BAI Newsletter – February 2020

Editorial article from Frank Dornseifer, Managing Director, BAI e.V.

Dear Ladies and Gentlemen, dear members,

institutional capital investment in the new year - and the new decade - poses new challenges for asset managers and investors alike. A large number of so-called megatrends - or to phrase it in a broader sense: mega factors - determine an entire economic and social cycle. Even though the Brexit squabble has now - hopefully - come to an end, the challenges posed by geopolitics, the market environment, regulation and, of course, digitalisation remain immense. Moreover, low interest rates are developing into a systemic risk and the new corona virus is mutating into a global menace.

Challenge 1: Regulation

Tax law also became somewhat sinister/frightening shortly before the turn of the year. On the one hand, the Federal Ministry of Finance surprised the public with the draft of the BMF's interpretative circular on special investment funds. The draft contains a further restriction of the concept of securities compared to supervisory law, which would de facto make closed-end funds – even when structures as a security- unacquireable for special investment funds. At almost the same time, the BMF presented a draft law on changes to foreign tax law with a three-day consultation period, which would subject the majority of foreign funds to CFC taxation ("Hinzurechnungsbesteuerung") and thus clearly place them in a worse position than domestic funds - which is in clear violation of European law.

As though the regulatory agenda had not already been set densely enough. This year and next year, various major regulatory review processes such as the AIFMD Review, the Solvency Review and the CRR Review are scheduled, which require a great deal of attention and commitment. And then - last but not least - there is an overriding regulatory topic that is not only continuously coming alive, but is also filling up with substantial bureaucracy: the Sustainable Finance Initiative with its centrepiece taxonomy.

It is truly not a dull year (decade) that the entire financial sector and institutional investors are heading into.

Challenge 2: Dealing with sustainability risks and the Sustainable Finance Initiative

It was not by coincidence that climate change was - once again - high on the agenda of the World Economic Forum in Davos. One derivation that is currently affecting the entire financial sector is how to deal with sustainability risks and the Sustainable Finance Initiative mentioned above and its comprehensive package of legislative measures: from taxonomy, reporting, advisory and disclosure requirements to CO2 benchmarks and risk management guidelines. Mrs von der Leyen has made the "Green Deal" and the financing of sustainable change one of the top priorities of her Commission work. So pay attention!

As is well known, work on the Sustainable Finance Initiative is continuing at full speed. More and more legislative acts have been adopted or are in the process of being adopted. The pace, but above all the scope of the measures that are being adopted should make one feel uneasy. Many principles of intelligent regulation are in danger of falling by the wayside. This applies in particular to fundamental principles such as personal responsibility and proportionality.

Let me illustrate this with some questions: Does a taxonomy, which, as we all know, so far only refers to the area "E", i.e. environmental, and which, in the qualification of sustainable economic activities, also only takes into account two of the six environmental objectives defined to date, but which nevertheless already comprises more than 400 pages, make investment, compliance, risk management and reporting processes simpler, or does it not make them more complex and bureaucratic? Follow-up question: Does such a complex and bureaucratic system lead to an improvement and increase in investment opportunities, or do they tend to be limited as a result? And looking even further ahead: Which investors and asset managers will ultimately be able to take into account and apply a taxonomy that will be finalised in the future, which may then comprise 1,500-2,000 pages, along with all the other directives, regulations and implementing provisions at levels 2 and 3, and above all to document it completely - not only vis-à-vis investors but also vis-à-vis the supervisory authorities? Is there a threat of an ecologically driven market shakeout at the expense of smaller asset managers?

Not to be misunderstood; it is not a question of denying sustainable investment and political impulses. It is much rather a matter of reminding people that, particularly when it comes to sustainability, individual responsibility must be the first priority. And at the same time, the principle of proportionality must be taken sufficiently into account. And it is precisely these aspects that are currently being neglected both in the public and in the expert discussions in the legislative processes! In this context, the question arises as to whether and in how far smaller and possibly even medium-sized investors and asset managers can shoulder the extremely complex ESG requirements, or whether they may become dependent on ESG consultants, precisely because they cannot achieve ESG and especially taxonomy compliance on their own. The wave of regulation following the financial crisis has already led to small companies (almost) collapsing under the regulatory burden. It is to be hoped that the well-intentioned Sustainable Finance Initiative will not deal them the death blow.

And may I also remind you that policy is currently rather reluctant to impose direct bans and sanctions not only on air and environmental pollution, but also in the "S" and "G" areas. At the same time, such measures would be much more efficient and would also have a faster effect. For the financial sector, taking sustainability risks into account is part of good risk management anyway, as are personal responsibility and proportionality!

Compatibility of SFI and Social Development Goals (SDGs)

Another aspect that is unfortunately overlooked is that the SFI is a European initiative and therefore "only" applies throughout Europe. By contrast, the financial sector operates globally. European standards are therefore not only of limited validity, they are also not easily enforceable with non-European business partners, especially if they involve considerable implementation and reporting costs. As an investor or asset manager domiciled in the EU, however, you will still be obliged to comply with the relevant requirements of the various OFI regulations, even if your assets or target funds are located in the USA, Asia or elsewhere. For these, too, one has to, or rather wants to, provide proof of ESG-compatibility. For this very reason, it is extremely important that global standards are applied when dealing with a global issue such as climate change. And precisely for this reason it is extremely important for investors, asset managers and the European legislator to take a firm stand on the global concept of the United Nations' Sustainable Development Goals (SDGs).

The SDGs are 17 political objectives that are intended to ensure sustainable development at the economic, social and ecological level on a global scale. The SDGs are "only" aimed directly at the community of states and are to be implemented by that community, as is the case in Germany, for example, with the German Sustainability Strategy adopted by the Federal Government in January 2017. But more and more investors and asset managers have also discovered the SDGs as "investment guidelines" and align their investment strategy and products - in part - with the SDGs. In other words: Investors and asset managers think globally, while politics "only" thinks on a European level and thus falls short.

Not only against this background, effort and benefit must be questioned, especially with regard to taxonomy. What is the point of a 1,500-2,000 page "heart" of the Sustainable Finance Initiative if it does not fit into a sustainable global structure, which is precisely what the SDGs are?

Challenge 3: Digitalisation and AI

Just as dominant as the sustainability debate was - not only in Davos - and still is the subject area of digitalisation and artificial intelligence and the disruption of value chains in all areas of life and the economy. Particularly in the financial sector as a whole, the change in business models and technologies (DLT/Blockchain, Artificial Intelligence, FinTech etc.) is taking very clear shape and the effects are enormous. It is not without reason that Mrs. von der Leyen has named "Digital Finance" as another top priority of her Commission work and recently presented the EU Digital Strategy.

For those for whom my - repeated - indications of the systemic risk of a low interest rate go too far, I recommend taking a look at the EIOPA Supervisory Statement on the Impact of the Ultra-Low/Negative Interest Rate Environment from February 19th. It states very bluntly: "EIOPA considers that the current ultra-low interest rate environment constitutes one of the most important sources of systemic risk for insurers for the coming years and encourages NSAs and undertakings to continue taking actions to mitigate the impact on the EU insurance sector". I think this statement needs no further comment. But it does raise at least one question that was also asked by our new member company Bridgewater at the joint Insight 58, namely "How resilient is your portfolio?". This sparked a lively discussion with clever proposals for action.

The fact that the financial sector is in the midst of a digital revolution and is also exposed to tough European and international competition does not need to be further elaborated on. However, it is true that FinTechs and foreign competitors are increasingly overtaking traditional banks and insurers. Branch network closures, the thinning of traditional distribution channels, etc. give an indication of the way forward. On the other hand, a contrary dynamic seems to be emerging in the fund/asset management industry, which has been on the upswing for years now with considerable inflows of funds, especially in the area of alternative investments. In Germany, however, asset management is often perceived only as an appendage to the financial sector, possibly because the banking and insurance sector currently employs significantly more people and contributes more to GDP than the fund industry. A large part of the value creation of the fund and asset management industry takes place outside of Germany. However, it is precisely this sector that will benefit in a unique way from digitisation & Co. The introduction of electronic securities and the regulation of crypto assets are only a first step. The mapping of the investment business on the block chain is only a question of time. AI is already used in many areas of asset management (due diligence, compliance, reporting, etc.). At the same time, the token economy represents a partly new and even more comprehensive investment universe, which also represents an undreamt-of potential for institutional investors. Reason enough to take a close look at it today.

So as not to be misunderstood here either: this is not about Bitcoins. Bitcoin is and remains a speculative investment. Supervisory law and/or internal investment catalogues prohibit such type of investments. It is rather about Crypto Assets, which are based on a serious and sustainable business model. And there are more of them than you think!

Challenge 4: Low interest rate environment

The ongoing low interest rate environment must also be considered a mega-factor - and systemic risk! It is increasingly driving insurance companies, pension funds and pension schemes into an investment crisis and there is no end in sight. Caution should be exercised in assigning responsibility for this to the ECB or the global central banks. It is not as simple as that, especially when you look at the scientific discourse on the impact of monetary policy on the real interest rate. Without delving into this discourse; it is important to note that the central banks are the ones who must take the lead in finding a way out of this tunnel. And this is where Mrs Lagarde in particular is now called upon.

As you might recall, low interest rates were also by far the most highly weighted challenge for investors in the BAI Investor Survey. Reason enough for BAI to continue to set the institutional investment as a benchmark for the association's work, not only at our numerous events, but also with this newsletter.

Seizing opportunities and breaking new ground

Where there are challenges, there are naturally also opportunities. This has always been the case and will continue to be the case, also in this new year and decade. So worrying certainly won't help. They exist, the industries and sectors that are profiting from the entire ESG debate, new markets are being opened up, and of course new - alternative - asset classes are also being developed. The new infrastructure that is developing around blockchain and AI needs to be expanded and financed, be it traditionally or via tokens. The legal framework for a token economy is already in place, or will be in the near future, and groundbreaking steps and measures at national and European level will follow. Therefore, it is already worthwhile to deal with the issue intensively.

Institutional investors should finally take a closer look at venture capital, especially with regard to technology issues. Especially the new and expanded activities of the German government should provide an opportunity to re-evaluate whether VC does not now fit into the institutional portfolio. In any case, these activities of the German government deserve broad support, also by institutional investors. And of course the BAI!

In short: no matter whether classical and meanwhile established alternative investments or indeed new alternative investment concepts and strategies, BAI will continue to support, accompany and inform you competently and progressively in the new year and decade, especially in order to further promote institutional capital investment in Germany.

So continue to rely on our good association work, or even better: get actively involved and committed, whether in the technical committees or within the framework of our numerous event and information formats. For instance, this year we will again present a top-class and extremely informative program at the AIC and are planning many more BAI Insights, webinars and workshops on both the regulatory and market side. In the technical committees, intensive preparation and coordination work is underway on various legislative procedures, including the above-mentioned ones, whether on the various review processes, the Sustainable Finance Initiative, or all aspects of block chaining, electronic securities, crypto assets & Co. Particularly if you are not yet active in this area yourself, but would like to be involved, please contact the office. On the BAI homepage you will find an overview of the specialist committees and the respective topics and committee members. Further information about the work will of course be available at the general meeting on March 18, which I would like to remind you of at this point.

About AIC 2020

In just over two months BAI AIC will take place for the 13th time on April 22 and 23! This year's conference will be opened by the well-renowned member of the German Council of Economic Experts ("Wirtschaftsweise") Prof. Dr. Dr. h.c. Lars P. Feld with the keynote speech "Economy, Climate Change, Infrastructure - Challenges for the German Economy". In the lecture he will give his assessment of the current economic situation and point out the structural problems that are associated with the slowdown in economic development. In a further keynote speech by Prof. Dr. Beatrice Weder di Mauro, Professor of International Economics, on "The World Economy in Interesting Times", the influence of various factors on global economic development will be highlighted, such as the shift of the world's economic centre of focus to the East, the confrontation between the major powers and the divergence of national debates on the reform of the Euro, the direction of monetary policy and fiscal policy.

In the further course of the programme you will find top-class specialist presentations from selected member companies, including on the diversified development of alternative risk premiums, the integration of ESG risks in the investment and risk process for alternative investments and on trends, strategies and investment opportunities for private debt. As in previous years, the topics were selected by institutional investors. 15 practical sponsor presentations on real estate debt, regulatory issues and secondary transactions in private equity round off the high-calibre programme.

Of course, our accompanying programme for institutional investors, consisting of dinner and a workshop, is not to be overlooked.

At the request of numerous participants of last year's AIC, we have decided to end the first conference day with a large evening event with buffet and drinks in the Westhafen Pier. The get-together lecture by Anders Indset, the popular economic philosopher, will also be held there.

The number of registrations to date indicates that we will - once again - have a record number of participants at AIC, also in terms of the number of visitors from institutional investors.

We look forward to seeing you on the 22nd and 23rd April! And don’t let you make mad by

Corona!

To the contributions in this newsletter

We dedicate this newsletter to the topic "Institutional Investors and Alternative Investments", accompanying the main topic on our homepage. You can look forward to the following informative specialist articles:

- “How institutional investors free their portfolio from the correlation trap“, by Dr. Alexander Zanker, Deka
- “The European Circular Bioeconomy Fund: an alternative investment fund focused on Sustainable Businesses”, by Dr. Michael Brandkamp and Clara Martinez, European Circular Bioeconomy Fund (ECBF)
- “Private Equity 2019 – Where Challenges Meet Opportunities”, an Interview with Johannes Nölke, VISTRA Germany

Furthermore, the newsletter contains a detailed presentation of our Private Debt Due Diligence Questionnaire, which was published earlier this month.

I wish you an informative and entertaining read

Frank Dornseifer