

International Underwriting Association's response to ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (AIFMD)

To Whom It May Concern:

IUA would like to thank you for the opportunity to respond to part IV.I of your recent consultation paper, which, amongst other things, sets out advice in respect of the purchase of professional indemnity insurance by prospective Alternative Investment Fund Managers as defined in the Directive.

The International Underwriting Association (IUA) represents insurance and reinsurance companies in the international insurance and reinsurance market working in and throughout Europe. For further information about our organisation and its membership please visit our website, www.iua.co.uk under the section 'About the IUA'.

As background, I am currently Chairman of the IUA's Banks' Underwriters' Group (BUG), which represents around 40 European and other regulated insurance companies and markets (in both the Lloyd's and company market) who currently underwrite Financial Institutions business including Professional Indemnity (PI) insurance for investment managers. Between the members of the panel, we represent the substantial majority of European insurers and reinsurers of the alternative investments PI market through which AIFMs will need to purchase cover. The membership of the committee is included at Appendix A.

We are responding to the consultation because we believe that, while in principle the concept of compulsory PI for AIFM's is sound, some of the specific matters do not fit the existing (or any realistic future) offering in the insurance market, and more importantly, they may actually harm European investors because some of the proposals limit the coverage and extent of insurance available.

Our areas of concern, and our guidance on these issues, are as follows:

1. CONCERN: First and most importantly, while we can see that the guidance suggests a minimum threshold that must be complied with, and we appreciate that no one is suggesting that the AIFMs cannot buy more than this minimum, the capping of this insurance at EUR 25m is still a significant disincentive in our view. Moreover, in our experience, we feel this is inadequate for the size of claims that can potentially occur, and indeed that have already arisen and been settled by our members.

WHY IS THIS A CONCERN? Limiting the coverage available would be extremely harmful to investors. We are aware of claims well in excess of EUR 25m, for example related to the Madoff case, recent breach of mandate claims, mis-selling claims and other major cases. Some run to hundreds of millions, and payments of this magnitude are made on a fairly regular basis. There is up to EUR 300m or more of insurance capacity available from our members which is well within the purchasing power of larger fund managers. A very large fund running into tens of billions will find very little benefit from only buying EUR 25m, when claims exist well in excess of this today.

RESPONSE: A limit requirement of 1% of AUM with no cap would seem a much more sensible approach, and there is plenty of insurance capacity to offer even the largest limits. At the very minimum, our membership would suggest a much higher cap of 100m.

2. CONCERN: The guidance is for there to be a separate any one claim limit, with a higher aggregate cap (with a minimum of EUR 2m per claim / EUR 2.5m aggregate cap).

WHY IS THIS A CONCERN? In our view, the capping of any one claim is not necessarily an advantage to investors, as the majority of claims from investors arise from one 'related' event, or set of events. This will have the effect of aggregating the claims in the policy. It is our advice that any inner limit for a given 'claim' will actually harm the availability of insurance due to investors overall, as they would be left with less available limit where they have been affected as a class. It is rare that one investor alone is affected by one event.

It is much better that each claim has sufficient overall AGGREGATE limit, to ensure all investors are protected as a result of one event. This comes back to our observation above that the aggregate limit needs to be sufficient. Furthermore, removing such an inner limit would have little effect on premium levels, as insurers will typically look at the overall limit in calculating premium.

RESPONSE: We recommend that this any one claim limit should be removed - making the entire aggregate limit available for any claim.

3. CONCERN: You will be aware that there is an embedded principle in European law that you cannot insure for your own crimes. This relates to Box 6 (description of potential risks) - where you are looking for the insurance to cover "losses due to dishonest, fraudulent or malicious acts by relevant persons". Please note therefore that, while many crimes are covered by our insurance policies, crimes by the owners of the fund manager cannot be insured (at least not to the point where they are acting as Directors of their company).

WHY IS THIS A CONCERN? Using the current language of the guidance provided, owners of an AIFM can buy insurance, commit a crime, then claim the liability to investors back from the insurance. This cannot be in the interest of public policy providers. That is not to say the fund manager entity, or its delegated service providers cannot be covered for their liability, we are simply saying the actual buyers of the insurance cannot then insure for their own crimes.

RESPONSE: The policy will cover fraud and dishonesty by the employees, and that for which the entity is liable, but not that exposure which could be directly attributable to an owner of the AIFM.

4. CONCERN: In our view, there is an imbalance with regard to the equation on own funds. The principle seems to be that managers can hold their own capital OR buy insurance to cover professional negligence claims. While it is not clear whether there is a preference, the result of the different weightings is that, in our members opinions, almost no managers will purchase insurance, as the holding of funds equation provides for substantially lower amount of funds versus the likely premium required for the equivalent policy.

WHY IS THIS A CONCERN? Take the following example: A fund manager with EUR 500m of FUM would need to hold funds of $\text{EUR } 500\text{m} \times 0.01\% = \text{EUR } 50,000$. The equivalent insurance limit required is 1% of EUR 500m, being EUR 5m. The typical insurance premium for a fund manager of this size would be EUR 25,000-35,000 per annum. This problem is accentuated when the excess also has to be retained as funds – this is often a minimum of EUR 25,000, more likely EUR 50,000, then you also have to add the effects of insurance premium taxes. As the premium is payable annually, it would make little economic sense to pay for this premium when instead the manager could instead hold one single amount of funds ad infinitum.

Using our example above, over a period of say five years, even the cheapest fund manager would pay $\text{EUR } 25,000 \times 5 = \text{EUR } 125,000$ in premium, plus hold a further EUR 25,000 to cover the retention – a total of EUR 150,000. This is in contrast with the holding of own funds at EUR 50,000 over the same 5 year period.

Even more importantly, from an investor protection viewpoint, the funds paid as premium provide access to a limit of insurance that pays claims, which could amount to millions of Euros. However funds held are simply that, there is no larger pot of insurance available to pay claims. To this end, when you consider claims run to many millions, the holding of EUR 50,000 in the example above would be woefully inadequate to pay claims from investors.

The same argument would apply across any size of fund manager, apart from the very largest funds (since they have a capped requirement for limit, but not for funds). Where funds cover multiple annual premium amounts would this make it a more 'even' decision to buy insurance as opposed to buying funds.

This would also provide a potentially helpful barrier to entry for managers in requiring them to raise a sufficiently large operational risk capital base before setting up, something that investors would expect in any case. As it is, such a low level of required funds provides no protection, and little disincentive to set up without the appropriate funds.

The fees argument is somewhat more difficult to estimate, as fees can fluctuate dramatically depending on the level of performance fees received by an AIFM. However, since the AIFM can choose between option 1 and 2, presumably they would choose that option which requires them to hold the least funds – thus the scenario above would be the most the manager would have to hold.

RESPONSE: The calculation for funds to be held in mitigation of purchase of an insurance policy should be much higher – at least 5 times as much (i.e. the weighting should be 0.05% as opposed to 0.01%). This should ultimately be enough funds to pay claims that could occur – under the current calculation it would not be.

CONCLUSIONS

In summary, while we support the intent of the proposals, we believe that their applicability is not optimal, particularly for investor protection. The European professional indemnity insurance market stands ready to serve investors to protect them from the potential of not having funds to access in the event of fraud or error – however as they currently stand these proposals do not, in our view, support investors best interests.

We would be happy to provide further detail on any of these matters to support your development of these proposals. Please do not hesitate to contact myself or any of our European membership who can answer any questions on behalf of their own companies as part of such consultation.

Yours sincerely,

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Appendix A – BUG Membership

Talbot
Munich Re
Axis Speciality
Zurich
Hardy
Ace
Chaucer
Liberty
CNA Europe
Argo
Canopus
Swiss Re
Markel
New Line
Catlin
RSA
Amlin
QBE
Aspen
Antares
Brit
Pembroke
Novae
AWAC
Barbican
Travelers
CV Starr
Alterra
XL Insurance
HCC Global
Fidelitas Global