Luxembourg, 24 October 2016

Response to the EU Commission consultation "Review of the EU macro-prudential framework" (1 August 2016) (the "Consultation")

Introduction

The Association of the Luxembourg Fund Industry (ALFI) is the representative body of the Luxembourg investment fund community. Created in 1988, the Association today represents over 1300 Luxembourg domiciled investment funds, asset management companies and a wide range of service providers such as custodian banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax experts, auditors and accountants, specialist IT providers and communication companies. The Luxembourg Fund Industry is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg-domiciled investment structures are distributed on a global basis in more than 70 countries with a particular focus on Europe, Asia, Latin America and the Middle East.

We thank the European Commission for the opportunity to participate in this consultation on the review of the EU macro-prudential framework. Bearing in mind that almost all questions ask for feedback from stakeholders on the existing ESRB / ECB system which is targeted to banks, we have focused in our response on question 2 regarding a potential expansion of the macro-prudential framework beyond banking.

We support the submission of the European Fund and Asset Management Association (EFAMA).

Question 2

a) Would you consider appropriate to expand the macro-prudential framework beyond banking? [Please rank your answer from 1 (fully appropriate) to 5 (fully inappropriate), and explain your scoring.] (b) If deemed appropriate, what kind of systemic risks should be targeted and how?

Response to question 2

Ranking: 4

In its consultation paper, the EU Commission rightly takes note of monitoring taking place in European and international bodies like the FSB and IOSCO. The discussion on whether the asset management and fund sector should be regulated and supervised in the same way as banks started a couple of years ago. ALFI followed and participated in these discussions from the outset, and we would like to point the EU Commission in particular to:

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- ALFI's comments on the European Commission green paper on shadow banking, dated 19 March 2012 (link);
- ALFI's comments on the European Parliament draft report on shadow banking, dated 14 August 2012 (link);
- ALFI's comments on the FSB consultative document "Strengthening Oversight and Regulation of Shadow Banking", dated 18 November 2012 (link);
- ALFI's response to the IOSCO/FSB consultation "Assessment methodologies for identifying non-bank non-insurer global systemically important financial institutions", dated 7 April 2014 (link);
- ALFI's response to the FSB and IOSCO consultative document (2nd) "Assessment methodologies for identifying non-bank non-insurer global systemically important financial institutions", dated 29 May 2015 (link);
- ALFI's response to the EBA consultation paper "Draft EBA guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 para.2 Regulation (EU) No. 575/2013", dated 19 June 2015 (link);
- ALFI's response to the FSB Consultative Document "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities", dated 21 September 2016 (link).

Regulatory environment applicable to asset managers and investment funds:

We generally support efforts to promote resilient and transparent financial markets and we appreciate the opportunity to engage with regulators and institutions on potential risks to the financial ecosystem.

However, as recently outlined in our response to the FSB Consultative Document "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities", we believe asset management and fund related activities do not entail structural vulnerabilities and would like to stress that the sector is already highly regulated by regulations such as the UCITS Directive, AIFMD, Solvency II, MiFID, EMIR or the Securities Financing Transactions Regulation, dealing with both transparency of information and supervision of the asset management industry.

Whilst these regulatory initiatives have been in place for a relatively short time frame, there have been a number of market events which have provided some evidence of the effectiveness of these tools. We would recommend that the EU Commission takes the impact of these initiatives into account as part of its systemic risk remit. In particular we call for more work to be conducted to assess the considerable amount of data that is being reported by asset managers to their regulators under recent regulatory developments such as AIFMD and to feed information back to the market on the aggregate trends observed.

As there is currently a large book of work ongoing to explore potential systemic risk linked to asset management, we think it would be premature to expand the macro-prudential framework. We would call on the European Commission to wait and learn from work streams already initiated by IOSCO and the FSB a while ago.

We would also like to refer to the European Union's CMU initiative led by the EU Commission itself, which seeks to develop capital markets such that European companies are no longer so reliant on bank financing. Rather than concentrating systemic risk in the banking sector the development of capital markets, especially when combined with ongoing transparency of positions held in investment funds, has the positive effect of spreading risk across a wide variety of asset owners with varying investment objectives and time horizons. This thereby reduces the risk of any one market event leading to material market inflows or outflows by any one set of asset owners. Various European governments have also put in place schemes which are designed to direct financing to small and medium sized businesses. Investment funds play a part in directing finance to such companies, thereby creating liquidity and diversifying the recipient's sources of lending. Moreover, detailed rules on risk management, ring-fencing of assets etc. ensure a higher level of investor protection if investment funds are used for this purpose.

Asset managers and funds are unlike banks:

We are of the view that asset managers are not a source of systemic risk. They are not the counterparty to trades they conduct on behalf of their clients. Neither are they responsible for the allocation by clients of their assets. Managers act as agents for their clients' investments. Moreover, asset managers do not employ leverage to the same extent as banks.

It is also important to note that the investments managed by asset managers on behalf of the clients are separate from those of the asset management firm. In the case of a UCITS or an AIF, the fund board appoints the investment manager to manage its investments. Separately the fund board will appoint a custodian / depositary that is independent of the asset manager. In the event of the asset managers default the investment funds assets will continue to be held by the custodian / depositary for the benefit of the fund and it investors. They will not be devalued as a result of the asset manager's distress.

The recently implemented UCITS V Directive also strengthened the role of the custodian / depositary in the EU. The UCITS V measures mirror those of the AIFMD and require that "financial instruments" owned by an investment fund are segregated from the assets of the depositary while also requiring verification by the depository of "other assets". In the event that these financial instruments are lost the depositary faces a strictly liability regime which requires that the value of the assets be restored without loss to the investment fund.

Investment funds contain characteristics that differentiate them from banks. In particular, fund investors absorb the negative effects that might be caused by the distress or even the default of a fund, thereby mitigating the eventual contagion effects in the broader financial system. The investor is made aware of the potential for loss in the funds constitutional documents and marketing materials prior to investment and accepts those risks upon investment.

In light of the foregoing we believe there should be little distress to the wider financial system in the event of the default of an individual asset manager given the high degree of competition and substitutability within this sector. Overall, we believe that it is inappropriate to expand the macro-prudential framework beyond banking to asset managers and investment funds.