BAI Considers Alternative Investment Sector to be Robustly Positioned, ECB-Warning against Risk Appetite in Investment Funds Warrants a Differentiated Approach

- ECB publishes bi-annual report on financial stability;
- Weaker economic growth and a persistently low interest rate environment are driving risk appetite in funds and insurance companies, which the ECB believes may lead to risks for financial market stability;
- BAI sees a need for action primarily at the ECB; regulatory intervention by funds and insurers is neither necessary nor expedient in view of the causality;
- Alternative investment funds are less exposed to risks with regard to their assets as well as through closed structures without return rights and special precautions in liquidity management.

Bonn, December 3, 2019. The **Bundesverband Alternative Investments e.V.** (BAI), the central lobby of the alternative investment industry in Germany, advocates for a differentiated analysis of alleged risks from the fund industry for financial market stability.

In its latest Financial Stability Review, the European Central Bank (ECB) addresses a number of potential risks to financial stability that could also selectively emanate from the fund industry. As a result of the global slowdown in economic growth and the continuing low interest rate environment, the ECB has identified a stronger appetite for risk, e.g. among investment funds and insurance companies, in this context, which is having an impact predominantly in the bond sector. In this respect, the ECB observes a stronger weighting of bonds with weaker credit ratings on the one hand and a significant decline in highly liquid bonds in portfolios on the other. At the same time, funds in the euro zone have reduced their cash ratio. As a result of the increasingly important role of investment funds and insurance companies, e.g. in financing the real economy, the ECB fears that in the event of a market shock the entire financial system could be distorted.

BAI Managing Director **Frank Dornseifer** comments as follows: “The ECB's warning words in the latest Financial Stability Report show the dilemma or causally linked dilemmas in a remarkable way. In the ongoing low-interest environment, classic interest-bearing securities, especially those with a high credit rating, have more or less become obsolete while investors of all kinds have to restructure; partly into bonds from the corporate or government sector with a lower credit rating, or into alternative investments such as infrastructure, private equity, private debt, etc., in order to

avoid the risk of a crisis. This shift is not necessarily, but can potentially be, associated with higher risks in individual cases."

From the ECB's perspective, it is potentially dangerous that, for example, highly liquid investment funds (UCITS or UCITS) increasingly hold weaker credit ratings or illiquid securities and that in the event of a market shock emergency sales, price falls, etc. occur, which may lead to distortions on financial markets as a whole.

Dornseifer adds: "Firstly, this is not a problem for the entire fund industry, but an asset- or structure-specific problem. Funds which are per se designed as closed vehicles or which provide for special redemption restrictions and which invest at least partially in illiquid assets are therefore not exposed to the risk identified by the ECB or are exposed to a much lesser extent. This differentiation is important. Just as important is the second observation; the ECB is essentially warning against itself. It is the ECB that sets the interest rates and is therefore responsible for the fact that so-called safe investments no longer yield a return so that investors are restructuring their portfolios. And this is precisely why I can only caution against demanding regulatory consequences for funds and insurers, for example. Not only would cause and effect then be confused, but also the fact that, for example, liquidity and stress management in investment funds are already given very high priority and the requirements are constantly being reviewed and adjusted. Incidentally, the European Securities and Markets Authority (ESMA) is responsible for investment funds in Europe."

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