# Fund distribution Market Zoom

Investment fund transparency
reporting for German institutional investors

# “Demystifying VAG, GroMiKV and Solva reporting for investment funds”

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## 1. Introduction

Recent European regulatory frameworks place more importance on the disclosure of institutions' assets and true risk profiles in order to increase transparency, including look-through on their holdings in investment funds. These regulations cover credit institutions, insurance companies, and pension funds.

Asset managers aiming to distribute their products to European institutional investors need to take these regulations into consideration and adapt their operations to address these transparency demands.

The challenges and complexity for asset managers resulting from this transparency trend follow three major axes:

- Regulatory expertise, in order to meet regulatory requirements underlying these disclosures (e.g., CRR, Solvency II, and also local requirements such as VAG, GroMiKV, FTK[1])
- Operational expertise, in order to deal with large data sets and multiple data sources, including derivatives information with the greatest quality and reliability standards
- Flexibility and system availability, in order to meet investor's monthly or quarterly tight deadlines for reporting to their local regulator

In this article, we will focus on the first two points, defining the requirements established for insurers and pension funds, and their impacts on investment funds in terms of disclosures, with a focus on the German market.


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## 2. The German investment fund market is dominated by institutional investors

Over the last 10 years, the share of Spezialfonds (funds for institutional investors only) in the German investment fund market followed an ascending trend, representing more than 50 percent since 2013. The most important investors in Spezialfonds are insurance companies, followed by pension institutions and credit institutions. In addition, institutional investors may also purchase retail funds (i.e., UCITS). In this context, German institutional companies are one of the most important investors in the fund market.

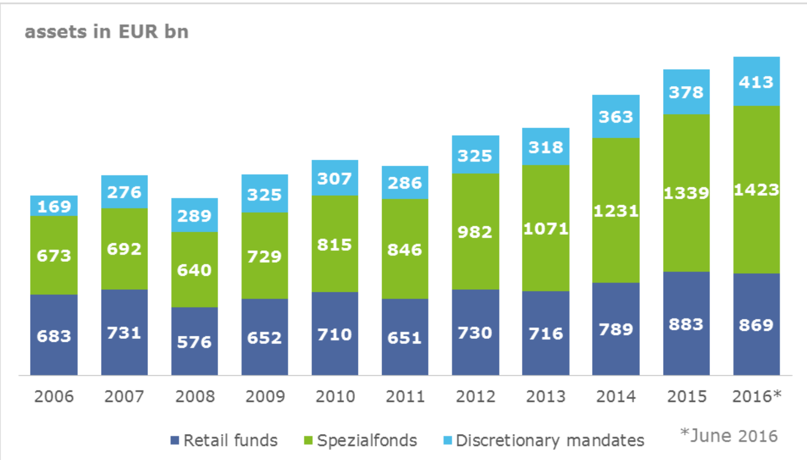


Figure 1: Assets under management in German investment funds
Source: German Investment Funds Association (BVI)

[1] See our previous market zoom on FTK reporting

## 3. VAG reporting for German pension funds and insurance companies

### 1. Origins

VAG reporting, which refers to Solvency I, covers pension funds and insurance companies. The stated regulation is ensued from the Circular 11/2005 (VA), which was first introduced in 2005 and amended in 2011.
In order to be compliant with the German insurance regulator's (BaFin) requirements, the fund will have to detail its holdings breakdown in the appropriate format. Moreover, the value of market risk potential has to be indicated, measured by either the Commitment or the Value-at-Risk approach.

A dedicated VAG reporting Excel template and guidelines have been established by the German Investment Funds Association (BVI).

This reporting is a NAV breakdown of the portfolio into specific VAG asset classifications (see Figure 2 below). This output mainly highlights the asset type, the rating, and the market place geographical localization for the holdings of the investment fund.

Moreover, within the information transmitted, a disclosure of the fund's principal debtors is performed. The goal of disclosing the debtors is to control and limit the concentration risk of German insurance companies and pension funds

"VAG reporting, which refers to Solvency I, covers pension funds and insurance companies."

| | Money Market fund | Equity Fund | EU bond Fund | US Bond Fund |
|---|---|---|---|---|
| Shares listed on EEA Market | 0% | 80% | 0% | 0% |
| Shares listed on non EEA Market | 0% | 18% | 0% | 0% |
| Bonds and Structured products | 70% | 0% | 98% | 98% |
| Bonds and Structured products non EE Market | 0% | 0% | 5% | 70% |
| Bonds and Structured products Not Listed | 0% | 0% | 5% | 5% |
| Governments Bonds | 6% | 0% | 50% | 50% |
| Corporate Bonds | 5% | 0% | 25% | 25% |
| Credit Institution Bonds | 59% | 0% | 23% | 23% |
| Structured Products | 0% | 0% | 0% | 0% |
| Bonds and Structured products Investment Grade (AAA-BBB) | 70% | 0% | 96% | 96% |
| Bonds and Structured products Speculative Grade (BB-B) | 0% | 0% | 2% | 2% |
| Investment with EE Credit Institution including Cash | 30% | 2% | 2% | 2% |

**Market Zoom - Investment fund transparency reporting for German institutional investors**

| | EM bond fund | Non transparent fund | High yield fund | Diversified fund |
|---|---|---|---|---|
| Shares listed on EEA Market | 0% | 0% | 0% | 18% |
| Shares listed on non EEA Market | 0% | 0% | 0% | 5% |
| Not listed shares | 0% | 0% | 0% | 3% |
| REITs portion | 0% | 0% | 0% | 2% |
| Bonds and Structured products | 90% | 0% | 90% | 40% |
| Bonds and Structured products non EE Market | 75% | 0% | 75% | 15% |
| Bonds and Structured products Not Listed | 10% | 0% | 10% | 5% |
| Governments Bonds | 60% | 0% | 10% | 20% |
| Covered Bonds | 0% | 0% | 0% | 2% |
| Corporate Bonds | 15% | 0% | 75% | 10% |
| Credit Institution Bonds | 13% | 0% | 0% | 5% |
| Structured Products | 2% | 0% | 5% | 3% |
| Bonds and Structured products Investment Grade (AAA-BBB) | 17% | 0% | 0% | 20% |
| Bonds and Structured products Speculative Grade (BB-B) | 65% | 0% | 70% | 10% |
| Bonds and Structured products Default risk/ Default (CCC-D) | 0% | 0% | 10% | 7% |
| Bonds and Structured products no rating (nr) | 3% | 0% | 10% | 3% |
| ABS, CLN and similar products pursuant to no. 10 | 5% | 0% | 9% | 20% |
| ABS, CLN and similar products below investment grade rating | 1% | 0% | 9% | 5% |
| Investment with EE Credit Institution including Cash | 5% | 0% | 1% | 10% |
| Residual Value | 0% | 0% | 0% | 5% |
| Non transparent funds | 0% | 100% | 0% | 5% |
| Unlisted shares and participation rights from 43 | 0% | 100% | 0% | 5% |
| ABS and CLN from 43 | 0% | 100% | 0% | 5% |
| Hedge funds in 43 | 0% | 100% | 0% | 5% |
| Commodities in 43 | 0% | 100% | 0% | 5% |

Figure 2: Illustrative VAG reporting, per fund type
Source: Deloitte analysis

The aim of VAG reporting is to enable institutional investors (insurers and pension funds) to monitor their exposures held through investment funds, in order to comply with the VAG investment restrictions of their restricted assets and counterparty concentration limits.
The process for institutions complying with the BaFin requirements is the following:

i. Insurance companies or pension funds assess whether an investment fund is eligible for investment or "VAG compliant"
ii. The investment fund performs a look-through on its assets, and fills in the VAG template, in accordance with VAG rules and BVI guidelines
iii. The insurance company or pension fund aggregates all reporting received, and sends a final report to the BaFin

"German pension funds and insurers of all size must comply with VAG regulation."

### 2. Evolution of VAG reporting following Solvency II application

German pension funds and insurers of all size must comply with VAG regulation. Whereas it is still unclear whether VAG will continue to apply for German insurance companies in the scope of the Solvency II framework, VAG will without a doubt continue to apply for German pension funds and small insurance companies not covered by Solvency II.

## 4. Solvability ratio, ECD & CVA, and GroMiKV reporting for German credit institutions

Following the Basel III Committee guidelines, the CRR Regulation and the CRD IV Directive emerged new capital requirements for credit institutions and indirect impacts on investment funds with regards to asset transparency. As a result, different transparency reporting was introduced and adjusted within the different EU countries.

### 1. Solvability ratio

Solva reporting discloses transparency according to own fund requirements for credit risk for units of collective investment funds. By attributing risk weights in accordance with the credit risk of the issuer/issue and by computing credit exposure for both on- and off-balance sheet products, the Solvability ratio is derived. This ratio is then used by credit institutions to derive their capital requirements for the credit risk associated with this investment fund.

As shown in Figure 3, transparency of investment funds can lead to regulatory capital relief compared to a no transparency approach, where assets are risk-weighted 100 percent.

Consequently, for credit institutions to continue to increase their fund investments, it is important for them to arrange to conduct look-through monitoring of their fund holdings.

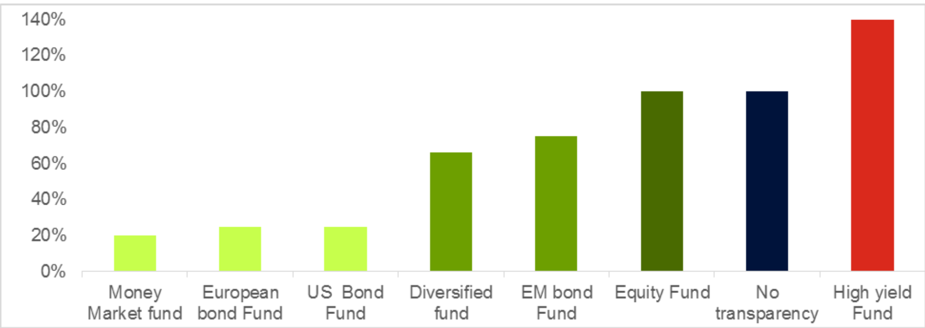


Figure 3: Illustration of Solvency Ratios under the Credit Risk Standardized Approach for different investment strategies
Source: Deloitte analysis

Two main computation methods are used in practice: the Standardized Approach (SA) based on pre-defined risk weights and external credit risk assessments, and the Internal Rating-Based Approach (IRB) based on internal credit risk assessment.
From the Solva reporting, two additional pieces of information are derived:

- The currency exposure (FX position ratio), which indicates the credit institutions' currency exposure through its investments.
- The country credit risk exposure, which indicates the credit institutions' credit exposure per country. This additional report allows the credit institution to calculate their own fund requirement related to the counter-cyclical capital buffer.

"The objective is to limit and control cross-investments between credit institutions and decrease systemic risk."

## 2. ECD & CVA

Equity Capital Deductions and Counterparty Valuation Adjustments Risk transparency reporting allow credit institutions to estimate two additional capital charges introduced by the CRR for:

- Direct and indirect exposures to financial sector entities (equity capital deduction - ECD)
- Exposure to over-the-counter (OTC) counterparty valuation risk "CVA-risk)

The ECD computes the percentage of the assets of an investment fund invested directly or indirectly in equity or equity-like securities issued by financial sector entities (i.e., credit institutions, insurers, etc.), which are then affected by a 1.250 percent risk weight, or equivalently deducted from their own funds of the credit institution. The objective is to limit and control cross-investments between credit institutions and decrease systemic risk.

The CVA exhibits the counterparty valuation risk resulting from OTC transactions for which mid-price valuation may not include bilateral counterparty risk, such as foreign exchange forwards contracts, interest-rate swaps, credit default swaps, etc. It also allows the credit institutions to calculate its own fund requirement for CVA risk.

See figure 4 below for an illustrative example.

| Date | WKN | ISIN | Weighting Capital Class Tier 1 Capital (CET-1) (in %) | CRSA Value of Deduction Items Capital Class Tier 1 Capital (CET-1) (in %) | Weighting Capital Class Additional Tier 1 (AT-1) Capital (in %) | CRSA Value of Deduction Items Additional Tier 1 Capital (AT-1) (in %) | Weighting Capital Class Tier 2 Capital (in %) | CRSA Value of Deduction Items Tier 2 Capital (in %) | CVA Risk (in %) |
|---|---|---|---|---|---|---|---|---|---|
| dd/mm/yyyy | XXX | LUxxxx01 | 58.94 | 22.82 | 0.00 | 0.00 | 0.00 | 0.00 | 0.21 |
| dd/mm/yyyy | XXX | LUxxxx02 | 27.07 | 11.04 | 0.00 | 0.00 | 0.00 | 0.00 | 0.20 |
| dd/mm/yyyy | XXX | LUxxxx03 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.03 |
| dd/mm/yyyy | XXX | LUxxxx04 | 16.36 | 16.36 | 0.00 | 0.00 | 0.00 | 0.00 | 0.20 |
| dd/mm/yyyy | XXX | LUxxxx05 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.09 |
| dd/mm/yyyy | XXX | LUxxxx06 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| dd/mm/yyyy | XXX | LUxxxx07 | 0.00 | 0.00 | 0.00 | 0.00 | 0.17 | 0.17 | 0.04 |

Figure 4: Illustrative ECD & CVA-risk reporting
Source: Deloitte analysis

### 3. GroMiKV

The GroMiKV (Großkredit und Millionenkreditverordnung) reporting discloses investment funds' large exposures in order for credit institutions to comply with their additional capital requirements and reporting for large exposures. GroMiKV reporting discloses exposures per issuer and parent group.

GroMiKV reporting is produced according to the Excel template provided by the BVI. The assets are categorized in the four following classes:

- Balance sheet products where ISINs apply (e.g., Shares, Bonds),
- Balance sheet products where ISINs do not apply (e.g., Treasury),
- Derivatives products (e.g., Futures, FX Forwards),
- Off-balance-sheet exposure products (e.g., CDS Sell, Reverse repurchase agreement)

An additional factor is disclosed in order to identify financial instruments exempted under the EU large exposure reporting and local GroMiKV regulation (national discretion).

"The regulatory framework of institutional investors is having an increasing impact on the operating model of asset management firms, which are required to provide more investor disclosure and reporting."

**Leverage**

| ISIN | Fund Name | 30/06/2016 | 31/05/2016 | Evol | Comments |
|---|---|---|---|---|---|
| Fund 1 | Fund 1 | 0.661077207 | 0.608992085 | 0.052085122 | |
| Fund 2 | Fund 2 | 0.911337204 | 0.916471739 | -0.00513453 | |
| Fund 3 | Fund 3 | 0.152624988 | 0.161792243 | -0.00916725 | |
| Fund 4 | Fund 4 | 0.973992282 | 0.942103988 | 0.031888294 | |

Figure 5: Illustrative leverage reporting under the GroMiKV regime
Source: Deloitte analysis

## 5. Impacts for asset management firms

### 1. Operational challenge

The regulatory framework of institutional investors is having an increasing impact on the operating model of asset management firms, which are required to provide more investor disclosure and reporting.

The growing number of reporting types for controlling the different risks involves a new operational expertise, which comes at a significant cost often overlooked in cross-border distribution market analyses. The factors to consider when assessing reporting solutions are:

- Regulatory expertise and regulatory watch
- Data requirements and synergies with existing data feeds
- IT developments needed in case of an internal or external solution
- Staff and system availability to comply with monthly and quarterly short deadlines
- Scalability in order to accompany institutional investor distribution across many jurisdictions;
- Compliance with EU and local regulatory rules and guidelines
- Flexibility to investors' custom reporting templates

- Proximity and support regarding institutional investors' questions on the reporting delivered
- A cost-benefit analysis between internal and external solutions

**2. A must-have that can turn into a competitive advantage for institutional distribution and sales**

Transparency reporting is now a must-have for asset management firms that seek to increase their institutional investors' market share. In the context of increasing capital requirements for institutional investors, disclosing the appropriate ratios leading to capital requirement reduction can create a competitive advantage for asset managers. As with the example of solvability ratios, it gives considerable information in terms of capital requirement compared to the conservative approach applied with no disclosure.

In addition, institutional investors are increasingly turning to their asset managers for support in their understanding of the composition and risk profiles of their investment products. Producing accurate transparency reports and providing a high and reactive sales support can reinforce client relationships and increase investor retention and additional investments.

Transparency and regulatory compliance will support asset managers to develop their relationships with institutional investors. In return, it can help asset managers to better manage their data and better understand how their investment products relate to the regulatory constraints of their institutional investors, for the benefit of both.

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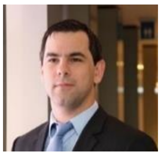

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