Union Investment

Comments by

Union Asset Management Holding AG

on the

Consultative Document (2nd)

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

of FSB and IOSCO

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Volksbanken Raiffeisenbanken
cooperative financial network

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Union Investment

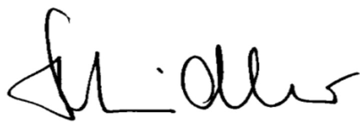
Dear Sirs and Madams,

Union Investment welcomes the opportunity to comment on the second 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 the asset manager of the German Cooperative Banking Network holding more than EUR 250 billion assets under management for more than 4.1 million retail and institutional clients.

Please find our specific comments to the questions below.

Yours sincerely



Schindler Dr. Zubrod

Questions and Answers

High-level framework for identifying NBNI G-SIFIs

Q2-3. Please explain any other NBNI financial entity types that should be excluded from the definition of NBNI financial entities so that NBNI G-SIFI methodologies would not apply and their rationale.

We completely support the approach of BVI and EFAMA to exclude investment funds operating under EU binding legislation such as the UCITS regime from the definition of NBNI financial entities so that NBNI G-SIFI methodologies and their rationale would not apply. Furthermore, this exclusion should also include funds which are subject to UCITS-like regulation and supervision, meaning investment funds which only use limited leverage comparable to UCITS funds and which have a conservative risk-return-profile comparable to UCITS.

Sector-specific methodologies (3): Investment Funds

At first, we would like to clarify that the simplified categorisation of “traditional” and “private” funds does not exist in the EU regulatory context. Such a broad categorisation as suggested by FSB/IOSCO could lead to misunderstandings and misinterpretations. AIFs can pursue very different investment strategies and be set up as professional or retail funds. Hence, the AIF universe ranges from classic retail funds such as mixed funds which deviate only slightly from the UCITS rules in terms of their investments to highly leveraged hedge funds or closed-ended vehicles investing e.g. in infrastructure or private equity. The level of regulation applicable to AIFs also displays considerable differences, with retail AIFs generally adhering to UCITS-equivalent standards and some professional funds not subject to any fund-specific rules.

Q6-1. Please explain any potential systemic risks associated with the financial distress or disorderly liquidation of an investment fund at the global level that are, in your view, not appropriately captured in the above description of each risk transmission channel? Are there elements that have not been adequately captured? Please explain for each of the relevant channels separately.

“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 di-

rect 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. Additionally we would recommend to refer to the definition of leverage for AIFs which only use leverage within the meaning of Art. 111 of delegated Act (EU) No 231/2013.

Q6-2. For the asset liquidation/market channel, to what extent is the potential for risk transmission heightened with respect to an individual fund that is a dominant player (e.g. its asset holdings or trading activities are significant relative to the market segment) in less liquid markets?

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[1] and AIFM Directive[2] provide already strict requirements for the management of risks.

UCITS: In particular there are strict requirements of risk diversification and segregation of assets and protection against insolvency. The European Commission has already stated that UCITS do not cause a systemic risk[3]. Notably, UCITS are safeguarded with the following product features:

- 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

AIFs: Regarding AIFs there are strict requirements of risk and liquidity management, segregation of assets and protection against insolvency and additional detailed requirements, particularly:

[1] Directive 2009/65/EC
[2] Directive 2011/61/EU
[3] 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."

- 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

In summary, the regulatory provisions for UCITS and AIFs are appropriate to avoid forced asset sales and amplify distress and putting the authorities in a position to monitor the build-up of exposures.

Q6-3. Under what conditions might the asset liquidation/market channel apply to an individual fund in ways that are distinct from industry-wide behaviours in contributing to broader market contagion?

The phrasing of the above question is quite misleading. Generally, an individual fund differs from other comparable investment vehicles. There are sparsely funds which are identically invested in the same asset classes, the same individual assets at any point of time, have the same investors or counterparties, and no manager will manage two portfolios in exactly the same way. In conclusion this means that there are always different ways for each individual fund by which it is affected of liquidation demands in the broader market. Therefore, from our point of view a pure definition of certain funds or asset managers as systemically relevant would not address the described concerns by FSB/IOSCO.
It is rather the investor who decides to invest in certain asset classes and hence, controls the strategic allocation of his assets and thereby, the flow of assets into and out of asset classes.

Q6-4. Is the proposed threshold defined for private funds appropriately calibrated? If not, please explain the possible alternative level (e.g. USD 200 billion of GNE) that could be adopted with clear rationale for adoption and quantitative data to back-up such proposed level?

Here, we would agree with BVI’s position. We disagree with setting initial thresholds for investment funds on the basis of a distinction between “private” and “traditional” funds. These terms derive from the US legal frameworks and are meaningless in legal terms outside the US. Regarding the EU, it would be particularly inappropriate to treat all AIFs as “private funds”.
As regards the proposed thresholds, we deem any estimations of systemic size in investment funds purely arbitrary. We call once again upon the FSB/IOSCO to reconsider the general assessment of potential systemic risk inherent in the asset management sector after a thorough analysis of the applicable legal frameworks and on the basis of the data collected by the authorities under the new requirements for regulatory reporting.

Should FSB and IOSCO nonetheless insist on defining thresholds for the purpose of the current initiative, we would suggest considering size in terms of leverage. Indisputably, leverage is a material factor of systemic risk. Most financial failures result from a liquidity failure due to a mismatched term structure of leverage.
In this regard, we decisively reject using Gross Notional Exposure (GNE) as a threshold and size indicator. The GNE approach is fundamentally flawed in that it fails to account for offsetting hedging transactions able to limit – if not completely annul – a fund's investment exposure to the broader market. The notional amount of a derivative contract does not equate to a true economic exposure, given that it only represents the present market value of the underlying asset the moment the trade is executed.
An appropriate measure of leverage should, in our view, capture the economic exposure that results from the use of derivatives and borrowing, and account for risk-reducing effect of hedging operations. Such approach is certainly most meaningful in determining the level of risk posed by an investment fund. From the EU perspective, we recommend using the "commitment approach" as defined in the AIFMD[4] for the purpose of leverage calculation. We encourage regulators to agree on definitions and harmonise the relevant reporting requirements wherever possible.

Q6-5. In your view, which option for the proposed threshold applied to traditional investment funds is the most appropriate initial filter to capture the relevant funds for detailed assessment and why? Also, are they appropriately calibrated? Please provide evidence (data or studies) to support your argument. If you prefer Option 2, please provide a practical definition of a dominant market player that can be applied in a consistent manner.

We would once again emphasise to consider size in terms of leverage which should be calculated by using the "commitment approach" established in the EU AIFM framework. For further clarification it would be helpful to define what technically qualifies as "leverage". It shall be only the positive exposure to the counterparty that is left uncollateralised and thus unsecured.
With regard to the FSB/IOSCO suggestions for "traditional funds", we disagree with setting a threshold with reference to the unspecific and unquantifiable attributes of "dominant player", "substitutability ratio" or "fire sale ratio" as envisaged under Option 2.

Q6-6. In addition to the two options for traditional investment funds, the FSB and IOSCO also considered a simplified version of Option 2 using GAUM (e.g. USD 200 billion) with no dominant player filters. Please provide your views if any on this as a potential threshold with the rationale (especially compared to the proposed two options above).

We do not support the approach to use gross assets under management as potential threshold, because it does not provide an accurate picture of the economic exposure in a fund.

[4] For further details, cf. Article 8 in conjunction with Annex II of the Implementing Regulation (EU) 231/2013.

Q6-7. Please explain any proposed revised indicators set out above that, in your view, are not appropriate for assessing the relevant impact factors and its reasoning.

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. From our point of view the indicators described in 6.4.4. are more important for hedge funds (as a sub-group of AIF) but not for already high-regulated UCITS funds.

Q6-9. What are the practical difficulties (e.g. data availability, comparability) if any with collecting data related to these indicators? Please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

It is of utmost importance that the authorities rely as far as possible on the already implemented standards for data collection in order to assess systemic importance of investment funds. Additional requirements shall be incorporated into the existing frameworks on regulatory reporting. Supervisory authorities should be able to assess systemic risk on the basis of comprehensive data reported through common used channels and feeding into a common database. Further work is also needed on the harmonised understanding of the specific data elements which shall form basis for the effective calculation of the indicators.

Q6-10. For "size", should GNE be adjusted? If so, please explain how GNE should be adjusted and the practicality of such adjustment (e.g. data availability).

We do not support the approach to use GNE as size indicator. Size should be considered in terms of leverage which should be calculated by using the "commitment approach" established in the EU AIFM framework and its notion of "substantial" leverage.

Q6-11. For "interconnectedness", should financial leverage measured separately from synthetic leverage?

From our point of view, we would support the approach to measure both leverage in combination. This would also be consistent with the commitment approach in the AIFM Directive.

Sector-specific methodologies (4): Asset Managers

Q7-1. Please describe any activities or services conducted by asset managers other than described above. In particular, please explain any other activities that, in your view, should be included in the scope.

We strongly express our opposition to the inclusion of asset management companies in the scope of systemic importance of NBNI entities. In many ways, the continued emphasis around the supposed "systemic" nature of asset managers as a result of their activities represents a "step back" in the FSB/IOSCO prior analysis and one we wish to counter with a renewed emphasis.

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[5]. 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[6], management of portfolios of investments, investment advice and safekeeping / administration[7]. For asset manager of AIFs this comprises the management of AIFs[8], the management of portfolios of investments, investment advice and safekeeping and administration and reception and transmission of orders[9]. 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 custodian which has to comply with the regulatory independence requirements. 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.

Q7-2. Please explain any potential systemic risks associated with the financial distress or default of an asset manager at the global level that are, in your view, not appropriately captured in the above description of each risk transmission channel. Are there elements of the relevant channel that have not been adequately captured? Please explain for the relevant channel separately.

For reasons tied to an extremely competitive global landscape in the asset management industry and on the basis of the general nature of the asset management

[5] Article 6 para. (3) Directive 2009/65/EC
[6] Art. 1 para 2 of Directive 2009/65/EC
[7] Art. 6 para 2 of Directive 2009/65/EC
[8] Art. 6 para. 1, 2 of Directive 2011/61/EC
[9] Art. 6 para. 4 of Directive 2011/61 EC

business with the client assets being legally and functionally segregated from the asset manager's balance sheet, we deem this question without substance.

Q7-3. For the exposure/counterparty channel, to what extent does the assessment adequately describe the types of risks posed by asset managers' activities, such as securities lending, distinct from individual funds? Are there other activities that warrant further assessment?

First of all, it is important to clarify that the asset manager is not the counterparty of any transaction and cannot be considered as transmitter of a counterparty risk.

Another clear misconception under section 7.2.1 of the consultative document is that asset managers investing seed money at the launch of one or more funds would transmit their own investment losses over to another counterparty. In this regard, we cannot iterate how such a transmission risk can occur.

As to securities lending and related indemnification programmes, we would like to stress that actual indemnification is only eventual and would materialise only once the lending firms' prior safeguards have proven insufficient. These include selective due diligence on counterparty borrower creditworthiness, over-collateralisation with collateral marked-to-market daily, applied haircuts on non-cash collateral, and the indemnification does not cover the full exposure of the loan, but rather the shortfall between the value of the received collateral and the replacement cost of the lent instruments. Re-hypothecation of non-cash collateral is strictly prohibited under the UCITS framework. Non-cash collateral must be placed in custody with the fund's depositary or another custodian subject to prudential supervision who is unrelated to the collateral provider[10].

Q7-4. For the asset liquidation/market channel, to what extent and under what circumstances might reputational or operational risks of the asset manager impact the entity's individual funds, contributing to high redemptions? How might it impact the transfer of SMAs?

We agree with the statement in section 7.2.2 of the consultation paper that "asset managers tend to have small balance sheets and the forced liquidation of their own assets would not generally create market disruptions". Asset managers do not transmit risks related to asset liquidation/market channel. Even in the worst-case scenario where an asset manager is not able to operate at all, management of investment funds or client portfolios would be transferred to another manager and it will not represent a level of systemic risk.

Q7-5. For the critical function/substitutability channel, are there any emerging activities that might be critical to a portion of financial clients that might in turn impair market functioning or risk management if no longer provided? Other than managing assets as an agent (i.e. core function), to what extent do asset managers engage in activities that may be relied upon by investors,

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[10] Cf. ESMA Guidelines on ETFs and other UCITS issues (ESMA/2014/937), para. 43 g) and i)

financial institutions and corporations, and which are difficult to readily substitute?

Once again, we agree with the statement in the consultation paper at hand that "asset managers primarily provide advice or portfolio management service to clients on an agency basis. This model makes their provision of this particular activity generally substitutable as there is considerable competition in the market place". The asset management industry is indeed highly competitive and there are numerous competitors[11] across different asset classes and investment strategies. Against this background we would see no risk arising from this fact.

Q7-6. Please explain any practical difficulties in applying the above proposed thresholds for an initial filter of the asset manager universe and limiting the pool of asset managers for which more detailed data will be collected and to which the sector-specific methodology (set out in Section 7.4) will be applied.

We do not fully understand the evident contradictions in section 7.3 of the consultative document, where on the one hand the separation between funds and the asset manager is acknowledged, albeit immediately after denied by stating that "nevertheless, certain risks generated at the asset managers' level might also be transmitted through the investment funds that it manages."
Therefore we would like to emphasise our already made comments and reiterate our opposition to the inclusion of asset management companies in the scope of systemic importance of NBNI entities.

Q7-7. Please provide alternative proposals, if any, for a more appropriate initial filter (with the rationale for adoption and quantitative data to back-up such proposals).
Q7-8. Please explain any proposed indicators set out above that, in your view, are not appropriate for assessing the relevant impact factors and its reasoning. What alternative indicators should be added and why would they be more appropriate?
Q7-9. What are the practical difficulties (e.g. data availability, comparability) if any with collecting data related to these indicators? Please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.
Q7-10. Which of the proposed indicators set out above, in your view, should be prioritised in assessing the systemic importance of an asset manager?

Please see our answer to question Q7-6.

[11] „3,300 Asset Management Companies", EFAMA Report: Asset Management in Europe, April 2014, p.30