efama

European Fund and Asset Management Association

EFAMA'S REPLY TO THE CONSULTATION PAPER ON CEBS'S DRAFT IMPLEMENTATION GUIDELINES ON THE REVISED LARGE EXPOSURE REGIMES (CP26)

EFAMA[1] welcomes the CEBS's Consultation on the implantation guidelines on the revised large exposure regime. Though fund management companies themselves are not subject to the large exposure regime under the revised Capital Requirements Directive (CRD), credit institutions are an important investor group and the regulation has considerable indirect impact on the fund industry. We will therefore limit our comments to the questions raised under section IV of this consultation, dealing with the "*treatment of exposures to schemes with underlying assets according to Article 106(3) of the CRD*".

Question 8: Does the proposal provide sufficient flexibility for institutions to deal with different types of schemes? If you believe additional flexibility is necessary, how should the proposal be amended?

Generally speaking, we support the principles underlying the guidelines proposed by CEBS and we agree with the idea that, whenever feasible, the look-through approach should be preferred as it provides the most prudent treatment from a large exposures' perspective.

We also recognize that the four approaches described under paragraph 83 of the Consultation paper will, in a number of cases, offer additional flexibility, compared with the current situation.

However, as will be explained in further detail below (see answers to questions 10 and 11), both the "Partial look-through" and "mandate-based" approaches will only prove useful in a limited number of cases to investments in CIUs. As a consequence of this, a credit institution investing in CIUs will often be left in practice with no other option than to apply either a full look-through (which can be extremely burdensome and costly in the case of actively managed portfolios) or no look-through at all (approach d).

Against this background, we think that approach d) would be far too conservative if any exposure to an intransparent CIU was to count with 100% of its value for the "unknown

[1] EFAMA is the representative association for the European investment management industry. It represents through its 26 member associations and 44 corporate members approximately EUR 11 trillion in assets under management of which EUR 6.1 trillion was managed by approximately 53,000 funds by the end of 2008. Just over 37,000 of these funds were UCITS funds. For more information about EFAMA, please visit www.efama.org.

exposure group", as it would not sufficiently take into consideration the principle of portfolio diversification in the treatment of exposures to collective investments.

This is particularly the case for schemes authorised under the Undertakings for Collective Investments in Transferable Securities Directive 85/611/CE (UCITS). The principle of risk-spreading is indeed at the heart of the UCITS model (and strongly contributed to its success) and provides one of the fundamental benefits of investing in a scheme, i.e. that risk is reduced when compared against direct investment. Investment in a UCITS should therefore avoid large exposures arising directly from that investment by virtue of the fact that the investment would be diversified.

We would therefore strongly recommend a more favourable treatment for investments in UCITS fund than the default position as currently drafted (see answer to question 12 below).

Question 9: Do the fall-back solutions (approaches b) to d)) appropriately take into account the uncertainty arising from unknown exposures and schemes?

We would like to point out here that, among the CIUs, there is a significant number of guaranteed funds. The existence of a legally enforceable guarantee provided by a third party to the investors will obviously reduce the credit risk as well as the market risk of a CIU portfolio.

Although a specific approach is probably not needed for guaranteed funds, we think that CEBS should state in its guidance that risk mitigation effects can be taken into account.

Question 10: Do you think the partial look-through approach provides additional flexibility or would an institution in practice rather apply either a full look-through or no look-through at all?

Most CIU portfolios are not static but dynamically managed, which implies that an ongoing monitoring, as described in paragraph 81 of the Consultation paper, will be necessary. This entails additional costs (IT, manpower ...) that ultimately will have to be borne either by the investors or by the management company of these CIUs. If the full look-through approach becomes too expensive or too burdensome, neither credit institutions, nor management companies will be willing to apply it.

In this context, the partial-look through approach represents an interesting alternative, especially in those cases where there is a rather small part of a CIU's portfolio for which it would be too difficult to gather data (in case there is a very granular part in the portfolio, for instance). The management company could, in this case, look through most of the portfolio, leaving only a small part of it intransparent. In terms of risk sensitiveness, this approach is clearly preferable to complete non-transparency. It would also significantly reduce the costs and the administrative burden.

Question 11: Do you think the mandate-based approach is feasible? If not, how could an approach based on the mandate work for large exposure purposes?

In a vast majority of cases, the investment mandate of a CIU does not list the names of the issuers in which the portfolio manager is/is not allowed to invest. Investment restrictions are usually defined in terms of type of asset classes (bonds, equities...), geographical or sector allocation, issuers' ratings, etc...

In that sense, the mandate-based approach will not often be applicable in the context of CIUs investments.

However connections between the CIU's portfolio and other exposures of the investing institution could be excluded if, for instance, the CIU restricts its investments to a geographical zone or sector with which the credit institution does not have any business. A mandate-based approach will also be useful with regard to CIUs investing mainly in assets where there is no "client" at all (e.g. real estate).

The Consultation paper rightly mentions that the granularity of a CIU portfolio is an important element when assessing investor's unexpected credit risk. In our opinion, and as already stated above, this aspect of diversification should be given more attention when dealing with intransparent UCIs.

As far as the mandate-based approach is concerned, this could, for instance, be done by adding the following rule: if the investment mandate provides that the CIU portfolio must consist of at least **x** different issuers, only 100- **y** % of the investment in this CIU must be taken into account as part of the group of "unknown connected clients". A set of thresholds or a formula could be used to determine the percentage of the CIU investment relevant for the "unknown exposure group" in relation to minimum diversification. This would also give an incentive to credit institutions to invest in well diversified CIUs.

Question 12: Do you believe that considering all unknown exposures and schemes as belonging to one group of connected clients is too conservative (approach d)? What alternative treatment would you propose?

As already stated in our answer to question 8, EFAMA is of the opinion that considering all unknown exposures and schemes as belonging to one group of connected clients is a far too conservative approach, in the sense that it does not sufficiently take into consideration the principle of portfolio diversification (and its mitigating effects) in the treatment of exposures to collective investments.

We therefore strongly recommend to apply a more favourable treatment to well diversified CIUs, and in particular to UCITS funds.

UCITS have to comply with a detailed set of diversification rules, whereby for example securities issued by a single issuer will, in principle, never make up for more than 10% of a UCITS portfolio (although there are a few exceptions). Combining all these rules, a UCITS portfolio will normally consist of securities issued by at least 16 different issuers (although, in practice, a UCITS portfolio is often much more diversified). Thus, even if the details of a UCITS portfolio are unknown, investors may count on a certain degree of granularity.

Given the diversifications requirements which are imposed by legislation, it does not seem appropriate to treat total unknown exposures which arise through investment in a UCITS as an exposure to a single client. Indeed, even in the worst-case scenario a UCITS would have five exposures to disparate groups of connected counterparties, amounting to 20% each[2].

We would therefore suggest that investment in a UCITS be considered as five exposures (buckets A, B ... E), each amounting to 20% of the total investment. Where investment is made in more than one scheme, the total exposures to buckets A, B ... E must be calculated (by summing the individual exposures to buckets A, B ... E) and must not exceed 25% of own funds in the investing institution. This would limit the impact of any potential consistency in the underlying portfolios of two or more UCITS.

This proposed alternative treatment for investment in UCITS provides a prudent approach (given the requirements imposed on the UCITS by legislation) whilst also mitigating the impact of potential cross-holdings within UCITS.

Question 16: In which case is there no risk for the scheme itself so that it can be excluded from the large exposure regime?

In our view, there is no specific risk for the CIU itself provided that the following conditions are met:

- Assets of the CIU must be strictly segregated from the own assets of the management company and the depositary or with the portfolio of other CIUs.

[2] Pursuant to Article 22(5) of the UCITS IV Directive "*Member States may allow cumulative investment in transferable securities and money market instruments within the same group up to a limit of 20%*".

- The CIU is not liable for claims against the management company, the depositary or any of its investors.
- The complete value of all units of the CIU is identical or nearly identical to the net asset value of its portfolio.
- The potential loss of investors is limited to the amount of their investment in the CIU. They are not personally liable for claims against the CIU.

These four conditions are met by all CIUs authorized under the UCITS directive.

We remain at your complete disposal for any clarification.

Peter De Proft
Director General

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