) asset managers and their funds collectively? Please also explain the reasons why you think the chosen level of focus is more appropriate than others.

Item (i): As the asset management market is very competitive it is not appropriate to deem an asset management entity as NBNI G-SIFI just a basis of an individual investment fund. Fund administration of an individual investment fund can easily be transmitted to another asset management company.

Item (ii) From our point of view it is not appropriate to deem a single asset management entity as global systemically important on basis of an assessment of family of funds it manages following the same or similar investment strategy. The asset management market is very competitive and fund administration of a family of funds can easily be transmitted to another asset management company.

We do not see a risk of circumvention the materiality threshold for an individual investment fund via creating a family of "similar" funds, too. As fund management activities are governed by a set of requirements, e.g. notification of each single investment funds[15], investment fund`s transparency in periodical reports[16] and pre-investment documents[17] every funds results in remarkable administration costs.

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[11] Art. 6 para. 4 of Directive 2011/61 EC

[12] See EFAMA International Statistical Release (2013:Q3), p. 9.

[13] See EFAMA Asset Management in Europe, Facts and Figures, 6th Annual review June 2013 , p. 2

[14] See EFAMA International Statistical Release (2013:Q3), p. 9.

[15] UCITS: each fund must be authorized by the competent authorities, Article 5 para 2 of Directive 2009/65/EC;

AIF: each fund must be at least notified to the authorities as part of managers' authorization and separately, for marketing purposes, Article 7 para 3 (a), (c) and Articles 31, 32 in connection with Annexes III and IV of Directive 2011/61/EU

[16] UCITS: half-yearly and annual reports according to Article 68 para 1 Directive 2009/65/EC;

Nevertheless, if FSB, in consultation with IOSCO, tends to install this indicator we see real challenges in determining clear and operable criterions as to globally assess whether funds have a same or similar investment strategy. Given this item it would be at least necessary to ensure a most harmonized approach in determining globally the scope and the requirements with clear definitions. These definitions would have to provide a sufficient set of technical criteria. Notably, it would not be sufficient to classify the funds just on the basis of the applicable regulation source (e.g. UCITS, AIF, EuSEF, EuVECA,) because this would be much too wide and misleading. We therefore agree with the proposed indicator 3-3 "investment strategies (or asset classes) with less than 10 market players globally" and the respective description of this indicator.

Item (iii) The approach with the "stand-alone entity basis" seems to be an appropriate indicator for assessing the global systemically importance of asset management entities as long as it is focused on the activities of the respective entity and not the assets the entity manages on behalf of its clients. Applying this item is of utmost importance to carefully define the requirements for being deemed a "stand-alone entity".

Notably, for the delegation of functions possible risks associated with this criterion are already sufficiently reflected at least on EU level. The existing regulations provide a set of requirements on both sides the outsourcing asset manager and the insourcing entity as well[18].

We do not agree in taking operational and reputational risks into consideration as both issues are –if at all- very difficult to determine and to assess. Against this background we do not see an advantage for the assessment of the global systemic importance.

Item (iv) please see answer for Q 6.2.

Q6-4. Should the methodology be designed to focus on whether particular activities or groups of activities pose systemic risks? If so, please explain the reason why and how such a methodology should be designed.

No.

AIF: annual report according to Article 22 Directive 2011/61/EU
[17] UCITS: prospectus according to Article 68 para. 1 Directive 2009/65/EC and Key information document according Article 78 Directive 2009/65/EC;
AIF: disclosure to investors according to Article 23 Directive 2011/61/EU
[18] AIFM: requirements for the delegation of AIFM functions Article 75 ff. Regulation 231/2013/EU with explicit requirements for delegation of portfolio or risk management, Article 78 Regulation 231/2013/EU;
UCITS: requirements for the delegation of functions, Article 13 Directive 2009/65/EC

Q6-5. Are the proposed indicators appropriate for assessing the relevant impact factors? If not, please provide alternative indicators and the reasons why such measures are more appropriate.

The **size** and more specifically the indicator 1-1 net assets under management seems appropriate to measure the impact for assessing global systemic risk relevance.

Interconnectedness is also an indicator which needs to be considered when it comes to global systemic risk. We agree to the fact, that leverage ratio is one important indicator to measure the impact. Nevertheless it is important to consider already existing regulations on EU level which limit the leverage ratio and therefore minimize global systemic risks of investment funds. For this reason it would be suitable to consider the systemic risk only if funds exceed a specific threshold, see Art. 25 AIFMD 2011/61/EC or Art. 83 (2) UCITS Directive. On EU level there are some regulations to prevent market participants from heavy losses as a result of extended financing to a fund or through direct linkages, e.g. CRR and Solvency II. The counterparty exposure ratio is as well considered as an appropriate indicator to define global systemic risk. As the abovementioned leverage ratio it is important to consider already existing regulations which limit counterparties credit exposure. One example is that ESMA has already published a consultation on collateral diversification which sets limits for UCITS on EU level. Additionally, we agree that intra-financial system liabilities are an appropriate global systemic risk indicator.

In general we agree to the approach that **substitutability** is an appropriate global system risk indicator. The figure trading turnover related to a specific asset seems to be an appropriate one. But it needs to be considered that on EU level and especially for UCITS funds there are diversification rules in line which minimise the risk that one single fund invests a big sum of money in a single asset and therefore cannot influence the asset’s underlying market no matter how high the turnover of the fund related to this specific asset is. The figure on trading activity relative to its peer seems to be an appropriate figure to measure global system risk. The most suitable figure of the substitutability indicator is the indicator 3-3 investment strategies with less than 10 market players globally.

Complexity does not seem to be an appropriate indicator for assessing global systemic risk importance of investment funds. The use of OTC derivatives does not automatically imply a higher systemic risk. Derivatives for UCITS and most AIFs are used for risk hedging reasons and not to speculate. Therefore the risk is relatively low and therefore limited. The indicators described in 6.3.4. are more important for hedge funds (as a sub-group of AIF) but not for already high-regulated UCITS funds.

Cross jurisdictional activities are important to assess systemic risk of investment funds. The number of jurisdictions in which a fund invests has an impact on the systemic risk relevance. But from our point of view the figure needs further adjustment. A jurisdiction shall only be counted if the investment fund invests a specific percentage/threshold of its assets in this country. Otherwise the consequence

could be that a globally invested investment fund could per se be assessed as systemic relevant.
Regarding indicator 5-2, number of jurisdictions in which the fund is sold/listed, please see answer Q 3-5.
Finally we agree that indicator 5-3, counterparties established in different jurisdictions, is appropriate for assessing systemic risk of an investment fund.

Q6-6. For "cross-jurisdictional activities", should "the fund's use of service providers in other jurisdictions (e.g. custody assets with service providers in jurisdictions other than where its primary regulator is based)" be used?

Generally, yes. But within the assessment process the competent authorities should take into consideration whether there are sufficient regulations in place to reduce the risk. UCITS Directive and AIFMD include such requirements (see answer Q 6.2). Regarding UCITS the EU Commission[19] published a draft proposal for amendments to the UCITS Directive (2009/65/EC) with changes to the UCITS Depositaries regime concerning the duties and liability of the depositary. This proposal includes new requirements for delegating depository duties to a third party in and outside the EU.

Q6-7. Is the definition of "net AUM" and "GNE" appropriate for assessing the "size" (indicators 1-1 and 1-2)?

Yes.

Q6-8. Is the definition of "investment strategies" sufficiently clear for assessing the "substitutability" (indicator 3-3)?

Yes, see answer indicator 3-3.

Q6-11. Should certain indicators (or impact factors) be prioritised in assessing the systemic importance of investment funds? If so, please explain which indicator(s) and the reasons for prioritisation.

From our point of view interconnectedness and in more detail leverage ratio shall be prioritised when assessing the systemic importance of investment funds. At EU-level there are already existing regulations which deal with this issue. But if we consider global systemic risk it is essential that there is a common definition or limit/threshold of a leverage ratio for all investment funds worldwide. For more details please see answer Q6-5.

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[19] EU Commission (COM) published a "Proposal for a Directive of the EP and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions" on 3 July 2012.