Investment Management Association

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le@c-ebs.org

Dear Sir/Madam

IMA response to CEBS Large exposures questionnaire

IMA represents the UK-based investment management industry. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of about £2 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies). We are grateful for this opportunity to comment on the large exposures issues with regards to investment management firms.

Summary of comments

- Firstly, we would question the need for any large exposures rules in a post CRD environment. Under Pillar 2, firms are required to identify their major risks, quantify these and determine how they would deal with these risks crystallising. Equally, under Pillar 2 the Regulator is under an obligation to review and evaluate this and satisfy itself that firms have sufficient capital in respect of their risks.

- In the possible event that the Commission determines that there is an ongoing need for large exposures rules; we would want such rules to recognise the different risk characteristics of investment management businesses. There seems to be no recognition of this in the existing rules in respect of large exposures and the nature of the questions in the current CEBS questionnaire indicates that there is still no recognition of this with regards to large exposures.

- Before CRD was finalised, we had proposed an amendment to CRD that for limited licence firms, amounts receivable within 90 days should be exempt from the large exposures requirements. Whilst the European Commission seemed sympathetic to this, there was no appetite to make changes ahead of the forthcoming review of large exposures. Now that the large exposures review process has begun we are very keen to have this anomaly removed.

65 Kingsway London WC2B 6TD
Tel:+44(0)20 7831 0898 Fax:+44(0)20 7831 9975

www.investmentuk.org

- Some of our members and indeed other institutions place some of their own money in AAA rated Money Market Funds. Our understanding is that under existing rules this would be considered to be a large exposure. As these funds are liquid with the additional benefit of diversification and a credit rating better than many banks, we believe that positions in AAA rated Money Market Funds should be exempt from the large exposures requirements.

- Authorised funds e.g. UCITS funds, operate within the diversification requirements of the regulations. Therefore, any rules relating to large exposures should recognise that the exposure is in fact to a diversified portfolio in a highly regulated vehicle.

Characteristics of the investment management sector

Investment management differs significantly from banking and investment firms that trade for their own account in a number of ways that make the risk characteristics of investment management fundamentally different, both for the firms and for the clients. These characteristics and some of the key differences are explained below so that large exposures can be properly considered in the context of investment management.

(a) Investment management firms manage client assets and earn a fee for providing this service. The client assets are always segregated from the assets of the firm and typically under the custody of an independent custodian.
(b) Investment management firms vary in size from small boutiques with a handful of employees and assets under management of less than 100 million euros to large firms with hundreds of employees and assets under management of hundreds of billions of euros.
(c) Whilst some investment management firms have many clients, some of the smaller firms may have only a few clients.
(d) Whilst some investment management firms invest client assets over wide geographical areas and in different types of securities, some are specialists that invest in a particular country or region and in a particular asset class.
(e) Investment management firms may be independently owned or subsidiaries of banking or insurance groups. Whilst many firms are incorporated, some operate as partnerships.
(f) It is expected that almost all IMA member investment management firms will be "limited licence" under the CRD rules. That is: They will not have permission to deal on own account or underwrite securities.
(g) Investment management fees are typically a percentage of the funds under management. (There may be performance fees and these are a percentage of the investment performance calculated in accordance with a pre-agreed formula with the client. If the investment management firm also manages authorised funds, fees may also be earned as a percentage of the value of the investment units sold.)
(h) The key driver of income is therefore funds under management. (Although investment performance may be a factor to the extent that income may be in part dependent on performance. Sales may also be a factor for managers of authorised funds.)
(i) Client agreements determine if the fees are charged in advance or in arrears. Fees are typically charged and collected on a monthly or a quarterly basis. Sometimes there is a clause in the client agreement allowing the Manager to

withdraw monies owed from funds under its management. (Where there is a performance fee that is typically charged annually. Where fees are charged on sales of investment units, fees are charged and collected at the time of the sale.)

(j) Accrued fee income, fees receivable and cash at bank are the key assets on an investment management firm's balance sheet that may potentially be caught by large exposures rules.

(k) Regulatory capital is not at risk in respect of fees receivable because fees receivable are not included in the regulatory capital until they are part of audited reserves. As the audit process takes several months, fees receivable are normally received by the time the audit is concluded.

(l) In respect of cash at bank, investment management firms rely on the existing exemption in respect of exposures to banks in respect of items with a maturity of one year or less.

(m) Investment management firms do not expose any principal amounts to risk as they do not lend money or take market positions on their own account.

(n) The large exposure rules are breached by a number of investment management firms from time to time. Typical reasons for the breaches are accrued performance fees, invoiced performance fees where performance has been particularly successful for a large fund. Equally for a small investment management firm with only a few clients, accrued or invoiced investment management fees could cause a breach. To the best of our knowledge, the FSA have to date not often required additional capital in respect of such breaches. In practice, the receivable amounts are received in a shorter time scale than a capital raising process.

(o) Where investment management groups have to comply with the CRD consolidated supervision requirements, large exposures rules apply to the group. Unless exemptions are introduced, big sales of units in a unit trust managed by a firm outside the scope of CRD are likely to be another cause for breach of large exposures rules.

(p) If there were a requirement to hold additional capital in respect of fee accruals or invoiced but not yet received fees or debtors in respect of exceptionally large sales of shares in an OEIC, it would raise the capital requirements to unreasonable levels. Equally, it is difficult to argue that increasing capital would improve investor protection or serve any other regulatory objective given the nature of investment management business.

(q) We understand that the large exposures rules are also a potential issue for investment management firms in Germany and France for similar reasons.

(r) CRD recognises these different characteristics of investment management firms and permits limited licence firms minimum capital requirements to be determined with reference to their expenditure (the Fixed Overhead Requirement). Therefore, in the possible event of a firm having to be liquidated or closed down, the client assets can be returned to the client or his appointed representative in an orderly manner.

Should you have any queries in connection with any of the points above or in the answers provided, we would be happy to discuss with you further.

Yours faithfully

Üner Nabi
Senior Adviser – Technical Regulation

Answers to your specific questions follow:

General approach to concentration risk

Q1: In general terms do you, for internal purposes, adopt an approach to concentration risk measurement and management which is closely linked to the limits and reporting requirements contained in the current national regulatory regime. If so, please describe your approach. Note if your answer to this question is positive, many of the questions set out below may not be relevant to your circumstances.

To the best of our knowledge, our members approach is driven by the regulatory requirements. Large exposures are monitored for regulatory purposes as credit risk is not considered to be a business risk of any significance by our members. Of course, ensuring that receivable amounts are received is an important function in any financial control environment and investment management is no exception. Indeed we expect that our members monitor their receivable amounts closely for commercial reasons even though they consider this not to be a major area of risk. However, failure to collect fee income would impact current year's profit but not the regulated capital of an investment management firm until such income was included in audited reserves or resulted in material losses. In connection with this, we would highlight that frequently the fee receivable giving rise to a large exposure is of windfall nature to the investment management firm. For example, it may be a large fee receivable upon the launch of a new closed end fund or a performance fee earned on better than expected performance. Once such fees are received, they give rise to some variable costs such as performance based bonuses.

In general terms, clearly an investment management firm that specialises in managing, say, Japanese equities, is acutely aware of the fact that its revenue depends on the value of Japanese equities and thus is sensitive to movements in the Japanese markets. Equally, a firm with just a few clients is alert to the fact that if one client was to leave its revenues would drop sharply. The firms which face concentration risks as described here are small; they are more able to reduce costs quickly. In the possible event of these businesses becoming not viable, the client assets may be returned back to clients without risking the client assets as they are segregated from the management firm's balance sheet and are in the safe custody of independent firms. The small scale operation of firms with this type of concentration risk also means that there would be no impact on market confidence if a firm was to be liquidated.

Nature of concentration risk

Q2: What is your understanding of the nature of concentration risk?

In answering this question you might address:

- *How you define the risk of loss resulting from concentration of risk in the credit portfolio*

Investment management firms do not have credit portfolios. The only credit risk they have is amounts invoiced but not yet received. Clients settle invoices without delays; direct debit mandates are frequently in operation to settle the invoices and sometimes client agreements permit the investment management to deduct the owed fee from the funds under its management.

- *What is it you are managing when you consider significant single name exposures and concentrations in your credit portfolio?*

To the best of our knowledge our members simply monitor that exposures do not breach the regulatory requirements. The regulatory requirement is considered to be irrelevant to the business of investment management and is considered to be an administrative burden on the industry with the potential of being a financial burden and a business deterrent. It has the effect of punishing success. For example, the better the investment performance, the higher the performance fee accruals or invoiced amounts will be. Although such amounts are not included in regulatory capital, the regulations potentially require capital in respect of these amounts.

- *What, for internal risk measurement and management purposes do you consider to be the risks associated with:*
  (a) single name concentration risk;
  (b) other concentration risk (for example – sectoral or geographic)

For example, do you consider such risks as being related to ensuring that portfolio credit risk capital calculations are not undermined by incorrect correlation or diversification assumptions? Do you consider such risks to be related to 'tail event' losses – i.e. to protect against losses in the distribution beyond a chosen confidence interval? Do you consider them to be related to aspects of model risk or the real world simply not fitting the modelled world? Do you consider them to be related to time horizon aspects – e.g. large unexpected losses occurring over a short timescale rather than over the normally considered horizon e.g. 1 year etc.?)

We would be grateful if respondents could in their responses distinguish as clearly as possible between singlename and other concentration risks aspects.

We believe that these questions have previously been answered.

Counterparties and relationships between counterparties for singlename concentration risk:

Q3: For your internal risk measurement and/or management purposes, how do you define 'connectedness' of counterparties? What factors do you consider determine 'connectedness'? To what extent and how, for your internal risk measurement and/or management purposes, do you take account of relationships/connections between counterparties (e.g. parent and subsidiary)?

Our expectation is that most of our members would be more interested in "connectedness" of counterparties from a client relationship management point of view than any concerns relating to concentration risk.

Q4: For your internal risk measurement and/or management purposes how do you approach the issue of exposures to entities or products consisting of underlying assets or items (e.g. exposures to special purpose entities, collective investment *units)? In what circumstances if any do you adopt a 'look through' approach? How do you calculate your risks in this context?*

Investment management firms earn a fee for managing assets. Generally the fees are a percentage of the asset values under management. It therefore follows that the income will directly depend on the value of those assets. In our experience, even small investment management firms regularly undertake "what if" exercises on the value of assets under management as a part of their business planning to perform some sensitivity analysis on how the business would perform with different assumptions about funds under management. This type of sensitivity work will have to be documented and formalised under the CRD Pillar 2 requirements.

Measurement of exposures:

Q5: For internal measurement purposes, how do you define the amount at risk? In particular please outline your approach to loans, undrawn facilities, guarantees and similar obligations, derivative exposures (with future volatility), structured transactions, intra day and settlement exposures.

For products where future exposure may fluctuate please outline your approach to this aspect (e.g. use a confidence interval, worst case scenario, other – please specify). If there are any other factors that influence the measurement of risk, please specify.

Investment management firms do not lend and do not have permission to lend. They simply manage the assets of their clients and these assets are completely segregated from the firm.

Q6: For your internal risk measurement and/or management purposes how do measure:
(a) single name concentration risk? ;
(b) other concentration risk? – sectoral, geographic, etc.
In answering this question we would be grateful if you would provide a detailed explanation of the conceptual basis of your approach in this regard – VaR, expected shortfall, etc? Please provide actual and concrete examples.

We believe that the question has previously been answered.

Q7: Are these approaches closely integrated into your internal business decision making? – Please give examples. For how long have you adopted this approach?

We would be grateful if respondents could in their responses distinguish as clearly as possible between singlename and other concentration risk aspects.

To the best of our knowledge, large exposures generally enters internal decision making and processes of our members with a view to complying with what are considered to be irrelevant and inappropriate regulations for investment management businesses.

Q8: In relation to securities financing transactions (repurchase agreements, securities/commodities lending/borrowing agreements, margin lending), what *approach do you take to the measurement of singlename exposures? Do you make use of an 'expected positive exposure' methodology? Please describe in detail the approach adopted and the conceptual basis.*

These are not activities that investment management firms engage in or are permitted to engage in.

Monitoring and management of risk:

Q9: What is your approach to the management of single name concentration risk and other concentration risk (e.g. sectoral, geographic, etc.)? Please provide a comprehensive and detailed descriptions and explanations.

We would be grateful if you would provide a detailed explanation of the approach(es) you use to manage single name concentration risk? You might address:

- *A full explanation of the conceptual basis for the approach that you operate.*

- *Whether, and to what extent, the type of counterparty is a material factor in determining your approach to managing and mitigating the risk? For example corporates, credit institutions and investment firms, other financial, government, SPEs/structured transactions.*

- *To what extent, if any, is the creditworthiness of the counterparty an important factor in the management of concentration risk? How is this aspect taken into account?*

- *Whether you use an approach based on limits? If so, what are those limits? Do you set absolute limits (e.g. €50m) or limits relative to something else (e.g. 10% of capital)? If you use relative limits, what do you measure against? What factors do you take account of in setting limits (e.g. product type, banking book/trading book, tenor, rating, type of counterparty, creditworthiness of the counterparty)? Do you set limits by counterparty or product? To what extent, if any, are portfolio effects recognised?*

- *Whether you adopt an approach based on capital allocation in your management of risk. If so, please provide a detailed description/explanation?*

- *Other than limits and/ or capital allocation, do you use any other risk management methodologies to manage single name exposure? If so, please tell us what you do and why.*

We would be grateful if you would provide a detailed explanation of the approach(es) you use to manage other concentration risk (sectoral, geographic, etc). You might address:

- *A full explanation of the conceptual basis for the approach that you operate.*

- *Indication of other types of concentrations of credit risk you consider in your risk management (e.g., sector, country, collateral issuer – concerning the latter see question 13 below).*
- *How do you manage those concentrations (e.g. limits, capital allocation, or more informal monitoring etc)?*
- *If you use limits, what factors you take into consideration in how they are set (e.g. credit rating of the government in setting country limits)?*
- *How you determine geographic, sectoral and/or other 'clustering' limits?*
- *Whether you use any risk mitigants against the concentrations identified above? If so, what are they? How do you take account of them?*

We believe that question has been previously answered.

Stress testing

Q10: Do you adopt an approach to managing concentration risk based on stress testing? If so please provide a detailed description/explanation.

In your response you might include the events/situations for which you test; the conceptual basis for your approach in this regard; how often you carry out stress tests; and on what proportion of your exposures.

We would be grateful if respondents could in their responses distinguish as clearly as possible between singlename and other concentration risk aspects.

Assets under management are a key business driver for investment management businesses. The assets go up and down in value for a variety of reasons, for example, investment performance, market movements, clients leaving or joining, key fund mangers leaving or joining, reputation. In doing stress testing on the business impact of changes in funds under management, firms do in effect stress test concentration risk to the extent that it is relevant to them. For example, a firm that specialises in investing in Japanese equities will perform sensitivity analysis on the movements of the Japanese market.

Single entity vs. Group level

Q11: Do you set limits and/or apply your concentration risk measurement and management policies at a group level, subgroup level, and/or at individual entity level? Please provide details and explanation.

We expect that policy and practice will follow regulatory requirements.

Q12: In relation to intragroup exposures please describe in detail the approach that you adopt. How do you set limits, allocate economic capital, etc in respect of such exposures? How do you approach the question of cross border intragroup exposures?

Please provide as detailed as possible an explanation of the conceptual basis for your approaches in the above regards.

Credit risk mitigation

Q13: Do you use credit risk mitigation techniques as part of your approach to reduce singlename concentration risk? If so, please describe the methods that you use (e.g. collateral, guarantees, netting etc) and the circumstances in which you would adopt a particular approach and why you use that approach.

Fees in respect of some clients are collected by direct debit and client agreements. Frequently client agreements have clauses enabling managers to direct the custodian to settle outstanding management fees before the client assets are returned to the client upon termination of the investment management contract. If there is a dispute over such fees, often there is a clause in the agreement requiring the amounts in question to be put in an escrow account until the dispute has been resolved.

However, we would stress that to the best of our knowledge, credit risk is not considered to be a major risk for investment management firms. In the possible event that some investment management firms consider this to be major risk, CRD Pillar 2 will require those firms to identify those risks, quantify them and explain how they would address those risks in the event of crystallisation.

In relation to funded credit protection you might address:

- *What types of collateral you use to reduce large exposure calculations for your internal purposes. Does this include collateral not recognised for regulatory capital purposes – please describe and explain your reasons.*

- *How you calculate the value, exposure, or loss reduction to be attributed to funded protection applied to large exposures? How you haircut the value of the collateral? How you take account of the frequency of remargining?*

- *How do you take account of correlation between collateral asset values and events (systemic, idiosyncratic) giving rise to or arising from the default of the counterparty (e.g. the need to realise a large amount of collateral in a short space of time).*

- *Whether you use a 'topslicing' approach – i.e. using credit protection to reduce the uncovered part of the exposure to a particular level e.g. the internal limit?*

- *Where you use netting agreements, the basis on which you calculate the net exposure? Please explain any differences between the regulatory and risk management netting sets (e.g. onbalancesheet, offbalancesheet, banking book/trading book etc).*

In relation to unfunded credit protection you might address:

- *What forms of unfunded protection you recognise as reducing credit risk (e.g. guarantees, credit derivatives)? In what circumstances do you use these approaches?*
- *How do you take account of unfunded protection (e.g. substitution, adjustment of loss estimates, etc)?*

- *How do you take account of correlation between the credit quality of the protection provider and events (systemic, idiosyncratic) giving rise to or arising from the default of the counterparty (e.g. the need to realise a large amount of collateral in a short space of time.*

- *What policies do you have on who you will recognise as a credit protection provider (e.g. guarantor)? In relation to both forms of credit protection do you take account of any legal risk associated with credit risk mitigants? If so, how?*

As investment management firms do not lend or take principal positions these questions are considered to be not relevant.

'Indirect Concentration Risk'

Q14: For your internal risk measurement and management purposes how do you deal with the issue of 'indirect concentration risk' – that is singlename or other concentration risk arising in respect of indirect exposures to the issuers of collateral or the providers of unfunded credit protection?

We believe that the question has been previously answered.

Governance and reporting

Q15: Please describe your internal governance and reporting policies and procedures relating to singlename and other concentration risk.

In relation to this aspect you might address:

- *Your governance structure for setting, amending, and dealing with breaches of limits? Are limits hard or soft?*

- *What factors influence monitoring frequency?*

- *What information and reports are provided to senior management and how often? Why did you select that information as having significance? What elements of risk is senior management monitoring?*

- *Any other aspects of your concentration risk governance structure not covered above.*

We believe that the question has been previously answered.

Regulatory Environment

Q16: Please set out your experience of, and views concerning, the current large exposures regulatory regime.
In your response, you might address:

- *Whether you consider the large exposures regime effective in addressing the key risks inherent in large exposures/concentration risk? Please give reasons for your view. How do you view the trade-off between the costs of the current framework and its benefits in terms of, for example, prudential soundness, simplicity, cross border harmonisation, competitive fairness, etc.?*
- *Whether you feel that the current limits are satisfactory, both from a prudential and from a level playing field perspective?*

- *Whether you feel that the current limits are adequate for all institutions and that the level of the limits should be commensurate with the risk profile of the institution.*

- *Whether you feel that the large exposures regulatory regime should capture (and limit) concentration risks (sectoral, geographic). Please explain the rationale.*

- *The extent, if any, to which the current regulatory regime constrains actions that you would otherwise have taken? Have the large exposures provisions impacted your business decisions? If so, in what way (e.g. competitiveness, cost, management time, opportunity cost/gain)? If an international institution, please also explain in global context.*

- *The consistency of current regulatory limits with internal management practices? To what extent do you use the information that you supply to meet the regulatory requirements for large exposures, and the systems that you use to capture and process that information, in your own risk management?*

We hope that our description of investment management businesses and the answers to the specific questions above makes it clear that in our view:

- The introduction of the CRD Pillar 2 requirements will remove the need to have specific large exposures or concentration risk requirements.
- In the event that it is considered that there is benefit in having specific concentration risk and large exposure rules, there should be an appropriate exemption in respect of receivables within 90 days as the current rules are inappropriate and a burden on the investment management sector.
- The existing exemption in respect of bank balances with less than one year's maturity should be retained.
- AAA rated money market funds should be exempt from any large exposures rules.
- In respect of UCITS funds any large exposures rules should recognise the diversification benefits and the tight regulatory environment of these schemes.

Q17: What is your perception of how the large exposures regime is applied across different member states? Is it applied in a consistent way? If not, what differences have you encountered and how have they impacted on your business.

Conversations with representatives from Germany and France would indicate that if the existing large exposures regime were to be applied in these states, there would be investment management firms in each of those countries that would breach the large exposure rules.