



# GERMANY

## FINANCIAL SECTOR ASSESSMENT PROGRAM

June 2016

### FUND MANAGEMENT: REGULATION, SUPERVISION AND SYSTEMIC RISK MONITORING—TECHNICAL NOTE

This Technical Note on Fund Management: Regulation, Supervision and Systemic Risk Monitoring on Germany was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in June 2016.

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# TECHNICAL NOTE

## FUND MANAGEMENT: REGULATION, SUPERVISION AND SYSTEMIC RISK MONITORING

Prepared By  
**Monetary and Capital Markets  
Department**

This Technical Note was prepared in the context of an IMF Financial Sector Assessment Program (FSAP) in Germany during November 2015 led by Ms. Michaela Erbenova. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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## Glossary

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive
AUM	Assets under management
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht
CIS	Collective investment scheme
EEA	European Economic Area
EU	European Union
FinDAG	Finanzdienstleistungsaufsichtsgesetz (Financial Services Supervision Act)
IOSCO	International Organization of Securities Commissions
KAGB	Kapitalanlagegesetzbuch (German Capital Investment Code)
KARBV	Kapitalanlage-Rechnungslegungs-und-Bewertungsverordnung
UCITS	Undertaking for Collective Investment in Transferable Securities

## EXECUTIVE SUMMARY

**Germany has a large and diverse asset management sector to which it applies a strong and comprehensive regulatory framework.** The sector is the third-largest in Europe, as measured by all managed assets, and comprises a broad range of management companies and funds. Full account is taken of the requirements set out in EU legislation and the standards and principles developed by IOSCO, with some adjustments to reflect the specificities of the German market and priorities of the main supervisor of the sector, BaFin. BaFin is seen as a well-respected and authoritative body which understands the asset management industry well and supervises it in a firm but fair manner. BaFin is sufficiently well-resourced that it can maintain close contact with asset managers and depositaries. This contact could be intensified even further through a program of more frequent on-site inspections.

**German asset managers and funds are subject to detailed rules on valuation of assets and NAV calculation.** Overall, the valuation framework is of a high caliber and is in line with international standards. With respect to liquidity risk management, additional safeguards were put in place since the previous FSAP to prevent a recurrence of problems experienced by certain open-ended real estate funds following the financial crisis. Nevertheless, the authorities should consider introducing mechanisms, such as swing pricing, to reduce the first-mover advantage that can exist in single-priced funds. Similarly, there would be benefit in allowing for a broader range of tools to deal with situations of market illiquidity that could have an impact on the ability of funds to meet redemption requests. Finally, additional steps should be taken to ensure that BaFin is made aware of pricing errors in investment funds and that rules on investor compensation are in place and applied by all asset managers.

**BaFin is able to monitor developments in the asset management sector by having access to an extensive set of data shared by the Bundesbank.** The data is sufficiently granular that individual exposures can be identified swiftly and accurately, allowing supervisory intervention where needed. BaFin's oversight of the sector using quantitative data will be further enhanced as the reporting under the AIFMD becomes more reliable. Pending the establishment by ESMA of a fully-functioning system for collection and exchange of data at EU level, BaFin should ensure it has a system in place to assess the information reported and, where necessary, bring issues of interest to the attention of supervisory authorities in other EU member states. Information on leverage of funds is of potential relevance from a systemic risk perspective. BaFin should contribute to discussions at European and international level on the development of a single method of calculating leverage.

<b>Table 1. Main Recommendations</b>	
<b>Recommendation</b>	<b>Priority</b>
Put in place requirements to ensure that fund depositaries are systematically informed of material pricing errors and that the information is immediately passed on to BaFin. Ensure that all management companies (including smaller ones) have policies in place to compensate investors in the event of material pricing errors.	High
Consider introducing a broader range of pricing tools, including swing pricing or ad hoc redemptions fees, for investment funds in Germany.	Medium
Consider putting in place a broader set of liquidity management tools, such as gates and side pockets, to complement the existing possibility to suspend redemptions.	Medium
Step up the intensity of BaFin's supervisory engagement by increasing the frequency of on-site inspections and accompanying external audits on a more regular basis.	High
Adjust BaFin's risk classification framework to take into account a broader range of factors than the AUM of an entity, e.g., the level of leverage and the extent of interconnectedness.	High
Carry out more structured and systematic analysis of information on funds and management companies.	Medium

# INTRODUCTION<sup>1</sup>

## A. Scope and Approach of this Note

**1. This technical note provides an update on the German asset management sector and an analysis of certain key aspects of the regulatory and supervisory regime.** The note has been prepared as part of the 2016 Financial Sector Assessment Program (FSAP) by Richard Stobo (an external expert engaged by the IMF), drawing on discussions during a mission that took place from November 3 to 18, 2015.

**2. The mission reviewed the effectiveness of the regulation, supervision and systemic risk monitoring of investment funds and their managers, using the relevant International Organization of Securities Commissions (IOSCO) principles and standards as benchmarks.** A significant proportion of the regulatory framework in this area, in particular that related to conduct of business and disclosure requirements, has been harmonized at the European Union (EU) level and is largely in line with the relevant international standards.<sup>2</sup> As a result, this technical note focuses on the areas where the EU requirements leave room for discretion by member states and where IOSCO has issued more detailed standards.<sup>3</sup> Particular emphasis has been placed on requirements with most direct relevance for financial stability, namely valuation, segregation and safekeeping of fund assets, and redemption of fund units. In addition, the mission reviewed how the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) has in practice applied the EU and domestic regulatory framework in authorizing and supervising funds and firms, and how the authorities have analyzed the potential systemic risk arising from fund management.

**3. The author is grateful to the authorities and private sector participants for their cooperation.** The author benefitted greatly from the valuable inputs and insightful views from meetings with regulators, supervisors, asset management companies, depositaries and industry associations.

**4. Germany has the third largest fund management market in Europe, as measured by all managed assets (UCITS, AIFs and managed accounts).** The total investment fund assets under management (AUM) by German fund management companies reached approximately EUR 1,600 billion at end 2013, representing roughly 57 percent of Germany's GDP (for an overview of the types of investment fund in Germany, see Box 1).

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<sup>1</sup> This Technical Note was done by Richard Stobo (IMF external Expert).

<sup>2</sup> The EU and German regulatory frameworks have been compared with Principles 24-28 of the IOSCO Objectives and Principles of Securities Regulation (IOSCO Principles).

<sup>3</sup> Principles of Suspensions of Redemptions in Collective Investment Schemes (CIS), January 2012; Policy Recommendations for Money Market Funds (MMFs), October 2012; Principles of Liquidity Risk Management for CIS, March 2013; Principles for the Valuation of CIS Assets, May 2013; and Standards for the Custody of CIS Assets, November 2015.

**5. BaFin has the primary responsibility for the regulation and supervision of fund management.** It has a mission statement which provides that BaFin's function is to limit risks to the German financial system at both the national and international level and to ensure that Germany as a financial center continues to function properly and that its integrity is preserved. In line with its macroprudential mandate according to the Financial Stability Act, Bundesbank monitors and analyzes risks in the investment fund sector from a macroprudential perspective.

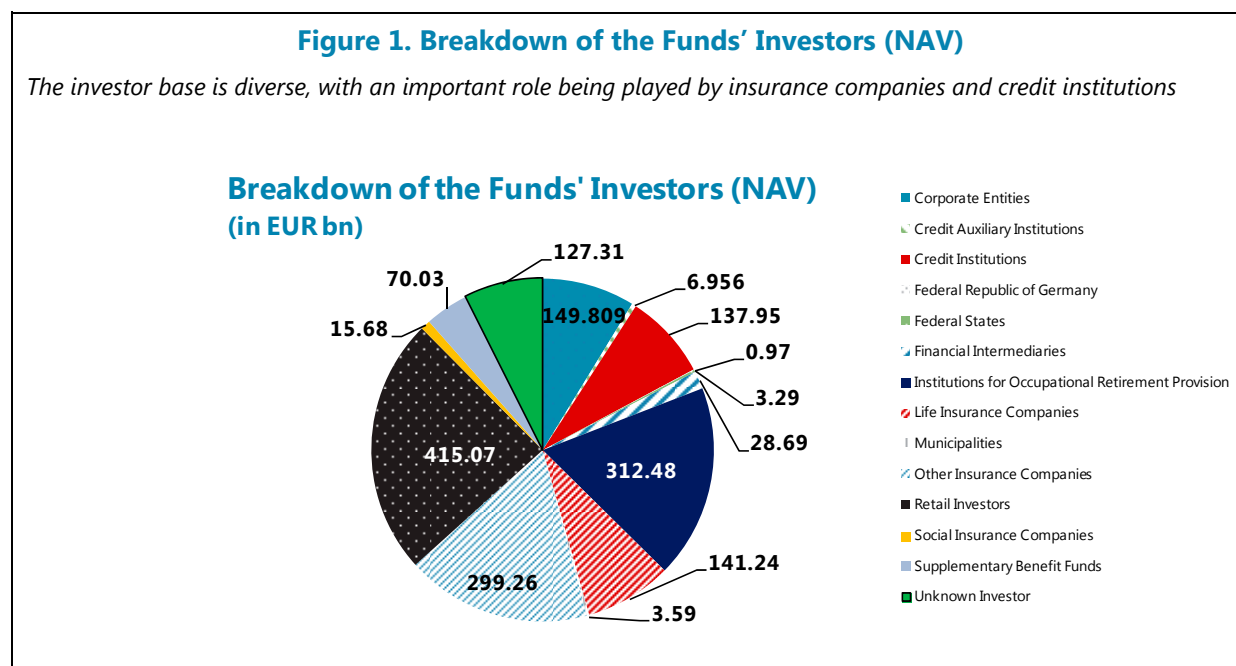
**6. As part of the last FSAP of Germany in 2011 an assessment was made against what were then Principles 17 and 18 of the IOSCO Principles.**<sup>4</sup> The recommendations arising from that assessment were that BaFin should review its approach to the supervision of CIS activity by: i) continuing to refine its approach to assessing and scoring risk; and ii) making more frequent use of on-site inspections to monitor compliance. BaFin has taken action to address both of these recommendations. Further details are set out in the section on Supervision in this note.

## FUND MANAGEMENT

### A. Market Structure

**7. Special AIFs represent 75 percent of the total AUM in Germany, while retail funds (i.e., UCITS and both open- and closed-ended retail AIFs) account for the remaining 25 percent.**

The investor base is diverse, with an important role being played by insurance companies and credit institutions (see Figure 1).



<sup>4</sup> The IOSCO Principles have since been updated.



### Box 1. Investment Fund Types in Germany

As an EU member state, Germany has to comply with the EU Directives on Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and Alternative Investment Fund Managers (AIFMD). This means that all German investment funds fall into one of two categories: UCITS funds or alternative investment funds (AIFs). The UCITS Directive requires a UCITS fund to be authorized, whereas the AIFMD applies to the manager (rather than the fund). Another key distinction in Germany is between open-ended and closed-ended funds.<sup>1,2</sup> Open-ended funds can be UCITS or AIFs, while closed-ended funds are all AIFs that are not open-ended. Germany also has a long-established regime for so-called Spezialfonds (or special AIFs). Special AIFs can be open-ended or closed-ended, and can only be marketed to professional and semi-professional investors.<sup>3</sup>

Type of fund		Legal form	Manager
<b>Open-ended fund</b>			
UCITS fund		Contractual investment fund Investment stock corporation with variable capital	German or EEA UCITS management company
AIF	Retail AIFs	Contractual investment fund Investment stock corporation with variable capital	German or EEA AIFM
	Special AIFs	Contractual investment fund Investment stock corporation with variable capital Open-ended investment liability partnership	German AIFM
<b>Closed-ended fund</b>			
AIF	Retail AIFs	Investment stock corporation with fixed capital Closed-ended investment limited partnership	German or EEA AIFM
	Special AIFs		German AIFM

<sup>1</sup> Open-ended funds are funds that have no restrictions on the amount of shares the fund can issue. Open-ended funds buy back units when investors wish to redeem.

<sup>2</sup> The definition of German closed-ended funds is broader than that of closed-ended funds under the IOSCO Assessment Methodology. While the latter only includes "closed-ended funds whose shares or units are traded on regulated or organized markets," the German definition of closed-ended funds does not include such a condition. This broader definition has been reflected in this note in order to cover the whole German collective investment scheme market.

<sup>3</sup> The KAGB sets out the criteria to be satisfied in order to be classified as a semi-professional investor. These include minimum investments of EUR 200,000, declaration of risk awareness and proof of expertise. The definition of professional investor is aligned with the EU Markets in Financial Instruments Directive.

**8. Money market funds (MMFs) represent a very small proportion of the German market.**

MMF represent less than EUR 4bn out of a total of EUR 1.7tn for open-ended funds. There are no MMFs with a constant net asset value as such a mechanism is legally prohibited.

**9. Both the UCITS Directive and AIFMD include a comprehensive set of regulatory requirements.**

The former covers both fund managers and funds, whereas the focus of the AIFMD is on the managers (AIFMs). Another key distinction is that the AIFMD includes a detailed framework for non-EEA AIFMs and the management and marketing of non-EEA AIFs in the EEA. This framework is not yet fully applicable; instead, non-EEA AIFMs and AIFs are currently subject to National Private Placement Regimes (NPPRs) implemented by some member states, including Germany.

**10. The discussion below focuses on the elements of the regulatory framework that are considered most relevant for financial stability.**

It highlights the areas where the German framework is directly based on EU requirements and those where discretion has been used to apply different or additional requirements. It points out the areas where the regulatory framework is not compliant with the relevant IOSCO Principles or Standards, or where enhancements are otherwise recommended to be made. The manner in which BaFin addresses compliance with the regulatory framework when authorizing and supervising firms and funds and monitoring the sector risks is discussed in sections and D. and E.

### Valuation of assets

**11. The UCITS Directive leaves the determination of valuation requirements for UCITS funds to the member state of the fund.**

It only requires that the rules for valuing the assets and calculating the price of UCITS units be laid down in the applicable national law, in the fund rules, or in the instruments of incorporation of the investment company.<sup>5</sup> A management company managing a UCITS fund domiciled in another EEA state has to comply with that state's valuation, accounting and pricing rules.

**12. UCITS fund managers are responsible for calculating the net asset value (NAV) of the fund and determining the related subscription and redemption prices.**

To achieve this, they are required to have accounting policies and procedures in accordance with the accounting rules of the UCITS fund's home state and procedures to ensure the proper and accurate valuation of the assets and liabilities of the fund in accordance with the fund rules and prospectus.

**13. Valuation has to be carried out at least twice a month, unless the fund applies limited redemption arrangements.**

In line with Article 76(1) of the UCITS Directive, a UCITS fund must not have fewer than two regular valuation points in any month and, if there are only two valuation points, they must be at least two weeks apart. The KAGB requires the NAV to be calculated on every occasion that there is a possibility to subscribe or redeem units, which means daily for most UCITS.

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<sup>5</sup> Further references to fund rules in this technical note cover also the instruments of incorporation of an investment company.

**14. The AIFMD contains an extensive set of valuation requirements for AIFs.** AIF assets must be valued and the NAV per unit calculated at least once a year. Where an AIF is open-ended, such valuations and calculations must also be carried out at a frequency that is appropriate to the assets held by the AIF and its issuance and redemption frequency. The valuation of financial instruments must take place every time the NAV per unit is calculated, and other assets must be valued at least once a year and every time there is evidence that the last determined value is no longer fair or proper. Where an AIF is closed-ended, such valuations and calculations must also be carried out in case of an increase or decrease of the AIF's capital. AIFMD implementing measures include detailed requirements on the content, consistency of application and periodic review of the valuation policies and procedures, use of models to value assets, and review of individual asset values.

**15. AIFMD also includes requirements as to who can conduct the valuation.** If the AIFM performs the valuation, those responsible for valuation must be functionally independent from the portfolio management function and the remuneration policy and other measures must ensure conflict of interests are mitigated. Any external valuer must be independent from the AIF, the AIFM and any other person with close links to the AIF or the AIFM. The AIF's depositary cannot be appointed as an external valuer of the AIF, unless it has functionally and hierarchically separated the performance of its depositary functions from its external valuer tasks; and potential conflicts of interests are properly identified, managed, monitored and disclosed to the investors. The external valuer is prohibited from delegating the valuation function. The AIFM must notify the competent authority of the appointment of the external valuer. If the valuation function is not performed by an independent external valuer, the AIFM competent authority may require it to have its valuation procedures and/or valuations verified by an external valuer or auditor. The competent authority can require an external valuer to verify the independence of internal valuation.

### ***Open-ended CIS***

**16. In Germany the same valuation rules apply to open-ended retail CIS and open-ended special CIS.** These provisions require, for example, that for assets which are admitted to trading on a regulated market, the quoted prices of these assets must be taken as the market value, provided that this ensures a reliable valuation. For assets which are not admitted to trading or for which no traded price is available, the market value should be established based on a prudent assessment using appropriate valuation models and taking into account market conditions.

### ***Closed-ended CIS***

**17. There are separate rules for the valuation of closed-ended funds.** For a period of 12 months following the acquisition of an asset, the purchase price of the asset is to be taken as the market value. However, if the AIFM is of the view that the purchase price is no longer a reliable indicator due to changes in valuation factors, it should calculate a new market value. The AIFM must document its decisions and reasoning for such a calculation. For tangible assets (such as real estate, ships or infrastructure) the acquisition costs should be estimated separately and written off over the course of the expected life-cycle of the investment or, at the latest, after ten years. If such an asset is

sold, the acquisition costs must be written off in their entirety. Details on the sale and purchase of tangible assets made during the reporting period are to be included in an annex to the financial statements of the fund.

### ***Role of depositaries and auditors***

**18. Both UCITS and AIF depositaries have important obligations with regards to the valuation of the units of the fund.** German law provides that the net asset value of a UCITS must be determined by the depositary in cooperation with the management company, or by the management company itself. If the management company values the assets, the depositary must supervise the valuation process. If the depositary values the assets in cooperation with the management company, the management company must verify the depositary's measurement approaches. Furthermore, German law requires that the management company's internal audit function check the compliance with the valuation principles. Finally, the depositary of an AIF has to ensure that the calculation of the value of units of an AIF complies with the statutory provision and the fund rules.

### ***Accounting rules***

**19. For contractual investment funds (i.e., those that do not have legal personality), which is the typical structure for investment funds in Germany, the accounting standards are set out in the KAGB and are further specified in the German Law on Investment Fund Accounting (KARBV).** For the annual financial statement of an investment limited partnership or an investment stock corporation, the provisions of the German Commercial Code (HGB) generally apply. These provisions are supplemented or modified by investment-specific accounting requirements under the KAGB and KARBV.

**20. The main differences between German GAAP (as set out in the KAGB and KARBV) and International Financial Reporting Standards (IFRS) relate to the valuation of liabilities and the valuation of fund units.** Under German GAAP, liabilities are measured at their repayment value, whereas under IFRS 39 financial liabilities are measured initially at their fair value and subsequently at amortized cost using the effective interest method. Regarding the valuation of fund units, German GAAP requires that they be measured at their last determined redemption price or, if they are admitted to trading on a stock exchange or other regulated market, at their current price. According to IFRS 10 para. 32, an investment entity is required to consolidate a subsidiary where that subsidiary provides services that relate to the investment entity's investment activities or to measure an investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9 or IAS 39 (IFRS 10 para. 31). The German requirements appear to comply with Principles 26 and 27 of the IOSCO Principles that require that the CIS accounts are prepared and their NAV is calculated in accordance with high quality, internationally acceptable accounting standards.

### ***Treatment of pricing errors***

**21. The UCITS Directive and AIFMD include only general references to the treatment of pricing errors.** UCITS Directive only notes that UCITS home member state rules apply to the errors in the NAV calculation and related investor compensation. AIFMD implementing measures require an AIFM to ensure that remedial procedures are in place in the event of an incorrect calculation of the NAV. IOSCO's Principles for the Valuation of Collective Investment Schemes state that "responsible entities" should have policies and procedures in place that seek to detect, prevent and correct pricing errors. The Principles also state that pricing errors that result in a material harm to CIS investors should be addressed promptly, and investors fully compensated.

**22. In Germany, additional requirements with respect to pricing errors are applied by means of the annual audit.** For example, the annual audit report must contain a statement on the orderliness of the calculation of unit prices. If a pricing error is identified, the reasons for the pricing error as well as the measures taken by the management company to eliminate the error have to be explained (unless the error is not material). However, in most cases in which pricing errors occur, the management company itself informs BaFin about such errors, the measures taken to eliminate them and the indemnification of investors. Larger management companies have internal guidelines on investor compensation.

**23. Recommendation:** BaFin currently relies on material pricing errors either being notified by the management company itself or being included in the auditor's report. Since such errors can have a potentially significant impact from an investor protection perspective, a requirement should be put in place to ensure the depositary is informed systematically of such errors where the management company has conducted the valuation, and that the depositary then informs BaFin immediately. BaFin should also ensure that all management companies (including smaller ones) have policies in place to compensate investors in the event of material pricing errors.

### ***Risk and liquidity management***

**24. UCITS funds are subject to investment limits and the fund manager is required to manage and measure the funds' risk on a continuous basis.** The detailed investment limits are set out in the UCITS Directive, which also requires the manager to employ a risk management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio. UCITS Implementing Directive includes additional requirements on due diligence in the selection of investments and on risk management and measurement. The risk management policy must comprise procedures to enable the manager to assess the exposure of each UCITS to, among others, liquidity risk. The competent authority must review the risk management policy when authorizing the manager and on an ongoing basis. Any material changes to the policy must be notified to the competent authority. A management company must adopt effective arrangements, processes and techniques to establish, implement and maintain a documented system of internal risk limits, including for liquidity risk, where relevant. The manager must employ an appropriate liquidity risk management process to ensure that each UCITS complies with its redemption obligation and, where appropriate, conduct stress tests which enable

assessment of the UCITS liquidity risk under exceptional circumstances. The liquidity profile of the UCITS must be appropriate to the disclosed redemption policy.

**25. In addition to comprehensive risk management requirements, AIFMD includes detailed obligations on the AIFM's liquidity management system and procedures.** An AIFM must ensure that the investment strategy, liquidity profile and redemption policy of each AIF it manages are consistent. It must also employ an appropriate liquidity management system and adopt procedures which enable it to monitor the AIF's liquidity risk and to ensure that the liquidity profile of the AIF's investments complies with its underlying obligations. It must also regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable it to assess and monitor the liquidity risk of the AIF. Further, the AIFMD requires the AIFM to disclose to investors a description of the AIF's liquidity risk management, including the redemption rights both in normal and in exceptional circumstances, and the existing redemption arrangements with investors. AIFMs are also required to identify, manage and monitor conflicts of interest between redeeming and remaining investors and between the AIFM's incentive to invest in illiquid assets and its redemption policy.

**26. BaFin issued a circular in 2010 setting out a robust and comprehensive framework with respect to risk and liquidity management (InvMaRisk).** These include an obligation on all funds to carry out stress testing on a regular basis.

### ***Pricing tools***

**27. Neither the UCITS Directive nor AIFMD expressly refers to the use of pricing tools.** Similarly, the German legislation does not make express provision for such tools. However, as part of BaFin's supervisory practice, redemptions in kind are allowed in the following cases:

- Special funds: a redemption in kind is allowed if it is laid down in the fund rules. However, a redemption in kind may only be carried out by way of "vertical slicing," i.e., the assets redeemed must be proportionate to the portfolio composition. This is an appropriate safeguard that aims to avoid a situation in which 'good assets' are redeemed while other assets remain in the fund.
- Retail funds: a redemption in kind is only allowed in exceptional cases, where investors agree unanimously and there is no adverse impact on market. As in case of special funds, a redemption in kind can only be carried out by way of "vertical slicing."

**28. A characteristic of frequent trading is that transaction costs are incurred and this dilutes the value of existing shareholders' interests in a single-priced fund.** This fall in value happens because the single price at which investors buy and sell the fund's shares only reflects the value of its net assets. It does not take into account the dealing costs that arise when the portfolio manager trades as a result of capital activity incurring a spread on the underlying securities. In other words, the charges incurred fall not on the client who has just traded, but on all investors in the fund. This can give rise to incentives for investors to be the first to redeem (the so-called first mover advantage), which can potentially be an exacerbating factor when there is a run on the fund.

**29. A broader range of pricing tools can be useful in reducing the first mover advantage in single-priced funds.** The IMF's Global Financial Stability Report of April 2015 suggested tools and measures aimed at reducing the first-mover advantage.<sup>6</sup> While such situations should ideally be prevented from arising at all due to proper liquidity risk management and appropriate supervision, fund share pricing rules that increase investors' incentives to run should be revised. In this context, so-called swing<sup>7</sup>- or dual-pricing rules could play a role. Charging redemption fees, which are found to be effective in smoothing redemptions, is another alternative for pricing-in the cost of liquidity.

**30. Recommendation:** consideration should be given to introducing a broader range of pricing tools, including swing pricing or ad hoc redemption fees, for investment funds in Germany. Since the use of such tools could lead to investor arbitrage,<sup>8</sup> the need for more detailed guidelines on their use should be monitored carefully by BaFin, with a view to contributing to any relevant EU or international standard-setting work.

### ***Suspension and deferral of redemptions***

**31. There are no specific requirements on the suspension of redemptions in the UCITS Directive or AIFMD.** Under Article 84 of the Directive, a UCITS may, in accordance with the applicable national law and the fund rules, temporarily suspend the redemption of its units. This is possible only in exceptional cases, where suspension is in the interest of unitholders. The competent authority and investors must be informed about any suspension. These requirements are reflected in German law. The IOSCO Principles of Liquidity Risk Management for Collective Investment Schemes provide that, where permissible and appropriate for a particular CIS, and in the interests of investors, the responsible entity should include in the CIS's constitutional documents the ability to use specific tools or exceptional measures which could affect redemption rights. BaFin has the power to order the management company to suspend redemption of fund units if this is necessary in the interests of investors or the public.

**32. Germany has put in place specific rules in relation to redemption of units in real estate funds.** First, investments in such funds have to be held for a minimum period of 24 months, and 12 months' notice is required for redemption requests. Secondly, the management company of such a fund is obliged to suspend redemption of units if the bank deposits and the proceeds from the funds invested are not sufficient to pay the redemption price and to ensure a proper management on an on-going basis, or are not immediately available. These provisions were developed in light of

<sup>6</sup> <http://www.imf.org/External/Pubs/FT/GFSR/2015/01/index.htm> (see Chapter 3).

<sup>7</sup> Swing pricing is a mechanism by which investors buying or selling a fund at a volume that could materially impact ongoing investors bear the trading costs incurred, rather than other shareholders bearing them on their behalf. There are two main methods of swing pricing. The first, known as "full" swinging, means that a fund's NAV is adjusted each time there is any net capital activity (i.e., flows in or out), with its direction being determined by the net flows of the day. The second, known as "partial," means the process is triggered, and the NAV swung, only when the net capital activity exceeds a predefined threshold known as the "swing threshold."

<sup>8</sup> In a situation where certain funds applied swing pricing while others maintained a single-price approach, some investors could be more strongly incentivized to redeem from the single-priced fund in order to benefit from the first-mover advantage.



the significant difficulties experienced by some German open-ended real estate funds in the financial crises of 2004/5 and 2008/9, which led to suspensions of redemptions.

**33. German law does not currently provide for other specific tools or measures to deal with problems of liquidity.** This could lead to situations in which the only option for a CIS manager is to suspend redemptions, while the liquidity situation would be such that other, less extreme measures could have been put in place. It is clear that there are investor protection issues to be considered in the use of such tools and that, in line with the aforementioned IOSCO Principles, they should only be used where the fair treatment of investors is not compromised.

**34. Recommendation: The amendments introduced in Germany with respect to real estate funds are to be welcomed.** The German authorities should consider the merits of putting in place other tools that could help in situations where normal redemption activity becomes challenging but a full suspension of redemptions would not be justified or in the best interests of investors.<sup>9</sup> Such tools include gates and side pockets.<sup>10</sup> Since the use of such tools could give rise to investor protection concerns, the need for more detailed guidelines on their use should be monitored carefully by BaFin.

### Use of leverage

**35. The EU regulatory framework on the use of leverage in UCITS funds and AIFs is very different.**<sup>11</sup> The UCITS Directive limits a UCITS fund's global exposure from derivative instruments to 100 percent of the total net value of the UCITS portfolio. The global exposure has to be calculated using either the commitment approach or the Value-at-Risk (VaR) method. Borrowing is not taken into account when determining the leverage of a UCITS fund, but UCITS funds are permitted to borrow only up to 10 percent of their NAV. The AIFMD defines leverage as "any method by which the AIFM increases the exposure of an AIF whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means." The Directive requires AIFMs to set leverage limits in respect of each AIF they manage, but does not set maximum limits on leverage.<sup>12</sup> Leverage must be calculated using two methods: the gross method and the commitment method. The overall leverage of an AIF is expressed as a ratio between the exposure of the AIF and its NAV.

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<sup>9</sup> It is recognized that the introduction of such tools would require changes to the KAGB.

<sup>10</sup> For macroprudential purposes, the Financial Stability Board (2013) and the IMF's Global Financial Stability Report of October 2014 suggest that regulation and fund contracts should include tools, such as fees, gates, side-pockets, as well as suspension of redemptions, to manage large redemptions.

<sup>11</sup> See Box 2.

<sup>12</sup> However, an AIF is considered to be "substantially leveraged" when the exposure of the AIF calculated according to the commitment method exceeds three times its net asset value. AIFMs that manage AIFs employing leverage on a substantial basis have to make available additional information to their competent authorities, including the overall level of leverage employed by each AIF and the extent to which the AIF's assets have been reused under leveraging arrangements.





Reuse of cash borrowing: the higher of the market value of the investment realized or the total amount of the cash borrowed

The gross method under AIFMD is calculated as follows:

Direct positions: absolute value
-
Cash equivalents
+
Derivatives: Sum of the absolute values of derivative positions converted into equivalent positions in the underlying assets
+
SFT: market value of the collateral received (including cash) when reinvested in assets.
+
Reuse of cash borrowings: the higher of the market value of the investment realized or the total amount of the cash borrowed

**36. Recommendation: No internationally agreed standard exists as yet in this area.** In order to allow authorities to have a clearer overview of the use of leverage by CIS, it would nevertheless be appropriate to work towards a common method for the calculation of leverage in the investment funds area. The German authorities should therefore continue to contribute to international work aimed at developing a common global approach to measuring CIS leverage, building on their supervisory experience and analysis of existing data.

## Depositaries

**37. The IOSCO Standards for the Custody of Collective Investment Schemes' Assets provide that the regulatory regime should make appropriate provision for the custodial arrangements of the CIS.**<sup>13</sup> This may include requiring the appointment of a single custodian for each CIS in order to have certainty over who is ultimately responsible for the custody of all CIS assets within a given CIS. The UCITS Directive and AIFMD are more prescriptive and require the appointment of a depositary for each UCITS fund and AIF.<sup>14</sup> As a general rule, a depositary must have its registered office or a branch in the same country where the fund is domiciled. This is aimed at ensuring that the depositary can properly exercise its safekeeping and oversight duties. However, a non-EEA AIF's depositary may be established in the AIFM home state. The competent authority of the UCITS member state must approve the depositary to act as a depositary for a fund domiciled in that EEA state; there is no such requirement in the AIFMD, but German law does require approval by BaFin for depositaries of retail AIFs. Under the current UCITS IV Directive, when the UCITS fund and its manager are located in different EEA states, they must enter into a detailed written agreement that regulates the flow of information necessary for them to perform their roles. AIFMD and UCITS V

<sup>13</sup> <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD512.pdf>

<sup>14</sup> UCITS V Directive specifically requires a single depositary for UCITS funds, which is currently not required under UCITS IV Directive.

Directive require such a written contract independent of the locations of the manager and depositary.

### ***Prudential requirements***

**38. The German requirements for UCITS depositaries are more stringent than those of the UCITS IV Directive.** UCITS IV Directive only requires a depositary to be an institution subject to prudential regulation and ongoing supervision, but leaves the determination of further eligibility criteria to member states. Unlike in other countries (such as the U.K. and France), in Germany only credit institutions may act as the depositary of a UCITS, subject to an initial capital requirement of at least EUR 5 million. UCITS V Directive depositary eligibility requirements are more detailed, and provide the member states discretion to specify them further.

**39. A depositary for a German AIF can be either a credit institution or a financial services institution which holds a license for limited custody business.** For financial services institutions acting as depositary, the initial capital has to be at least EUR 730,000. A derogation is provided for certain types of closed-ended AIF such that a trustee can be engaged as depositary if the trustee meets certain personal and professional requirements (e.g., having sufficient financial guarantees in the form of capital and liability). BaFin has issued a circular in which the obligations on trustees are detailed further.

### ***Depositary independence***

**40. AIFMD and UCITS V Directive include depositary independence requirements that go beyond the UCITS IV Directive prohibition for the management company to act as the depositary.** They prohibit a depositary from carrying out activities with regard to a fund or its manager unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed. AIFMD also specifically prohibits an AIF's prime broker from acting as the AIF's depositary, unless the prime brokerage and depositary functions are separated and conflicts of interest are properly identified, managed, monitored and disclosed.

**41. German law provides for additional requirements with respect to the independence of the depositary which are not based on EU legislation.** Managing directors of a depositary, its holders of a power of procuration and the agents with authority to represent the depositary in the entire scope of its business may not be employees of the AIFM or the UCITS management company. Moreover, the depositary must, by way of organizational and procedural rules, ensure that, in performing its tasks, conflicts of interest between the depositary and the management company are prevented. The law further provides that an independent unit must be tasked with monitoring compliance with the rules on conflicts of interest.

**42. A number of asset managers in Germany are in the same corporate group as the depositary of their funds.** The implementation of the stricter requirements on independence set

out in the UCITS V Directive will require adjustments to the composition of supervisory boards of some management companies and depositaries, but this is not expected to cause any particular challenges to the industry.

### ***Safekeeping and segregation of fund assets***

**43. The IOSCO Standards for the Custody of Collective Investment Schemes' Assets provide for the segregation of CIS assets.** CIS assets should be segregated from:

- a. the assets of the responsible entity and its related entities;
- b. the assets of the custodian / sub-custodian throughout the custody chain; and
- c. the assets of other schemes and other clients of the custodian throughout the custody chain (unless CIS assets are held in a permissible omnibus account).

**44. The AIFMD has more detailed segregation requirements than the UCITS IV Directive.**

The AIFMD requires that financial instruments held in custody be registered in the depositary's books within segregated accounts and that depositaries keep such records and accounts as are necessary to enable them at any time and without delay to distinguish assets held for one client from assets held for any other client, and from their own assets. The same standard of segregation is due to be made compulsory for depositaries of UCITS under the UCITS V Directive.

**45. Taking a prudent stance, BaFin applies certain safekeeping and segregation requirements to UCITS depositaries.**<sup>15</sup> The depositary must place the securities, certificates of deposit and deposits belonging to a UCITS in a blocked account (in the sense that specific restrictions exist with regard to the powers of the account holder). As the account holder, the management company can only dispose of the funds in the account with the cooperation of the depositary. The depositary itself has no power of disposition and may dispose of the funds in the blocked account only upon the instruction of the management company.

**46. Assets that cannot be held in custody must be monitored by the depositary on an ongoing basis.** In order to ensure such monitoring, the depositary agreement must stipulate that the management company promptly and comprehensively informs the depositary about each transaction. In addition, the depositary is obliged to maintain a list of the assets which cannot be held in custody.

**47. Under German law, UCITS and AIF depositaries are subject to the same rules with respect to the delegation of safekeeping functions to third parties.** For financial instruments which can be held in custody the depositary ensures that all financial instruments which can be booked on a securities account are registered in the books of the depositary on separate accounts opened in the name of the AIF or its management company, so that the financial instruments can be

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<sup>15</sup> Despite the current lack of detailed EU level requirements.

clearly identified at all times belonging to the AIF. For other assets the depositary verifies the ownership title of the AIF or its management company and keeps records of those assets. Further segregation obligations stem directly from the AIFMD Level 2 Regulation.

**48. The depositary may only delegate its safekeeping function to a third party (sub-custodian) if certain requirements are fulfilled.** One of the requirements is that the sub-custodian separates the assets of clients of the depositary from its own assets and from the assets of the depositary in a manner that they can be clearly and at all times identified as belonging to the clients of a particular depositary. This segregation obligation is further specified in the AIFMD Level 2 Regulation, which states that the depositary must ensure that the sub-custodian keeps such records and accounts as are necessary to enable it at any time and without delay to distinguish assets of the depositary's AIF clients from its own assets, assets of its other clients, assets held by the depositary for its own account and assets held for clients of the depositary which are not AIFs. The sub-custodian cannot make use of the assets unless it has received prior consent from the AIF or the AIFM and notified the depositary.

**49. Particular requirements apply in the case of delegation of custody to third parties based outside the EU.** Where the law of a third country requires that certain financial instruments be held in custody by a local entity and no local entities satisfy the delegation requirements laid down elsewhere in the AIFMD, the depositary may delegate its functions to such a local entity only to the extent required by the law of the third country and only for as long as there are no local entities that satisfy the delegation requirements. In such cases, the investors of the relevant AIF must be duly informed that such delegation is required due to legal constraints in the law of the third country and of the circumstances justifying the delegation, prior to their investment; and the AIF, or the AIFM on behalf of the AIF, must instruct the depositary to delegate the custody of such financial instruments to such local entity.

**50. The UCITS V Directive significantly enhances the requirements on delegation by the depositary.** Only safekeeping functions are permitted to be delegated, subject to specific conditions. Reuse of client assets for the account of the depositary or the account of another client is prohibited.

**51. Recommendation:** Given the current lack of clarity on the proper interpretation of the segregation obligations in the AIFMD when safekeeping duties are delegated, BaFin should continue to contribute actively to discussions at the EU level on the development of a common approach with a view to increased investor protection and reduced scope for regulatory arbitrage.

### ***Depositary liability***

**52. The AIFMD depositary liability requirements are more explicit than those of the UCITS IV Directive,<sup>16</sup> but enable contractual discharge of liability in case of delegation.**

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<sup>16</sup> Under the current UCITS IV Directive member states have taken different approaches on whether the depositary is liable for any loss of financial instruments held in custody.

Notwithstanding delegation, the depositary remains liable for any loss of financial instruments held in custody. If this happens, the depositary will have to return to the AIF or the AIFM a financial instrument identical to the type lost or the corresponding amount. The depositary will however not be liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary (*force majeure*). Subject to the AIF's agreement, the depositary can also discharge itself of liability if it can prove that a written contract between the depositary and the delegate expressly transfers the liability to the delegate and makes it possible to make a claim against the delegate.

**53. UCITS V Directive largely aligns the depositary liability requirements with those of the AIFMD.** However, UCITS V Directive is even more stringent since it does not allow any discharge of liability (including for loss of assets) when safekeeping duties has been delegated to a third party. UCITS V Directive also requires member states to ensure that, in the event of insolvency of the depositary or a delegated third party, the assets of the UCITS held in custody are unavailable for distribution among creditors of the depositary or of the third party delegate.

**54. Under German law the more detailed depositary rules of the AIFMD are already applied to depositaries of UCITS.** BaFin has also issued a circular with more specific rules on delegation of safekeeping, including that the delegation must not result in a transfer of responsibility of the managing directors to the delegate and that the arrangement must not prevent BaFin from performing its functions.

## B. Authorization

**55. BaFin is responsible for authorizing firms to conduct fund management activities.**

There are a number of key elements that need to be satisfied in order for an entity to obtain authorization, including satisfying the requirements on initial capital, having directors that are fit and proper, and submitting an appropriate business plan. Before granting a license to an entity, BaFin often holds meetings with managers and relevant staff of the management company and, if necessary taking into account the kind of license to be granted, BaFin also visits the premises of the company.

**56. The authorization of fund management companies is carried out by the asset management department of BaFin.** It is common practice for applicants to make informal contact with BaFin before submitting a formal application. This helps ensure that any more problematic issues are identified at an early stage. Case officers to whom authorization applications are assigned assess both the management company as a corporate entity and the individuals that will hold the key functions. The general policy is to have two case officers looking at each firm, both in the authorization and supervision stages.

**A tailored approach is taken to registered management companies, which are those falling below the relevant threshold of the AIFMD.** Where the registered AIFM manages only special AIFs, the management company is subject only to registration and reporting requirements. Where

the registered AIFM also manages retail AIFs, it is subject to a broader set of rules covering, inter alia, conduct and organizational requirements, and depositary obligations.

### Delegated management

**57. If the management company delegates portfolio management to a third party, the third party must be authorized or registered for the purposes of asset management or financial portfolio management and subject to supervision.** The only exception to this is in the case of AIFMs where, if the conditions cannot be met, the delegation may be granted subject to prior approval by BaFin. This ensures strong customer protection. If the delegation is to an entity outside the EU, appropriate cooperation arrangements must be in place between BaFin and the third country regulator.

### Trustees and depositaries

**58. BaFin approval is required for the appointment (and any change thereof) of the depositaries of UCITS and retail AIFs, but not for special AIFs.** If a trustee is engaged as depositary, evidence of financial guarantees must be provided to BaFin.

### Funds

**59. BaFin approval is required for the fund rules of retail CIS (UCITS and retail AIFs).** The approval must be granted within a period of four weeks after submission of the application, if the fund rules meet the statutory requirements. The first step for the case officer is to check the fund rules against the sample fund rules that the German mutual fund association, BVI, has developed (in cooperation with BaFin) and which are freely available on the BVI's website.

**60. In the case of special AIFs, no approval is required; a notification is sufficient.** This reflects the relatively sophisticated nature of the investors in such funds. There are two types of special fund: i) general special funds, which have no limits on their eligible assets; and ii) special funds with fixed investment rules, which have a more limited range of eligible assets. Sample fund rules for special funds have also been developed by the BVI.

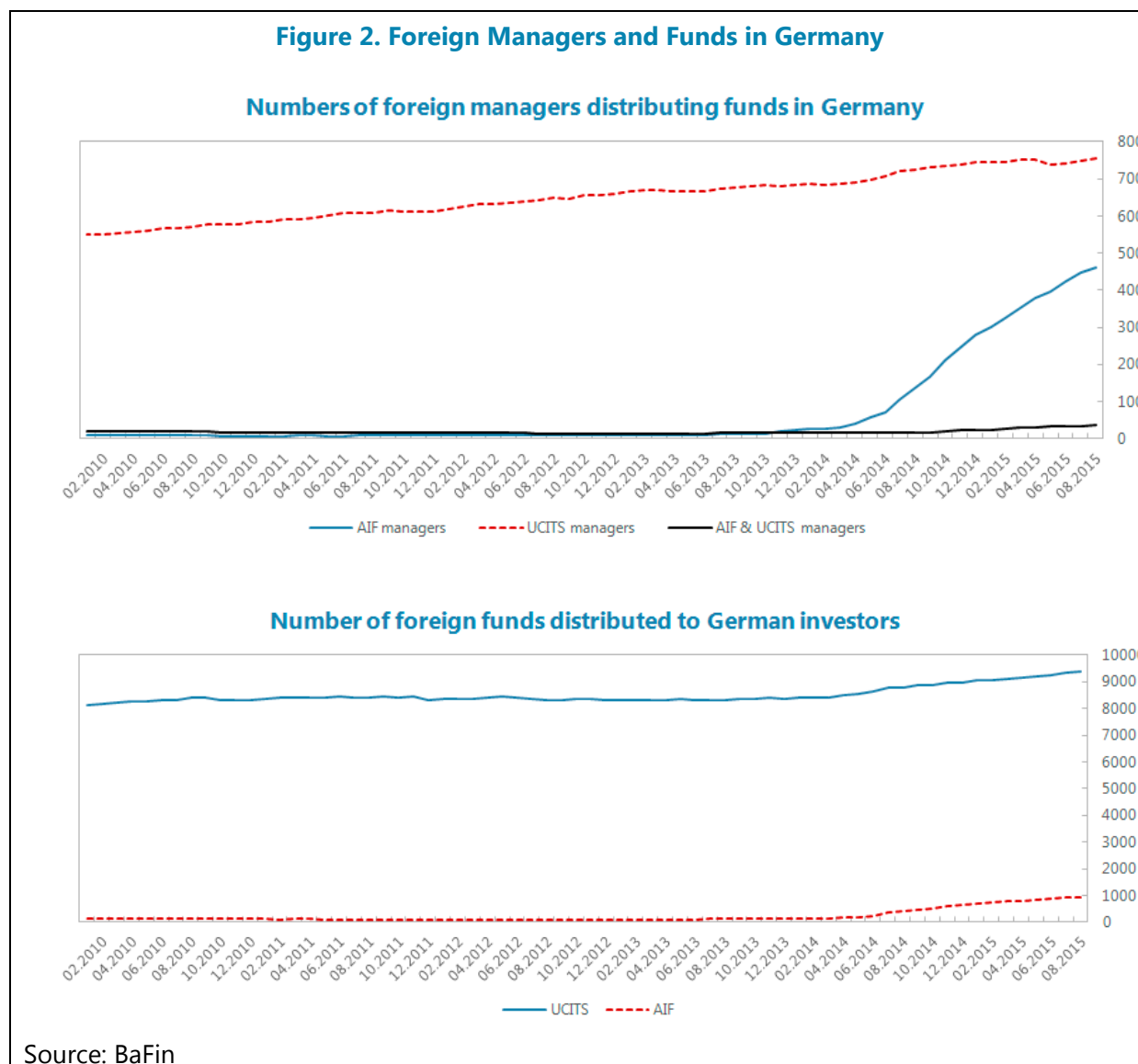
**Table 2. Approvals of Funds by BaFin in 2012–14**

Year	Number of Funds Approved	Breakdown by Type of Fund
2012	132	Retail funds only
2013	29 <sup>1</sup>	Retail funds only
2014	87	57 UCITS, 7 open-ended retail AIFs, 23 closed-ended retail AIFs

Source: BaFin.

### Foreign funds

**61. Foreign UCITS and AIFs can be marketed to investors in Germany under certain conditions.**<sup>17</sup> Distinction is made between funds that can be marketed to retail investors and those that can be marketed to professional investors. The process for EEA and non-EEA AIFs and AIFs managed by EEA and non-EEA AIFMs is also different. The funds that can be marketed to retail investors are EEA UCITS funds passported under the UCITS Directive.



**62. Non-German EEA UCITS and AIFs can be marketed in Germany pursuant to the passporting framework set out in the UCITS Directive and the AIFMD.** The marketing of non-EU CIS to retail investors is subject to strict criteria under Germany's national private placement regime (NPPR), including that the management company of the AIF complies with the requirements of the

<sup>17</sup> Figure 2 shows the evolution since 2010 in the number of foreign managers distributing funds in Germany and the number of foreign funds distributed to German investors.



AIFMD. Even in the case of marketing of non-EEA CIS to professional/semi-professional investors in Germany, it is stipulated that the AIFM should comply with most of the AIFMD. Germany does not permit non-EEA AIFMs to manage German AIFs.

**63. The use of the NPPR is subject to sufficient cooperation arrangements.** The AIFMD requires cooperation arrangements to be in place for the purpose of systemic risk oversight and in line with international standards in order to ensure an efficient exchange of information that enables the relevant EEA authority to carry out its duties in accordance with the directive in two cases. In the case of Germany this means that cooperation arrangements should be in place:

- between BaFin and the supervisory authority of a non-EEA AIF in case a German AIFM is marketing the non-EEA AIF; and
- Between BaFin and the supervisory authority of a non-EEA AIFM and, where different, the supervisory authority of a AIF, in case the non-EEA AIFM is marketing a EEA or non-EEA AIF in Germany.

**64. BaFin has established the necessary cooperation arrangements with authorities in the main global financial centers.**<sup>18</sup> Notwithstanding the network of MOUs, in practice there has been relatively little activity involving non-EU AIFMs or AIFs in Germany so the cooperation arrangements have not been fully tested.

## C. Supervision

### Organization and resources

**65. Supervision of asset managers, funds and their depositaries lies within the Investment Funds Department in the Securities Division of BaFin.** The department is made up of 118 staff members split across 7 units. This compares favorably to the number of management companies authorized under the KAGB – 132 – as of August 2015.

### Approach to off-site and on-site inspections

**66. On-site inspections include routine meetings and event-driven meetings with the management companies and depositaries, as well as statutory audits, routine audits and event-driven audits.** Audits are carried out by external auditors and are often accompanied by BaFin staff.

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<sup>18</sup> So far BaFin has concluded MoUs with the following supervisory authorities of third countries: Australia (ASIC); Bermuda (BMA); Canada (AMF, OSC, ASC, BCSC, OSFI); Cayman Islands (CIMA); Guernsey (GFSC); Hong Kong (SFC, HKMA); India (SEBI); Japan (JFSA, METI, MAFF); Jersey (JFSC); Republic of Korea (FSS, FSC); Singapore (MAS); Switzerland (FINMA) and USA (SEC, CFTC, FED/OCC).

**67. The frequency of BaFin’s routine inspections depends on the risk classification of the management company concerned.** BaFin has developed an internal classification procedure according to which all management companies are classified on a 12-point risk matrix. The classification takes into account the quality of the firm (i.e., quality of organizational structure, management and financial soundness) and its market impact (i.e., as measured by AuM). The classification reaches from 3A (high impact and high quality) to 1D (low impact and low quality). The higher the impact and the lower the quality, the more frequent the routine inspections by BaFin. A similar risk classification procedure is applied to depositaries.

**68. In 2012 BaFin drew up a manual for on-site-inspections.** The manual specifies, among other things, the frequency at which routine meetings should take place or audits accompanied by BaFin staff. For example, routine meetings with management companies with a risk classification of 1A may take place annually but at least once every two years, and each supervision unit must accompany once a year at least two management companies’ routine audits.

**69. Off-site inspections include the analysis and review of reports (in particular semi-annual, annual and audit reports), notices and requested data provided by the management company, depositary or their auditors as well as personal contacts between the responsible supervisory team and the management company/depositary.** The management company, as well as all CIS (retail and special), are subject to an independent audit on an annual basis. Regarding retail CIS, semi-annual and annual reports as well as the audit reports have to be filed with BaFin and are subject to review and analysis. Audit reports of special CIS are only submitted to BaFin upon request.

**Table 3. BaFin’s Periodic Inspections for the Past Three Years**

<b>Year</b>	<b>Supervisory visits and annual meetings on-site</b>	<b>Audits accompanied (statutory, routine and event-driven)</b>
2012	54	25
2013	96	22
1014	80	9 <sup>1</sup>

Source: BaFin

<sup>1</sup> The limited number of audits in 2014 is due to the implementation of the AIFMD and the high workload it has generated.

## Information on thematic inspections for the past three years

**70. In 2012 BaFin has started to carry out thematic inspections on fund managers and various types of CIS.** These thematic inspections form a part of BaFin’s market surveillance. The themes come from a wide range of sources such as the national press, suggestions made by BaFin’s directors or the working group on risk (AGR<sup>19</sup>), findings from regular supervision or review of the data on CIS provided by the Bundesbank or from investor complaints.

**71. The first investigation BaFin carried out was across all management companies under BaFin’s supervision on rather general subjects such as new products planned by the firms, potential new markets and accompanying risks.** This was followed by an inspection of the implementation of rules on good conduct across all management companies under BaFin’s supervision. A further inspection related to the issue of “cyber-crime.” In 2014 BaFin started an investigation on so-called closet indexing by active funds<sup>20</sup> and is currently preparing a full thematic inspection on this subject across a limited number of management companies. In late 2015 BaFin started a thematic inspection concerning the risks of the bond market (liquidity risk, low interest rates risk, risk of rising interest rates etc.).

**72. BaFin’s approach to supervision reflects its overall mission statement, namely to limit risks to the German financial system at both the national and international level and to ensure that Germany as a financial center continues to function properly and that its integrity is preserved.** In addition, particular emphasis is placed on the protection of investors; this reflects the obligation on BaFin to protect consumers’ collective interests, as set out in section 4, paragraph 1a of the German Financial Services Supervision Act (Finanzdienstleistungsaufsichtsgesetz – FinDAG).

**73. Recommendations: Considering the size and diversity of the German market, BaFin should consider stepping up the intensity of its supervisory engagement.** In particular, BaFin should look for more opportunities to carry out audits or inspections of its own, or at least to accompany external audits on a more regular basis. BaFin’s risk classification framework is an important tool in allowing supervisory resource to be targeted in the most effective way. The assessment of the impact of a management company should take into account a broader range of factors than the AUM, e.g., the level of leverage (to the extent that this is available) and the extent of interconnectedness of the entity. This would be particularly useful in allowing BaFin to capture better the potential systemic impact of investment funds.

## Reporting

**74. BaFin receives a significant range of reports relating to fund management.** A significant new reporting requirement is the AIFMD transparency reporting. The information to be reported covers such aspects as the principal markets and instruments in which the AIFM trades, the current

<sup>19</sup> See Appendix 1 for more details on BaFin’s approach to identification and monitoring of risks.

<sup>20</sup> Closet indexing is the practice whereby a management company that holds itself out as pursuing an active management strategy (and is charging fees that correspond to such an activity) is in reality tracking a benchmark.

risk profile of the AIF and, for funds that are substantially leveraged, the extent to which the AIF's assets have been reused. BaFin started the process to receive AIFMD reports relatively recently and has not yet started meaningful analysis of the data.

**75. BaFin receives data on open-ended funds from the Bundesbank.** These data, which the Bundesbank also provides to the ECB in aggregated form, are delivered on a monthly basis. They provide BaFin with information on the portfolio composition of open-ended funds and enable it to act proactively and to check portfolio developments also during reporting periods. BaFin intends to work further on the use of these statistical data for supervisory purposes. The Bundesbank has recently started to include data on closed-ended funds in the information it gathers. It is expected that these data will start to be shared with BaFin in the course of 2016.

**76. Specific periodic reporting requirements with respect to risk models and derivatives are set out in the Regulation on Derivatives (Derivateverordnung – DerivateV).** Management companies have to set up yearly reports for each UCITS regarding derivatives used and structured products with derivative components. For open-ended retail AIFs and special AIF these reports need to be provided at BaFin's request. The reports contain a list of the types of derivative and structured product with a derivative component used in the reporting period, including their underlying material risks and the purpose of their use with regard to the investment strategy and the risk profile of the investment fund. Furthermore, BaFin must be informed quarterly about the number and size of outliers in backtesting.

**77. BaFin uses reports (periodic and ad hoc) to conduct thematic analysis.** Recent examples include calculation of investment funds' exposure to Greek securities or determination of funds' currency risk exposure to the Swiss franc when the Swiss exchange rate was allowed to float.

**78. Recommendation: Building on recent efforts to prioritize and allocate more resource to this activity, BaFin should carry out more systematic analysis of the information that it is receiving from fund managers (whether received directly from management companies or indirectly via the Bundesbank).** This could include, for example, automatic flags in case of particular thresholds being breached. Analysis should also be carried out of the AIFMD data BaFin receives from German AIFMs in order to identify any risks or problems as they arise, while work continues to put in place to ensure a smooth collection and exchange of AIFMD data at EU level.

## D. Enforcement

**79. In case of failure to comply with regulatory requirements, BaFin generally acts through stepping up regular supervision.** The analysis and review of suspected breaches is part of the day-to-day tasks of the supervision teams. In case of a breach, the officers responsible for the respective management company and its CIS decide on any specific measures to be applied on a case-by-case basis. More serious or numerous breaches are likely to result in near term and more frequent on-site or on-the-spot inspections. The mere possibility that BaFin could resort to use of its formal enforcement powers is typically sufficient to ensure that a concern it has raised with a firm is addressed promptly.

**80. BaFin has an extensive set of enforcement powers at its disposal.** For example, in case a management company infringes the provisions of the KAGB on an ongoing basis, BaFin may revoke the license. Alternatively, BaFin may require the dismissal of the responsible managing directors and prohibit them from carrying out their professional activity.

**81. BaFin may also issue administrative fines when an administrative offence has been committed.** This would be the case when, for example, anyone deliberately or recklessly does not make available to the public the fund rules or does so incorrectly or in an incomplete manner. An administrative offence may, depending on the case, carry a penalty of up to EUR 50,000 or EUR 100,000. The implementation of UCITS V will result in a significant increase in the level of fines that can be imposed, reaching as high as EUR five million. In addition, BaFin has a general power to issue all orders deemed necessary and appropriate to ensure compliance with the KAGB. Where such orders are not complied with, BaFin may issue an enforcement fine (Zwangsgeld). In accordance with the Financial Services Supervision Act, BaFin may issue an enforcement fine up to EUR 250,000. In the past three years BaFin has not imposed any administrative fines or other sanctions.

**82. BaFin has carried out more extensive investigations on a range of subjects over the past three years.** These include:

- Appropriateness of transaction fees, including a high proportion of soft commissions (e.g., commissions for broker research);
- Illegal price agreements between a management company's trading desk and an external broker; and
- Breach of the depositary's duty to segregate the CIS' assets properly.

## E. Systemic Risk Monitoring

**83. The Securities Division of BaFin has established a regulatory process to monitor, mitigate, and manage systemic risk, which is part of a BaFin-wide, cross-sectoral process.** The process was originally established in 2010 and has since been adjusted to take account of internal restructuring within BaFin. The process is designed to be bottom-up as well as top-down, and a total of three units are involved. Further details can be found in Appendix 1.

### Box 3. Loan Origination by Funds

The UCITS Directive prohibits UCITS from originating loans. However, there are no specific rules on this activity in the AIFMD. Until relatively recently BaFin had considered that loan origination by investment funds was generally not permissible. Following extensive discussions with stakeholders and within the Financial Policy Committee, in May 2015 BaFin issued a communication explaining that it was changing its administrative practice with regard to the origination of loans by investment funds. All AIFs for which the KAGB foresees no specific product rules, which are marketed to professional investors only, and which are managed by an authorized or registered AIFM, are now entitled to originate loans.

The decision by BaFin took into account the current situation in Europe, especially the national legislation or administrative practice in several other Member States and the effects on AIFs marketed into Germany by way of the AIFM passport regime. BaFin also had regard to the recent EU Regulations on European Social Entrepreneurship Funds (EuSEF), European Venture Capital Funds (EuVECA) and European Long-term Investment Funds (ELTIF), all of which expressly permitted the granting of loans by funds in certain circumstances.

The new administrative practice is due to be enacted into German law in parallel with the transposition of the UCITS V Directive. In view of the upcoming legislation, BaFin's communication made certain recommendations as to the types of AIF domiciled in Germany which would be allowed to originate loans, the types of loan recipient, the level of leverage of the AIF, risk management requirements, maturity transformation, risk distribution and minimum liquidity. BaFin recommended that AIFMs adapt their practices to the recommendations in advance of the application of formal legislative requirements.

The development of such a source of non-bank financing is welcome. Appropriately regulated, loan origination funds can diversify sources of funding for the economy and reduce overall leverage. BaFin will monitor the take-up of these funds and use its experience in the discussions on a possible common EU framework for such funds.

## Appendix I. BaFin's Internal Processes for Monitoring of Systemic Risk

**84.** In line with the macroprudential mandate according to the Financial Stability Act, which entered into force in January 2013, the Bundesbank has set up a team responsible for monitoring risks in the non-bank non-insurance sector and financial innovation. Within its monitoring framework, it also monitors the growth and structure of the investment fund sector and analyses potential risks arising from developments detected in the investment fund sector from a macroprudential perspective. The team also actively participates in international and European efforts to strengthen the monitoring and macroprudential analysis of the non-bank non-insurance sector. The quantitative monitoring aims at improving existing data (e.g. flow of funds statistics, investment fund statistics, Financial Vehicle Corporations (FVC) statistics and supervisory data) as well as their augmentation by new data which will become available as a result of regulatory reforms (e.g. AIFM data, data on closed-ended funds), at the development and calculation of risk indicators as well as at further developing methods for risk assessment.

**85.** The **Risk Secretariat** is the central hub (organization and coordination) for systemic risk issues within securities supervision, as well as the central point of contact for the BaFin (cross-sectoral) Risk Secretariat. The secretariat is chaired by a head of unit from the investment management department and staffed with 3 people.

**86.** The **Working Group on Risk** is led by the head of securities supervision; further members are all heads of securities supervision departments, the members of the Sub-Group on Risk (UAGR), and representatives of the international department, the BaFin (cross-sectoral) risk secretariat, and the securities supervision risk secretariat. The function of this group is to monitor systemic risks within the securities markets as well as to decide on instruments to mitigate and manage those risks. Depending on the potential consequences of a new instrument, the final decision would be taken in the BaFin risk committee or by the BaFin executive board. The group meets on a quarterly basis (and if necessary ad hoc).

**87.** The **Sub-Group on Risk** consists of working-level representatives of all securities supervision departments, the international department, the management assistant of the head of the securities supervision and the risk secretariat. The function of this group is to identify and discuss relevant risk issues, prepare contributions for the working group on risk in securities supervision (AGR) and to carry out or take care of work assignments resulting from the AGR or the BaFin risk committee.

**88.** In the BaFin (cross-sectoral) level, the structure consists of two more units: the BaFin Risk Secretariat and the BaFin Risk Committee.

**89.** The **BaFin Risk Secretariat** is the central hub (organization, coordination) for systemic risk issues within the BaFin as well as the central point of contact to the executive board, BaFin risk committee, the BaFin business areas, to the Bundesbank and the Financial Stability Committee (AFS).

The secretariat is chaired by a head of the cross-sectoral unit and staffed with 3 people. Regular meetings and conference calls take place with the other sectoral risk secretariats.

**90.** The **BaFin Risk Committee** is led by the head of the cross-sectoral department; further members are the heads of the international department, the head of prosecution of unauthorized business, the head of cross-sectoral risk modelling, each two heads of departments of banking, insurance and securities supervision. The role of this group is the identification and assessment of risk issues from a cross-sectoral perspective as well as bringing together micro- and macro-prudential aspects of supervision. The committee meets on a quarterly basis.

**91.** BaFin uses the following information for the purposes of its systemic risk monitoring:

- data analysis (internal data from supervisory reporting, supervisory surveys, data from Bundesbank, or market data) carried out by the responsible units within the securities supervision;
- qualitative and quantitative information from ongoing supervision;
- analysis of market data by the cross-sectoral economic department;
- risk reports of other institutions (ESMA, IOSCO, ESRB, IMF); and
- international working groups (ESMA, IOSCO, ESRB).

**92.** The outputs of the processes described above are a **BaFin risk report and a sectoral risk list**. For each identified risk issue a list of existing and implemented regulatory measures, as well as possible further measures or regulatory gaps, is included.

**93.** In recent years new arrangements have been put in place to ensure the proper **sharing of information between authorities within Germany**. Communication and information sharing on systemic risk issues is established between BaFin (mainly the BaFin Risk Secretariat) and the Bundesbank (several departments). Regular physical meetings take place on a quarterly basis (BaFin Risk Committee). In addition, there is regular contact at working level.

**94.** Another national regulatory body with responsibility for systemic stability is **the Financial Stability Committee** (Ausschuss für Finanzstabilität), founded in 2013. Members of this high-level body are the Finance Ministry, Bundesbank, BaFin and the Financial Market Stabilization Agency (FMSA). Communication with the securities supervision (risk secretariat) takes place mainly in the form of contributions to the regular meetings and the processing of work assignments, which are channeled by the BaFin Risk Secretariat. One example of an issue related to asset management that was discussed within the Financial Stability Committee is loan origination funds (see Box 3).

**95.** BaFin also shares views and information on systemic risk issues in working **groups at EU (ESMA, ESRB) and international (IOSCO) level**.



**The key elements of the AIFMD transparency reporting obligations can be summarized as follows:**

- The reporting obligation below applies only to authorized AIFMs.
- AIFMs whose AIFs' AUM exceed EUR 500 million but do not exceed EUR 1 billion, report on a half-yearly basis and AIFMs whose AIFs' AUM exceed EUR 1 billion report on a quarterly basis.
- An AIFM subject to the half-yearly reporting obligation still has to submit quarterly reports for each AIF whose AUM exceed EUR 500 million.
- An AIFM has to submit only annual reports for each unleveraged AIF that invests only in unlisted companies and issuers in order to acquire control.

<b>Reporting obligations of authorized German AIFMs and above threshold non-EEA AIFMs</b>			
<b>Type of AIFM</b>	<b>Content of the report for each AIF</b>		
	AIFMD requirement		
	Main instruments, markets, exposures and concentrations (AIFMD Article 24(1))	Instruments traded, turnover, illiquid assets, risk profile, risk management, stress tests and asset categories (Article 24(2))	On each AIF that employs leverage on a substantial basis overall level of leverage, leverage breakdown (borrowing and embedded leverage), reuse of assets, five largest borrowing sources), (Article 24(4))
Authorized German AIFM (managing a German AIF or EEA AIF, whether or not that AIF is marketed in Germany or EEA)	x	x	x
Authorized German AIFM (managing a non-EEA AIF that is not marketed in Germany or EEA)	x		x
Authorized German AIFM (managing a non-EEA AIF that is marketed in Germany or EEA)	x	x	x
Above threshold non-EEA AIFM marketing in Germany (reporting only on the AIF being marketed)	x	x	x