Regulations in Circular 11/2017 (VA) on investment funds

Introduction

BaFin Circular 11/2017 (VA) of 12 December 2017 is based on the thorough revision of the Investment Regulation (AnlV) in March 2015 following the introduction of the Investment Code (KAGB). The provisions applying to investments in funds in relation to insurance undertakings were recast as part of these amendments. The former legal position under the Investment Regulation applying until March 2015 and Circular 4/2011 classified the permissible investments in investment funds, in accordance with the then applicable Investment Act (InvG), into the three categories of domestic investment funds, shares in domestic investment stock corporations (Investmentaktiengesellschaften) and foreign investment units.

In the Investment Regulation in force since March 2015 and BaFin's new Capital Investment Circular, the criteria for investment funds are whether a fund meets the UCITS criteria or is a transparent special AIF, or whether it falls into the new residual category of investment funds. Furthermore, the supervisory practice which has applied since April 2011 of prohibiting the purchase of real estate mutual funds for an undertaking's restricted assets has been incorporated in the Investment Regulation and the corresponding BaFin circular.

With the introduction of Solvency II on 1 January 2016, the entire assets of primary and reinsurance undertakings are now only subject to the qualitative investment rules of section 124(1) of the Insurance Supervision Act (VAG).

However, the new Capital Investment Circular largely follows the same structure as the old Circular 4/2011. It contains a detailed definition of the investment types that may be included in the guarantee assets, as well as qualitative requirements for investment management, provisions on investment rules and asset mix and diversification guidelines.

Who does the circular apply to?

With the introduction of Solvency II on 1 January 2016, the entire assets of primary and reinsurance undertakings are now only subject to the qualitative investment rules of section 124(1) of the Insurance Supervision Act (VAG). The direct regulation of investments held in the restricted assets (e.g. in the form of permitted investments and asset mix/diversification ratios) has been replaced for these insurers by risk-based solvency capital requirements (market risk module, counterparty default risk).

On the other hand, small insurance undertakings with premium income of under €5 million and gross technical provisions of under €25 million, provident societies and pension funds are still subject to the old supervisory regime, where the investments held in the guarantee assets are directly regulated. Provident funds linked to professional groups (e.g. doctors), however, are regulated at regional level, although the regional supervisors often continue to follow the Investment Regulation. The provisions of the Investment Regulation and Pension Fund Supervision Regulation, and therefore also the rules of the new Capital Investment Circular 11/2017, are thus still of relevance for these entities.

Requirements for permissible investments in investment funds

Private equity funds under section 2(1) no. 13b AnlV

After the amendment of the Investment Regulation in March 2015, investments in private equity funds became officially eligible for the guarantee assets, following many years of administrative practice allowing such investments. Alongside unlisted investments, private equity funds can also invest directly or indirectly in equity-like instruments such as participation certificates, subordinated loans or other corporate funding instruments. Merely holding loans is not sufficient for private equity funds to be eligible for the guarantee assets. However, if loans are reviewed on an individual basis and the loan portfolio is monitored continuously, the fund may be eligible for the guarantee assets in accordance with no. 13b. The private equity fund must be subject to the law of an EEA or OECD country and the management company must be based in an EEA or OECD country and be subject to public supervision. To ensure sufficient fungibility, the units and shares in the investment fund must be freely transferable. When investing in private equity funds the insurance undertaking must have in-house expertise to be able to evaluate the quality of the investment.

Real estate funds under section 2 (1) no. 14c AnlV

Both open-ended and closed-end special real estate AIFs and closed-end mutual real estate AIFs are deemed by BaFin to be suitable for inclusion in the guarantee assets. However, open-ended mutual real estate AIFs may not be held in the guarantee assets. If they were acquired before 8 April 2011, though, they may remain in the guarantee assets portfolio. Only units and shares in domestic or EU investment funds are eligible for the guarantee assets. The investment fund's borrowing may not exceed 60% of the market value of the real estate portfolio. Short-term borrowing is limited to 30% of the value of the AIF. Shares and units in closed-end investment funds must be freely transferable. Shares and units in real estate investment funds qualifying under no. 14c must be included in the asset mix quota for real estate.

UCITS funds under section 2(1) no. 15 AnlV

Transparent UCITS funds where the management company is based in the EEA ordinarily qualify for the guarantee assets. The general principles of investment prudence apply, e.g. in relation to rating requirements for the securities held in the UCITS fund's portfolio.

Open-ended special AIFs with fixed investment rules under section 2(1) no. 16 AnlV

Transparent open-ended special AIFs with fixed investment rules as defined by section 284 KAGB are suitable for inclusion in the guarantee assets if the contract documentation contains the following restrictions. The securities held by the special AIF must meet the qualitative standards of section 193 KAGB. In accordance with section 197(1) KAGB, the derivatives exposure of the investment fund may at most double the potential market risk. Unlisted securities as defined by section 198 no. 1 KAGB are limited to 20% of the AIF's net asset value, and for other investment instruments as defined by section 198 no. 1 to 4 KAGB such as equities (for which an application for inclusion in an organised market must be made within one year) are limited to 30% of the AIF's net asset value.

Furthermore, uncertificated loan notes are limited to 30%, investment in real estate and real estate funds in accordance with section 2(1) no. 14c AnlV to 49%, precious metals to 30% and unlisted investments including private equity funds to 20% of the AIF’s net asset value. Shares and units in other funds which meet the requirements of section 2 no. 17 AnlV may amount to a maximum of 49% of the AIF’s net asset value. Assets other than the permissible investment types listed in section 2(1) of the Investment Regulation must be included in the alternative investments quota of 7.5% of the guarantee assets in accordance with section 3(2) no. 2 AnlV.

Units and shares in other AIFs under section 2(1) no. 17 AnlV
The residual category of section 2(1) no. 17 AnlV allows an entity to purchase investment funds which do not meet the aforementioned criteria and hold them in the guarantee assets. For example, no. 17 would permit an entity to purchase investment funds that invest 100% of their assets in uncertificated loans.

This residual investment category is limited to units or shares in a domestic or EU investment fund. No. 17 also requires units and shares in closed-end investment funds to be freely transferable. In addition, an investor’s potential loss must be limited to the value of the investment and an obligation to inject additional funds excluded. Physical delivery of precious metals and commodities to the insurance undertaking is prohibited. In addition, the general investment prohibitions of section 2(4) AnlV apply. Open-ended mutual real estate funds may not be purchased, even under section 2(1) no. 17 AnlV.

Investment rules and asset mix/diversification guidelines for investment funds
In addition to the permissible investment types, Circular 11/2017 also sets out the investment rules for the guarantee assets based on section 215(1) VAG. The principle of investment security applies equally to each individual indirectly held asset. As a result, each asset held in the investment fund should in principle have an investment grade rating.

Investment funds which permit investments with speculative ratings are not suitable to be held in the guarantee assets in BaFin’s view. However, if the undertaking has sufficient risk-bearing capacity, both direct and indirect investments in non-investment grade paper can be included in the guarantee assets, provided they have at least a speculative grade rating. High yield investments may amount to at most 5% of the guarantee assets and must be included in the risk capital investment quota. Alternatively, high yield investments may also be purchased under the "escape clause" of section 2(2) AnlV.

If the investment fund holds investments with a rating below speculative grade, their treatment depends on whether they account for more or less than 3% of the value of the investment fund. If the share exceeds 3%, the paper must be sold. If this is impossible, the investment fund is unsuitable as cover for the guarantee assets and must be sold within six months in a manner that safeguards policyholders' interests or be reclassified to the unrestricted assets. BaFin appears to be willing to tolerate a share of less than 3%, provided it does not have a detrimental impact on the interests of policyholders.

Stricter rules apply to ABS paper held in investment funds. Non-investment grade ABS paper with a maximum share of 3% of the investment fund is tolerated. With a share of over 3%, the investment fund is no longer suitable as cover for the guarantee assets and must be sold in a manner that safeguards policyholders' interests or be reclassified to the unrestricted assets. Non-investment grade ABS paper and investments with credit ratings below speculative grade must be combined when calculating the 3% limit.

The rules on the asset mix of the different investment types are designed to achieve a balanced risk profile between the asset classes. Both direct and indirect investments (and therefore also investments held by investment funds) are included in the asset mix ratios of section 3 of the Investment Regulation such as the risk capital investment quota of 35% of the guarantee assets, the 15% quota for unlisted investments and the 7.5% quota for alternative investments.

The regulations on diversification, on the other hand, are intended to avoid excessive concentration in relation to individual issuers (borrowers) or individual assets (properties). For shares and equity investments, however, the focus is on avoiding cluster risks through an excessive concentration on particular industries or countries. The 10 biggest borrowers in an open-ended investment fund must be included in the borrower-related diversification ratios of section 4 of the Investment Regulation. Investments in shares or units in an open-ended investment fund that is itself sufficiently diversified are not treated as investments with a single borrower. However, in BaFin's view an excessive concentration on a single portfolio manager should be avoided. According to the circular, excessive concentration exists where the investment assets managed by the same portfolio manager exceed 20% of the guarantee assets.

Investment process for investments in funds

As well as laying down rules on the permissible investment types and investment rules, Circular 11/2017 (VA) also sets out requirements for the investment process. These describe the process to be applied when investing in funds. Before purchasing a fund an undertaking must analyse whether the investments are appropriate to implement the investment strategy, comply with the investment rules and cover the guarantee assets. The investment terms and conditions, investment guidelines, information on the current investment policy and transferability of the shares and units must be considered in making this assessment. This process must be documented appropriately.

Moreover, due diligence must be performed when selecting investment funds. The due diligence should cover a range of information including the asset manager, risk measurement and management, the valuation process, performance, financial reporting and fees.

The circular also stipulates that investments in funds must be included in the insurance undertaking's risk management. The economic and legal risks of the investments must be analysed both when they are purchased and during the holding period. The impact of the fund investments on the portfolio must be quantified. In addition, the exposures must be monitored continuously for compliance with the investment strategy and the regulatory requirements. This monitoring must be documented in a verifiable manner.

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