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ASSOCIATION DES BANQUIERS CANADIENS
CANADIAN BANKERS ASSOCIATION

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
baselcommittee@bis.org

Dear Sir/Madam:

Re: CBA[1] Comments on the Basel Committee on Banking Supervision's Consultative Document: Capital requirements for banks' equity investments in funds

Thank you for the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) consultative document: Capital requirements for banks' equity investments in funds. We understand that the BCBS originally intended to review the regulatory capital treatment of banks' exposures to funds acting as shadow banking entities but expanded the scope of its review to include capital requirements that apply to banks' investments in the equity of all types of funds. While we recognize that this was done to ensure an appropriately risk sensitive and consistently applied regulatory capital standard, we caution that an overly burdensome approach may have negative unintended economic consequences.

For example, banks often provide seed capital to startup new mutual funds. These low risk investments are required in order to ensure that the investment manager's incentives are aligned with the investor. Consequently, they should not be penalized. In addition, the Canadian government recently announced (January 2013) the Venture Capital Action Plan which is a comprehensive strategy for deploying new capital over the next 7 to 10 years. This is expected to attract as much as $1 billion in new private sector funds for increased business investment, further stimulating economic growth. The Canadian banks are being encouraged and are generally interested in exploring these investment opportunities. However, we are concerned that the proposed changes would result in undue regulatory burden and onerous capital requirements thereby creating disincentives for the banks to invest in these funds. This runs counter to our government's policy of financing bona-fide business to support economic expansion.

In addition, we would emphasize that equity investment within the banking book is often a non-core banking activity. Furthermore, investments under the new Venture Capital Action Plan are expected to be relatively small but still important in generating economic growth. We therefore

[1] The Canadian Bankers Association works on behalf of 56 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 275,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

recommend that the BCBS consider applying a threshold approach that would exempt immaterial equity investments and equity investments in funds from the proposed requirements. For example, currently in the case of non-significant investments in the capital of financial institutions, a 10% threshold test applies to exempt from capital deduction the amount of investment which falls below the threshold. Similarly, a threshold test could be created such that the proposed rules outlined in the consultative document would not apply where the total of equity investments and equity investments in funds represents less than 10% of a bank's capital.

Alternatively, under paragraph 358 of the Basel III framework, we note that flexibility is allowed to national supervisors enabling the exclusion of equity exposures from the IRB treatment based on materiality. We require clarification that this flexibility will continue to be permitted within the proposed changes for equity investments in funds.

Finally, we understand that there are some concerns being raised over clarity with respect to the current treatment of banks' equity investments within the Basel II framework. For example, the existing framework does not explicitly require that banks reflect the relevant fund's leverage when determining capital requirements associated with a bank's investments, even though leverage is an important risk driver. To this end, we understand that the BCBS believes that a revised standard should appropriately reflect both the risk of a fund's underlying investments and its leverage.

While the CBA welcomes efforts to improve consistency and clarity in the application of the BCBS rules, we nevertheless have several concerns and questions on the proposals as outlined below.

Scope of application

We note that the proposed framework for calculating capital requirements for banks' equity investments in funds applies to equity investments in funds that are held in the banking book. One of the reasons that some equity investments in funds are managed in the banking book instead of the trading book is because they cannot be decomposed. The proposed framework would make these investments non-viable in the future due to the proposed framework's excessive capital requirements.

Look-through approach (LTA)

Under the LTA, it appears that banks would be required to risk-weight at 1250% where granular data is not available. This is considered excessive as it is equivalent to a capital deduction as compared with the 100% risk weighting these investments currently receive. In relation to paragraph 14 of the consultative document, we would also like to clarify whether banks will be required to apply a risk weight of 1250% if they cannot look through to the fund underlying the fund of funds. The example in Annex 5 of the consultative document seems to suggest that this would be the case. We would also seek clarification of whether lack of external ratings on securitization exposures constitutes a case where granular data is not available. If affirmative, would banks be required to use the 1250% prescribed by the Ratings-Based Approach (RBA) or can IRB banks continue to use either the Supervisory Formula (SF) or the Internal Assessment Approach (IAA) in such cases, which may return a risk weight less than 1250%.

Under the proposed framework, we also note that the LTA must be used when:

(i) there is sufficient and frequent information provided to banks regarding the underlying exposures of the fund; and
(ii) such information is verified by an independent third party.

In addition, we note that examples of third parties are included in paragraph 13 of the consultative document. We believe that retaining the services of an independent third party may not be necessary as some decomposition of funds can easily be done by looking to well recognized index baskets (e.g. Bloomberg, index provider) that are supported by reliable data. Quarterly financial statements may also be received from management companies that are contracted by the general partners to manage certain aspects of the funds (e.g. books and records, preparing financial statements, filing, etc.). We would request clarification of whether this would meet the requirement of information being verified by an independent third party.

Finally, we note that the BCBS recognizes that a full LTA approach may not always be feasible. For example, this may depend on the nature of underlying investments in existing funds. We propose that banks' equity investments in funds made prior to the implementation of a new framework be grandfathered such that existing capital requirements would continue to apply. This is important given that banks may not have access to the necessary information for existing investments and are unable to apply the proposed framework, particularly for investments in existing funds that have been exempted under a supervisor's materiality threshold.

Mandate-based approach (MBA)

Under the MBA, we note the following requirements in paragraph 19 of the consultative document:

- [w]hen a bank has an investment in a fund (Fund A) that itself has an investment in another fund (Fund B), the bank will be required to look through to the mandate of the second fund (Fund B) to determine the risk weight to apply to the investment of the first fund (Fund A's investment in Fund B). However, for all subsequent layers (e.g. Fund B's investments in Fund C), the funds' investments in other funds will be risk-weighted at 1250%.

We believe that applying the 1250% risk weight to the second layer of funds is overly punitive. The ability to look through the mandate of the third fund should be allowed as it is with the LTA.

Fall-back approach (FBA)

Currently, on the basis of economic substance, equity investments in fixed income funds are not considered equity exposures, and are capitalized as fixed income through a Probability of Default (PD)/Loss Given Default (LGD) approach. In the absence of PD/LGD information, the investment is risk-weighted at 100%. Moreover, under current rules, the largest risk weight applicable for equity exposures (below materiality threshold) is 100%. Under the revised standard, the fall-back risk weight will be 1250% which is equivalent to a capital deduction. We also suggest that the BCBS should continue to apply the 10% of capital threshold for significant investments, including significant investments in funds, applying 250% for amounts below the threshold and a capital deduction for amounts above the threshold. Given the operational complexity of implementing the proposed framework, we are concerned about the possibility of having to risk-weight all equity investments in funds by 1250% which would have a material impact.

We would also appreciate clarification on the basis of defaulting to a 1250% risk weight when the LTA and MBA approaches are not feasible. The banks' equity investments in funds are diversified and treating them similar to a deduction from capital is not risk-based.

Leverage

Under the proposed framework, we note that when information on leverage cannot be obtained, the fallback risk weight of 1250% applies. However, we cannot assume that leverage is the binding constraint when calculating capital requirements, in particular for funds that are considered low risk. We also note that paragraph 27 the consultative document states that "[t]he effect of the leverage adjustment depends on the underlying riskiness of the portfolio".

Resulting capital requirements

We understand that two options are proposed for calculating capital requirements related to equity investments in funds. Our recommendation is that option 1 should be adopted as it captures risks more appropriately. As noted in the consultative document, option 1 results in a capital requirement that is equivalent to the requirement that would result from a proportional consolidation of the fund and this approach may therefore be sufficiently conservative. Given our interest in continuing to invest and support economic growth, including those that involve equity investments in funds, we believe that option 1 produces reasonable capital requirements without detracting from investment opportunities.

Nevertheless, we would request clarification on the amount of leverage necessary for option 2 in relation to the statement in paragraph 24 of the consultative document that "[t]his is a conservative approach that results in a higher capital requirement than Option 1 for all cases where the fund has leverage and the cap does not bind". We believe that option 2 is very punitive as even with high risk weighting of assets, the leverage adjustment is the key component that produces capital charges that could be higher than a deduction from capital.

This is demonstrated through the example calculation of the LTA in Annex 2 of the consultative document. At 5% leverage, the difference in the capital charge between option 1 and 2 is 5%, but at 50% leverage, the capital charge under option 2 is two times higher. Furthermore, we believe that it is overly punitive to apply a 100% risk weight on the equity forward and this is also inconsistent if the positions are owned directly by the bank (e.g. this would most likely attract a market risk charge). Please provide more clarity on the treatment of the equity forward.

From review of the example calculation of the MBA in Annex 3, we find that there are inconsistencies with business practices that make the calculation difficult to assess. Our main concern is with the overly conservative treatment of OTC derivatives under the MBA. The risk weighting applied to such investments is far greater than what banks could possibly lose. Moreover, the use of large notional amounts is unrepresentative of the risk associated with these derivative contracts.

Transition

Given the operational complexity with obtaining sufficiently granular data for implementing the LTA and MBA approaches, we are concerned that the BCBS expects these changes to be implemented for 2019 in accordance with the required full phase-in of Basel III deductions. This

proposal represents a significant change and the timeline for implementation should be sufficiently extended to enable banks to properly plan and budget for the costs of implementation.

Overall, we believe that materiality should continue to be a key consideration within the assessment of the approach required. Banks with small equity portfolios should be able to retain their existing and simplified threshold approach. It is also important to note that banks may not have all of the required information to apply the new framework for existing funds and therefore grandfathering of these existing funds is recommended. We find that in many situations, the LTA is not viable because the information is not available, the MBA requires a significant amount of work and with minimal impact to risk weighted assets, and the FBA imposes unreasonably high capital requirements.

We thank you for taking our comments into consideration and would be pleased to discuss them further at your convenience.

Sincerely,