European Fund and Asset Management Association

EFAMA's response to the BCBS Consultative Document "Identification and measurement of step-in risk"

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 26 member associations and 61 corporate members EUR 21 trillion in assets under management of which EUR 12.6 trillion managed by 56,000 investment funds at end 2015. Just over 30,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 25,900 funds composed of AIFs (Alternative Investment Funds). For more information about EFAMA, please visit www.efama.org

Preliminary remarks

As a concerned stakeholder, we welcome this opportunity to respond to the BIS consultation document on the *Identification and measurement of step-in risk*. We understand that the Committee's work in this field emanates from the first of the FSB's five mandates to prevent the re-emergence of systemic risk from "shadow banking" entities, and namely, the one aimed at mitigating risks in banks' interactions with such entities[1]. Within this remit, the Committee has already issued separate *Standards* on (i) *Capital requirements for banks' equity investments in funds* in December 2013 and (ii) *Supervisory framework for measuring and controlling large exposures* in April 2014. Our understanding is that these existing *Standards* would apply to circumstances where a bank's exposure to an investment fund structure is already consolidated. The Committee's present work around the scope for consolidation for the identification and measurement of step-in risk would be the third and final part within the FSB's abovementioned first mandate, intended to outline a framework addressing banks' exposures to non-consolidated entities/activities.

As a first preliminary observation, we care to note that parent banks have historically only very seldom stepped-in to support their intra-group fund activities, including money market funds (MMFs). However, to address the Committee's concerns regarding the latter, EFAMA cares to point out that major reforms have been carried out in a number of jurisdictions to strengthen the resilience of MMFs, including in the U.S. and in Europe (see *infra*). To complement these efforts, a relevant proposal made by the European Commission for a Money Market Funds Regulation (MMFR) in September 2013 – proposing *inter alia* a ban on sponsor support - is presently still being negotiated by the EU co-Legislators.

Secondly, we care to remind the Committee that potential spill-over risks from asset management activities within a larger financial group are naturally contained by the very "agency" nature of the

[1] We refer to the FSB Strengthening Oversight and Regulation of Shadow Banking - An Overview of Policy Recommendations, published on 29 August 2013; available at: http://www.fsb.org/wp-content/uploads/r_130829a.pdf

asset management business, whereby professional investment managers bear a fiduciary duty *vis-à-vis* their third-party investors to invest their funds in line with the specificities of an investment mandate tailored to the preferences and risk tolerance of individual investors. Consequently, unlike credit institutions, asset management companies do not take financial market risks onto their balance sheet. Rather, it is the individual investors that deliberately seek these exposures the moment they acquire the services of a professional asset manager to manage their funds – whether these be cash reserves, long-term savings and/or private wealth - in return for a fee. To the extent that financial market risks are duly disclosed, recognised, subject to extensive regulatory and/or contractual constraints, and borne upfront by investors, the opportunity for a complementary step-in risk framework for parent credit institutions would in our view deny this investment rationale and, additionally, raise a moral hazard dilemma for market investors.

As a third observation, making the probability of step-in risk for a bank even more remote is the very extensive and prescriptive nature of the applicable regulation to asset managers and their activities, enshrined in Europe under the UCITS (2009/65/EC) and AIFM (2011/61/EU) Directives. A detailed analysis of the specific rules under each of these key pieces of legislation (and their implementing acts) is beyond the scope of our response, although we do attempt to provide a "primer" in our response to Question 7 (see *infra*), including a sub-section on MMFs. These rules embody numerous safeguards – from portfolio diversification, to rules on eligible assets, from liquidity management requirements (including stress-tests) to limits for counterparty exposures and leverage – that make the prospect of an implicit bank "step-in" even less likely. In the aftermath of the 2008 global financial crisis, such regulation has undoubtedly been broadened and, where necessary, even reinforced. As asset management companies do not operate in a vacuum, other significant pieces of EU legislation which have in many ways "revolutionised" the pre-existing financial market ecosystem should be taken into account, particularly those intended to address contagion risks, *in primis*, the European Market Infrastructure Regulation (EMIR).

Fourthly, EFAMA welcomes the fact that the Committee has sensibly acknowledged the limitations behind the often generic use of the term "shadow banking" under paragraph 27 of the consultation document. Further to the FSB's own broad definition of "credit intermediation involving entities and activities outside the regular banking system", with potential four key risk factors (i.e. maturity transformation, liquidity transformation, imperfect credit risk transfer and/or leverage)[2], the term has indeed and too often become a "catch-all" to improperly designate all non-bank entities, regardless of existing, and at times very extensive, market regulation[3]. We thus agree with the Committee's approach of identifying specific situations – rather than stand-alone entities – for the purpose of identifying potential step-in risks.

As a fifth preliminary observation, we welcome the consultation document's references to international accounting standards, as these constitute objective discriminating factors on the basis of which step-in risk should ultimately be judged. In our view, these complement overarching regulatory

[2] Please refer to the FSB Recommendations *Shadow Banking: Strengthening Oversight and Regulation*, published on 27 October 2011; available at: http://www.fsb.org/wp-content/uploads/r_111027a.pdf

[3] Within the EU, we refer particularly to the UCITS Directive (2009/65/EC, as amended) and the AIFM Directive (2001/61/EU) for collective portfolio management services; and to the Markets in Financial Instruments Directive (or "MiFID" 2004/39/EC, as amended) for discretionary portfolio management services on a client-by-client basis.

reforms by assisting regulators in appreciating true economic exposures between a bank and potential off-balance sheet entities/activities on a case-by-case basis to determine their degree of consolidation.

A final preliminary remark would concern the broad notion of “sponsorship”. Paragraphs 32 and 45 of the consultation document define it, although admit this notion is largely “borrowed” from the Basel framework related to securitisation and made to fit – we contend rather loosely – entities and their activities in the non-bank space. We note in this regard that the term “sponsor” becomes particularly mis-leading when used to define the relationship between a bank parent and an intra-group regulated fund vehicle, where the latter in reality is entirely managed by a fully independent (both functionally and legally) asset management subsidiary and where the funds’ assets are mandated by regulatory requirements to be segregated in the name of the fund and held on an account with a separate custody bank (or “depository” as more commonly known in Europe). Unlike for securitisation vehicles, these safeguards are important as they legally prohibit and *de facto* impede the transfer of credit (and other forms of investment) risk from the fund vehicle to the bank parent.

In light of our specific views as the European asset management industry’s trade body, we would invite the Committee to especially consider our reply to Q.7 below carefully, as we take the opportunity to elaborate on some of our industry’s key features.

We remain at your disposal to answer eventual further questions on any of the following points developed in our answers, as well as on others that you may deem relevant for your work going forward. In this regard, please do not hesitate to contact Federico Cupelli at the EFAMA Secretariat.

Q1. What are commenters’ views on the four overarching principles? Are there any others that should be included?

With regard to **Principle 1** and with the important premise that a pre-arranged agreement for support does not exist between the parent bank and the non-bank entity (e.g. via credit enhancements, standing credit facilities, etc.), we note that the possibility of a bank parent stepping-in to support a non-consolidated entity remains largely theoretical, as it is purely optional and dependent on myriads of factors, both behavioural and reflecting real market conditions in one specific moment, that would prove impossible to model and predict with a fair degree of accuracy. Ensuring therefore that the parent has *ex-ante* adequate resources available to contain a hypothetical stress event and the pro-cyclical nature of it is irrelevant. Should such circumstances arise, decisions on the amount of an eventual and available support should be left entirely up to the parent’s management body, once informed by the subsidiary’s management and relevant internal functions, and taken in coordination with the competent domestic regulator. The parent institution would thus be best placed to decide whether it would concretely have to provision for sufficient resources to support a non-consolidated entity, with little or no impact on its continued operations as a going concern.

EFAMA would also observe that an *ad hoc* framework intended to anticipate (and possibly also quantify) step-in risks by prudential regulators risks distorting investor signals by creating a serious moral hazard in announcing, or more subtly manifesting, a parent’s institution’s intent to stand behind the eventual losses deriving from intra-group activities. Assuming, as investors would, that a group parent bank is provisioning to shore-up losses from non-consolidated entities in addition to the already consolidated ones has very far-reaching implications by *de facto* altering a product's risk profile altogether.

Out of the three circumstances outlined by the Committee under paragraph 52 of the consultation document, we would only deem the third one to be relevant for the purpose of this consultation, i.e. that financial support is provided where there is no *ex-ante* arrangement and is prompted purely by reputational considerations. Differently, where financial support is contractually agreed in advance, such exposures should be accounted for under the relevant IFRS standards as contingent liabilities and call for varying degrees of risk capital to be set aside. In this regard, in a European context, the Committee should refer to the separate risk categories assigned under Annex I of the EU Capital Requirement Regulation 575/2013 ("CRR") to these off-balance sheet items, referred to therein primarily as "undrawn credit facilities"[4].

Principle 2 assumes that any framework should be simple and consistently applied. Given that certain market conditions may be unforeseeable and beyond those captured by internal risk metrics or stress-test models, no matter how sophisticated these are, a unique conceptual framework may never be simple and its consistent implementation across jurisdictions would be impossible. The diversity of the institutions involved and the political consequences for given courses of action in times of turbulent markets would be the prime reason for this. This logic would apply to **Principle 3** as well, where any residual risk remains purely hypothetical.

For the same reasons we contend under **Principle 4** that no framework can "properly" identify step-in risk situations *ex-ante* from which to draw "straightforward" conclusions. More pragmatically, we do agree with the Committee that each particular case should be considered *per se*, in close cooperation with the appointed supervisory authority and with decisions based on the best information available (i) to the parent bank, (ii) at the level of the non-consolidated entity (including its management) and (iii) in the market at one specific point in time.

Q2. What are commenters' views on the proposed indicators for step-in risk? Are there any additional ones that the Committee should consider?

As anticipated in our preliminary remarks, the notion of "sponsorship" borrowed from the December 2014 BCBS document on *Revisions to the securitisation framework* under Basel III – intended to frame banks' exposures to securitisation vehicles - is particularly ill-suited when attempting the same analysis *vis-à-vis* investment funds. Looking more specifically at the three elements the Committee is proposing to define a hypothetical sponsorship link between a bank and an investment fund - (i) decision-making (i.e. via management and/or advice), (ii) operations (i.e. via placing securities into the market) and (iii)

[4] Please refer to the Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms. For each of the items listed in Annex I, Article 111 of the Regulation further prescribes the calculation of their "exposure value" after the deduction credit value adjustments.

financial support (i.e. via provision of liquidity facilities or credit enhancement) – we would note the following:

(i) With regard to **decision-making**, within a financial group we note that it is the authorised asset management subsidiary that fundamentally has full decision-making authority (and consequent responsibility) over the group's fund-related business, from the initial launch to the daily management of its fund product range, adjusting it accordingly to reflect multiple factors, such as investor demands, market conditions and competitive pressures, etc. to name only a few. A bank parent thus neither manages, nor advises the group's asset management business which remains at all times functionally and hierarchically independent accountable to different Boards. Moreover, there are extensive regulatory requirements, including around conflict of interest rules, which are monitored on an ongoing basis by independent compliance functions, supported by internal audits and verified by independent ones for the purpose of financial reporting via consolidated statements and relevant shareholder information;

(ii) Referring to **operations**, or the placement of securities into the market, such hypothesis is negated – as *per* the above considerations - by the operational independence between the parent bank and the group's asset management entities. Unlike the credit exposures that are typically transferred from the books of an originating bank into *ad hoc* securitisation vehicles and where the bank would be required to retain and service these exposures up to a certain amount (for the purpose of calculating risk-weighted assets), a group's asset management arm – additionally, also subject to extensive rules and oversight by an independent depositary - is solely responsible for the issuance of a fund's individual units or shares, representing for each investor a *pro-rata* entitlement to the value invested on their behalf by the manager of the underlying fund portfolio. Moreover, as the bank categorically has no discretion or control over the composition of the fund's portfolio, absent is any incentive for a bank to want to "sponsor" it in the sense alluded to in the consultation document. Seed capital funding is a noteworthy exception, although irrelevant from a prudential consolidation stand-point as we shall explain further below; and

(iii) Finally, with regard to potential forms of **financial support**, these remain fundamentally at odds with the nature of fund investing and its underlying rationale; i.e. fund structures are not bank deposits and their investors deliberately expose themselves behind the payment of a fee to potentially higher returns/losses in financial markets. With very few negligible exceptions (see *infra*), investors generally do not (and should not) count on any form of explicit or implicit support, regardless of whether from the group parent bank, a sovereign government bail-in or a central bank liquidity backstop.

In line with our arguments above, the Committee's indicator-based approach between primary and secondary indicators to identify step-in risk, as drawn from the Basel III revised securitisation-based framework, would not be a correct gauge to identify potential risks to the going concern of a bank parent stemming from group asset management activities. Not that some of the proposed indicators are irrelevant, but we question the purpose of them attempting to quantify residual risks by falling back precisely on the same accounting notions used to consolidate the same exposures. For example, proposed indicators such "upfront facilities", "decision-making", "capital ties" or the "power to exercise a significant influence over the management" would in our opinion be tested while performing an initial consolidation analysis based on international accounting standards. Where such analysis yields negative results, the exposures should simply be recognised as non-consolidated.

We maintain that a bank's potential exposures to investment vehicles and consequent step-in risks deserve to be assessed more concretely on the basis of contractual commitments and solely in light of the relevant IFRS accounting rules (see *infra* in our response to Q.7). Step-in risk measured purely on a hypothetical basis by applying the three proposed approaches (including credit conversion factors) used under Basel III to treat off-balance sheet items by calling forth eventual additional capital treatments would fundamentally deny the purpose of differentiating between consolidated and non-consolidated exposures under prior accounting treatments. As mentioned above, attempting to model step-in risk would ignore a full range of contingent assumptions which may not be foreseen in advance and which also largely depend on human judgment. Any *ex ante* estimate therefore risks being partial, if not a gross oversimplification, especially when human behavioural and psychological factors – as those exemplified by the Committee as secondary indicators (e.g. brand communication, investor expectations, their ability to bear losses or to dispose of their instruments, etc.) - come into play.

Q3. What are commenters' views on the proposed secondary indicators for step-in risk? Are there any additional ones that the Committee should consider? Should any of them be considered as primary indicators?

Please refer to our reply to Q. 2 above.

Q4. What are commenters' views on the different potential step-in risk assessment approaches? Are there any other approaches that the Committee should consider to account for step-in risks?

Please refer to our reply to Q. 2 above.

Q5. What are commenters' views on the proposed mapping between the primary indicators and the potential approaches?

Please refer to our reply to Q. 2 above.

Q6. What are commenters' views on proportionate consolidation for joint-ventures?

Please refer to our reply to Q. 2 above.

Q7. What are commenters' views on risks stemming from banks' relationships with asset management activities and funds and the appropriateness of the direction envisaged?

Our views reflect those of several of our member asset management companies, consolidated as subsidiaries of a larger financial group, where:

1. The parent entity of the financial group is a CRD-licensed credit institution under EU law[5]; and
2. The asset management company is a holder of a UCITS management/investment company and/or of an AIFM company and/or of a MiFID investment firm license enabling it to provide collective/individual portfolio management service across the EU, in line with the applicable set of directives[6].

Of relevance to the BIS are those "unconsolidated entities" (including their activities) that, either expressly or tacitly, would benefit from forms of financial support provided by a group parent entity under certain exceptional circumstances. For our industry, these entities would consist in a variety of fund structures and/or individual mandates created to manage investment portfolios on behalf of third-party investors. By definition, therefore, the business model of our members is that of an "agency" business, where the asset management company carries out a fiduciary duty *vis-à-vis* third-party investors by investing their sums to purchase financial market assets comprising the underlying investment portfolios. *Per se*, the asset management company – regardless of its form or denomination across multiple EU jurisdictions – would therefore not be the object of this specific consultation, as generally understood to already be a consolidated group entity within the meaning of CRD/CRR[7]. Paragraph 28, letter e) of the consultation document, therefore, should not include asset management companies among the short-listed entities to which a bank would anecdotally need to provide sponsor support. Further below we explain why the same should apply for MMFs, cited under letter d) of the same paragraph. In the meantime, the following section wishes to provide the Committee with a "primer" on the main safeguards featured under current EU fund regulation, as well as "best practices" for our industry, to avoid the risk of liquidity mismatches, often assumed by central bankers to be the main weakness behind some of our industry's open-end fund structures.

Liquidity risk management requirements and practices

To date, the liquidity risk management requirements of the UCITS and AIFM Directives – as further detailed in their respective implementing acts - are probably the most advanced ones set in legislation

[5] As subject to Directive 2013/36/EU (the "CRD IV") and Regulation (EU) No. 575/2013 (the "CRR").
[6] Notably, the UCITS Directive (2009/65/EC, as recently amended via Directive 2014/91/EU), the AIFM Directive (2011/61/EU) and the "MiFID" Directive (2004/39/EC, as recently amended via Directive 2014/65/EU and Regulation (EU) No. 600/2014), including their relative implementing measures and array of associated ESMA *Guidelines*.
[7] For a financial group in the sense of the CRD/CRR, Article 18(8) of the CRR expressly provides that subsidiary asset management companies – i.e. where holders of a UCITS license – are to be consolidated for the purpose of prudential oversight. As to asset management companies with a non-UCITS license, depending on the case, these may or may not be prudentially consolidated, in line with the conditions foreseen under Article 19(1) of the CRR.

across the world and have been successfully tested in the context of several significant episodes of market turmoil since their initial implementation. These requirements can be clustered around:

1) **A permanent and independent risk management function**: Management companies operating under any one of the above licenses shall establish and maintain a permanent risk management function. Hierarchically and functionally independent from other operating units of the management company, the latter is responsible for implementing effective risk management policies and procedures in order to identify, measure, manage and monitor all risks (including liquidity risk) on an ongoing basis, relevant to each individual fund's investment strategy and risk profile. Regular reports are provided by this function to senior management, as well as to internal compliance and supervisory functions, outlining current levels of risk incurred by each managed fund, as well as any actual or foreseeable breaches to their respective risk limits[8]. Finally, the risk management policies and procedures of authorised funds are subject to regulatory review on an on-going basis after authorisation has been granted and any material changes to the policies and procedures are to be reported to the competent national authority.

2) **Specific liquidity risk management requirements**: These are substantiated by the obligation for the asset management company to employ – especially for funds which are open-end - an appropriate liquidity management system, including procedures to monitor the liquidity risk of the funds and to ensure that the funds' investment strategy, their liquidity profile and their redemption policy are consistent. Stress-tests (see *infra*) under both normal and exceptional liquidity conditions lie at the core of this liquidity assessment. Managers are furthermore required to demonstrate to the competent authorities of their home Member State that an appropriate liquidity management system and effective procedures are not only in place, but also to prove how these are calibrated on the investment strategy, the liquidity profile and the redemption policy of each fund. Such requirements are complemented by the obligation for the asset management company to document its liquidity management policies and procedures, as well as review them on a periodic basis. Appropriate escalation measures are also in-built to the above systems, foreseeing procedures to address anticipated or actual liquidity shortages or other distressed situations of the managed funds.
   Such requirements are particularly essential to UCITS structures, as by definition, these are to ensure – under Article 84(1) of the relevant directive – that investors are able to repurchase or redeem their units upon request. By way of derogation, however, in accordance with the applicable national law, the fund rules or the instruments of incorporation of the management company, the manager or the competent supervisory authorities may even temporarily suspend the repurchase or redemption of a fund's units under extreme market circumstances (e.g. when

[8] As an example, Article 44 of the delegated Regulation (EU) No. 231/2013 accompanying the AIFM Directive introduces quantitative and/or qualitative risk limits for each managed fund, intended to at least cover (i) market risks, (ii) credit risks, (iii) liquidity risks, (iv) counterparty risks, and (v) operational risks. In addition, Box 10 of CESR's *Risk management principles for UCITS* (CESR/09-178) of February 2009 also requires the UCITS management company to provide a system of risk limits to monitor and control the relevant risks (including liquidity risks) for each managed UCITS, as approved by the Board of Directors and found to be consistent with the risk profile of the fund. Please see CESR's *Risk management principles for UCITS*; available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/09_178.pdf

prices for the underlying assets may not be available, or where a manager may deem that it is in the best interest of fund investors).

3) **Controls to monitor performance of illiquid assets**: Stemming from the above, UCITS and AIF management companies are required to monitor liquidity on an ongoing basis, ensuring that each fund is sufficiently liquid to meet its underlying obligations *vis-à-vis* investors. This analysis is based on an assessment of the relative liquidity of the underlying funds' assets in the market, their trading volumes and price sensitivity, of individual spreads in normal and exceptional liquidity conditions, of time required for their liquidation, including the price or value at which this may be performed and their sensitivity to other market risks or factors. Additionally, it is fundamental that the manager have a detailed view as to the profile of the fund's investor base, including the type of investors, the relative size of their investments and the redemption terms to which these investments are subject[9].
For UCITS structures in particular, we wish to stress that the liquidity requirements illustrated above in reality already represent a second line of defence against liquidity risk. The first and most important element that has successfully guaranteed the liquidity of the UCITS product in line with its Article 84(1) obligation, from its inception in 1985 until this day, are the specific portfolio diversification requirements under Article 52 *et seq.* of the directive, as reinforced by a list of eligible and non-eligible assets under the previous Article 50.

4) **Stress-testing**: As mentioned above, stress-tests are to be integrated into, and lie at the core of, the prescribed risk management procedures. Both UCITS and AIFM frameworks provide expressly for these to be performed both under normal and exceptional market conditions. It is particularly under the AIFM Directive's implementing Regulation (EU) No. 231/2013 – Article 44(2) thereof - that their design is specified to some extent[10]. In fact, stress-testing is to be carried out on the basis of reliable and up-to-date information both in quantitative terms and qualitative terms, where appropriate, by simulating a shortage of liquidity of the assets in the fund and atypical redemption requests. The stress-test must be designed to cover all market risks and any resulting impact, including on margin calls, collateral requirements or credit lines. It must additionally account for valuation sensitivities under stressed conditions and be conducted at a frequency which is appropriate to the nature of the fund, taking in to account the investment strategy,

[9] Complementary specification that address liquidity are also to be found in ESMA's 2012 *Guidelines on ETFs and other UCITS issues* (as revised in 2014), albeit these address the liquidity of collateral received in the context of efficient portfolio management (EPM) transactions and/or OTC derivative ones. For instance, under paragraph 43 letter a) of the Guidelines, the liquidity of received collateral – other than cash - is to be ensured by trading it on a regulated market or multilateral trading facility, with transparent pricing, in order for it to be sold rapidly and at a price that is close to pre-sale valuation. Salient is also paragraph 45 by recommending that a UCITS receiving collateral for over 30% of its NAV conduct regular stress-tests are carried out under normal and exceptional liquidity conditions. Please refer to the ESMA *Guidelines on ETFs and other UCITS issues*, as revised and published on 1 August 2014; available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-0011-01-00_en_0.pdf

[10] For UCITS-specific requirements, please refer to the CESR *Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS* (CESR/10-788) of 28 July 2010, particularly to Box 19 – 21, or to the CESR's *Risk management principles for UCITS* (CESR/09-178) of February 2009, particularly Box 7 and the relevant explanations under paragraphs 41-43.

liquidity profile, type of investor and redemption policy. The latter must ensure the fair treatment of all investors, in accordance with the fund's redemption policy and its obligations.

5) **Regulatory disclosures**: Asset management companies must regularly report to the competent authorities of their home Member State information on the principal markets and instruments in which they trade for the funds they manage on behalf of their third-party investors, including a break-down of the relative financial instruments and other assets, the funds' investment strategies, as well as their geographical and sectoral investment focus. Requirements for AIF management companies are more prescriptive by virtue of the less liquid nature of the types of funds they typically manage. Here the regulatory disclosures must also include the mainly traded instruments, the principal exposures and most important concentrations for each of the funds managed.
For those funds (AIFs) that employ leverage on a "substantial" basis – defined as a leverage factor above 3:1 relative to NAV – more comprehensive reporting requirements are triggered, including information on the overall level of leverage employed by each fund managed, a break-down between leverage arising from the borrowing of cash or securities vs. leverage embedded in financial derivatives, as well as the extent to which the fund's assets have been reused under leveraging arrangements to the competent authorities. Such information shall include the identity of the five largest sources of borrowed cash or securities for each of the funds and the amounts of leverage received from each of those sources for each fund. Finally, where necessary for the effective monitoring of systemic risk, the competent authorities may require additional information on a periodic, as well as on an *ad hoc* basis, and inform ESMA accordingly.
Both regimes also foresee relevant public disclosure requirements in fund prospectuses and in other offering documents, sufficient to inform investors as to the nature and risk profile of their investment.

Apart from the above regulatory requirements, asset managers may also count on a variety of operational tools intended to manage the liquidity profile of their funds. As also acknowledged in the IOSCO *Final Report Liquidity Management Tools in Collective Investment Schemes* of December 2015, recourse to these tools is common across many global jurisdictions and has proved successful by enabling fund managers to counter all sorts of market events[11]. Moreover, within important fund domicile jurisdictions, buy-side industry associations have pro-actively sought to provide some practical guidance and marketplace codes of conduct concerning fund liquidity management[12], or specific aspects of it[13].

[11] For a series of concrete examples of suspensions in the recent financial history, please refer to the IOSCO *Final Report Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 survey to members* of December 2015; available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf

[12] In this respect, please refer to the *Code de bonnes pratiques concernant la gestion du risque de liquidité dans les organismes de placement collectif (OPC)*, as adopted in January 2016 by the French asset management industry association (AFG).

[13] For an in-depth example, please refer to the recent *Guidelines on Swing Pricing*, issued by the Association of the Luxembourg Fund Industry (ALFI) on 10 December 2015; available at http://www.alfi.lu/sites/alfi.lu/files/Swing-Pricing-guidelines-final.pdf

In the following sub-sections, for the Committee's information, we turn to describe some among the most common of these tools in brief. This series of tools is not necessarily appropriate in all cases and indeed may not be available to each investment fund depending on the domestic regulatory framework and/or on the individual fund rules. In any event, recourse to one or more of these tools has to be assessed and used depending on the specific circumstances (for instance, some tools are more appropriate when dealing with professional investors rather than retail investors, or depending on the size of the redemption request).

1) **Swing pricing**: A swing pricing mechanism enables a manager to charge, or "swing", the relevant transaction costs tied to the net subscriptions, or net redemptions, respectively on the incoming or outgoing investors. In other words, transactions costs associated with subscriptions and redemptions are allocated to either the bid or offered side of the market, depending on which side is greater (i.e. net inflows or net outflows) for any given fund. In this manner, those fund shareholders that remain invested do not bear the incoming or outgoing shareholders' trading costs which would otherwise affect the former's NAV (especially when buying or selling occurs at a volume). Although not mandated by existing EU law, swing pricing is commonly used for UCITS regulated funds in individual EU jurisdictions such as France, Ireland, Luxembourg and the United Kingdom among the main ones.

2) **Dual Pricing**: Dual pricing constitutes another mechanism by which funds are "dual-priced" in that funds publish and investors deal at separate redemption (bid) and subscription (ask) prices reflecting the spread, and thus the dealing costs, in the underlying assets. Assets held by the fund are priced on a mid-market basis which is used to obtain a mid-NAV per unit/share. Subscriptions and redemptions are matched as portfolio managers trade, so that overall trading and related costs are reduced for subscribers and redeemers. Transaction costs are calculated and then added to the NAV to obtain the subscription price or deducted from the NAV to derive the redemption price, later attributed respectively to the incoming and outgoing investors. This protects existing investors from the effects of trades triggered by dealing/trading

3) **Dilution levy**: As an alternative to swing pricing or dual pricing, a dilution levy may also be applied. This consists in an adjustment made to the price of the units/shares in the fund vehicle to reflect the transaction costs stemming from large investor inflows or outflows. The levy is intended to protect existing or remaining investors against the adverse performance impact of new or leaving investors and is paid back into the fund. Additional charges may therefore be levied on investors buying or selling units/shares in a fund, intended to offset any potential effect on the fund NAV resulting from the additional transaction costs (i.e. market spreads, brokerage charges, stamp duties, etc.).
   As with swing pricing or dual pricing, such tools prove useful particularly in funds experiencing sizeable inflows or outflows, or simply passively tracking a market, where managers would frequently have to buy or sell the fund's underlying holdings to prevent cash overhangs or to be overdrawn. *Per se*, the dilution levy is not a standard charge and its application is very much a policy decision at the discretion of the manager on the basis of a disclosed policy, depending on a series of indicative factors; e.g. a fund over a dealing period experiences high net sales or

redemptions relative to its size, in the presence of one-off large inflows/outflows, where inflows/outflows are continuously in decline or increasing, etc.

4) **In-kind redemptions**: These consist in the "in-kind" - or *in specie* - (i.e. non-cash) payment of the redemption proceeds over to the redeeming investor. There would therefore be no need to sell underlying assets of the fund, thereby protecting both remaining and redeeming investors from any transaction costs. Remaining investors are particularly protected when there is a falling market. Usually, to settle a redemption in cash, a fund manager would sell underlying assets after the valuation point at which the redemption has been priced. In a falling market the assets would be sold at a lower price than their value at the valuation point.
   Typically, the manager would retain some discretion regarding when to make an in-kind redemption payment to a particular fund investor, as well as the composition of that in-kind payment. As an example, the manager may decide to make an in-kind redemption payment in liquid securities, or in thinly-traded ones, or in any combination of these alternatives, in line with the relevant fund documents where provided for.
   Alien to the retail fund space, in-kind redemptions represent viable alternatives to cash payments to redeeming large institutional investors out of a specific fund vehicle. An important driver behind these types of redemption is the preservation of the underlying portfolio's characteristics which may not necessarily be amongst the most liquid and easily convertible to cash, and which the portfolio manager may wish to preserve to not generate a performance drag for the other remaining institutional investors.

5) **"Out -of–the-money" (OTM) gates in fund structures**: Facing liquidity pressures, a fund may choose to temporarily "gate" an investor's access to its capital, by either partially or fully restricting investors' ability to redeem their interest in the fund. Such gates may be imposed either at the fund-level or at the investor-level with differing thresholds. For instance, a fund-level gate of 10% would translate into a redemption prohibition from the fund should on aggregate fund redemptions over a given period exceed 10% of the fund's assets. An investor-level gate of the same percentage would prevent any single investor from withdrawing more than 10% of their interest in the fund, regardless of the withdrawal behaviour of other investors.

6) **Suspension of dealings**: Where open-end fund structures exist, fund managers may decide to suspend dealings when they deem that the relative transactions would run counter to the interests of investors, thus further enhancing the likelihood for a "run" on the fund. Such suspensions – when foreseen by a fund's constituent documents - would allow managers to meet redemptions in an orderly manner, as well as liquidate assets at their full value once pricing conditions improve. Suspensions may be imposed, for instance, where prevailing market conditions do not allow for the fair valuation of the underlying securities, where specific stock exchanges may be closed, or even on occasion of fund mergers or terminations.
   In Europe, such practice is also expressly envisaged under the relevant Article 84(2) of the main UCITS Directive, as a derogation to the main UCITS feature of offering investors continuous liquidity. These decisions are taken by senior management of the asset management company and communicated to the national supervisory authority of the fund's domicile, as well as to those in which the fund has been distributed. The possibility to temporarily suspend the repurchase or

redemption of the fund's shares/units in fact may even be required by the national authority in the interest of the investors or of the public.

7) **"Side-pockets"**: Where assets remain hard to value and may not be orderly liquidated in the market, an asset manager may have recourse to what are commonly known as "side-pockets". These consist in the segregation of the illiquid portion of a fund's portfolio into a separate, illiquid investment vehicle. From an accounting viewpoint, the remaining liquid securities are reflected in the fund's regular account and concur to the value of the fund's unit/shares. Differently, as the side-pocket is illiquid and remains so even for lengthy periods until the assets can be sold-off in an orderly manner, the manager may still continue to charge fees on side pockets, though they are typically accrued once the assets are able to be liquidated again. For those investors that decide to sell out of the fund's regular account, they will still remain invested in the side pocket until the assets can be sold. For new investors to the fund following the creation of the side pocket, these do not share in the side pocket.

A closer look at MMFs

Referring to the examples of specific non-bank entities referred in Part 1 of the consultation document, as well as those under the following paragraph 28, we care to note that there are fundamental differences between securitisation conduits, Structures Investment Vehicles (SIVs), mortgage and finance companies and the like on the one hand; and regulated investment funds on the other. Of the latter category, MMFs remain a very specific product category. Caution should be required when addressing potential bank vulnerabilities from a bank's sponsorship of/investment in MMFs from a regulatory perspective. These vehicles, we argue, should not be treated as one solid investment category, as they do not present – under a more refined categorisation - the same potential risk features, if any, to a bank parent.

Since 2008, MMFs have been the object of extensive reforms, as adopted by regulators – in light of the October 2012 IOSCO Recommendations - in numerous jurisdictions around the world, including most notably in the U.S. between 2010 and 2014 (as referenced also in the BIS consultation document), as well as in the EU with *CESR's Guidelines on a common definition of European money market funds* (CESR/10-049) of May 2010[14] - as supplemented by an ESMA Q&A (ESMA/2012/113) in February 2013[15]. More significantly, the European Commission's following proposal in September 2013 for a Money Market Fund Regulation (MMFR) and the European Parliament's amendments[16] to this proposal support the principle of banning sponsor support. Moreover, the MMFR, which has yet to be finalised, also puts numerous safeguard mechanisms for MMFs in place: a special regime for the treatment of Constant NAV (CNAV) MMFs, including constraints on use of amortised cost accounting, stricter diversification requirements, introduction of liquidity requirements, "know your customer" policy requirements, as well as numerous transparency disclosure requirements. For the same reason,

[14] These are available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/10-049_cesr_guidelines_mmfs_with_disclaimer.pdf
[15] The ESMA Questions and Answers (Q&A) on *A Common Definition of European Money Market Funds* is available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-113.pdf
[16] In this regard, please refer to the European Parliament's voted text at its Plenary in April 2015.

these should no longer be viewed as “shadow banks”, given that in Europe a large majority of MMFs – approximately 90% of the available offer – are at the same time regulated as authorised UCITS vehicles.

Finally, apart from the above considerations, MMFs should in the eyes of prudential regulators not overshadow our industry’s other core products and underlying portfolio and risk management expertise, consisting in the conservative management of investors’ medium- to long-term savings, in line with their investment horizons, and across a vast and alternative product offer and range of asset classes. It is these products which constitute a more representative sample of the European asset management industry, as embodied by UCITS (non-MMFs), AIFs and individual mandates managed on a client-by-client basis.

Key considerations around group consolidation

We agree with the importance of applying the relevant accounting standards – in particular IFRS 10 – to ascertain a group parent entity’s degree of “control” over a subsidiary’s activities, as mentioned in the consultation document. If a subsidiary asset management company is thus generally consolidated for regulatory purposes[17], less obvious, however, is the consolidation of an individual fund’s portfolio (and thus exposure) on the asset management company’s own balance sheet and, by extension, on that of a group parent’s for the purpose of consolidating financial statements. Relevant in this regard - as also correctly pointed out under footnote 6 of the consultation document - is the guidance provided under IFRS 10 concerning the notion of control, calling for a case-by-case assessment of an entity’s exposure to the individual fund.

Overall, by applying the first IFRS 10 criterion, a parent bank’s control over the activities of asset management subsidiaries is naturally absent, or at least strongly limited, by the fact that the latter run an “agency” business on behalf of third-party investors. For instance, the parent could not exercise any authority by directing asset selection or the investment allocation by virtue of parameters agreed upon with individual investors (in the case of discretionary mandates), or due to legal and regulatory factors like for UCITS, where the underlying portfolio would need to comply with the diversification requirements of Article 52 *et seq* of the Directive. Such fund vehicles would therefore not trigger consolidation and a resulting exposure on the parent’s own balance sheet. An identical conclusion is drawn from considering the remaining two IFRS 10 control criteria, i.e. the impossibility for the parent bank to claim rights to the variable returns from the fund vehicle and the impossibility for the parent to affect the variability of the fund’s returns[18].

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[17] With the caveat provided for under Article 19(1) of the CRR whereby non-UCITS management companies may be excluded from the scope of prudential consolidation based on the total amount of assets and on off-balance sheet items.

[18] By virtue of the second and third criteria, control also implies the power of the management company to affect the magnitude and the variability of the returns it receives from the fund relative to the returns investors expect from their participation. For instance, if the variable returns a manager receives from the fund are only limited to the base management fee it receives – calculated as a fixed percentage on the fund’s net asset value (NAV) or of committed capital – the manager would essentially qualify as an agent.

We do acknowledge with the Committee that the above IFRS 10 criteria necessarily call for a degree of judgement to be exercised by consolidating authorities, accompanied by other relevant factors that would merit a lengthier illustration beyond the scope of this response[19]. However, we disagree with the Committee's assumption under paragraph 13 of the consultation document, implying that "a high degree of judgement" applied across different jurisdictions would be responsible for allowing certain entities to escape the scope of consolidation. As IFRS are global standards, these should be applied consistently and by allowing for a moderate (and not "high") degree of judgement to be made, the consolidating institutions can also recognise the natural diversity of structures that exist cross-border without being too prescriptive. For these precise reasons, we are furthermore cautious of the Committee's overarching principles in the direction of simplistic solutions to frame a very hypothetical step-in risk, deriving from franchise reputation or other non-contractual sources.

Apart from the case-by-case application of IFRS 10 when consolidating financial exposures, of particular relevance to investors is IFRS 12, concerning a parent entity's disclosure of interests in "other" entities such as subsidiaries, joint arrangements, associates and unconsolidated structured entities. In the event that a fund is not consolidated on the balance sheet of the parent, the fund remains an independent entity for which information needs to be provided to investors, in particular regarding the size, the nature and the potential for investment losses. For the purpose of this note, we would underscore the significance of IFRS 12 disclosures for informing investors as to the ultimate risks of their investment. These should be appreciated together with the regulatory disclosures required in the product-specific documentation released at the point of sale, so as to make investors fully aware, in advance, of whether the parent's (or broader group's) potential involvement in exceptional circumstances will ultimately render their investment any safer.

EFAMA believes that the above accounting standards are largely sufficient to determine which bank exposures to non-bank activities deserve to be consolidated for regulatory purposes. Moreover, attempting *ex-ante* to estimate a parent banks' potential commitment in terms of capital to cover any future non-consolidated exposure unrealistically assumes the parent is perfectly informed of the individual exposures of all funds managed by a subsidiary asset management company, including access to results of eventual portfolio stress-tests and scenario analysis performed by the risk management function of the management company, so as to then gauge the magnitude of a hypothetical bail-in and provision additional capital accordingly. As illustrated, given the legal and operational independence between the parent bank and the asset management company, such estimation remains irrelevant and would defeat the desired logic of this separation. Moreover, it is

[19] Other factors that play a role in this key determination and that further underscore the degree of judgement that needs to be exercised when considering consolidation are those pertinent to the rights of the investors in the fund. Where in rare occasions these are able to exercise "kick-out" rights for instance – i.e. the power to remove the manager at an extraordinary general meeting of shareholders in a corporate fund – and despite the investment management agreement granting the latter daily decision-making authority over the fund, the power of the manager may consequently be substantially tempered to the extent that it does not trigger consolidation. The same would apply where the proper management of a fund is delegated to a third-party manager, where the latter may again be removed at any point in time as contemplated in the delegation agreement. Analogous conclusions may be drawn when third-parties are able to exercise other substantive rights *vis-à-vis* the manager, i.e. rights which may be held by a board of directors, the rights to modify an investment mandate, to put the shares/units back into the fund (i.e. redemptions), or to force the liquidation of the fund.

important for the Committee to bear in mind the specific capital treatment rules applying in Europe under the dedicated sections of the CRR, whereby capital charges are calibrated on the type of economic exposure to specific entities[20]. The same CRR framework also accounts for risk-mitigating techniques to be applied, although confined only to credit risk. For the purpose of this response, there are various other risk-mitigating, or “hedging”, techniques which concur to reduce these exposures considerably, prior to any considerations around a potential step-in scenario.

On the Committee’s additional indicators and specific approach for asset management activities

With regard to the additional indicators under paragraph 87 of the consultation document that a bank should consider in assessing the likelihood of it having to step-in for non-consolidated funds (either directly or through its asset management subsidiary), we wish to re-iterate that elements such as guarantees on fund performance, explicit commitments to investors to meet shortfalls, or relevant interests in any of the funds (other than for seeding purposes), are already factored into the group’s consolidation on the basis of the aforementioned accounting standards. As a result, guarantees and other types of commitments referred to in paragraph 87 of the consultation document are already caught in the parent bank’s prudential capital treatment and therefore already consolidated. In fact, under the EU CRD/CRR capital regime for credit institutions, these specific off-balance sheet items receive varying degrees of risk capital treatment depending on the risk categories assigned to them under Annex I of CRR in light of their “exposure value” calculation (net of credit value adjustments) according to Article 111 of CRR. The Committee should therefore not consider them as non-consolidated exposures as *per* paragraph 87 of the consultation document.

Regarding the specific approaches for which the Committee is seeking feed-back under the following paragraph 88, we address these (in *italics*) individually below:

- *Consolidate the unconsolidated asset management company because of capital ties or that its external credit rating is based on the bank’s own rating;*
  As illustrated above, the IFRS and deriving European rules under the CRR generally consider asset management company subsidiaries of a banking group to be consolidated already[21]. As to external ratings, these would hardly be indicative, as asset management subsidiaries may not be rated separately at all. Moreover, emphasis on ratings would contravene the post-financial crisis regulatory efforts under the aegis of the Financial Stability Board (FSB) to reduce investors’ over-reliance on external ratings. We would therefore firmly discourage the Committee to use external credit ratings – as *per* its primary indicator No. 10 in the consultation document – in light of their evident limitations and would invite it to not contravene the widely shared principles of the FSB in this respect[22].

[20] See in this respect Article 112 of the CRR, listing several exposure classes.
[21] Apart from UCITS-licensed management companies – as these are always consolidated in accordance with Article 18(8) of the CRR – the following Article 19(1) provides the conditions for the exclusion of non-UCITS management subsidiaries from the prudential consolidation based on their total amount of assets and on off-balance sheet items.
[22] Please refer to the FSB Principles for *Reducing Reliance on CRA Ratings* of October 2010, as complemented by their relative implementation *Roadmap* of November 2012; respectively available at http://www.fsb.org/wp-content/uploads/r_101027.pdf and at http://www.fsb.org/wp-content/uploads/r_121105b.pdf.

- *Based on the sponsoring indicators applicable to funds, applying a conversion approach to the assets under management (AUM). In which case, the conversion approach described above might apply to for example 1% of the total assets of the fund;*
  In line with our replies to Q.1 and Q2 above, we deem that a precise quantification of the residual non-consolidated risks and consequent financial commitment by the parent institution is impossible *ex ante*. The conversion approach – as described in section 4.1 of the consultation paper – would therefore not be relevant.
- *Based on the sponsoring indicators outlined above (i.e. performance guarantees, explicit commitments to meet any shortfalls in returns or relevant interests in the fund other than its management fee), the banking group should consider its relationship with such funds. This would reflect the fact that the group is providing a guarantee of the value of the assets of the fund and so has the obligation to provide such support to the entity when the value of its assets falls. In which case, the conversion approach described above might apply to for example 1% AUM.*
  Please refer to our response to the bullet point above.

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Brussels, 17 March 2016
[16-4016]