AFME Position Paper

CRD 5/CRR2: Equity Investments in Funds

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Introduction

The banking industry makes substantial investments directly and indirectly in assets and investment projects. The mix of direct and indirect investments is in part to manage concentration risk, through maintaining exposures across a diversified pool of investments. Indirect investments through investing in units or shares of funds enables exposure to a wider, more diversified asset base at lower cost. As such, we welcome the CRR amendments which permit the use of the look-through approach, which ensures that the regulatory treatment / capital requirement for investing in a diversified fund is not more punitive than investing directly in those same assets. We do note however, that the application of the requirements have been restricted to UCITs and AIFs marketed in the EU and note our concerns in this area and our proposed recommendations.

Risk weights for investments in funds other than UCITs and AIFs

As per the draft CRR explanatory text, the draft CRR amendments related to equity investments in funds implement the Basel Committee on Banking Supervision's (BCBS) standard published in December 2013 (BCBS 266[1]). The Industry believes however, that the draft CRR text diverges from the BCBS standard by restricting the look-through approach to UCITs and AIFs marketed in the EU (together 'collective investment undertakings' or 'CIUs'), and requires additional attention. See Appendix 1 for further elaboration of this point.

Equal Treatment of CIU and non-CIU funds

The European Commission's CRR proposal amends the definition of a CIU under Article 4(1)(7) by deleting the reference to non-EU AIFs and "funds subject to the law of a third country which applies supervisory and regulatory requirements at least equivalent to those applied in the Union". It is understood that it is the intention that third country funds are considered to fall under the AIF definition and that any equivalence requirements for such funds regulation are out of scope of CRR.

BCBS 266 applies to banks' investments in funds wherever they are established. However, according to Article 132 (3), institutions will not be able to apply the risk-based methods (the look-through approach (LTA) and mandate-based approach (MBA) as detailed under articles 132 and 152) to third country funds unless they have been marketed in accordance with Article 42 of the AIF Directive. The fall-back approach (1250% risk weight) would then apply to any investments in third country funds which

[1] http://www.bis.org/publ/bcbs266.pdf

have not been so marketed, or to investments in any EU funds which are neither UCITS nor the aforementioned AIFs.
Particular investments which might be penalised with a 1250% risk weight in accordance with the current proposed text include:

- Investments in the form or UCITs and AIFs located in third countries, which would be eligible for the application of the LTA or the MBA if the funds were located in the EU.
- Investments in funds designed to provide growth capital to small and mid-sized companies or green initiatives both in Member States and in third countries, which for structural reasons might be neither UCITS nor AIFs.
- Investment of the surplus liquidity of non-EU subsidiaries in a local bond or liquidity fund which may not have been approved for marketing in the EU even though it might be heavily regulated in its home jurisdiction.
- Investments by US subsidiaries in Bank Owned Life Insurance – a common investment by US banks to hedge the cost of key person insurance which is usually structured as a collective investment scheme.
- Investment by in-house investment divisions in private equity funds outside of the EU, which provide opportunities for diversifying returns on capital at a group level.

Furthermore, Article 132(2) states that institutions may calculate the risk weighted exposure amounts for their exposures using a combination of approaches as per Article 132a. We believe it would be beneficial to include this statement in Article 132a, which describes the approaches for calculating risk weighted exposure amounts of CIUs, while further specifying that an institution can apply the LTA to the extent it has sufficient information to do so, with only the remaining portion of the underlying assets to be treated with one of the other approaches. In this respect, it would be beneficial to revise Article 132a (4) to mandate the EBA to draft regulatory technical standards specifying how the combination of approaches should be practically applied.

We also believe that there is no prudential rationale for requiring a fund to be regulated in a particular way or domiciled in a particular jurisdiction in order to permit institutions to use the LTA. What is important is that the institution knows with sufficient certainty the underlying assets contained in the fund. If the risk weight of the underlying asset is known, the use of the look-through approach will provide the most accurate measure of the fund's overall risk and ensure capital requirements are commensurate with the risk. Further, we note that under the market risk rules (Art 325k) a non-EU AIF can be looked-through regardless of whether it is marketed in the EU; and for the purposes of the rules relating to indirect holdings in Financial Sector Entities in Own Funds Part III[2] the

[2] Commission Delegated Regulation No 241/2014 of 7 January 2014 as amended by Commission Delegated Regulation (EU) 2015/923 of 11 March 2015 … with regard to regulatory technical standards for own funds requirements for institutions – specifically the rules in article 15d relating to indirect holdings in financial sector entities.

regulatory status of a fund is irrelevant for look-through purposes. We do not believe it makes sense to apply different look-through standards in different areas of the rule book. In addition, the current proposed text gives rise to perverse incentives: a bank investing a small amount in a fund not qualifying for look-through under Art 132 would be required to apply 1250%, but by increasing the investment so that consolidation is required a bank would be forced to look through to the underlying assets under the consolidation rules and risk weight them accordingly. By increasing its risk, a bank could reduce its RWAs.

Where the quality of regulation of the fund ***may be*** of relevance is in the ability of the investor to rely on the attestation of the manager for details of the underlying investments rather than an independent third party. Where, therefore, a fund does not meet CIU or CIU-equivalent standards, it may be necessary to require an investor to obtain independent third party confirmation of the underlying investments (for example, from the custodian bank) in order to achieve look-through.

Therefore, in order to maintain consistency with the global bank capital framework designed by the BCBS, internal consistency within CRR2, and to avoid penalizing investments that do not meet narrow regulatory criteria, thus placing EU banks at a disadvantage to third country banks, the industry believes that *all* funds should be assessed using the same methodologies as EU CIUs to calculate their risk weights and the associated capital requirement:

- Where an institution has sufficient information about the individual underlying exposure of a fund, it should be able to look through to those exposures to calculate the risk-weighted exposure amount of the fund;
- Where an institution does not have sufficient information about the underlying individual exposures to use the look-through approach, it may calculate the risk-weighted exposure amount of those exposures in accordance with the limits set in the fund's mandate and relevant legislation.
- Institutions that do not apply the LTA or the MBA shall apply the fall-back approach i.e. a 1250% risk weight is assigned to the fund exposure.

While we strongly believe that penal treatment of investments in unregulated or third country funds is unwarranted, the Commission may want to retain some form of equivalence adjudication for the purposes of the risk based methods, for example for the application of the MBA or for the level of reliance placed on the manager for the LTA. Such adjudication could be under the AIF Directive, or could be implied by the equivalence determinations under CRR Art 107(4), or at the discretion of national competent authorities – provided that an equivalence adjudication by one NCA could be relied upon by institutions operating in other member states. Similarly if the Commission is of the view that investments in unregulated EU funds should be discouraged except in exceptional circumstances, the Commission may wish to delegate to NCAs the discretion to allow firms to apply the LTA or MBA to investments in specific funds which are of national importance or which perform a specific public good, again with the proviso that

institutions in other member states should also be permitted to apply LTA or MBA to those funds.

With reference to the eligibility criteria, Article 132 (3)(c) limits the ability to apply the approaches set out in Article 132a (LTA and MBA) to instances where the business of the CIU is reported at least as frequently as that of the investing institution. However, most immovable property and private equity funds report only on a half-yearly basis as per current regulation and this would disincentive institutions from engaging in these investments. The reporting eligibility criteria should therefore be deleted or amended to allow less frequent reporting. Moreover, since for the purpose of applying the LTA, the information should be verified by an independent third party, it should be specified that the asset manager is equivalent to an independent third party to ensure consistency with Basel's final standards.

Interaction with prudential framework

The draft CRR amendments make no mention of the treatment of derivative exposures as covered in the BCBS standards, and we ask that alignment is maintained with Basel in this area:

Derivative exposure

Paragraph 80(vii)(b) of the BCBS standard, which relates to the treatment of derivative exposures and off-balance sheet items when using the MBA, sets out that where these items have received a risk weighting treatment under Pillar 1, the notional amount of these items is risk weighted accordingly.[3]

Calculation of CVA

The BCBS standard requires firms to approximate CVA RWAs by first increasing the derivative counterparty credit risk exposure by 50%, and then applying the relevant risk weight. In contrast, the comparable text in the draft CRR 2 proposal allows firms to replace the ***own funds requirements*** for CVA at 50% of the derivative ***exposure value***. This will result in an RWA 6.25x what is required by the BCBS standard. Take for example, a derivatives position with an exposure of 100. Assume the counterparty is risk-weighted at 100%. Under the BCBS standard, in order to calculate the RWA a firm would multiply the exposure by 1.5 before applying the risk weight – (100*1.5)*100% = 150. Under the CRR proposal, a firm must calculate its ***own funds requirement*** by multiplying the exposure value by 50% – (100*50%) = 50, which has an equivalent RWA of 625 (50/8%). Therefore, in order to avoid significant inflation CVA risk RWAs, the CRR text should be amended to reflect the BCBS standard.

[3] Footnotes 10 and 11 of the BCBS standard are as follows:

[10] If the underlying is unknown, the full notional amount of derivative positions must be used for the calculation.

[11] If the notional amount of derivatives mentioned in paragraph 80(vii) is unknown, it will be estimated conservatively using the maximum notional amount of derivatives allowed under the mandate.

Conclusion

The industry believes a harmonized approach to own fund requirements for equity investment in funds is desirable. Equal treatment of CIU and non-CIU funds allows banks to manage investment risk through maintaining exposures in diversified portfolios. Dis-incentivising non-CIU fund investments may lead to more direct investments, which would be counterproductive from a risk management perspective and lead to increased concentration risk. Additionally, it is believed that equal treatment would help ensure investments are retained at existing levels in non-CIU funds and that maintenance of this liquidity / project finance in the EU is important in helping to achieve its growth objective.

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Appendix 1: Case study in respect of non-EU funds.

Consider an EU-headquartered banking group with a US bank subsidiary. That subsidiary, for liquidity management purposes, invests some surplus cash in a domestic US-regulated liquidity fund. That fund is only designed to be marketed to US investors and there is no intention to market it to overseas investors, and specifically no intention to market it to investors in the EU.

For the purposes of the consolidated capital requirements of the whole group, how should the investment in the liquidity fund be risk weighted?

Following Basel rules, the answer is simple: if the fund meets the transparency requirements, you would simply look through and risk weight in accordance with the risk of the underlying investments. Under CCR2 text, the considerations are as follows:

Is the fund a CIU?

Under new Art4(7), a CIU is "a **UCITS** as defined in Article 1(2) of Directive 2009/65/EC of the European Parliament and of the Council or an **AIF** as defined in point (a) of Article 4(1) of Directive 2011/61/EU of the European Parliament and of the Council"

Is the fund a UCITS?

The US liquidity fund is clearly **not a UCITS** – as that regime applies specifically to funds "established within the territories of the Member States"[4].

Is the fund an AIF?

A literal reading of AIFMD[5] Art 4(1)(a) suggests that the domestic US liquidity fund **is an AIF**: it raises capital from a number of investors and invests it in accordance with a defined mandate; and because there is no intention to market it in the EU there is no need to get it authorised under the UCITS framework. However, because AIFMD is only interested in funds that are marketed in the EU there are no passporting or marketing requirements specified for the fund.

Let us assume that the correct reading is that the US liquidity fund is an AIF. It is therefore a CIU (under the definition in CRR Art 4(7)). Therefore, in order to risk weight its holding in the fund, the bank needs to apply Article 132 or 152 depending on whether it applies standardised or IRB methods.

[4] Art 1(1) of the UCITS Directive (Directive 2009/65/EC)

[5] 'AIFs' means collective investment undertakings, including investment compartments thereof, which:
(i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and
(ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC

However, because the fund was never intended for marketing in the EU, the fund meets none of the criteria laid out in Art 132(3)(a). The bank therefore is not permitted to apply the look-through or mandate-based approaches defined in Art 132a (or 152(2) and (5)). It therefore has to apply the fall-back approach (1250% risk weight) specified in Art 132(2) (and 152(6)). This is a perverse result for an investment in a fund which may more transparent and less risky than an investment in a hedge fund which meets the criteria laid out in Art 132(3)(a).

In the event that the correct reading is that the US liquidity fund is NOT an AIF, then we are left with the problem that the bank has an investment in a fund which looks just like an EU fund (other than its domicile and target market) but for which no look-through regime has been specified. CRR2 is therefore not fully implementing the Basel requirements laid out in BCBS 266 and the investor has no guidance as to how to risk weight its investment.

Appendix 2- Further considerations in relation to AIFMD

In the amendments which the Industry suggests be made to the CRR2 regime for equity investments in funds, we suggest that paragraph 3(a) of Art 132 be deleted in its entirety. This is because we do not believe that a fund's status under the UCITS Directive or AIFMD is relevant for its prudential treatment under CRR. What is relevant is the transparency and governance requirements set out in current paragraphs 3(b) and (3)(c) of that article.

A further justification for deleting the requirements in Art 132(3)(a) is that those requirements are dependent upon the establishment of a new passporting regime under AIFMD which will not be available to non-EU AIFMs or to non-EU AIFs unless and until the European Commission adopts the necessary legislation extending the passport. While non-EU AIFs can also legally be marketed under national private placement regimes (under AIFMD Art 36) if they cannot otherwise be marketed under the passporting regimes (under AIFMD Art 35), until those passporting regimes are established, which are dependent on equivalence determinations, the availability of marketing under Art 36 is not effective.

The prudential treatment of non-EU AIFs which are intended for marketing in the EU is therefore made dependent upon a passporting and approval process which may take some years. While perhaps this delay is not relevant for a domestic EU bank wanting to invest in such a fund (presumably the domestic EU bank will be unable to invest in the fund anyway until the passporting regime is approved), it is a very big issue for a global EU bank where its overseas (non-EU) subsidiary can legally invest in that foreign fund: on consolidation, the EU banking group will be required to risk weight that fund at 1250% until the relevant passporting regime has been established, even though it might meet all the transparency and governance requirements established under BCBS266.

Categories of AIF under CRR Art 132(3)(a) and their marketing status under AIFMD

(ii) EU AIF managed by an EU AIFM registered under AIFMD Article 3(3)	• EU Passport already available
(iii) (non-EU) AIF managed by an EU AIFM authorised under AIFMD Article 6	• EU Passport under AIFMD Art 35 not yet available • National private placement regimes under AIFMD Art 36 not yet available
(iv) AIF managed by a non-EU AIFM authorised under AIFMD Article 37	• EU Passport / National private placement regimes under AIFMD Art 37 not yet available
(v) non-EU AIF managed by a non-EU AIFM and marketed in accordance with AIFMD Article 42	• EU Passport under AIFMD Art 40 not yet available • National private placement regimes under AIFMD Art 42 not yet available where satisfactory cooperation agreements not yet in place.