FEDERATION
BANCAIRE
FRANCAISE

Banking supervision
And Accounting issues Unit

The Director

Paris, October 4th 2013

French Banking Federation comments on the Basel committee consultation on banks' equity investments in funds (BCBS257)

Dear Sir,

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

We welcome the Basel Committee on Banking Supervision's (BCBS) review of the prudential treatment of banks' equity investments in funds and we support the objective of removing the ambiguities and shortcomings of the existing regime by establishing an explicit and coherent approach to the treatment of capital requirements for equity investments in funds.

Nevertheless we would like to highlight the following points:

We believe it would be sensible to have a certain degree of discrimination between regulated and unregulated funds to ensure that the framework provides the appropriate incentives.

It is essential to remind that a large proportion of funds invested in private equity or venture capital are primarily mandated to provide financing to SME and non-listed companies. Both US and EU regulations acknowledge that SMEs are at the heart of the economic growth not to say its backbone as far as the Euro area is concerned. So it is of utmost importance that the revised framework for equity investments in funds does not jeopardize this critical financing channel.

Mr. Wayne BYRES
General Secretary of the Basel Committee
on banking and supervision
Secretariat of the Joint Forum
Bank for international Settlement
CH-4002 Basel
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We believe that the risk weight of 1250% is unduly penalizing given that funds are typically portfolios of different exposures with differing degrees of diversification, and hence, the portfolio effect should be taken into account. Therefore we recommend the BCBS to contemplate intermediate stages between the MBA and the 1250% Fall Back Approach (FBA).

We believe it is important to ensure a certain consistency between the trading book and banking book exposures but only to the extent there is an economic consistency between this two types of exposure be it in terms of holding horizon and of management features.

You will find in the appendix attached our response to consultation that is organized in 2 sections:

- the first section consists of general comments on the consultation;
- the second one is dedicated to answers to the questions raised in the consultative document.

We thank for your consideration and remain at your disposal for any question or additional information you might have.

Yours sincerely,

Jean-Paul Caudal

French Banking Federation response to BCBS Consultative Document on banks' equity investments in funds (BCBS257)

We welcome the Basel Committee on Banking Supervision's (BCBS) review of the prudential treatment of banks' equity investments in funds and we support the objective of removing the ambiguities and shortcomings of the existing regime by establishing an explicit and coherent approach to the treatment of capital requirements for equity investments in funds.

While we do not disagree with the BCBS' rationale of expanding its review beyond the "shadow banking entities" to looking at all types of funds, we believe it would be sensible to have a certain degree of discrimination between regulated and unregulated funds to ensure that the framework provides the appropriate incentives.

Beyond such distinction, it is important to remind that a large proportion of funds invested in private equity or venture capital are primarily mandated to provide financing to SME and non-listed companies. Both US and EU regulations acknowledge that SMEs are at the heart of the economic growth not to say its backbone as far as the Euro area is concerned. It is of utmost importance that the revised framework for equity investments in funds does not jeopardize this critical financing channel.

Section I: General comments

The scope of the framework

We understand the proposal would apply to all types of funds, not only unregulated ones (i.e. typically funds acting as "shadow banking entities"), and irrespective of their size.

As mentioned above, we believe a uniform framework that would apply to funds irrespective of their jurisdiction and their regulatory treatment would fail to provide the right incentives. It should be stressed that regulated funds (such as UCIT or AIFMD funds) are subject to stringent prudential rules and as such should have a differentiated treatment reflecting the extent of regulation applied to those funds. A possible approach could be use the equity simple risk weight method as a fall back approach as opposed to a 1250% risk weighting.

Similarly, a proportionality principle should be reflected in the framework through the introduction of a materiality threshold below which funds would not be subject to the Look-Through Approach (LTA). Such a threshold could be expressed both in relative and absolute terms.

The relative threshold would be expressed as a percent of banks Tier 1 capital (an appropriate level could be 0.25% in our view) while the absolute threshold could be based on the size of the fund (for example, when aggregate total assets are (a) less than €500 million for regulated UCITS funds; or (b) less than €100 million for AIFM, subject to certain conditions and notifications as specified in the EU's Alternative Investment Fund Management Directive (AIFMD). Under this proposal, funds below the materiality thresholds would be excluded from this framework and subject instead to the simple risk weight method laid down in paragraph 344 and 345 of the Basel framework if institutions consider that it is too burdensome to apply the LTA or MBA

As a side remark, we note that in the second paragraph of the second bullet of paragraph 15, the BCBS refers to the concepts of "originator" and "sponsor". As those terms are usually used in the context of securitization, it would be helpful to have a precise definition of their meaning in the context of funds.

Private equity funds are vital for the SME sector

Many funds are invested in private equity or venture capital and their mandate consist in investing in SME and non-listed companies. Any deterioration in the capital treatment of those funds will therefore have a direct impact on the financing of this important segment of the economy. This issue is particularly acute in Europe where SMEs constitute about 98% of all euro-area firms, employ around three-quarters of the euro-area's employees and generate around 60% of value added. The revised framework should not jeopardize those funds ability in financing SMEs by imposing too punitive capital charges.

Third parties calculations should not be too penalized

We note that in paragraph 16, the BCBS allows the use of third-party calculations for determining the risk weights associated with their exposures but propose that the risk weight should be "one notch higher". First, while this approach is simple to apply under the standardized approach, it is not clear how to apply it under the internal ratings-based approach (IRB) and further explanations about how it would apply exactly would be welcome.

Second, while we agree with the aim of incentivizing banks to carry out their own assessments, there may be cases where it is more efficient for a third party to provide the calculations. In such cases, the 'one notch higher' rule could prove to be a disincentive to the development and use of well-regulated third party providers.

We therefore suggest allowing an exemption from the 'one notch higher' approach for cases where the third party provider meets certain conditions, such as being subject to stringent regulation or complying with existing standards for third party providers.

We are also unclear on the definition of a "third-party calculation". How should calculations carried out by a wholly owned subsidiary be treated? Firms presume a subsidiary should not be counted as a *third party for these purposes but it would be helpful if the final framework could confirm this.*

The proposed risk weights

We understand the standard approach based on a risk weight of 100% which could be extended to 150% will be no longer possible. The proposed treatment could now lead to a RW of 1250% in many cases, which is very punitive, as the conditions to comply with the LTA and Mandate Based Approach (MBA) are very restrictive. We believe that this risk weight value is unduly penalizing given that funds are typically portfolios of different exposures with differing degrees of diversification, and hence, the portfolio effect should be taken into account. We recommend the BCBS **to contemplate intermediate stages between** the MBA and the 1250% Fall Back Approach (FBA). Such a treatment should be applied only to extreme cases, where for instance funds are not covered by any legal framework (please see appendix for more details).

In addition we consider that there is a consistency issue in paragraph 14 as institutions are asked at the same time to apply the cascading approach consisting in using first LTA, then MBA and only as a last resort FBA and to apply a risk weight of 1250% to a fund's exposures to other funds. We assume this is probably a simple wording issue and ask the BCBS to confirm that the intention is indeed to apply the 1250% risk weight to the funds exposures to the funds if and only if neither LTA nor MBA are possible.

Trading book banking book consistency

We support the revision of the equity funds treatment in trading book in the context of the BCBS trading book fundamental review. We believe it is important to ensure a certain consistency between the two treatments but only to the extent there is an economic consistency between the two types of exposure be it in terms of holding horizon and management features.

An area where such consistency would be much relevant is the funds that are dynamically managed and that provide a guarantee on capital. Those funds are typically more subject to a market risk than to credit risk. One possibility could be to capitalise them using the market risk standard approach. A fall-back could be to at least apply a maximum loss cap principle. Thus, a certain degree of consistency with the trading book treatment would be ensured without fundamentally departing from the BCBS proposals for the treatment of equity funds.

Section 2: Answers to specific questions

Q1. The Committee welcomes views on: (i) the proposed definitions of leverage; and (ii) options for incorporating leverage into the calculation of risk weighted assets.

We note that under the option 2 there is a double counting of the leverage effect as demonstrated thereafter :

$$RWA_{Investment} = RWA_{fund} * Lvg / Equity_{Fund} * Equity_{Investment}$$

(with a cap at $1250\% * Equity_{Investment}$)

As

$$RWA_{Fund} = Assets_{Fund} * AvgRW_{Fund}$$

then

$$RWA_{Investment} = (Assets_{Fund} * AvgRW_{Fund}) * Lvg / Equity_{Fund} * Equity_{Investment}$$

Re-arranging ...:

$$RWA_{Investment} = (AvgRW_{Fund} * Lvg * Equity_{Investment}) * (Assets_{Fund} / Equity_{Fund})$$

The first parenthesis is the option 1 investment RWA while the second parenthesis is the leverage ratio. So:

$$RWA_{Investment}(Option\ 2) = RWA_{Investment}(Option\ 1) * Lvg$$

As a consequence we suggest the Basel Committee to consider the option 1 for incorporating the leverage effect into the calculation of risk weighted assets.

Q2. The Committee welcomes views on the proposed policy framework.

The LTA and MBA that are already in place for equity exposure to funds under the IRB approach are not in line with the risk management practices which could question the use test principles: indeed, if for a corporate exposure, the current Basel framework is in line with risk practices: the Basel II risk parameters (PD, LGD) are part of the credit decision and thus are compliant with the use test principles, we want to underline the fact that the decision to invest in a fund or to renew an investment in a fund will rely on the track-record, the regulatory classification, the investment policy of the fund but very rarely on a look-through approach or on the mandate based approach as described in the current framework. Indeed the look-through is a point-in-time picture of the portfolio of a fund and an investment decision based on the look-through is not relevant except for a fully static fund. Similarly, if the mandate based approach is a maximum possible risk exposure of a fund, the investment decision will not rely on such approach. The investment decision will rather rely on the track-record of the fund, the regulatory classification of the fund (a monetary fund for instance), its target volatility, In addition, if the application of the mandate based approach is theoretically feasible, we note that for many funds, the investment policy is not precise enough to allow a prudent application. Indeed, for instance some funds have the obligation to invest in "high credit quality" bonds but this high quality can be measured either through external credit assessment and internal ratings of the asset manager.

In this situation an investment in a high quality CP issued by an ABCP will be eligible and thus lead to a 1250% RW because the fund could invest in a non-externally rated asset...

As a consequence, the non-application of the look-through approach or mandate based approach by institutions would not be due to a weak assessment of risk but rather because these approaches are not in line with risk management practices.

A revised hierarchy of approaches has been proposed in appendix 1. Please note the revised decision tree does not cover the bank's investment in PE, for which a proposed treatment is detailed in paragraphs below.

Bank's investment in private equity funds

By investing in Private Equity (PE) funds, banks participate to the financing of the economy, and particularly the financing of the vital SME sector. It is therefore of the uttermost importance that the proposed framework does not jeopardize these investments.

Therefore, we would like the Basel Committee to ensure that investments in Private Equity funds are not unduly over capitalized. Indeed, we fear that in the proposed framework those investments might attract higher risk weights.

Investments in Private Equity funds are not materially different from direct investments in equities of non-financial companies. The only difference is the fact that the choice of the investments and their management is delegated to a fund manager. As such, the applicable risk weight to the fund investments should always be identical to the risk weights that would apply to a direct investment in the companies.

However, some conditions for applying the look through approach might not be met:

(i) Though PE funds do provide details of their investments on a quarterly basis, the positions reported are often as of a few months back (usually as of last quarter end).

(ii) The reporting is made by the managing company.

Therefore, we would like the Basel Committee to make a caveat for PE funds whereby:

- The time gap between the institutions own fund requirements calculation and the positions reported is not viewed as a breach of condition (i) of point 12.
- The second condition for the usage of the look-through approach is somewhat confusing as information is required to be verified by an independent third party, nevertheless this third party can be the management company [point 13]. We would like the Basel Committee to clarify that with respect to Private Equity funds, reporting by the fund manager is suitable, i.e; condition (ii) of point 12 is met. Indeed, PE funds reports are very thorough and easily ascertainable, are audited regularly (usually twice yearly) and besides, each capital call purposes are duly documented by the fund manager

If the look-through approach was not granted, the mandate-based approach could be used but it would often lead to a 370% RW as rarely do funds limit in their mandate the possibility of investment in listed companies even though they hardly ever do so.

Appendix 1: Proposal for revised decision tree