Spezialfonds bounce back

Whatever shorter-term setbacks and criticisms Spezialfonds are subject to, **Till Entzian** sees substantial growth ahead for this robust investment vehicle

If we look at the receipts statistics, it would seem that the attractiveness of securities-based Spezialfonds is definitely past its peak. For the fifth successive year, receipts have fallen; in 2003 they were hovering around the level of 1995/96, and at €22.8bn stood at just one-third of the total for the record year 1998, when the Spezialfonds investment fund management companies (KAGs) took in €66.9bn.

Nevertheless, although the managed volume of the Spezialfonds had fallen in 2001 by 1.4%, and in 2002 by 5.5%, it rose perceptibly in 2003. The increase was a respectable 9.4%, which means that the Spezialfonds (investing in securities and not real estate) volume has increased from €470.6 bn to €514.8bn. As only €22.8bn of this increase can be attributed to net receipts, the remaining €21.4bn is due to price increases brought about by the emergent capital market recovery.

If we look for an explanation of the declining interest among institutional investors in the Spezialfonds instrument, we come across a number of very different reasons.

Among the major investor groups, there is now a certain degree of market saturation, with the insurance companies, for instance, which have invested two-thirds of their portfolio investments in Spezialfonds. In the next largest investor group, the credit institutions, Spezialfonds still make up one-tenth of the total security holdings, which is a very high value considering that portfolio investments are a core business for many credit institutions. In the other groups, too, most of the institutions that are suitable for Spezialfonds investment probably already hold an instrument such as this. There is still growth potential here, to the same extent that the total assets of existing customers are growing. Although it is becoming more difficult to win new investors – many potential investors have yet to recognise the enduring advantages of the Spezialfonds – it is not altogether impossible.

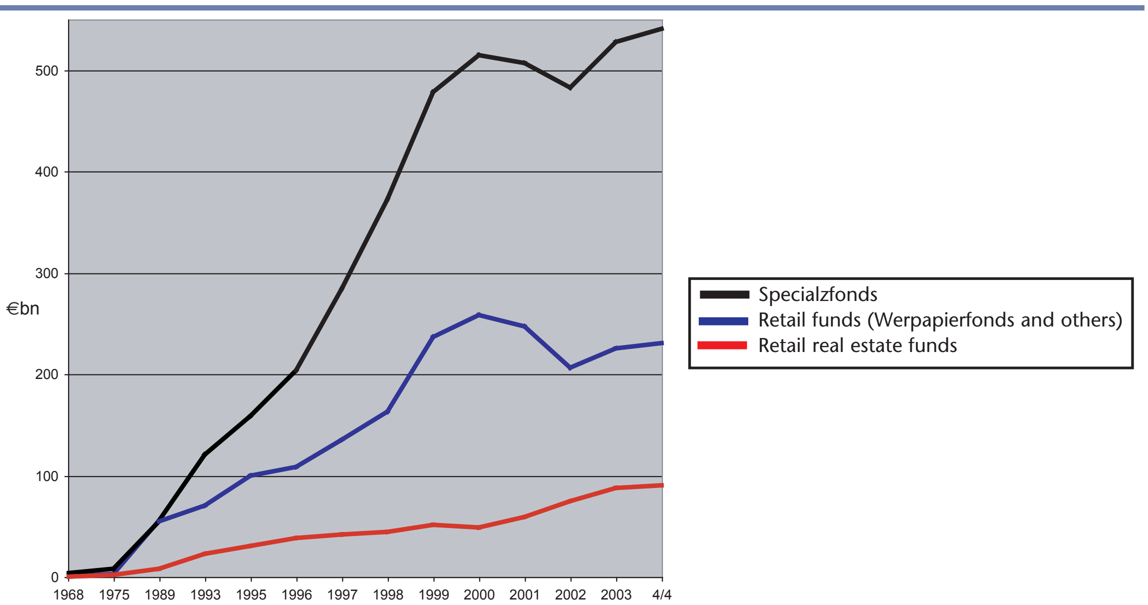
The imminent change in the investment law might have persuaded some potential investors to postpone setting up a Spezialfonds. But even more significant than investment legislation could be accounting legislation, and the imminent changes to it. The mandatory consolidation projected by the IFRS (= IAS) may mean that many investors in Spezialfonds will have to report any income, profits and losses generated by the fund directly under the corresponding positions in the investors' income statements, irrespective of the fund's financial year and independently of any dividend from the KAG. At group level, in such a case, it will no longer be possible to manage a balance sheet using the Spezialfonds dividend amount and timing.

Of course, not all investors are affected by this. And of course it would make it much easier for those investors who are affected to do their own securities bookkeeping if the KAG were to supply the figures required under the IFRS already prepared. But not all KAGs have yet grasped the significance of this issue, so it would seem that there are more often relatively major or relatively minor problems or delays in preparing the figures required by the investor.

Once the KAGs recognise their opportunity here, and also develop into specialists in portfolio accounting under IFRS, they will be able to offer investors not only the 'outsourcing' of portfolio management but also the outsourcing of booking and reporting portfolio investments.

The massive losses by many investors have seriously restricted room for manoeuvre. So any restructuring of existing portfolio holdings into Spezialfonds will fail, for example, if investors are unwilling or unable to convert the floating losses on existing investments. Moreover, the high volatility of the equity markets in recent years has resulted in a certain restraint, not only among private investors, but also among institutional investors towards securities-based funds.

Figure 1: Changes in fund volumes €bn



Market shares changing, number of Spezialfonds KAGs falling

With the market as a whole recently standing at just 1.3% above its highest level to date, reached in 2000, Spezialfonds providers have also experienced a series of changes over the past year. The most notable development was that for the first time in the history of the Spezialfonds the number of providers has fallen. The number of institutions offering securities-based Spezialfonds last increased in 2000; since then it had remained unchanged at 59 companies. In 2003 the number fell to the current 55.

BNP Paribas Invest no longer operates as a KAG; since early 2003 it has restricted itself to its role as a sales and marketing unit for institutional customers of BNP PAM in Germany. The portfolio investment company classed as belonging to the Brenninkmeyer family, GWA, has also disposed of its entire Spezialfonds volume, but is still being carried by the German Financial Services Supervisory Authority (BaFin) as an existing KAG. The Merrill Lynch Investment Management KAG has been wound up, as has the Swiss Life Asset Management KAG (end 2003). Additionally, the Citigroup and SwissRe have also split from their Spezialfonds KAGs.

The trend is continuing this year. Mannheimer Asset Management was wound up on 6 June 2004. Other providers are also reconsidering whether they should hold on to their KAGs or concentrate on asset management and where appropriate start up as external managers of Spezialfonds.

The closure and disposal of KAGs has started a trend that was already foreseeable in the boom times for establishing investment fund management companies. Ultimately, it is not unusual for a boom phase to be followed by a consolidation phase. The consolidation that is evident now among Spezialfonds providers has certainly been sustained by developments on the equity markets. The equity market recovery that started early in 2003 will slow the consolidation down somewhat, but will not be able to reverse it completely.

No new Spezialfonds companies were established in 2003. However, two companies are worthy of mention having been acquired by their managements and joined the market under new names. They are the Asecuris Asset Management KAG (formerly SwissRe) and the First Private Investment Management KAG (formerly Citigroup). Both companies are now wholly owned by their respective managements and to that extent are unusual. In the case of two other companies, Union Panagora and Lupus Alpha, it is known that the managers have a minor stake in the KAG.

For the current year, however, Fidelity is another new provider that has announced the establishment of a KAG, which will also be offering Spezialfonds to institutional customers.

Figure 2: Receipts by domestic investment funds since 1980

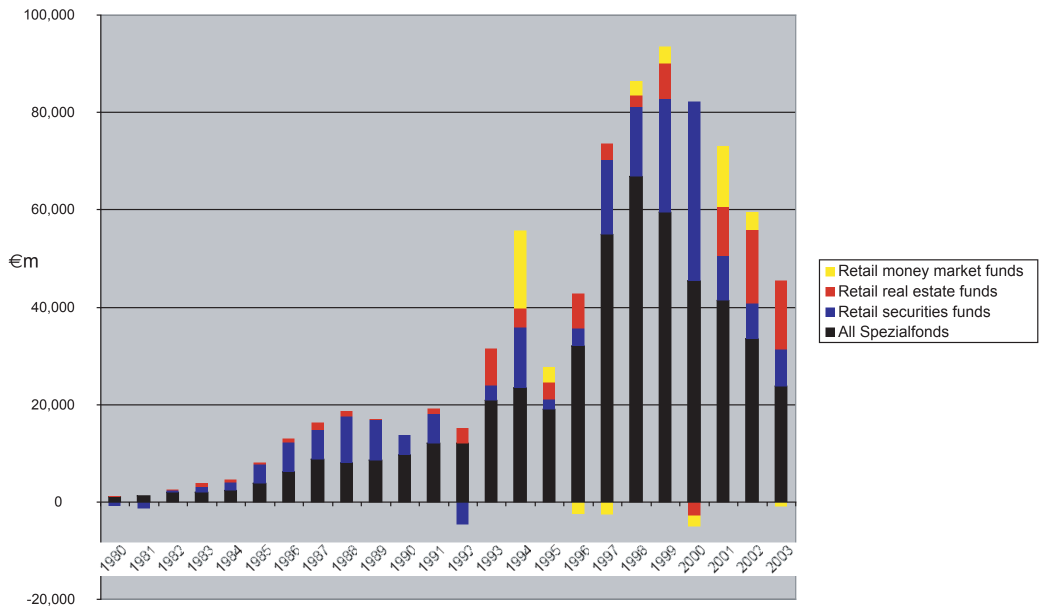
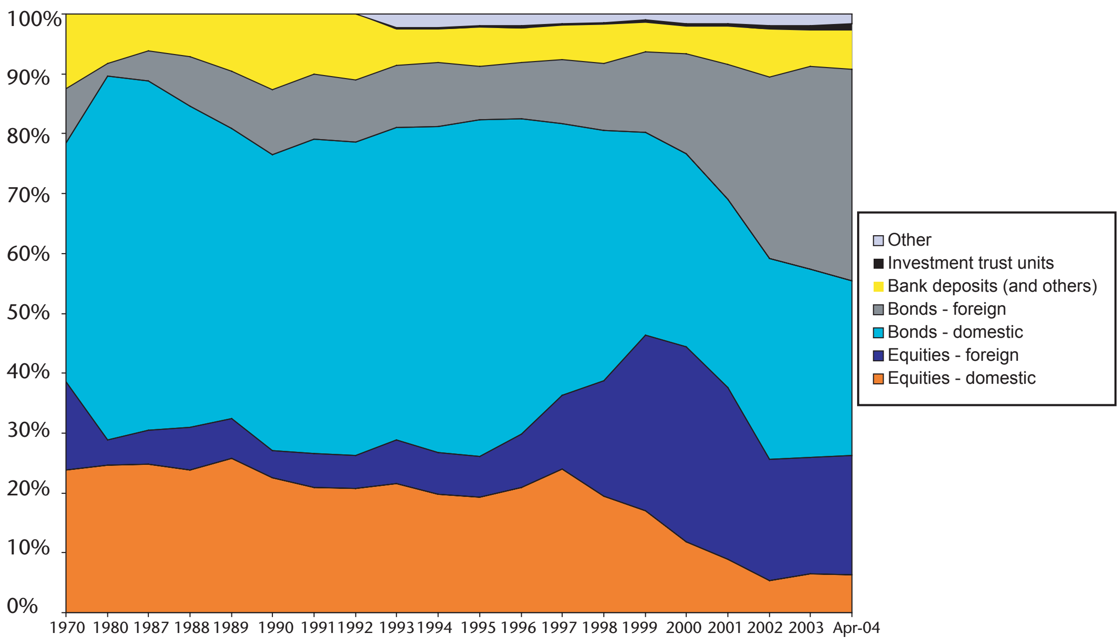


Figure 3: Asset breakdown of Spezialfonds (excluding real estate funds)



No changes for Kandlbinder studies

The survey established and conducted for many years by Kandlbinder was carried out again this year, with no changes. For each individual KAG, the survey covers the managed year-end Spezialfonds volume, the number of Spezialfonds and the structure of investors who were investing in these Spezialfonds on the qualifying date.

Although the Bundesbank also publishes the structure of Spezialfonds holders in its capital market statistics, an independent survey not only enables a rather different methodology to be used, but also provides a more detailed evaluation in which the structure of Spezialfonds holders, based on the different provider groups, can be analysed. This would not be possible using the Bundesbank statistics.

The findings of the Bundesbank statistics and our own survey differ in a number of respects. The obvious differences between the two can be explained both by different types of classification, ie, a different definition of the investor groups and by a different methodology for classifying mutual funds (Gemeinschaftsfonds) on the other. In form 10 380, for 'type of unit holder' the Bundesbank allows the reporting KAGs under heading 08 'Type of Unit Holder' only a single response, even for Gemeinschaftsfonds. Accordingly, if several investors from different investor groups are investing in one Spezialfonds, the total fund assets are attributed to the investor group with the largest stake. This means that the volume of the investor group with the largest stake may be overstated, and the volume of the other investor groups in a Gemeinschaftsfonds understated.

Following the methodology of the Kandlbinder study, however, we endeavour to determine the exact level of participation by the different investor groups in a KAG. This is regardless of whether the investors concerned are investing in an individual fund (Spezialfonds with just one investor) or as a majority or minority investor in a Gemeinschaftsfonds (Spezialfonds with several investors). This is done from the point of view of determining the exact sales of Spezialfonds units among the different investor groups, whereas the Bundesbank is more interested in structural market issues at the level of the instruments, ie, the special assets (Sondervermögen).

The methodology established by Kandlbinder has always distinguished between the insurance sector, ie, insurance companies established under private and public law, and institutionalised pension providers, ie, the pension funds, benefit funds, occupational, governmental and/or company pension schemes. The Bundesbank has always amalgamated these two investor groups into a single category. Since the beginning of this year, the Bundesbank now also differentiates between the two groups referred to above, which means that it has adapted its statistics to the Kandlbinder methodology. This not only corroborates the subdivision used here, but also means that the cost to the KAGs of taking part in this survey is again reduced, as they can simply pass on the Bundesbank report to the present author without changing it.

Participation in the survey

One again it was pleasing to note that all 55 KAGs took part in the survey for the year 2003; according to the Bundesbank's statistics on the qualifying date a total volume of €514bn was managed in 5,176 Spezialfonds. So once again the whole Spezialfonds market was included in the survey. In evaluating the survey findings there is - as in the year before - a rather higher total volume than the volume determined by the Bundesbank, and also a different number of Spezialfonds.

The relatively small variations are, however, within the range of previous years, and are partly based on subsequent corrections by individual companies and partly on calculation errors. Such variations can probably never be avoided altogether, but fortunately they do not detract from the meaningfulness of the survey.

Change in investor composition

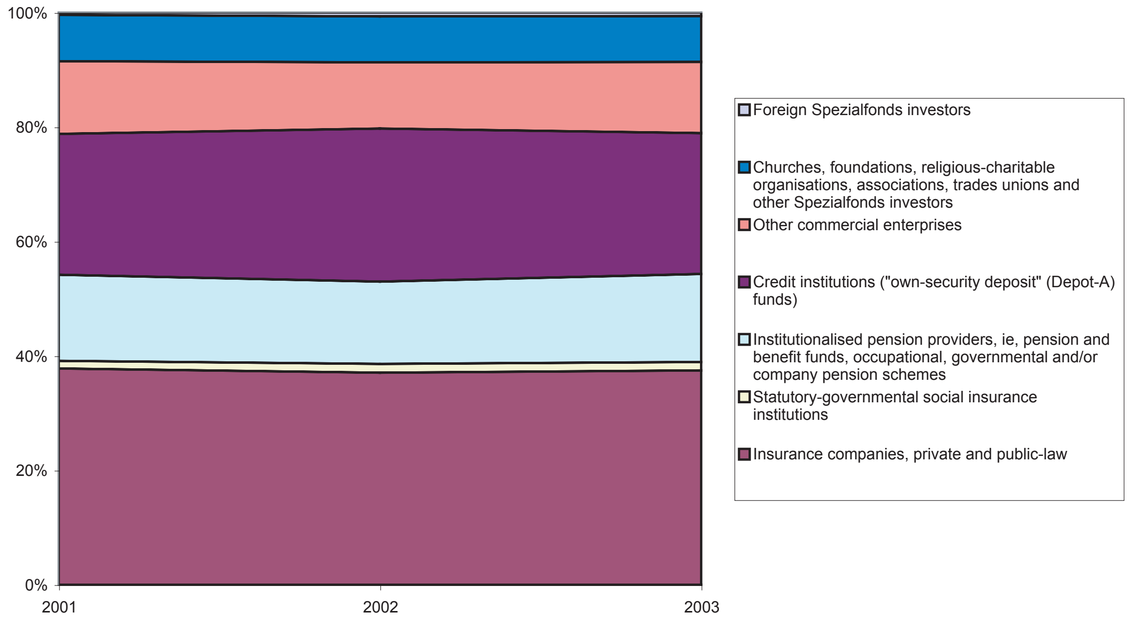
By contrast with the year before, the structure of Spezialfonds holders has only changed slightly. According to the survey findings, the largest investor group, the insurance companies, has once again slightly increased its share (by 0.5%) and now holds 37.5% of the total Spezialfonds volume. This figure is therefore still 1.0% below its highest level in recent years, the 38.5% reached in 2000.

The second largest group, the credit institutions, has fallen by 2.1% to 24.6%. In absolute terms, this represents a fall from €128.7bn to €127.8bn. The reason for this fall are a few, but very substantial outflows of funds that could not be made up by normal business with many of the credit institutions. Other commercial enterprises now have a 12.4% (+ 0.8%) share of the Spezialfonds volume, equivalent to a total of €64.7bn.

The group of institutionalised pension providers has raised its share of Spezialfonds volume from €69.3bn to €80.1bn, from 14.4% to 15.4%. The churches, foundations, religious-charitable organisations, associations, trades unions and other Spezialfonds investors now hold a total volume of €41.9bn, corresponding to a virtually unchanged 8.1% share.

The statutory-governmental social insurance institutions have

Figure 4: Structure of Spezialfonds investors



also changed by just 0.1%, and now hold €7.4bn in Spezialfonds units, or 1.4% of the total volume. The foreign Spezialfonds investors have reduced their investment volume by 10%, from €3.3bn to €3.0bn which means that their share has decreased by 0.1% to 0.6%.

Changes in market shares of provider groups

Market shares between the provider groups also changed very little during 2003. The biggest change was among the private banks, which increased the volume of Spezialfonds under their management from €65.1bn to €76.5bn, thereby raising their market share from 13.6% to 14.7%.

The foreign bank subsidiaries have lost €1.9bn, reducing their market share from 6.7% to 5.8%. In this case, however, it should be borne in mind that three of the original 15 KAGs have dropped out of this provider group, and that of these, MLIM alone had been contributing a volume of €2.3bn at the end of 2002. The KAGs from the cooperative sector also lost some of their managed volume (from €34.5bn to €33.7bn), as well as market share (from 7.2% to 6.5%). The termination of large individual mandates might have been responsible for this.

The KAGs of the savings banks (Sparkassen) and central savings banks (Girozentralen) managed to increase both the number of their mandates and the volume (at the end of 2003 they were managing a total of €103.4bn, compared to €96.4bn the year before); however, as this increase was less than that for the Spezialfonds market as a whole, their market share has nevertheless fallen from 20.1% to 19.9%. By contrast, the companies of the major and regional banks, despite a marked reduction in the number of managed Spezialfonds (from 1,822 to 1,660) increased both in terms of managed fund volume (from €163.6bn to €180.3bn) and in terms of market share (34.2% to 34.7%).

The ‘other companies’ also recorded a rise in their market share, and now cover 4.3% (from 3.9%) of the Spezialfonds market. This increase is partly due to the fact that the number of KAGs allocated to this group has increased, and that First Private has introduced some fund volume.

With all of these changes, however, it should be borne in mind that the over the year the equity markets have risen by about one-third. And of course, the KAGs that were best able to profit from this trend were those whose investors are more inclined to take risks, while the KAGs with more risk-averse investors and a correspondingly lower proportion of equities in the Spezialfonds managed by them have automatically lost ground to those in the first group.

Changes in investor composition among individual provider groups

Minor shifts in investor structures were evident among the various KAG groups in 2003. These shifts were most marked among the foreign bank subsidiaries, which again could be due to the three companies that dropped out of this group. In this case the share of institutionalised pension providers fell by 4.1% to 17.4%; the credit institutions’ and other commercial enterprises’ share increased by 2.5% to 37.1%, and the social insurance institutions’ share doubled from 2.2% to 4.4%.

Also noteworthy is the fact that at the end of 2003 even among the foreign bank subsidiaries only 0.8% of Spezialfonds volume was actually derived from foreign investors; a year before the figure was 1.8%.

The insurance KAGs seem to be concentrating even more on their traditional investor clientele, with the proportion of insurance investors rising from 86.6% to 87.8%. The credit institutions, however, are becoming less significant among the KAGs of the Sparkasse sector; they are now responsible for just 55.9% here (previous year: 60.0%).

The insurance investors are also still gaining in importance among the KAGs of the major and regional banks, and have raised their share of the Spezialfonds managed by these banks from 36.1% to 38.1%. As in the Sparkasse sector, the credit institutions’ share of Spezialfonds assets has fallen, and at the end of 2003 totalled just 12.8% (2002, 14.6%).

Composition of the Spezialfonds

Unfortunately, the composition of the Spezialfonds cannot be classified according to the different investor groups. Nevertheless, the statistics do provide some interesting insights. In 2002 there was a sharp decline in the equity quota, from 37.7% to 25.6% (the highest level, reached in 1999, was 46.3%); but this decline has now been halted and the equity quota has even risen slightly again.

At the end of 2003, 25.9% of the total Spezialfonds volume consisted of equities. Domestic equities have once again increased (6.5% compared to 5.3% the previous year), while investments in foreign equities have fallen slightly (from 20.3% to 19.4%).

Investment by Spezialfonds in fixed-interest securities has continued to expand, and now comprises 65.3% (previous: 63.9%). The lowest value of the past 30 years was in 1999, when the bond quota was just 47.3%. But over the past year, the trend was opposite to that seen in equity investments; the funds increased the proportion of foreign bonds (from 30.3% to 33.7%) and reduced the proportion of domestic securities (from 33.5% to 31.6%).

Importance of the Spezialfonds for banks and insurers

The insurers’ share of net receipts by Spezialfonds, as measured by the Bundesbank, was still around 75% in 2002, but this was certainly an exception. In the past year, the insurers were still contributing just below half of the total receipts, which meant that they were still the largest investor group.

Investment funds, on the other hand (including Publikumsfonds) are still an important investment instrument for the insurers, making up roughly two-thirds of their investment portfolio. In previous years, this figure had risen from 62.9% (2000) to a high of 67.9% (2002), and by the end of last year had fallen to 65.1%.

Relative to the total capital investments by the insurers, the share of investment trust units ended up at 22.2%, equivalent to the figure for 2000. In 2001 and 2002 this figure had been 22.9% and 22.8%, respectively. Capital investments by the insurers rose by 5.3% in 2003 because of premium income and investment earnings, but the value of the insurers’ investment trust units was only 2.6%.

These figures mean that the insurers, too, have been rather cautious with their new issues or top-ups of Spezialfonds. The reasons for this caution among investors has already been discussed and also apply to the insurers.

The banks, too, have further reduced the proportion of Spezialfonds in their total investment portfolio. The peak level of 12.1% was reached in 2001; by the end of 2003 this had fallen to 10.7%. At the end of April 2004 the statistics showed a figure of just 10.2%. There are no obvious signs of a turnaround in this trend, so it seems likely that there will be a further decline as the year progresses.

Changes brought about by the Investment Modernisation Act

The Investment Modernisation Act (IMA) came into effect at the beginning of the year, with the Investment Act and the Investment Tax Act replacing the Investment Management Company Act (KAGG) and the Foreign Investment Act (Auslandinvestmentgesetz). This provided an opportunity for the previously scattered regulations on supervisory law and organisational facilities for Spezialfonds to be grouped together in a special section. In addition, there have been amendments to a number of provisions that are significant, not just for Publikumsfonds, but also for Spezialfonds.

The number of investors permitted in a Spezialfonds has been raised from 10 to 30. Now, according to the current German Association of Mutual Funds (BVI) statistics (31 March 2004), there are a total of 6,150 Spezialfonds investors in 5,021 Spezialfonds. Of those Spezialfonds 4,512, or 90%, have just a single investor. The 509 Gemeinschaftsfonds have an established total of 1,638 investors, which works out to an average of just over three investors for each Gemeinschaftsfonds. It therefore seems unlikely that the increase in the number of permitted investors will have much practical significance.

On the other hand, it is now at least possible that there will be a greater number of investors participating in a Spezialfonds, with each investor holding less than 10% of the Spezialfonds. Accordingly, investors can continue to utilise most of the advantages of the Spezialfonds, without necessarily being obliged to consolidate, for instance in respect of Basel II.

Another future possibility for a Gemeinschaftsfonds is an investment policy tailored to the individual investor. The whole fund assets must be uniformly managed, so that the fund manager cannot make allowances for the willingness of individual investors to bear risks. It is therefore up to the Gemeinschaftsfonds investor to manage the overall risk outside the Spezialfonds, for instance by means of hedging operations or switching between different Spezialfonds with different investment policies.

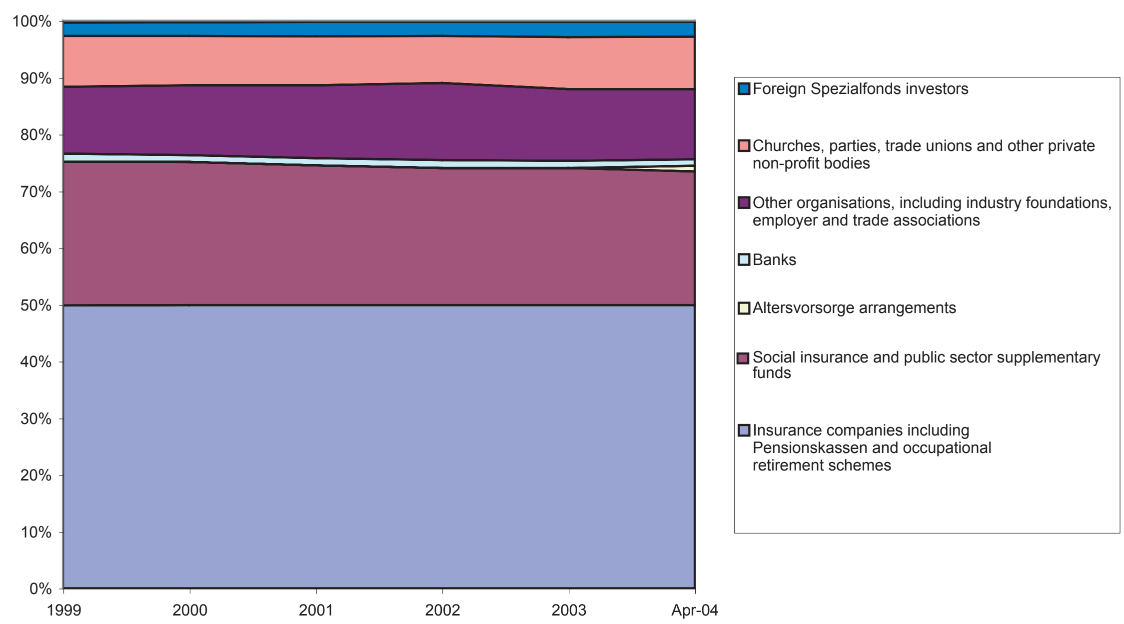
With Gemeinschaftsfonds too, however, the timing and amount of dividends can be based on the needs of the different investors. Since the 4th Financial Market Promotion Act came into effect in 2002, it has been possible for a Spezialfonds to create any number of unit classes, each of which operates a different dividend policy.

It seems that the meaning of 'umbrella construction', introduced by the Investment Act, has still to be definitively clarified. Under the original draft bill, it was still planned to permit a number of sub-funds with different principal investment objectives under the umbrella of a single Sondervermögen. Now, however, the KAGs have only been given the possibility of grouping several Sondervermögen under one umbrella. It has been pointed out that the advantage of this is that investors can, for example, be granted the facility to switch between funds grouped under one umbrella on more favourable terms (eg, without paying a front-end fee).

Many KAGs have, however, been offering their customers this facility for some time, so to that extent there is nothing fundamentally new here. In the Spezialfonds sector, however, some consideration is being given to the question of whether the creation of umbrella constructions might enable investors to avoid any possible obligation to consolidate.

This would be the case, for example, if they were determined within the limits for the consolidation obligation on the basis of the total assets of the umbrella construction, and not on the basis of the fund volumes of the individual Spezialfonds. Such considerations are certainly welcome, as in most cases the consolidation obligation for Spezialfonds produces more disadvantages than advantages and is unjustified on its merits.

Figure 5: Structure of Spezialfonds investors according to Bundesbank categories



Tax-neutral funds merger without approval from the BaFin

It is actually in the Spezialfonds sector that the possibility of tax-neutral fund mergers has long been expected. Up to now, the necessity of revealing undisclosed reserves or liquidating floating losses has been a decisive obstacle when the question of grouping several Spezialfonds mandates into one master fund has arisen. This obstacle has now been removed, and the conditions for tax-neutral grouping are now relatively easy to fulfil:

- Where the Sondervermögen to be grouped are managed by different KAGs, the Sondervermögen to be transferred must only be transferred to the KAG that manages the accepting Sondervermögen at least one scintilla temporis prior to grouping;
- With most Spezialfonds, investment principles and limits as laid down in the ruling contract terms are identically worded. Any existing variations can either be interpreted as 'not material' or eliminated by a short-term harmonisation of the contract terms;
- The precondition that a transfer should only take place at the financial year-end of the transferred Sondervermögen, does not obviate a free choice of the timing of the transfer. By setting up a short financial year the transfer qualifying date can be set at any time to the desired date;
- Approval is not required from the BaFin, only the investors have to agree to the transfer.

Nevertheless, before the funds are merged, the contract terms of all participating Sondervermögen should be converted to the IMA. That is because the wording of the regulation for the continuation of the book value as projected by the IMA could be interpreted in such a way that the tax neutrality only applies to Sondervermögen within the meaning of the IMA. Where funds are grouped together which are still governed by the KAGG, the risk would therefore arise for the investors of undisclosed reserves becoming liable for tax following a subsequent company audit.

From the wording of the Act, it is rather unlikely that cross-border grouping of Sondervermögen will be possible. Ultimately, the transferred Sondervermögen must be in accordance with the IMA, which means they must be domestic. And because both funds have to be managed by the same KAG, the accepting Sondervermögen can hardly be domiciled in another country. A liberal interpretation, or an analogous application of the regulations by the tax authority, could also make cross-border groupings possible in future.

Extended period of notice does not apply to Spezialfonds

Although the periods for notice and amendment of Publikumsfonds contract terms has been extended from three to 13 months

Figure 6: Changes in market share compared with previous year

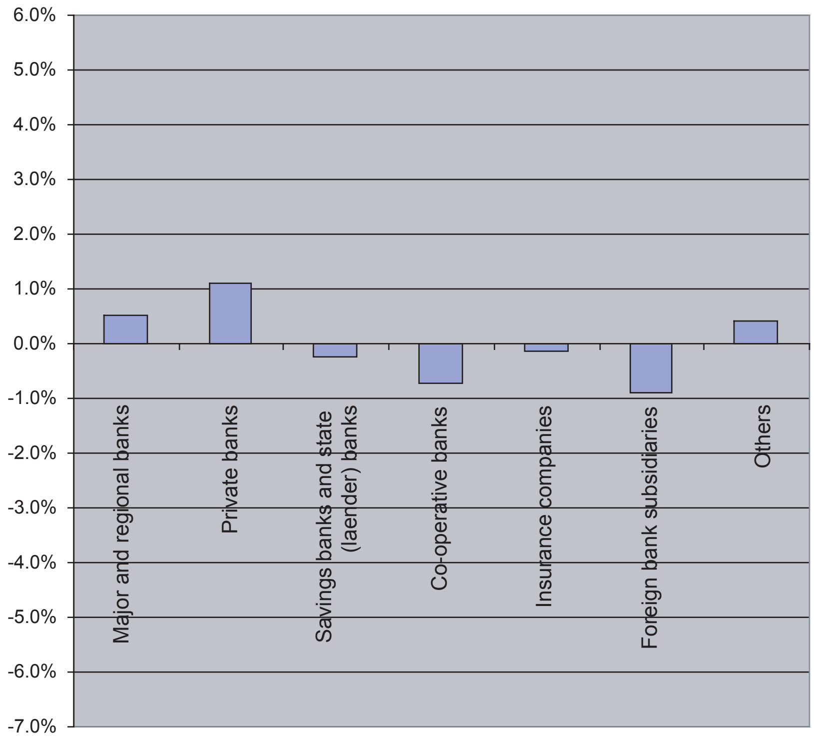
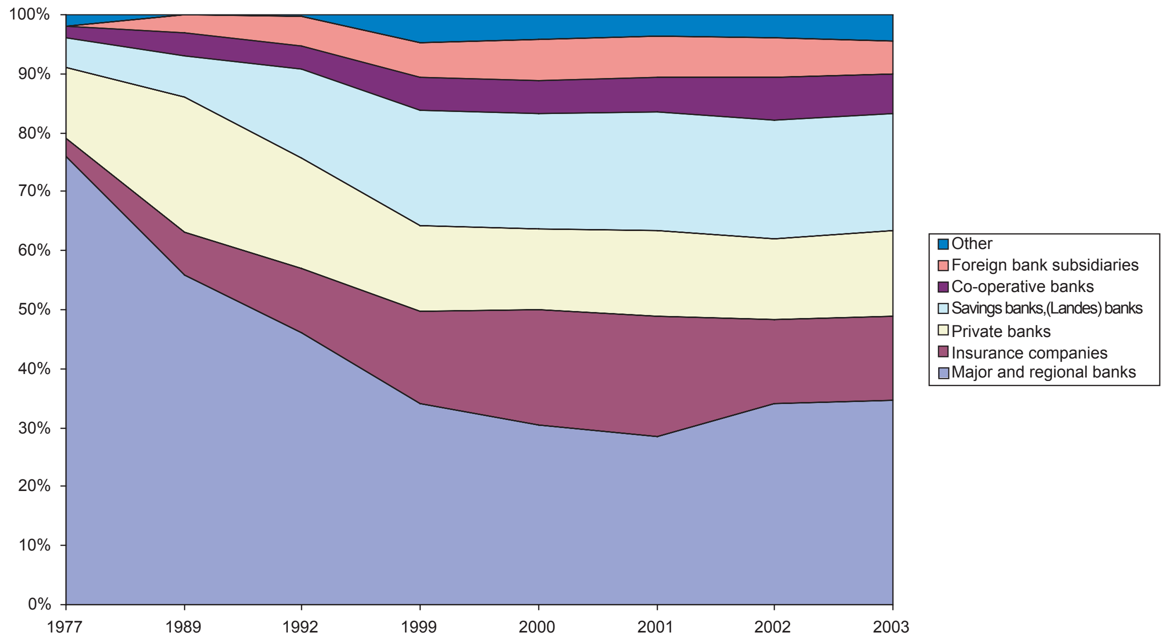


Figure 7: Growth of market share of Spezialfonds (excluding real estate Spezialfonds) by KAG grouping



(investors should have the possibility of waiting until the end of the 12 months' period of capital gains tax liability to sell the units they have just purchased), it has been made clear that these periods do not apply to Spezialfonds.

In line with the recently accepted practice, Spezialfonds can therefore be terminated without observance of a period of notice, transferred to another KAG or their contract terms amended.

In this connection, clarification is still awaited from the German finance ministry on whether the publication of notice or contractual amendment in the Federal Gazette may be dispensed with.

Interim and liquidation reports
It is now a requirement that on transfer of a fund to another KAG and on liquidation of investment funds a report is drawn up, giving the same details as the financial statement, and audited by the certified auditor. In practice, many companies have already produced such reports in the past, so the new regulation does not create any additional expense.

A liquidation report could be dispensed with for the tax-neutral grouping of investment funds. Although this also means terminating the transferred Sondervermögen, the whole takeover procedure must in any case be audited by the statutory auditor.

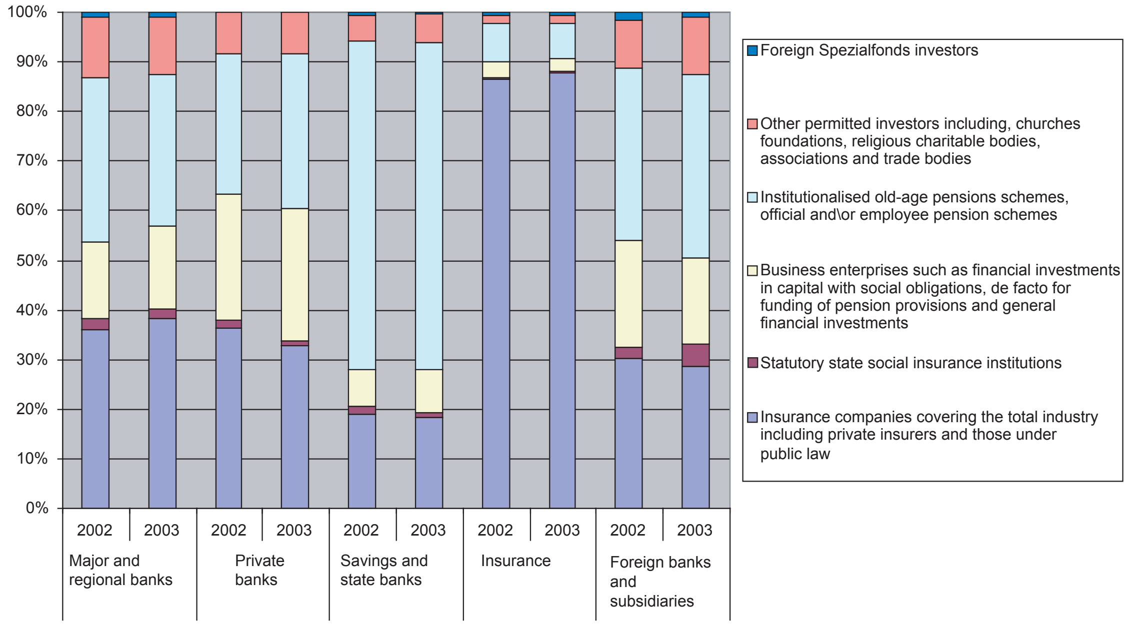
No sales prospectus and foreign-language contract terms
It has been made clear that no sales prospectus has to be drawn up for Spezialfonds, something that in practice has also not been done before. It was also made clear that the contract terms for Spezialfonds do not have to be drawn up in German, and that the annual reports to the BaFin and the Bundesbank only have to be filed on request.

Investment regulations
The amendment of the investment regulations makes it possible for Spezialfonds to employ additional investment instruments and to achieve the target asset allocation more efficiently. As a rule, a Wertpapier-Spezialfonds will be converted to the mixed 'Gemischtes Sondervermögen' type of fund newly created by the IMA. Gemischte Sondervermögen are initially allowed to acquire all assets that are permitted for the so-called directive-compliant 'Richtlinienkonforme Sondervermögen'.

The key innovation for Richtlinienkonforme Sondervermögen lies in the raising of the 5% limit for investment in other investment funds (target funds). This will make it possible to achieve every permissible investment target entirely as the fund manager wishes, both by direct investment in appropriate assets and by the acquisition of appropriate target funds. It may be worthwhile, particularly for smaller Spezialfonds, for example to present a 30% target equity share by the acquisition of equity funds. The acquisition of funds of funds, ie, of all investment funds that themselves invest more than 10% in target funds is prohibited.

Over and above the advantages allowed under the UCITS Directive, Gemischte Sondervermögen may also invest in units in open-ended real estate funds (Immobilienfonds) and up to 10% in single hedge funds. Unfortunately, the acquisition of umbrella hedge funds has not been permitted, although this would certainly have been sensible in terms of better spreading of the hedge fund investment risk. And because the legislature was obviously afraid of attempts to circumvent the regulations, single hedge funds may also only be acquired if they do not invest their resources in other investment assets. Some revision of the law on this point would be desirable, if only from the outset to restrict the cascade effects caused by the investment limits, held at a very low 10%.

Figure 8: Structure of Spezialfonds investors according to KAG group type



Derivative Regulation and possibility of leverage to 200%
Another fundamental change relates to the use of derivatives. The most important innovation in this case is that the risk potential of the investment fund may be doubled with the aid of derivatives. Between 1990 and 1998 it was possible for a fully invested fund to achieve an investment rate of about 140%, by making full use of the 20% limit for futures and the 20% limit for options. Then the 100% overall limit was introduced in the 3rd Financial Market Promotion Act, so that it was no longer possible to apply any further leverage to the fund.

Now, therefore, an investment rate of 200% is permitted, enabling fund managers to hit their benchmarks even when markets are rising. Just how much this facility will be used in practice naturally depends on the risk-bearing capacity of the Spezialfonds investors concerned. If the investor is unable and not permitted to carry any losses, the fund manager must still refrain from leveraging the Spezialfonds.

The new regulation for controlling interest rate risks is a valuable one. In this case, even a fully-invested fund will be able to extend the average residual term by purchasing appropriate interest rate futures contracts, something that was not previously possible because of the clumsily worded 100% overall limit.

Moreover, foreign exchange forwards are no longer limited to hedging operations. Because the ban on short sales does not apply to foreign exchange transactions, the typical Spezialfonds will in future be able to incur uncovered currency risks, ie, it may purchase and/or sell currencies forward. Provided the fund does not hold any assets denominated in foreign currencies, the total contract values on the forwards may be up to 200% of the fund's assets.

New regulations for ban on short sales
The fact that the ban on short sales has also been largely lifted has given fund managements new possibilities. Whereas previously they were only permitted to arrange transactions that were counter to the market when there were corresponding assets or corresponding interest rate risks in the Sondervermögen, under the new law short sales are only prohibited:
❑ As spot transactions (disposal of borrowed securities);
❑ As derivatives, where the contract partner may request delivery of assets and where there is some likelihood of this happening.

If, however, the Sondervermögen is in a position to choose (eg, purchase of a put option), or if the transaction concerned is an interest rate hedge, or if the actual delivery of the underlying assets is a contractual possibility but unusual in practice, these cases will not be regarded as prohibited short sales.

Compliance with the 200% limit will be verified by the KAG either by means of the so-called 'simple approach ('Einfacher Ansatz'), which essentially functions like the previous regulation. The derivative regulation now provides an alternative in the so-called 'qualified method' ('Qualifizierter Ansatz'), which uses a value-at-risk calculation.

The amount of risk of the Sondervermögen actually managed as calculated using the value-at-risk

Figure 9: Share of investment funds in investments of insurance companies

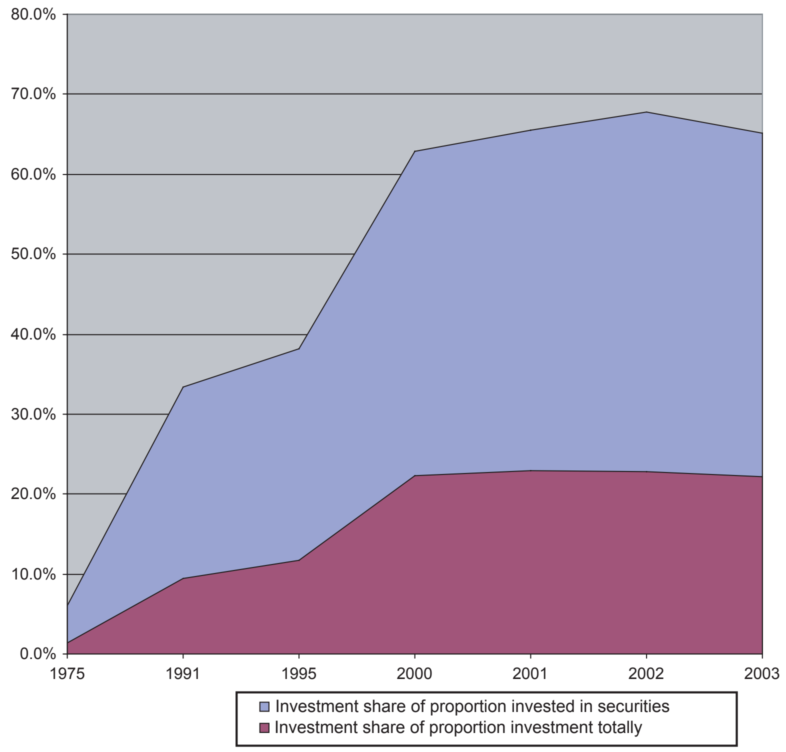
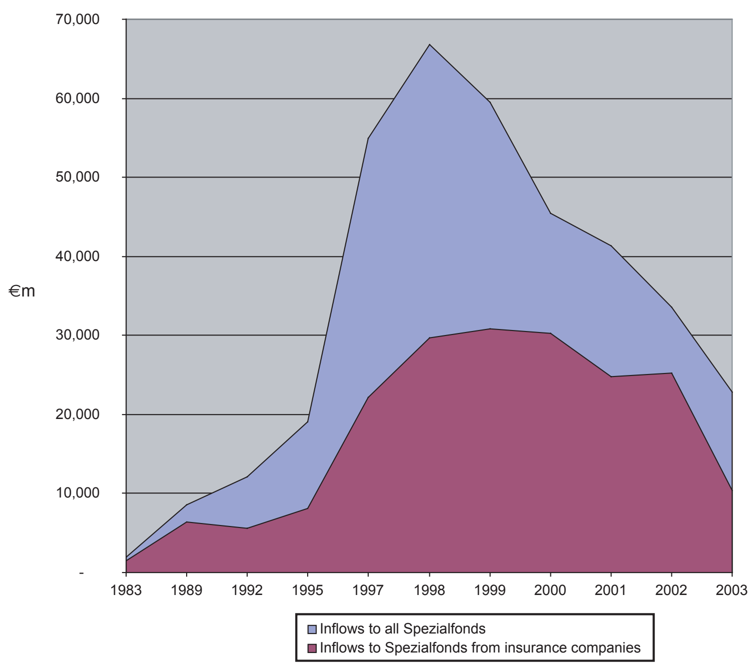


Figure 10: Inflows from insurance companies compared with all Spezialfonds investment (excluding real estate funds)



method may be twice as large as the amount of risk, calculated by the same method, on a virtual comparative asset comprising exclusively - appropriate - underlying securities. Now, the value-at-risk is deduced from the level of fluctuation in market prices, whereby the result does not depend on the direction of fluctuation.

The 200% limit can therefore - for example in the case of a fully-invested Sondervermögen - be used, not only by increasing the investment rate to 200%, but also by reducing the investment rate to -200% by means of a threefold hedge. This example shows that using the 'qualified approach' of the derivative regulation will make it possible to apply a series of strategies that had previously been the preserve of hedge funds.

Money market instruments for liquidity and investment

Up to now, the purchase of money market instruments to invest in money market funds (Geldmarktsfonds) was reserved. In practice, this was not a problem, as each investment fund was permitted to invest up to 49% of its liquid assets in bank deposits, but also in money market instruments. Incidentally, the last time more than 10% of Spezialfonds' assets were invested in liquidity instruments was in 1990. Under the IMA, money market instruments are now equivalent to securities as full-value assets. The same applies to bank deposits, and only 20% of the Sondervermögen may now be invested in bank deposits at one and the same credit institution.

In this regard an additional 20% limit will constitute a certain restriction. In line with the provisions of the UCITS directive, the IMA no longer considers bank deposits in Germany to be fully protected, but restricts the total of all securities, money market instruments, bank deposits and OTC derivatives that the Sondervermögen has invested with a single institution, or has purchased from that institution, to 20% of the Sondervermögen. In this case, problems may arise if, for example, the KAG not only deposits the liquid assets of the Sondervermögen at the depository bank, but also purchases from the latter issued equities, bonds or derivatives.

Interestingly, the 20% limit only applies to individual institutions, but not to all investments by the enterprises of one group. Group aggregation only needs to be done in the case of securities and money market instruments.

Hedge funds

Both single hedge funds and umbrella hedge funds (Dach-Hedgefonds) can be set up as Spezialfonds. The same investment regulations apply as for Publikumsfonds, ie, there are few restrictions on single hedge funds in using derivatives and in the choice of strategies for generating income; and Dach-Hedgefonds are no longer allowed to invest more than 20% in one and the same single hedge fund, and in a maximum of two single hedge funds for which the same issuer or fund manager is responsible. As in the case of 'Gemischte Sondervermögen', the purchased single hedge fund may not invest its resources in other target funds. It remains to be seen what level of interest there is in hedge funds among institutional investors, especially as certain hedge fund strategies can also be used by conventional funds under the new derivatives regulations.

Capital adequacy requirements

The new capital adequacy requirements are of interest to the KAGs, but less so for investors. Whereas according to previous management practice, KAGs had to have an equity capital - which the IMA calls nominal capital ('Nennkapital') - of €2.5m, according to the new regulation €730,000 are sufficient. This minimum figure increases by 0.02% of the excess amount if the managed fund volume exceeds €3bn. So, with a fund volume of up to €11.85bn, the new regulations are therefore simpler than the previous rule, and the greater the fund volume the greater the capital requirements. Most Spezialfonds KAGs therefore need less equity than before, but there are still 12 KAGs that are affected by the higher capital adequacy requirements solely because of the Spezialfonds volume managed by them.

KAGs now often have parent companies that may well require an additional dividend; if this equity is no longer required, it seems a logical notion to make it available by means of a dividend, or by means of a capital redemption. However, such a step should be carefully considered with regard to the KAG's reputation with the BaFin and possibly also in the market.

Investment stock corporations

The IMA imposes virtually no equity capital requirements on the newly-regulated investment stock corporations ('Investmentaktiengesellschaften'). These simply require an 'initial capital' of at least €300,000. This initial capital is already represented by the fund assets; there are in any case no plans for a capital stock like the equity capital of a KAG, which is available to investors in the event of compensation claims.

Depending on how the BaFin applies the other establishment conditions in practice, the barriers for new fund providers to enter the market are very much reduced by the creation of the Investmentaktiengesellschaft. However, it remains to be seen whether this vehicle will be correspondingly successful, mainly because of the wide-ranging operation of the German Companies Act (Aktiengesetz).

Also questionable is whether 'Spezialfonds-Investmentaktiengesellschaften' are permissible at all. According to the argumentation for the government bill on S 91 Para. 2 of the IMA, all provisions of this Act should apply to Spezialfonds, unless otherwise stipulated in the clause on special Sondervermögen.

However, the wording of the provision makes no express reference to the chapter on the Investmentaktiengesellschaft. In addition, the Investmentaktiengesellschaft must offer 90% of its shares for sale to the public within six months of being granted a licence. This could lead to the conclusion that the Investmentaktiengesellschaft may not be set up as a Spezialfonds. But neither does the Act include an express ban on selling all of an Investmentaktiengesellschaft's shares to a single institutional investor.

New disclosure requirement

The disclosure requirements newly introduced under the IMA are another potential source of substantial additional expense for KAGs. In future, KAGs will not only have to send asset schedules to the BaFin as part of their financial statement and half-year report, but on a 'regular basis' and by remote data transfer. Using the transmitted data the BaFin should be able to verify that the investment limits are being observed. In addition, the KAG is responsible for reporting each transaction to the BaFin, and the IMA specifies in detail which data have to be included.

Figure 11: Proportion of investments through Spezialfonds in credit institutions' portfolios

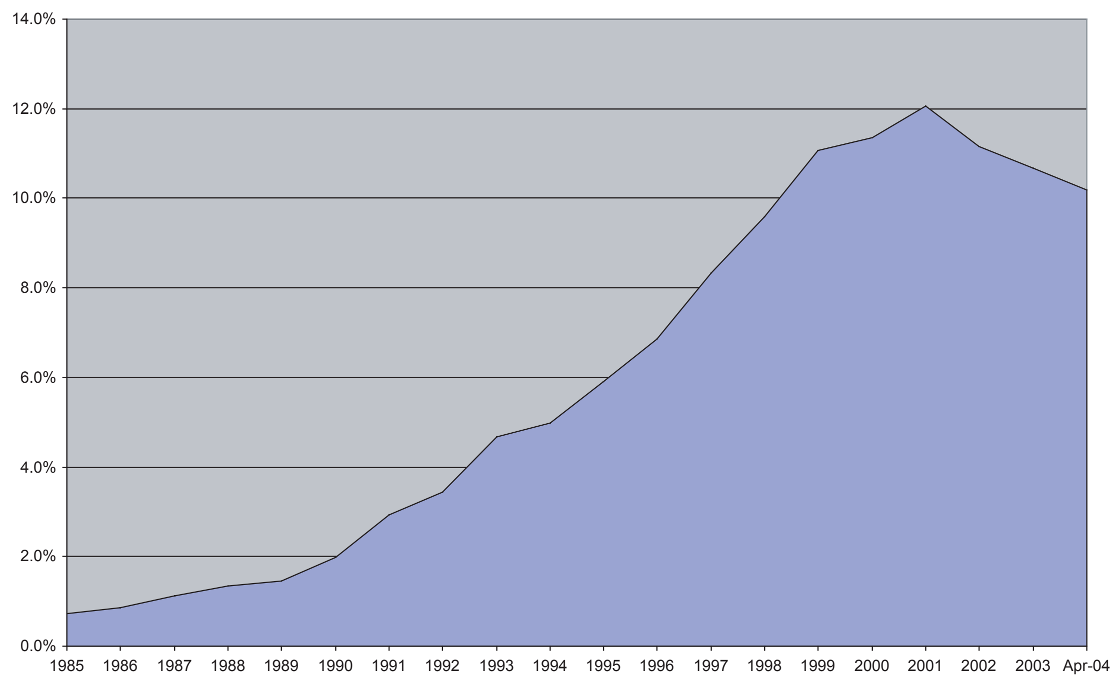
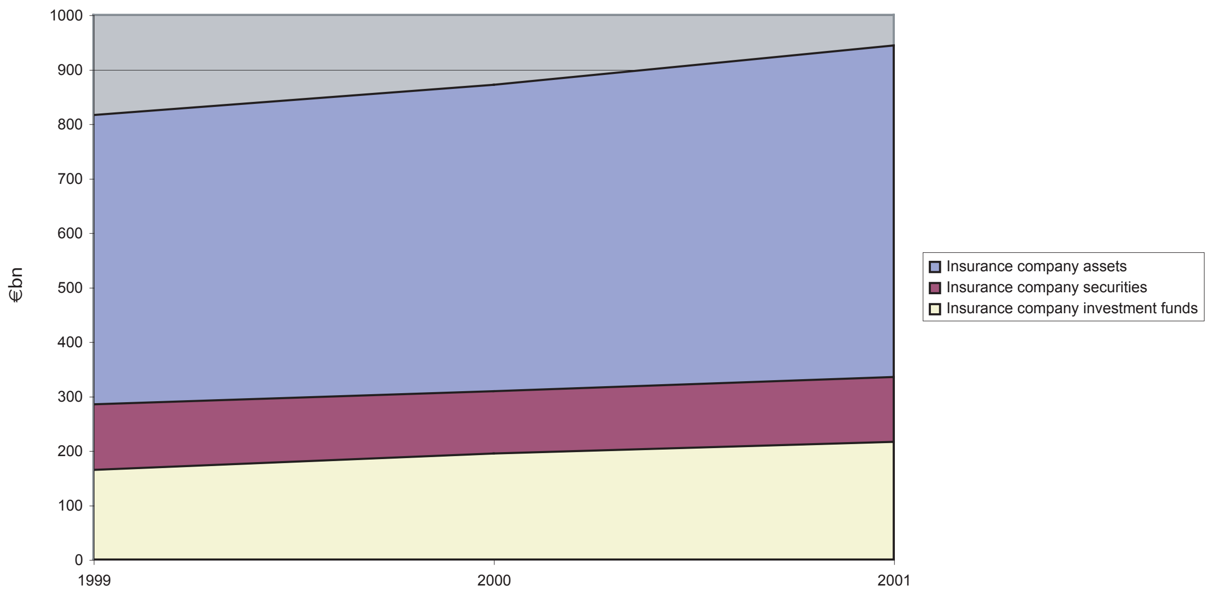


Figure 12: Insurance companies – assets, securities and fund investment (€bn)



THE KANDLBINDER REPORT

For over 30 years Dr Hans Karl Kandlbinder, the originator of the *Spezialfonds* concept, presented the Kandlbinder Report on *Spezialfonds* for the previous year. This year's report is authored by Till Entzian.

A German version appeared recently in the *Zeitschrift für des Gesamte Kreditwesen* by Frankfurt-based publishers Fritz Knapp Verlag.

The transaction report is to serve as the 'qualitative control', and enable the BaFin, for example, to monitor grievances relating to price structures. The legislature, at least, has given no plausible reasoning as to the extent to which it is already possible to achieve this aim through the existing supervisory and control facilities, rather than through the additional disclosure requirements, which would be costly to implement.

The BaFin wishes the data to be delivered daily, although the supervisory authorities would probably be prepared to put up with a couple of days' delay.

The decisive factor for the KAGs in this regard is that longer reporting cycles, for example once a month, or only the reporting of excesses, could possibly suffice when it comes to Spezialfonds.

Outsourcing of fund management permissible

For the first time, the IMA includes a specific statutory regulation on the outsourcing of its business by a KAG. As well as a reference to the prerequisites of S25a of the German Banking Act (KWG), created especially for deposit-taking credit institutions, the IMA establishes the additional requirement that the KAG should not be prevented from acting in the interests of its investors because of the outsourcing. In addition, only such enterprises that are licensed asset managers and are subject to official supervision can be considered as external fund managers.

The KAG cannot, however, transfer liability for errors to the external manager; the KAG is liable for the latter's errors just as for its own. Compared to the earlier regulation and practice, whereby the KAG took all decisions itself and only took advice from the external asset manager, the new regulation provides no relief from liability for the KAGs. In view of this, it is expected that the advisory model practised up to now will continue to be used in the future.

Investment consultancy as a permissible secondary activity for KAGs

The IMA has now made it clear that KAGs may also provide investment consultancy services as a secondary activity, if their business licence also covers free portfolio management. This has previously been a contentious issue, as the BaFin considered consultancy services as an activity to be distinguished from management, whereas the investment sector regarded consultancy services as a 'drawback' to management, ie, something that was already covered by a corresponding licence.

Regulation regarding the investment limitations for insurance companies

The expansion of the investment possibilities for an investment fund has necessitated a revision of the regulation regarding the investment limitations for insurance companies. The amended regulation was due to come into effect in August 2004. It now states that the eligibility of investment funds to serve as collateral will no longer depend on certain wordings in the contract terms. This means that in principle every investment fund may be purchased for the benefit of the cover assets (Deckungsstock – now 'Sicherungsvermögen').

But the insurance company then has to distinguish between transparent funds and funds that have a non-transparent asset structure.

In the case of transparent investment funds the insurer must be informed about the current leverage, and also set off the risk amount in excess of 100% on certain Sondervermögen of existing assets against the 35% rate. In addition, other assets held by the investment fund, such as ABS and CLN, bonds, equities and profit sharing rights from non-EEA states and hedge funds, must be set off against the corresponding limits.

For the KAGs, this new regulation will mean that they will have to make the corresponding data available to the insurance companies.

Outlook

Although receipts by the Spezialfonds have fallen for five consecutive years, and this instrument is sometimes viewed critically with regard to preparation of the accounts under IFRS, in the future there will still be substantial receipts contributing to the growth of the Spezialfonds.

These can possibly be substantially increased if the KAGs are prepared to accept the critical aspects as a challenge, and also provide investors with services such as the key figures required for preparation of the accounts, in addition to the expected performance.

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