Frankfurt am Main
14 January 2013

BVI's response to the FSB Consultative Document "Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities"

BVI[1] welcomes the opportunity to comment on the preliminary findings relating to oversight and regulation of shadow banking as presented by the FSB work stream WS3. In this paper, we would like to deal specifically with the proposed approach to regulation of "other shadow banking entities".

***Q1:** Do you agree that the high-level policy framework effectively addresses shadow banking risks (maturity/liquidity transformation, leverage and/or imperfect credit risk transfer) posed by non-bank financial entities other than MMFs? Does the framework address the risk of regulatory arbitrage?*

The assessment of shadow banking risk based on the economic functions performed by non-bank financial entities as proposed by WS3 is capable of capturing the relevant activities of all market participants in a comprehensive manner. Therefore, this approach is in our view preferable to a categorisation based on legal forms or market sectors.

Nonetheless, it must be acknowledged in the further discussion that the activities of many non-bank financial institutions are governed by long-established regulatory regimes which account for the specificities of their business models and indeed, already provide for adequate treatment of potential risks associated with shadow banking. This pertains in particular to mutual and other investment funds which in most jurisdictions are subject to dense regulation and supervision. We will revert to this aspect in detail in our response to Q4 below.

On the other hand, the effectiveness of combating regulatory arbitrage will depend to a great extent upon implementation of the proposed policy tools at national level. The risk of regulatory arbitrage will obviously remain in case of significant divergences of standards among jurisdictions as well as in relation to different financial sectors.

***Q2:** Do the five economic functions set out in Section 2 capture all non-bank financial activities that may pose shadow banking risks in the non-bank financial space? Are there additional economic function(s) that authorities should consider? If so, please provide details, including the kinds of shadow banking entities/activities that would be covered by the additional economic function(s).*

We would like to focus our following comments on WS3 findings with relevance for investment funds.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 80 members currently handle assets of EUR 2.0 trillion in both investment funds and mandates. BVI enforces improvements for fund-investors and promotes equal treatment for all investors in the financial markets. BVI`s investor education programmes support students and citizens to improve their financial knowledge. BVI`s members directly and indirectly manage the capital of 50 million private clients in 21 million households.BVI's ID number in the EU register of interest representatives is 96816064173-47. For more information, please visit www.bvi.de.

The **first economic function** identified by WS3 relates to **"management of client cash pools with features that make them susceptible to runs"**. In this context, WS3 casts the net wide in accordance with the two-step approach defined by the FSB and considers all pooled investments in financial products with a discretionary mandate which engage in maturity or liquidity transformation and/or leverage. In a further step, the consideration is narrowed down to certain types of "credit investment funds" without defining which vehicles shall be comprised by this phrase.

In light of the general FSB approach to shadow banking, we understand that only investment funds engaging in some way in credit intermediation e.g. by investing their client's money in sovereign or corporate bonds can be possibly considered "credit investment funds". We understand further that among "credit investment funds" in general, only those featuring the characteristics identified in section 2.1 of the consultation document as potential systemic risk will qualify as shadow banking entities.

Assuming that our understanding is correct, we agree with focusing further regulatory measures on vehicles raising the identified concerns in terms of systemic risk. This is without prejudice to our general reservations against the involvement of regulated investment funds in the shadow banking debate as communicated to the EU Commission in June 2012 (**annexed** to this reply). The main challenge for the future regulatory initiatives will be to introduce policy measures targeted at those identified vehicles without affecting other investment funds in line with the guiding principles of focus and proportionality advocated by the FSB[2].

In this context, however, we object to the assumption demonstrated on page 13 of the consultation document that "real estate vehicles" shall be considered "credit investment funds". Obviously, real estate vehicles such as open-ended real estate funds invest their client's money in property assets and generally do not engage in credit intermediation of any kind. **Therefore, real estate funds with investment policies limited to real estate investments should not be considered part of the shadow banking sector and remain unaffected by the FSB initiatives.**

As regards the **fifth economic function** described as **"securitisation and funding of financial entities"**, WS3 refers among others to investment funds that are used by banks or non-banks financial entities to fund illiquid assets by raising funds from markets. Particular focus is put on ETFs, both synthetic and physical, which allegedly accept illiquid collateral from banks in the course of securities lending or derivative transactions.

For the European market, it must be recognized that by far the most ETFs are launched as UCITS and thus observe the regulatory standards of the UCITS regime. Since July 2011, UCITS engaging in derivative transactions are required to accept only liquid collateral; this applies also to total return swap agreements common in synthetic ETFs. In summer 2012, the European Securities and Market Authority ESMA decided to extend this requirement to securities lending and repo trades[3]. The new ESMA guidelines will come into force at EU level in February 2013. The liquidity criterion which has been slightly modified in wording will from then on read as follows:

> "Any collateral received other than cash should be **highly liquid** and **traded on a regulated market or multilateral trading facility** with **transparent pricing** in order that **it can be sold quickly at a price that is close to pre-sale valuation**."

[2] Cf. „Shadow Banking: Strengthening Oversight and Regulation. Recommendations of the Financial Stability Board" dated 27 October 2011, section 3.1.
[3] Cf. Para. 40 a) of the ESMA Guidelines on ETFs and other UCITS issues dated 25 July 2012 (ESMA/2012/474).

Against this background, we believe that it is justified to claim that the risk of liquidity transformation identified by WS3 in terms of ETFs does/will not pertain to the European market.

Q3: *Are the suggested information items listed in the Annex for assessing the extent of shadow banking risks appropriate in capturing the shadow banking risk factors? Are there additional items authorities could consider? Would collecting or providing any of the information items listed in the Annex present any practical problems? If so, please clarify which items, the practical problems and possible proxies that could be collected or provided instead.*

European investment funds, both UCITS and alternative investment funds (AIFs), already provide comprehensive information to the authorities and the public. Especially, under AIFMD coming into force in July 2013 a new quality of supervisory monitoring will be achieved due to the ambitious reporting requirements incumbent on managers of alternative investment funds. Supervisory reporting shall be mandatory for most funds on a quarterly basis and is supposed to encompass nineteen pages of details on portfolio composition, principal exposures and most important concentrations, risk profile and liquidity management. The AIFMD reporting will also provide helpful data for assessing the interconnectedness between banks and other financial institutions as it is envisaged to identify 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[4]. These requirements have been developed with the dedicated aim of enabling supervisory authorities to effectively monitor systemic risk associated with AIF management[5]. Nonetheless, and despite their level of detail, they do not fully provide for the availability of data on maturity and liquidity transformation requested by WS3.

The AIFMD reporting requirements are unique in the EU financial sector as regards their frequency and extensiveness. Their implementation by mid next year will present a great challenge for European fund managers in both operational and financial terms.

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

Q4: *Do you agree with the policy toolkit for each economic function to mitigate systemic risks associated with that function? Are there additional policy tool(s) authorities should consider?*

Again, we would like to confine our remarks to policy toolkits envisaged with regard to the economic functions 1 and 5 which are of relevance for investment funds.

Management of client cash pools with features that make them susceptible to runs (section 3.2.1)

We have significant reservations against the suggestion for imposing restrictions on maturity of portfolio assets (tool 1). Such measure may be appropriate in terms of MMFs which are marketed as alternatives to deposit accounts and must ensure sufficient level of liquidity for satisfying redemption requests.

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[4] Cf. Q 20 of the pro-forma for AIFM reporting to competent authorities presented in Annex V of the ESMA's technical advice on AIFMD implementation (ESMA/2011/379).
[5] Cf. Article 24 especially para. 5 and recital 49 of AIFMD.

However, the situation is very different for traditional bond funds, especially those investing in long-term loans. These vehicles do not compete with overnight bank deposits, but are explicitly marketed as investment products with dedicated investment horizons. Potential investors are informed by fund documents and optimally also in the course of individual advice that fund performance may be subject to fluctuations depending on market developments and the envisaged investment goals can be achieved only after a mid- to long-term holding period. Therefore, there is no risk of short-term runs comparable with the circumstances surrounding MMF investments.

Furthermore, standards on liquidity risk measurement represent a more commensurate approach to constraining potential systemic risk arising from maturity transformation. Such standards are currently being raised for alternative investment funds launched and marketed in Europe. Under AIFMD, fund managers shall be bound to maintain a level of liquidity in the fund portfolio which is appropriate to the fund's underlying obligations and shall monitor the liquidity profile of the portfolio having regard to the contribution of individual assts and to the profile of the investor base. Further, it is required that fund managers implement and maintain liquidity risk measurement procedures to assess the risk of positions and intended investments, and put into effect tools and arrangements necessary to manage the liquidity risk of each fund[6].

In our opinion, measures enhancing the standards of proper liquidity risk measurement are sufficient and appropriate to mitigate potential detrimental effects of maturity transformation in investment funds. Maturity limits, if at all considered, should be strictly confined to funds bearing MMF-like features, especially short-term oriented, low risk investment strategies and the reasonable expectation of low volatility.

Further tools discussed by the WS3 with regard to credit investment funds are already sufficiently established under the EU fund regimes. In this respect, we would like to note the following:

- **Tool 2 (Limits on leverage):** All European investment funds are either already subject to leverage limits or will be submitted to the supervisory authority's power to impose restrictions on the level of leverage once the AIFM Directive comes into force in July 2013[7]. For UCITS, there is the clear requirement that the global exposure obtained through the use of derivative instruments may not exceed the total net value of the fund portfolio[8]. Physical borrowing is generally forbidden except for temporary loans up to 10% of the fund assets[9].

- **Tool 3 (Tools to manage liquidity risk):** The UCITS Directive limits the potential for asset concentrations by imposing strict requirements on diversification of fund investments. Diversification must be ensured in terms of instruments, issuers and counterparties[10]. Similar rules apply in Germany as well as in other European countries to other mutual funds regulated at national level. Moreover, European UCITS are in principle not allowed to invest in illiquid assets; only up to 10% of the fund value can be invested in transferable securities and money market instruments which are not admitted to trading on regulated markets[11]. As explained

[6] Cf. Box 32 of ESMA's technical advice on AIFMD implementation (ESMA/2011/379).
[7] Cf. Article 25(3) of Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers (AIFMD).
[8] Article 51(3) of Directive 2009/65/EC of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS Directive).
[9] Article 83(2)(a) of the UCITS Directive.
[10] Cf. Articles 52 to 56 of the UCITS Directive.
[11] Article 50(2)(a) of the UCITS Directive.

above, the AIFMD entry into force in July 2013 will significantly raise the regulatory standards of liquidity risk management for alternative investment funds.

As regards liquidity buffers envisaged to mitigate the effects of liquidity transformation (tool 3c), we agree that such measures might be appropriate for vehicles investing in illiquid assets in order to ensure the fund's ability to satisfy redemption requests from investors. Such vehicles comprise among others real estate investment funds. **Notwithstanding the fact that the assumed classification of real estate funds as credit intermediaries is in our view unfounded**, we would like to emphasize that the regulation of German open-ended real estate funds already provides for sufficient liquidity ratio as well as other mechanisms for containing redemption pressures. German law imposes a liquidity ratio of at least 5% of the fund value on German open-ended real estate funds which must be maintained on a daily basis.[12] Moreover, the fund may optionally mitigate redemption pressures by limiting the fund's redemption frequency down to once a year. Redemptions of units in German open-ended real estate funds may further be subject to temporary suspension (in this respect please refer to our below remarks concerning tool 4).

- **Tool 4 (Managing redemption pressures in stressed market conditions):** Temporary suspension of unit redemptions is already allowed under the UCITS Directive to protect the interests of the fund investors in exceptional circumstances[13] and acknowledged by the national fund regimes existing in the EU with regard to domestic non-UCITS funds[14]. Suspensions can be decided upon by the fund manager or ordered by the competent authority if it is deemed in the interest of the unit holders or the public. Further measures for managing redemption pressures such as side pockets or gates are not yet very common in the European fund practice. Their authorisation is currently being discussed under the UCITS regime[15]. BVI is mindful of the potential benefits of such tools and takes an active part in shaping the modalities of their application.

  Moreover, we support the possibility for investment funds to impose redemption fees as a tool for restraining redemptions. However, we believe that it would be disproportionate to require redemption fees which are applicable at all times. To prevent runs by fund investors in crisis situations, is should be sufficient to introduce trigger-based redemption fees. The relevant trigger should be dependent on factors which can be hardly anticipated by investors (e.g. level of liquidity in the fund portfolio) in order to avoid pre-emptive withdrawals of the invested money.

Securitisation and funding of financial entities (section 3.2.5)

As explained in our answer to Q2 above, the European framework for UCITS has been recently amended to require provision of high quality liquid collateral in relation to securities lending and derivative transactions. On this basis, we are convinced that **tool 2 (restrictions on eligible collateral)** is already effectively in place for UCITS and see no need for further regulatory action in this regard. Especially, we do not agree with the WS3 observation on possible deterioration of "high quality" collateral during a crisis. The possibility of assets losing value or otherwise suffering in terms of their

[12] § 80 para. 1 sentence 2 of the German Investment Act (Investmentgesetz).
[13] Cf. Article 84(2) of the UCITS Directive.
[14] By way of example, cf. § 37 para. 2 and 3 of the German Investment Act (Investmentgesetz).
[15] Cf. Consultation Document „Undertakings for Collective Investment in Transferable Securities (UCITS): Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments" issued by the European Commission on 26 July 2012, Box 4.

quality in times of crises pertains to all financial instruments regardless of whether they are held as collateral or belong directly to the fund portfolio.

Furthermore, as regards **restrictions on exposures to, or funding from, banks or other financial entities (tool 3**), it should be noted that the UCITS Directive already imposes restrictions on the possible fund exposure to banking counterparties. For derivative transactions, counterparty exposure to a single institution must not exceed 10% of the fund assets if the counterparty is a credit institution or 5% in other cases[16]. According to the new ESMA guidelines for UCITS, these limits shall also capture exposure to counterparties from securities lending transactions[17]. In addition, the German law restrains the extent of securities lending conducted with one counterparty to 10% of the fund's NAV on a gross basis (without accounting for collateralization). Transactions with several counterparties belonging to the same corporate group are all counted towards the same limit[18].

On balance, we believe that the European and German frameworks applicable to investment funds including ETFs already provide an adequate answer to the potential systemic concerns raised by WS3.

Q5: *Are there any costs or unintended consequences from implementing the high-level policy framework in the jurisdictions on which you would like to comment? Please provide quantitative answers to the extent possible.*

As explained in our reply to Q3 above, the costs of separate regulatory reporting on matters relevant to shadow banking risk would be excessive especially in light of the comprehensive reporting requirements being currently implemented for investment funds at EU level. Hence, we urge the FSB to recommend to its members the introduction of integrated reporting processes for detecting systemic risk, including the risk associated with shadow banking.

Moreover, the contemplated restrictions on maturity of portfolio assets for funds other than MMFs would represent a disproportionate intervention into fund investment strategies and might impair the fund's ability to generate yields. The purpose of mitigating risks arising from maturity transformation can be served in a more commensurate manner by imposing standards on liquidity risk management by investment funds. For further details, please refer to our reply to Q4 above.

[16] Cf. Article 52(1) third subparagraph UCITS Directive.
[17] Para. 38 of the ESMA Guidelines on ETFs and other UCITS.
[18] Cf. § 54 para. 1, second sentence of the German Investment Act.

BVI · Bockenheimer Anlage 15 · D-60322 Frankfurt am Main

Bundesverband Investment
und Asset Management e.V.

Contact:
Dr. Magdalena Kuper
Phone: +49.69/154090-263
Fax: +49.69/154090-163
magdalena.kuper@bvi.de

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Mr. Mario Nava
Ms. Nathalie De Basaldua

Directorate H
DG Internal Market and Services
European Commission
rue de Spa 2
B-1000 Bruxelles

BELGIUM

EU Green Paper on Shadow Banking

Dear Mr. Nava,
dear Ms. De Basaldua,

BVI[1] is grateful for the opportunity to submit its views on the EU policy considerations relating to the area of shadow banking as presented in the Commission's Green Paper.

General remarks and major requests

Closing of regulatory gaps and elimination of deficiencies in the financial market is clearly a key request from the G20 voiced at the Seoul summit in 2010 and further endorsed in Cannes in 2011. As a representative of the highly regulated German investment fund industry, BVI would like to express

[1] BVI Bundesverband Investment and Asset Management represents the interests of the German investment fund and asset management industry. BVI`s offices are located in Berlin, Brussels and Frankfurt. Its 82 members currently handle assets in excess of EUR 1.8 trillion in both investment funds and mandates by managing directly or indirectly the capital of 50 million private clients in 21 million households. BVI's ID number in the EU register of interest representatives is 96816064173-47. For more information, please visit www.bvi.de.

Director General:
Thomas Richter
Managing Director:
Rudolf Siebel

Bockenheimer Anlage 15
D-60322 Frankfurt am Main
Postfach 10 04 37
D-60004 Frankfurt am Main
Phone: +49.69.154090.0
Fax: +49.69.5971406
info@bvi.de
www.bvi.de

its full support for this mission. Unregulated market areas create distortions of competition and entail the incentive of regulatory arbitrage towards the regulated financial sector.

Nonetheless, we have the impression that the premises of the current discussion are not entirely valid. First and foremost, the use of the term "shadow banking" establishes a presumption that the initiative focuses on entities performing banking functions without being subject to banking-equivalent regulation. However, many aspects of the EU Green Paper rightly pertain to either enhancing the standards applicable to traditional banks[2] or to market activities performed by any financial market players, including authorised credit institutions[3]. Hence, the slogan "shadow banking" creates in the public debate a wrong impression of the affected players. Secondly, it appears misguided to treat any form of credit intermediation as an original banking function. The raising of capital in the financial market by issuance of loans or other debt instruments is an activity open to the public and does certainly not require a banking license on the part of investors.

We are particularly concerned by the obvious misperception of investment funds in the context of the shadow banking initiative. Open-ended investment funds are recognized investment vehicles for both retail and institutional investors. They offer investment opportunities by investing the collected funds directly in the target markets and avoiding any kind of credit risk transfer. In this respect, they are fundamentally different from the deposit business pursued by credit institutions. Both EU frameworks for investment funds, the UCITS Directive and the AIFMD, prohibit credit institutions from obtaining a fund manager license and concurrently, exclude banking business from the catalogue of activities permissible for UCITS or AIF managers[4]. Hence, investment funds are no disguised banks, but entirely distinct entities subject to sector-specific regulation and supervision.

In terms of the latter, it is justified to claim that European open-ended investment funds obey the highest regulatory standards present in the market. Under the UCITS Directive, both the fund manager and each individual fund must obtain authorisation from the competent authority before carrying on any activities in the market. Managers of funds other than UCITS

[2] Cf. sections 6.1. and 7.1..
[3] This refers to securities lending and repurchase agreements, cf. section 7.3..
[4] Cf. Article 6(2) and (3) Directive 2009/65/EC, Article 6(2), (4) and (8) Directive 2011/61/EU.

are required to obtain a license under AIFMD which is due for entry into force by July 2013. Also under AIFMD, each fund must be at least notified to the authorities as part of the manager's authorisation and separately, for marketing purposes[5]. Both Directives impose on fund managers strict requirements for the management of risks, including liquidity risks, inherent in the managed funds[6]. Potential conflicts of interest must be capaciously identified, managed by internal arrangements and if not fully eliminated, disclosed to investors[7]. For UCITS, there are in addition extensive provisions in place regarding assets deemed eligible for fund investments as well as applicable investment limits in terms of issuer and counterparty risks[8]. There are also strict limits to the level of leverage that may be employed by UCITS through the use of derivatives; UCITS' engagement in direct borrowing is reduced to a negligible size. AIF managers, on the other hand, are under the obligation to define the maximum level of leverage for each AIF and to report on its implementation to investors and competent authorities[9].

Therefore, and backed up by the arguments presented below, we strongly request the Commission to leave out European open-ended investment funds, UCITS and AIFs alike, of the shadow banking initiative. Instead, the focus of regulatory attention should be put more clearly on entities currently slipping through the regulatory net and unregulated activities raising potential stability concerns.

Alternatively, should the Commission insist on maintaining the broad scope of the debate, we firmly believe that any regulatory measures deemed necessary for European investment funds should be consistent with the regulatory approach currently in place. Potential new requirements resulting from the regulatory analysis should, where possible, be realized through moderate adaptations of the existing EU frameworks for UCITS and AIFs.

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[5] For further details, cf. our reply to Q g) below.

[6] Cf. Article 12 and Articles 38-43 Directive 2010/43/EU (UCITS Implementing Directive), Articles 15 and 16 Directive 2011/61/EU plus Boxes 25 to 34 of the ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, Final Report (ESMA/2011/379), in the following cited as ESMA's technical advice on AIFMD.

[7] Articles 17-20 Directive 2010/43/EU, Article 14 Directive 2011/61/EU and Boxes 20 to 23 of the ESMA's technical advice on AIFMD.

[8] Articles 50-57 Directive 2009/65/EC in conjunction with Directive 2007/16/EC.

[9] For further details, see our answer to Q a) b) and d) e) below.

Specific comments

In light of the aforesaid, we would like to provide the following responses to the questions for consultation:

Q a): *Do you agree with the proposed definition of shadow banking?*
Q b): *Do you agree with the preliminary list of shadow banking entities and activities? Should more entities and/or activities be analysed? If so, which ones?*

We think that the definition of shadow banking proposed by the Commission is too extensive. Compared to the FSB definition[10], it lacks the decisive limitation to activities raising particular concerns in terms of systemic risk and/or regulatory arbitrage.

Analysis of the proposed definition

For investment funds, applying the proposed broad criteria would have the following consequences:

- Funding with deposit-like characteristics: It appears from the further statements made in the Green Paper that short-term funding in general is being considered as similar to bank deposits[11]. On this basis, however, virtually all open-ended investment funds and certainly all UCITS might be classified as shadow banking entities. It is an essential feature of open-ended investment funds to provide frequent, in most cases daily, redemption opportunities to investors. From the investor protection perspective, this element of the fund model has been mostly perceived as highly desirable because it allows for full flexibility as regards the timing of capital withdrawal.

- Maturity and/or liquidity transformation: Most funds investing in government or corporate bonds undergo maturity transformation in terms of the life span of their portfolio securities as compared to the funding capital. The same pertains to money market funds, even

[10] Cf. „Shadow Banking: Scoping the Issues. A Background Note of the Financial Stability Board" dd. 12 April 2011, section 1.2 on page 3.
[11] Cf. Section 4 (i) on page 4 where it is stated that „certain shadow banking activities are financed by short-term funding which is prone to risks of sudden and massive withdrawals of funds by clients".

though the effects of transformation are in this case considerably less relevant. The implementation of the new CESR's Guidelines in July 2011[12] has further reduced the weighted average maturity of European money market funds' assets, thus setting a solid foundation for MMFs' liquidity risk management. Moreover, it should be borne in mind that many of the instruments held by European bond and money market funds are traded on secondary markets which further limit the risk of liquidity shortages.

In addition, should liquidity transformation per se be considered one of key features characterizing shadow banking, then all open-ended investment funds investing in real estate would necessarily be deemed shadow banking entities.

- Credit risk transfer: This effect is quite uncommon in investment funds which invest the assets entrusted to them by the fund unit holders directly in the target markets without taking any risks on their own account. Thus, as regards credit risk, investment funds are not different from direct engagements by individual investors. Only in the case of investment funds providing genuine capital guarantees, credit risk corresponding with the fund assets is usually transferred to the guarantor involved.

- Direct or indirect financial leverage: Depending on the definition of leverage, this element may be found in many investment funds. However, the UCITS Directive and many national regimes for non-UCITS set strict limits to the allowable level of leverage. Under the UCITS Directive, the fund's global exposure acquired via derivatives may not exceed the total net value of its portfolio assets[13]. With direct borrowing restricted to temporary transactions not exceeding 10% of the fund value[14], engagement in derivatives is virtually the only means to leverage a UCITS portfolio. The limits applicable in this respect appear very moderate compared to the leverage level common in the regulated banking sector.

[12] CESR's Guidelines on a common definition of European Money Market Funds dd. 19 May 2010 (CESR/10-049).
[13] Cf. Article 51(3) first subparagraph of Directive 2009/65/EC.
[14] Cf. Article 83(2) Directive 2009/65/EC.

Consequences for investment funds

Hence, it becomes clear that the broad criteria proposed by the Commission would basically submit all open-ended investment funds to the shadow banking definition. Indeed, the compilation of possible shadow banking entities on page 3 of the Green Paper acknowledges that “money market funds and other types of investment funds or products with deposit-like characteristics” and “investment funds, including ETFs, that provide credit or are leveraged” might be in the focus of the Commission’s work on shadow banking.

There are serious shortcomings in this listing. Firstly, assuming that “deposit-like characteristics” refers to short-term funding by readily withdrawable money, nearly all open-ended investment funds would be encompassed by the first component. Secondly, in the universe of traditional investment funds, there are none that “provide credit” other than by purchasing public or corporate loans or money market instruments issued on capital markets. Lastly, ETFs as a rule track the performance of a benchmark and in doing so, neither provide further forms of credit nor are leveraged. ETFs are not different from other investment funds as regards their portfolio composition or investment techniques and therefore, should not be distinguished in any particular way.

More importantly, however, we do not believe that it is pertinent to debate the treatment of investment funds in the context of shadow banking. As depicted in our general remarks above, European open-ended investment funds are densely regulated vehicles subject to ongoing public supervision. They cannot be put on equal footing with entities such as securitisation vehicles as they are miles ahead in terms of the applicable regulatory standards and accordingly, do not pose the risks associated with shadow banking (we will revert on the latter in our answer to the subsequent questions c)-e)).

Suggestions for reduction in scope

Consequently, we urge the Commission to reasonably reduce the scope of the current debate by following more closely the definition developed by the FSB. Under this approach, the focus of regulatory attention shall be narrowed to entities and activities which by fulfilling the broad criteria analysed above give rise to concerns in terms of either systemic risk or regulatory arbitrage[15].

By applying this second layer of testing, we are convinced that most investment funds should fall out of the shadow banking definition. Especially, it is very unlikely that open-ended investment funds with their high degree of regulation would be used for circumventing banking-specific requirements. As regards systemic risk, we think that the investment fund universe is diversified enough in order to withstand the impact of potential turmoil in specific market sectors. The FSB has allegedly identified potential stability risks in relation to money market funds due to their vulnerability to “runs” meaning sudden and massive withdrawals of funds by investors. However, money market funds are exposed to such risk to the same degree as other investment funds offering daily redemption opportunities. Furthermore, European MMFs have not reached a systemically relevant size yet. The total assets under management of European MMFs amounted to Euro 1,171 million at end 2010[16] which accounts for only 2.6% of the total volume of the shadow banking system reported by the FSB[17]. Monetary data from the European Central Bank show that MMF shares/units held by Euro zone investors are nearly negligible compared to the deposits managed by the Euro zone credit institutions (only 3.7% at end 2010)[18]. The ECB data also show that MMFs held less than 2% of all debt securities issued by euro area non-financial sectors in mid 2010 and 7% of all debt securities issued by Euro zone credit institutions[19].

On balance, we believe that there is no convincing argument to involve any European open-ended investment funds in the regulatory debate on shadow banking. Any initiatives deemed pertinent from the financial stability perspective should be discussed in the context of the already

[15] Cf. „Shadow Banking: Scoping the Issues. A Background Note of the Financial Stability Board” dd. 12 April 2011, section 1.2 on page 3 and further “Shadow Banking: Strengthening Oversight and Regulation. Recommendations of the Financial Stability Board” dd. 27 October 2011 where at the bottom of page 3 it states the following:
“In terms of policy actions, the authorities’ focus is further narrowed to the parts of the system which pose systemic risk as they create the potential in particular for “runs” and regulatory arbitrage concerns.”
[16] Source: EFAMA statistics.
[17] Cf. „Shadow Banking: Strengthening Oversight and Regulation. Recommendations of the Financial Stability Board” dd. 27 October 2011, section 2.3.1 on page 8.
[18] Source: ECB Statistical Data Warehouse.
[19] Source: ECB Monthly Bulletin October 2010, page 23.

comprehensive regulatory frameworks applicable to investment funds (cf. in particular our comments on questions f) and g) below).

Q c) *Do you agree that shadow banking can contribute positively to the financial system? Are there other beneficial aspects from these activities that should be retained and promoted in the future?*

We agree with the positive effects of shadow banking identified by the Commission.

In relation to investment funds, however, different benefits must be highlighted which again clearly distinguish investment funds from the purported shadow banking sector:

- <u>Investment funds are an indispensable element of the European old-age provision.</u> They ensure the management of pension savings for several millions of EU citizens. Investment funds become the vehicle of choice either by direct individual investments via saving plans or by integration in dedicated pension products such as the so-called Riester- and Rürup-Rente in Germany or the PERCO in France. Moreover, the assets of other pension providers like insurance undertakings or pension funds are also to a great extent managed by customized investment funds.

- <u>Investment funds offer retail and professional investors direct participation opportunities in various markets around the globe.</u> They ensure portfolio diversification at the fund level and thus contribute to a reasonable reduction of risks for each individual investor.

- <u>Managers of investment funds owe a fiduciary duty towards their investors.</u> Accordingly, fund managers are bound to act in the sole interest of investors when managing investment funds which is a unique obligation in the universe of financial products. This also means that fund managers must take appropriate steps to align their interests with the interests of their investors; any conflicts of interests must be reasonably identified, managed and disclosed.

- <u>Investment funds entail no counterparty risk in relation to the fund manager.</u> The fund assets of European open-ended investment funds are in the most cases economic property of the fund investors; under German law, investors hold even the legal ownership in assets of funds investing in financial instruments[20]. Moreover, the fund assets are entrusted to the depositary for safekeeping. The depositary being a third party financial institution holding mostly a banking license is obliged to register the fund assets in segregated accounts, thus ensuring that assets belonging to the fund remain unaffected by potential insolvency of the fund manager.

Q d) *Do you agree with the description of channels through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?*
Q e) *Should other channels be considered through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?*

The Commission has identified a number of typical risks associated with shadow banking activities on which we would like to comment from the specific investment fund perspective:

- Deposit-like funding structures may lead to "runs": The possibility of unexpected massive withdrawals of the invested capital is imminent in all open-ended investment funds offering daily, or otherwise frequent, redemption opportunities. It is by no means limited to money market funds as apparently suggested by the FSB. On the other hand, however, European investment funds are committed to high standards of liquidity risk management which ensure that they are able to meet the redemption requests from investors. Management of liquidity risks is an intrinsic part of the risk management procedures under the UCITS Directive and has been further developed as a separate function under the AIFMD[21]. The global financial crisis in 2008 caused therefore only limited strains for European investment funds of which only very few were forced to temporarily suspend redemptions. In 2010-2011, in turn, investors reduced significantly their holdings of European MMFs mainly because of the low level of short-term money market rates and the growing competition from banks actively encouraging their clients to

[20] Cf. §30(1) first sentence, second alternative of the German Investment Act which is the model used by most German securities funds.
[21] Cf. Article 16 Directive 2011/61/EU.

reallocate assets to bank deposits. Nevertheless, MMFs were able to cope with these withdrawals without suspending redemptions or being forced to sell securities at fire-sale prices.

- Build-up of high, hidden leverage: This risk can be rejected for all European investment funds. For UCITS, there are limits to the allowable leverage level from both the use of derivatives (100% of the portfolio's global exposure) and temporary borrowing (10% of the asset value). Furthermore, since July 2011 all UCITS are under the obligation to disclose the actual level of employed leverage in the annual report[22]. European funds other than UCITS must observe the standards of AIFMD which is due for national implementation by July 2013. Under this framework, each fund must define a maximum limit in terms of leverage which shall be disclosed to investors as part of the offering documents[23]. The responsible manager must be able to demonstrate to the authorities that the defined leverage limits are reasonable and being observed at all times[24]. The level of leverage effectively implemented within the fund portfolio must be reported to competent authorities on a regular, probably quarterly, basis[25] and in addition, disclosed in the fund's annual report[26]. More stringent reporting and transparency requirements still apply to funds employing leverage on a substantial basis[27].

- Circumvention of rules and regulatory arbitrage: This is also a highly unlikely scenario for investment funds. Fund management activities are governed by extensive sets of rules requiring in any case proper authorization and prudential supervision of the fund manager and in most instances, also authorization and marketing notification of each single investment fund (cf. our explanations under general remarks above). In these circumstances, it appears very improbable to use investment funds in order to avoid regulation or supervision applicable to the banking sector.

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[22] Cf. Box 25 of the CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS dd. 28 July 2010 (CESR/10-788).
[23] Cf. Article 15(4), 23(1)(a) Directive 2011/61/EU.
[24] Article 25(3) first sentence of Directive 2011/61/EU.
[25] Cf. Q 32 of the pro-forma for AIFM reporting to competent authorities presented in Annex V of the ESMA's technical advice on AIFMD.
[26] Cf. Box 109 of the ESMA's technical advice on AIFMD.
[27] Article 24(4) of Directive 2011/61/EU.

- <u>Disorderly failures affecting the banking system:</u> There are certainly diverse linkages between investment funds and the banking sector. Funds invest in securities issued by credit institutions and are parties to various contractual relationships involving banks, including derivative transactions. On the other hand, banks often manage their assets by investing in funds. Hence, it is obvious that any difficulties or failures pertaining to the one counterparty might affect the business of the other. However, investment funds apply firm limits to the relative value of transactions that may be concluded with one single counterparty which are either based on legal requirements or laid down in the fund rules/articles of association. For instance, under the UCITS Directive, the so-called 5/10/40%-test applies to investments in transferable securities or money market instruments issued by the same body[28]; in addition, the total exposure to one single entity may not exceed 20% of the fund assets[29]. These measures aim to ensure that the counterparty risk in investment funds is limited to a reasonable extent. It might be worth to consider introducing similar limitations in the banking regulations in order to reduce potential impact of a counterparty's failure on banking activities.

  Moreover, the risk of massive sales having repercussions on market prices implied by the Commission is not specific to shadow banking, but inherent in trading activities of all financial market players, including traditional banks. In our view, this risk must be tackled by appropriate market regulation involving in particular suitable trading control mechanisms (e.g. trading halts, volatility interruptions etc.) to confront volatile market conditions.

On balance, it is obvious that none of the risks associated with shadow banking can be specifically allocated with investment funds. In our opinion, this outcome presents a further strong argument for a general carve-out of investment funds from the current debate.

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[28] Cf. Article 52(1) and (2) first subparagraph of Directive 2009/65/EC.
[29] Cf. Article 52(2) second subparagraph of Directive 2009/65/EC.

Q f) *Do you agree with the need for stricter monitoring and regulation of shadow banking entities and activities?*

We agree with the need for stricter monitoring and regulation in areas of financial markets currently subject to insufficient regulation and supervision. In terms of investment funds, however, we strongly reject any requests for new regulatory measures. The European fund industry already observes the highest regulatory standards at both manager and product level (for details, see our general remarks above). Any further regulatory action at EU level pertaining to investment funds should clearly aim at enhancing the existing frameworks of UCITS Directive and AIFMD.

Q g) *Do you agree with the suggestions regarding identification and monitoring of the relevant entities and their activities? Do you think that the EU needs permanent processes for the collection and exchange of information on identification and supervisory practices between all EU supervisors, the Commission, the ECB and other central banks?*

In general, we do not object to the suggestions for identification and monitoring of the relevant entities or collection and exchange of the relevant data.

As regards investment funds, however, we firmly believe that no further measures in addition to the existing rules are necessary in order to achieve the objective pursued by the Commission.

All European investment funds and their managers are or in near future will be identified to the authorities. For UCITS, public authorisation of the manager and each individual fund is required prior to any activities in terms of fund management[30]. Managers of funds other than UCITS must obtain a license under AIFMD[31] which is due for entry into force by July 2013. Also under AIFMD, each fund must be at least notified to the authorities as part of the manager's authorisation and separately, for marketing purposes[32]. In the German market, the supervisory authority BaFin has already at its disposal information on each open-ended investment fund launched or marketed in Germany; the same is valid for many other Member States.

[30] Cf. Article 5 and 6(1) Directive 2009/65/EC.
[31] Article 6(1) Directive 2011/61/EU.
[32] Article 7(3)(a),(c) and (e), Articles 31, 32 in connection with Annexes III and IV of Directive 2011/61/EU.

Monitoring of investment fund activities is possible on the basis of half-yearly and annual reports required for UCITS and many other publicly marketed investment funds. Under AIFMD, however, a new quality of supervisory monitoring will be achieved due to the ambitious reporting requirements incumbent on managers of alternative investment funds. According to the ESMA's recommendations on AIFMD implementation, reporting shall be mandatory for most funds on a quarterly basis and encompass several pages of details on portfolio composition, principal exposures and most important concentrations, risk profile and liquidity management[33]. The AIFMD reporting will also provide helpful data for assessing the interconnectedness between banks and other financial institutions as it is envisaged to identify 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[34]. Further, it is proposed that these extensive reports are submitted to competent authorities for each AIF managed or marketed in the EU not later than one month after the end of the reporting period[35].

These reporting requirements are unique in the EU financial sector as regards their frequency and level of detail. Their implementation by July 2013 presents a great challenge for European fund managers in both operational and financial terms. It must be by any means avoided that the current debate on shadow banking prompts further modifications or even aggravation of the AIFMD reporting rules. Thus, we urge the Commission to focus its attention on information gaps present in other financial sectors.

Q h) *Do you agree with the general principles for the supervision of shadow banking set out above?*

We agree with the general principles for supervision as proposed by the Commission. As regards investment funds, we would like to highlight once again that UCITS and other EU retail investment funds are already subject to product-related supervision. In the area of alternative investment funds, notification with the authorities entailing provision of detailed information is

[33] Cf. Box 110 and Annex V of the ESMA's technical advice on AIFMD.
[34] Cf. Q 20 of the pro-forma for AIFM reporting to competent authorities presented in Annex V of the ESMA's technical advice on AIFMD.
[35] Box 110 para. 2 of the ESMA's technical advice on AIFMD.

required for each AIF marketed in the EU[36]. Furthermore, the extensive reporting standards referred to above will equip the authorities with the necessary tools for supervision in macro-prudential terms. Hence, there is clearly no need for additional measures in order to ensure effective supervision of investment funds.

Q i) *Do you agree with the general principles for regulatory responses set out above?*

We agree with the general principles for regulatory responses as outlined by the FSB and the Commission. In particular, we fully endorse the Commission's view that "a specific approach to each kind of entity and/or activity must be adopted".

Hence, should regulation of investment funds be further debated in the shadow banking context, we believe it must be perceived as a combination of the points (ii) and (iii) identified by the Commission. However, in relation to investment funds, the main emphasis should be put on the existing regulatory frameworks of UCITS Directive and AIFMD meaning that no "new" specific regulation should be required. Instead, the existing specific fund regulation could be adapted or revised to some extent if such necessity will be established by objective arguments.

Q j) *What measures could be envisaged to ensure international consistency in the treatment of shadow banking and avoid global regulatory arbitrage?*

We recommend a close coordination of regulatory measures under the auspices of the FSB and the international committees of competent supervisors (IOSCO, BCBS and IAIS where appropriate). Especially, the criteria for identifying shadow banking entities and activities should be to the widest extent possible aligned at international level in order to minimize the potential for regulatory arbitrage. In this respect, we believe that the two-step approach developed by the FSB represents an appropriate point of reference (cf. also our comments on Q a) and b) above).

[36] Cf. Articles 31, 32, 35, 36, 39 and 40 Directive 2011/61/EU.

***Q k)** What are your views on the current measures already taken at the EU level to deal with shadow banking issues?*

We believe that the current EU regulation of investment funds already entails reasonable provisions to meet the concerns in terms of systemic risks. In their combination, the UCITS Directive and the AIFMD ensure that every manager of investment funds issued or sold in the EU is subject to prudential regulation and supervision, including prior authorisation of its business. UCITS investments are mostly limited to financial instruments and subject to strict diversification rules designed to reduce the investment risk for retail investors. In respect of AIFs, the frequent and detailed reporting of portfolio data will provide the competent authorities with comprehensive means to detect and avert any potential risks to the financial stability. Further elements of the EU fund framework are depicted in our above comments.

Once again, we would therefore like to express our firm conviction that investment funds should not be in the focus of the current discussion on shadow banking.

***Q l)** Do you agree with the analysis of the issues currently covered by the five key areas where the Commission is further investigating options?*

With respect to investment funds, we would like to take a stance on regulatory issues mentioned in sections 7.2. (asset management regulation issues) and 7.3. (securities lending and repurchase agreements).

Asset management regulation issues

We support the current review work by ESMA aimed at introducing common EU standards for securities lending by UCITS and enhancing the requirements for collateral to be delivered to the fund. In our view, this review will further improve the quality of UCITS investments, even though the systemic risks associated with securities lending should be better tackled by horizontal measures envisaged in section 7.3.. However, it is important to note that the discussions at ESMA are being led with reference to the general UCITS framework and are by no means limited to ETFs. Therefore, it is surprising that the Green Paper puts such a strong emphasis on ETFs as an alleged part of the shadow banking sector.

The investment techniques commonly used by ETFs, especially securities lending and swap agreements, can be found to a different degree in other types of investment funds. The only truly unique feature of ETFs is the fact that they are “exchange-traded” which prompts differences in the way the ETF units are acquired and disposed of by investors. Hence, the only regulatory measures considered by ESMA in relation to ETFs concern their unequivocal labeling and adequate arrangements to ensure effective redeemability of fund units. This should be of little relevance in macro-economic terms.

Consequently, the FSB does not recommend any regulatory action associated with shadow banking with regard to ETFs and we urge the Commission to follow this appraisal.

As regards MMFs, we are once again puzzled by the Commission’s perception that MMFs are particularly exposed to the risk of runs. The possibility of massive withdrawals of assets by investors is inherent in all open-ended investment funds as explained with reference to Q a) and b) above. The portfolio diversification rules laid down in the UCITS Directive and the standards of liquidity risk management applicable under the UCITS Directive, the AIFMD or the relevant national law, however, allow MMF managers to cope with redemption requests. Hence, neither the financial crisis of 2008 nor the considerable reductions in MMF holdings by investors in its aftermath caused significant strains to European MMFs.

The perceived risks that MMFs may pose to the financial stability and possible policy options to address that risks are currently subject to a consultation by IOSCO[37]. BVI will constructively contribute to this discussion with the aim of developing a viable approach to the regulatory reform of MMFs. We would also like to encourage the Commission to closely collaborate with IOSCO and the FSB in order to ensure that the structures of European MMFs are duly taken into account in the IOSCO’s final recommendations.

Securities lending and repurchase agreements

Engagement by investment funds in securities lending and repurchase transactions (repos) is partially regulated under the UCITS Directive with

[37] IOSCO Consultation Report „Money Market Fund Systemic Risk Analysis and Reform Options“ dd. 27 April 2012.

further standards applicable at national level. The German law, for instance, imposes on investment funds the obligation to fully collateralize securities lending transactions with only selected high quality assets being eligible for collateral[38]. There are also strict counterparty limits[39], rules relating to the collateral safekeeping and to re-investment of cash collateral[40]. At EU level, ESMA is currently working on harmonised provisions on securities lending and repos for all UCITS.

From the macro-economic perspective, however, we think that any regulatory measures relating to securities lending and repos should be horizontal in nature and apply regardless of the identity of market participants engaging in these activities. We agree that in this regard, regulators should be particularly committed to enhancing collateral management, reinvestment practices concerning cash received as collateral and terms of collateral re-use. In respect of the suggestion to improve transparency for supervisory authorities, however, we would like to point out that the regulatory reporting incumbent on AIFM shall already encompass information on the value of borrowings of cash or securities for each individual fund as well as on the value of collateral posted to other counterparties and where applicable, percentage of its re-hypothecation. These details represent only a small fraction of the very challenging reporting requirements which for the time being must not be further intensified.

Lastly, also in this area, it appears highly desirable to coordinate the regulatory efforts at international level. Very recently, the FSB has issued an interim report on financial stability issues relating to securities lending and repos[41] on which BVI has submitted a set of comments. We urge the Commission to collaborate closely with the FSB in order to achieve a universal agreement on regulatory standards which minimize the risk of regulatory arbitrage.

[38] Cf. § 54 of the German Investment Act.
[39] According to § 54 para. 1, second sentence of the German Investment Act, no more than 10% of the fund asset value may be lent out to a single counterparty.
[40] § 54 para. 2, second and third sentence of the German Investment Act.
[41] „Securities Lending and Repos: Market Overview and Financial Stability Issues" Interim Report of the FSB Workstream on Securities Lending and Repos dd. 27 April 2012.

***Q m)** Are there additional issues that should be covered? If so, which ones?*

From the viewpoint of the European investment fund industry, there are no further issues to be covered by the Commission's initiative on shadow banking. On the contrary: as advocated at several points in our reply, investment funds in general should be spared from the current debate and their regulatory reform, if any, should be discussed in the context of the existing EU frameworks of UCITS Directive and AIFMD.

***Q n)** What modifications to the current EU regulatory framework, if any, would be necessary to properly address the risks and issues outlined above?*

As regards investment funds, we would strongly dissuade from amending the AIFMD framework at the current stage. This Directive has not become effective in practice yet and its standards in terms of managers' authorisation, risk or liquidity management and regulatory reporting already represent a true step-change for many alternative investment fund managers.

In terms of UCITS, different strands of regulatory reform are currently under discussion. The UCITS V proposal to be published shortly aims at aligning the UCITS Directive with the AIFMD standards in selected crucial areas such as depositary regime and remuneration. Concurrently, ESMA is developing an enhanced approach to the application of UCITS requirements regarding securities lending and repos as well as certain derivative transactions. Apart from the question whether the latter may become fully workable by means of Level 3 guidelines or will necessitate changes to the Level 1 text, we see no need for further modifications to the UCITS regime.

***Q o)** What other measures, such as increased monitoring or non-binding measures should be considered?*

In the area of investment funds, binding regulation already covers virtually all aspects of the fund business. Hence, we see realistically no room for non-binding measures to be considered as an alternative to regulatory action.

We trust that the Commission will take our comments into account and ensure an appropriate treatment of investment funds in the context of the shadow banking debate. We remain at your full disposal for any questions or further discussion of the subject at hand.

Yours sincerely

Thomas Richter Dr. Magdalena Kuper