

OPINION OF THE EUROPEAN MONETARY INSTITUTE

on a consultation from the Council of the European Communities under Article 109f (6) of the Treaty establishing the European Community (the "Treaty") and Article 5.3 of the Statute of the EMI;

on a Commission proposal for a European Parliament and Council Directive amending Directive 85/611/EEC on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

CON/94/8

1. The present consultation was initiated on 22nd November 1994 by the Council of the European Communities which, for this purpose, transmitted to the EMI the relevant documents concerning the Commission proposal (COM (93)37 final ("initial proposal"), modified by COM (94) 329 final ("amended proposal")).
2. The main objectives of the proposal are, firstly, to broaden the scope of Directive 85/611/EEC in order to include four new categories of investment funds (money market funds, cash funds, funds investing in units of other UCITS and master/feeder funds), secondly, to update certain provisions of the Directive to bring them more in line with developments which have taken place in other Community legislation in the financial field and, finally, to permit UCITS to choose a depository established in other Member States.
3. The EMI's competence to deliver an opinion in this consultation is based on Article 109f (2) and (6), first paragraph, of the Treaty as some of the provisions of the proposal affect the stability of financial institutions and markets as well as the conduct of monetary policy.
4. The EMI does not deem itself to be competent to assess whether the widening of the scope of the Directive is consistent with the spirit of the original Directive and therefore does not comment on the question as to whether, in particular, the cash funds provided for in Amendment No. 1 would still fall under the notion of undertakings for collective investment in *transferable securities*.

Concerning the stability of financial institutions and markets there are two aspects to which the EMI would like to draw the Council's attention: first, the impact of money market funds and cash funds on financial markets and notably on financing of credit institutions and secondly, the stability of the new funds themselves.

- 4.1 As regards the first aspect, it is likely that the establishment of harmonised money market and cash funds will further contribute to the shift of clients' deposits from traditional non-interest or low interest individual retail deposits with credit institutions towards alternative deposit arrangements, such as these funds. If money market and, in particular, cash funds become widely accepted, they may lead to significant changes in the liability structure of European credit institutions. Retail deposits which are cheap and, taken as a whole, relatively stable would be replaced by wholesale deposits made on behalf of investment funds. Taken as a whole, these deposits will be less stable and more expensive than equivalent retail deposits. This could exert further pressure on credit institutions' interest rate margins and contribute to higher competition for funding. It should be noted, however, that experience in the United States with money market funds has not shown that this posed a major threat to the stability of the US banking system until now.

However, in the European context the EMI would suggest the Council to consider imposing an obligation to inform the investor that his investment in a cash fund or money market fund will not be subject to deposit protection. Such an obligation (by an extension of Annex, Schedule A, to the Directive 85/611/EEC) appears desirable as the units in these funds are likely to be sold as substitutes for bank deposits which, from the implementation of the Deposit Guarantee Directive (94/19/EC) scheduled for 1st July 1995, will require to be protected by a deposit protection scheme. Although the principle of risk spreading will reduce the risk of total loss to an investor, the provision of appropriate information to investors about the risks represented by particular classes of investments is essential for the stability and maintenance of trust in the financial markets.

- 4.2 This issue is related to the second aspect, namely the stability of the funds themselves. The EMI welcomes the proposals that the new funds will, as a general rule, be subject to the same supervisory standards as are already laid down for UCITS and which have so far proven to be effective. The EMI also welcomes Amendment No 9 which would restrict a cash funds'

maximum placement with the same credit institution. The limit suggested is 25% of the assets of the fund. In this context, it should though be borne in mind that, under the proposal as it stands, an investor could lose up to 25% of his investment through the failure of one single credit institution. The level of this potential risk of loss adds further weight to the inclusion of the information on deposit protection advocated above and it might be also be considered whether this limit is itself too high. A further possible protection might be given through an appropriate qualitative standard being applied to deposits (e.g. allowing only deposits placed with credit institutions subject to prudential supervision standards equivalent to those of the EU and/or credit institutions covered by a deposit protection scheme).

In addition, for cash funds the Council might consider whether the restriction of these funds to investment exclusively in deposits with credit institutions is too strict. Other assets, such as liquid assets of high quality, should be permitted and might contribute to greater stability of these funds following the principle of risk-spreading.

5. Amendment No. 2 of the proposal concerns Article 8 of the Directive. This Article, as currently contained in Directive 85/611/EEC, stipulates that a depositary must have an establishment in the same Member State as that of the UCITS. Given that the Second Banking Co-ordination Directive (89/646/EEC) and the Investment Services Directives (93/22/EEC) provide banks and investment firms with the freedom of supplying financial services, including safekeeping and administration services (which are relevant for UCITS), the amended proposal intends to remove the foregoing restriction by allowing UCITS to also select a depositary which is established in other Member States and supplies services on a cross-border basis.

The EMI recognises that the possibility of choosing a depositary which exercises this function, on the basis of a cross-border provision of services, would contribute to the further development of a single market for financial services. However, the exercise of the important control functions of a depositary on a cross-border basis could prove extremely difficult given the still existing differences among the Member States' legal and administrative systems. The EMI acknowledges that the provisions foreseen in amendments 3 and 5 of the amended proposal are intended to ensure that a cross-border depositary can fulfil its control functions. However, there remain substantial doubts as to the possibility of achieving an effective framework under the prevailing legal situation.

6. The EMI therefore suggests that the desirability of the free choice of a cross-border depositary be stated as a policy objective which should be achieved pending further harmonisation of the relevant legal provisions.
7. Amendment No. 8 of the proposal on Article 21 of the Directive aims at the introduction of a quantitative ceiling for the use of derivative instruments by UCITS with a view to providing a harmonised framework. This aim is clearly stated in the 11th recital of the amended proposal. The EMI welcomes the intention to add such limit and holds that such a quantitative ceiling would be a valuable contribution to the stability of the financial system.
8. Furthermore, the EMI would draw Council's attention to proposals to class Master/Feeder funds as UCITS. In view of the lack of tax harmonisation among EU Member States, these funds could create substantial flows of assets which may have some impact on financial stability. The Council might therefore wish to give further consideration to the issue of the impact of these funds.
9. Finally, the EMI notes that the text on which this opinion is based has been subject to extensive discussion at Council level and may, in certain respects, be superseded. However, the EMI is confident that the points set out above will still be relevant to Council's further consideration of the substance of this proposal. The EMI welcome the opportunity to comment, as appropriate, on any future text modifying the present proposal.
10. Dissenting opinions of the Banque Nationale de Belgique, the Danmarks Nationalbank, the De Nederlandsche Bank, the Deutsche Bundesbank and the Central Bank of Ireland are attached as an Annex to this opinion.

27th July 1995

ANNEX

**DISSENTING OPINIONS ATTACHED TO EMI OPINION ON THE COMMISSION
PROPOSAL FOR A EUROPEAN PARLIAMENT AND COUNCIL DIRECTIVE AMENDING
THE UCITS DIRECTIVE**

Dissenting opinion of the Banque Nationale de Belgique, the Danmarks Nationalbank and the De Nederlandsche Bank

Three National Central Banks (BE, DK and NL) do not agree with Paragraphs 5 and 6 of the opinion in the consultation procedure CON/94/8. These central banks believe that leaving the free choice of a cross-border depositary subject to further harmonisation and stating only a policy objective would be inconsistent with the principles of the Treaty and would run counter to the content of the Banking and Investment Firms Directives. These central banks believe that the possibility of choosing a depositary which exercises this function on the basis of a cross-border provision of services should explicitly be granted now in the proposal to amend the Directive 85/611/EEC.

However, this amendment has to ensure that there will be a sufficient co-operation between the authorities of the Member States in order to guarantee an appropriate supervision of the control function of the depositary.

Accordingly, the Belgian Central Bank suggests that, as a consequence, the provisions foreseen in amendments 3 and 5 of the amended proposal should be strengthened, in particular, in order to stress the condition of uniformity in the approach by different Member States when granting derogations to the establishment requirement. Further, the directive should state explicitly that the depositary must fully comply with the legal and regulatory provisions prevailing in the Member State of the management/investment company.

Dissenting opinion of the Deutsche Bundesbank

The Deutsche Bundesbank points out that the proposal may impact on the conduct of the monetary policy. A particular concern is that the proposal, as currently drafted, blurs the borderline between money market funds and cash funds on the one hand, and the traditional securities funds on the other hand. This blurred borderline may, in the future, cause problems for the collection of statistical data and difficulties for defining monetary aggregates. At the same time a possible overlap between investment

fund activities in the short and long-term range could render an analysis for monetary policy purposes difficult. Even if, in the future, the European Central Bank has the possibility to collect data directly from the funds or their management companies, the absence of a clear legal definition of the respective funds will make the inclusion of units in investment funds into a broadened definition of monetary aggregates very difficult. Therefore, the Deutsche Bundesbank suggests that money market funds, cash funds and securities funds be defined as separate types of investment funds with separately defined areas of activity.

Dissenting opinion of the Central Bank of Ireland

The Central Bank of Ireland has expressed its opposition, in principle, to the proposal to allow a UCITS to select a depositary which is established in another Member State. As a result, the Central Bank of Ireland dissents from the statement, contained in paragraph 6 of the EMI opinion, that the desirability of the free choice of a cross border depositary should be stated as a policy objective to be achieved following further harmonisation of relevant legal provisions. In its view, the duties of a depositary, which are onerous, cannot be carried out properly by a depositary which is not established in the same Member State as the UCITS itself. It considers that the depositary is an integral part of the UCITS and the competent authorities cannot properly supervise a UCITS unless they can directly supervise the activities of the depositary. It also considers that any proposal to permit UCITS to appoint non-established depositaries is inconsistent with recent legislative developments in the financial services area which have adopted a principle of one complete unit for supervision and one authority being responsible for the core substance of that unit.