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Editorial article from Frank Dornseifer

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Dear Ladies and Gentlemen,

BAI Investor Survey 2022 / Alternative Investments still on the rise, but German funds are not

Even in times of inflationflash, disruptive interest rate turnaround and Ukraine war: German investors continue and increasingly rely on alternative investments; German funds however, play almost no role at all. These are a few key messages from this year's BAI Investor Survey, which was published earlier this month. The results are not only representative, but also speak for themselves. The share of alternative investments (AI) in the portfolios of German institutional investors, which primarily make up private, corporate or even occupational pension plans in Germany, is growing and growing. 106 participants from the sectors of insurance companies, pension funds, pension funds, family offices, banks, etc., which manage more than 2.2 trillion euros of assets under management (AuM) and participated in this year's BAI Investor Survey, have meanwhile invested more than 23% of their assets in alternative investments, and the trend is still rising!

Especially the so called private markets strategies enjoy great popularity. Around three quarters of all participants stated that they had invested in real estate, infrastructure and private equity. Around half of the participants also stated that they were invested in private debt and real estate. Liquid hedge fund -(esque)- strategies follow at a significant distance, coming in at 15% and 12%, respectively. Crypto and tokenized assets, on the other hand, are hardly represented in the portfolio and stand at around 2%.

For us as industry protagonists, this is of course no surprise, as there are good reasons to invest in alternative investments, which we have been emphasizing for many years. First and foremost the superior effect of portfolio diversification, followed by the good risk-return profile and the illiquidity premium that can be generated precisely with private markets strategies. In this context, however, it is interesting to note that more than two-thirds of the participants - and the trend is rising - are now pursuing a dedicated ESG strategy. In other words, ESG and alternative investments are not a contradiction in terms; on the contrary, they are being used specifically to invest sustainably, and not just in the infrastructure or renewable energies segment.

Of course, it will be exciting to see whether and how the alternative trend will continue, especially in consideration of the inflation flash, the - from some perspectives almost disruptive - interest rate turnaround and, of course, the Ukraine war with all its serious effects on people and economies. The recession scenario, which is not only indicated by the yield curve in Germany, but which the IMF is now warning about very clearly on a global level, as well as a financial crisis, is also clearly clouding investor sentiment. And these issues were also addressed in the survey, and of course there are revealing answers here as well. A clear majority of 65% believe that high inflation and rising interest rates will not fundamentally change strategic asset allocation (SAA); however, the remaining 35% are almost equally undecided, with just under 20% betting that this will reduce allocation to alternatives in favor of traditional investments, while more than 15% believe that these factors will lead to a further increase in AI allocation. With regard to geopolitical factors, the predominant view is also that these tend not to influence the allocation to AI, although here too there are still almost 40% of participants, half of whom expect the portfolio to be reallocated toward or away from alternatives. In this context, it is interesting to note that large investors tend to expect no impact on SAA, while medium and smaller investors expect changes, but not uniformly. Investors' expectations regarding performance development in a persistent inflation scenario of more than 3% and further rising interest rates are also very mixed. Of course, this is not surprising, especially as the recession scenario, which is becoming increasingly apparent, will have a significant impact here as well. On the other hand, there is - unfortunately - great agreement on another central topic of the survey, namely the role of German fund structures in investments in alternative investments. Portfolio expansion and structuring have always been significantly shaped by supervisory and tax law, with investment funds naturally continuing to be the preferred access route for investors, especially in the area of alternative investments. And here, more than 80% of the investors surveyed stated that German fund structures play no or only a subordinate role in investments in alternative investments, at best in the context of so-called master funds. The main reasons that speak against German fund vehicles from the point of view of the investors continue to be the investment tax law and the investment supervision law, i.e. the KAGB, in the view of around 40% of the participants in each case. Neither the repeated reforms of the investment tax law nor the so-called "Fondsstandortgesetz" and other modernization laws were able to provide any impetus to make German fund structures more attractive and competitive.

In this context, it is not surprising that more than a quarter of the participating investors also criticize the unequal treatment of funds with regard to the turnover taxation of the management fee, which is generally not granted to AIFs - with the exception of open-ended special AIFs with fixed investment conditions - and thus puts them at a disadvantage in competition with leading European fund domiciles. And last but not least, the supervisory regime for the investors themselves is also criticized by a significant proportion of investors. Around one fifth of the participating investors see the regulatory regime applicable to them in general (i.e. in particular the Solvency II framework or the Investment Regulation as well as the CRR) as an obstacle to investing in alternative investments. The statements are even clearer specifically with regard to the Investment Regulation. More than half of the participating investors who are subject to this national regulatory framework (i.e., small insurance companies, pension funds, pension plans) position themselves to the effect that the various alternative investment strategies are not adequately reflected in the investment catalog of the Investment Regulation, both with regard to the blanket allocation to the risk capital ratio and with regard to the lack of special regulations, especially with regard to investments in infrastructure and private debt, which regularly lead to allocation and structuring problems in practice.

It is interesting to note that Solvency II investors are now making greater use of the SCR optimization options introduced in the recent past, which also apply to investments in alternative investments. Almost three quarters of the relevant insurance companies hold so-called qualified infrastructure and just under 30% so-called long-term equities in their portfolios. With both modules, capital adequacy can be significantly reduced compared to the requirements of the standard model, of course taking into account the respective risk profile. Regulatory differentiation has therefore had a positive impact here. This is what is known as enabling regulation. And we also need this more frequently in Germany, precisely in order to reflect the changing portfolio reality of institutional investors.

While the statements in the survey regarding alternative investments and further allocation are consistently positive, the findings from a regulatory perspective are rather sobering. At least German fund structures play no or only a minor role for investments in alternative investments. In short, there is a clear need for reform, especially in Germany, not only with regard to funds themselves, but also in supervisory law for investors.

A targeted and pragmatic strengthening of Germany as a fund location will benefit not only asset managers and fund initiators, but also the institutional investors behind them, who provide private, occupational or professional retirement provision for the majority of the population in Germany and, last but not least, the German economy. After all, alternative investment funds not only finance the expansion and renewal of infrastructure in Germany, they also provide substantial financing for German SMEs, both on the equity side and increasingly also on the debt side. The alternative asset classes and strategies that are reliable and necessary even in times of crisis must be consistently taken into account not only in the portfolio but also in regulation. This is also a core statement of this year's BAI Investor Survey. The many upcoming review processes at EU level - not only the AIFMD review itself, but also, for example, the Solvency or CRR review - are therefore reason enough to tackle various fund construction sites in Germany as well. Here, we are relying on the federal government's reform ambition on the one hand, but also on its stability and common sense on the other. After all, these are also important parameters for successful and sustainable investment. The example of the UK recently showed how quickly and massively political escapades and folly can get institutional investors into trouble. Hopefully, under the new Prime Minister Sunak, British politics and the British economy will return to calmer waters, although skepticism is definitely warranted in this regard.

Focus on ESG & Impact Investing / Workshop on November 2

As mentioned at the beginning, our Investor Survey has also impressively shown the outstanding role ESG and Impact Investing play for institutional investors. The fact that two thirds of the participating investors already pursue a dedicated ESG strategy speaks volumes. So does the number of publications, announcements and events on this complex, and of course the number and volume of pronouncements from legislative and regulatory bodies. It only takes a small snapshot to further illustrate this development.

Just recently, the EU Platform on Sustainable Finance published two more comprehensive reports of around 200 pages, including its recommendations on practical data collection and processing and on - better - usability of the taxonomy. Also almost hot off the press is the EU Commission's 19-page, 33-question supplementary FAQ on sustainability disclosures pursuant to Art. 8 of the EU Taxonomy Regulation. The European Securities and Markets Authority (ESMA) has not been inactive either, and on September 23 published its final guidelines on MiFID requirements for the suitability of financial instruments, in which ESG aspects relating to client preferences, product characteristics, costs, data, etc. are equally relevant. Similarly, with regard to the European Sustainability Standards (ESRS), ESMA has responded to a first draft of the European Financial Reporting Advisory Group (EFRAG). The ESRS are known to be a key element in achieving the objective of the Corporate Sustainability Reporting Directive (CSRD). The ESRS are intended to ensure sustainability reporting that is relevant, comparable across the EU and understandable. EFRAG is expected to submit its final draft ESRS to the European Commission in November 2022.

Finally, together the ESAs (EBA, EIOPA and ESMA) have produced the first annual report on voluntary disclosure of negative environmental impacts under the SFDR, based on a survey of relevant NCAs. In the preliminary overview, they highlight positive examples of best practices and negative impacts related to voluntary disclosures. Here, the extent of voluntary disclosures varies significantly among respondents.

Overall, the initial disclosures since the application of the SFDR are not very detailed - but this will change in the disclosures for the 2022 reporting period once the Delegated Regulation on the SFDR applies. The report also makes a number of recommendations to national supervisors to ensure appropriate supervision of financial market participants - including, for example, conducting regular surveys of their own markets to determine whether financial market participants are complying with the disclosure requirements under Article 4 of the SFDR.

Finally, no less important for practical implementation is the revised version of the European ESG Template (EET) recently put out for consultation by standard setter FinDatEx. And then on a national level, BaFin has also published a Q&A document to clarify how to interpret aspects of the SFDR as well as the Q&A documents published by the EU Commission in July 2021 and May 2022. In a welcome move, BaFin's Q&A provides some detailed guidance on the application of the SFDR, while excluding independent financial advisors from its scope. On top of that, it provides guidance on how firms can best make pre-contractual/periodic disclosures.

To reiterate: In these few - and above all, non-exhaustive examples, we are talking about announcements, etc. of the last 3-4 weeks. The ESG regulatory machinery has been running at this pace for about two years now. And also for the following period or the following years, the Implementation Timeline of ESMA, among others, already gives a good and not only promising overview of how things will continue in this respect. As is well known, the focus of the Sustainable Finance Strategy is currently on "E", "S" and "G" will follow. Moreover, only 2 of the 6 environmental goals have been covered so far; so again, we are likely to be at the beginning rather than the end. The ESAs, as we know, play an elementary role in the transposition and implementation of the multiple legal acts. And ESMA, for example, has just taken up the issue of Sustainable Finance in particular as part of its long-term strategy for the period 2023-2028, among other things to prevent greenwashing, ensure transparency and further expand the competencies of national authorities (NCAs), as well as to monitor and analyze ESG markets more closely. Of course, sustainable finance also plays an important role in ESMA's Work Program 2023: Enabling sustainable finance is one of the key deliverables for 2023.

In view of the topics listed here, which are only exemplary and cursory, and their diversity and scope, it is therefore essential that our industry and investors are kept informed on an ongoing and well-founded basis. You know from the past that this has always been a major concern of the BAI, and you are sufficiently familiar with our diverse communication channels and platforms on this topic as well. For this very reason, we have once again dedicated a separate newsletter to the topic of ESG and impact investing, which highlights this topic in a multi-faceted manner with a large number of profound and practice-oriented specialist articles.

And in keeping with the thematic focus, there will once again be a flanking workshop on Sustainable Finance & ESG, which will soon take place on November 2, 2022 and for which registrations are still open. With the participation of high-caliber industry players from academia and business, and filled with presentations and panels on taxonomy as well as sustainable finance 3.0, the program promises to provide participants with a practical and entertaining in-depth look at the topic of ESG and sustainable finance.

Start BAI Member Platform

In order to be informed comprehensively and up-to-date about the topic of Sustainable Finance, but of course also about a multitude of other topics of the BAI association work, especially in the area of regulation and the work in the expert committees and working groups etc., I would like to refer once again to the new BAI member platform, which was activated this Monday for all association members and in parts also for investors. I had already announced this in the newsletter before last. Now we have been able to put our concept and ideas into practice in a structured and user-friendly way in order to further improve the association's work in this respect as well in the coming years and to make it as efficient and productive as possible.

I can therefore only strongly recommend that you register quickly and make active use of the platform. Not only will you have central access to all essential information for members, especially with regard to the work in the technical committees, which have been reorganized and reconstituted. Also the articles of the BAI Infomails are posted here up-to-date and thematically structured in advance. You can use a notification function to select individually and specifically when and on which topics you would like to be informed. In addition, our platform provides you with new and easier ways to exchange information with the office and with other members. Ultimately, this should make the BAI network more tangible and recognizable, so that the exchange among members is also intensified, who can then exchange information more directly and quickly, not only around our numerous BAI events. On the member platform you will already find a variety of relevant contributions and information e.g. around Sustainable Finance, so that you can and should start directly!

Those of you who have not yet participated in the technical committees but are interested in doing so and would possibly also like to chair a committee are hereby cordially invited to contact me. We are always pleased to have active member companies who also support the association's work in the technical committees. At our regulatory pre-event on the occasion of AIC 2023, we will likewise make greater use of members of the technical committees in the selection of speakers. Here, too, further expressions of interest are welcome.

BAI Insight and Science Award

I am sure that I am not the only one who is very pleased that the BAI Science Award will again be presented as part of an attendance event this year. And I would like to invite you once again to attend the award ceremony on November 10, 2022. It will take place in Bad Homburg, on the occasion of a BAI Insight together with our member company FERI on the topic "Private Markets & Impact Investing - Requirements for Measurement and Reporting in Practice".

After a long forced break in Corona, we are finally able to hold our BAI event series in presence again. After the great success of the BAI Alternative Investor Conference (AIC) in May 2022 with a registration record of more than 700 participants, a lavish 25th anniversary celebration of BAI in June 2022 and the BAI Innovationsday on September 11, 2022 in Frankfurt, we are looking forward to the upcoming events with you! Feel free to sign up for the last remaining spots and contact us if you are interested in hosting a future BAI Insight.

To the articles

As always, our newsletter with its focus on ESG is packed with articles that are well worth reading. I would like to take this opportunity to thank all the authors who have contributed.

At the same time, I would like to point out that - as usual - we provide information on the highly topical subject area of ESG & Impact Investing in the relevant thematic focus on the BAI homepage with a large number of further specialist articles, interviews, guidelines, studies, lecture documents and, of course, statistics to accompany the newsletter and hopefully provide new food for thought. Please feel free to click through.

I wish you an informative and entertaining read!

Frank Dornseifer