Ref: CHC/57/H25

October 4, 2013

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

Japanese Bankers Association

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the consultative document: *Capital requirements for banks' equity investments in funds*, released on July 5, 2013 by the Basel Committee on Banking Supervision (the "BCBS").

We hope that our comments below will be of assistance and offer an additional point of reference as you work towards finalising the framework.

General Comments

We respectfully express our support for the BCBS's move towards further clarifying the internationally-agreed framework and ensuring regulatory consistency across jurisdictions by reviewing the capital requirements for banks' equity investments in funds.

It is expected that this revision will be meaningful in light of its objective and that our comments below will be taken into account so that the fund market can successfully fulfill its necessary function as a financial intermediary under the revised framework.

1. Objective and effect of the implementation of the revised framework

(1) Effectiveness in strengthening the shadow banking regulation

The consultative document ("CD") explains in paragraph 1 the objective of this revision, namely that the BCBS agreed to review the risk-based capital requirements for banks' exposures to funds in order to strengthen the oversight and regulation of shadow banking.

Although banks are indeed one investor in shadow banking entities over which the BCBS has a concern, there are also a number of other non-bank investors.[1] Given

[1] Taking hedge funds as an example, the "2012 Preqin Global Investor Report: Hedge Funds" reports that approximately three-fourths of North American investors are non-banking institutions such as foundations and endowments and pension funds.

such circumstances, we question whether revising the capital requirements focusing on banks' exposures to funds will contribute to strengthening the shadow banking regulation comprehensively and fundamentally. The BCBS should assess whether this revision is an effective measure to deliver its objective before implementing the revised framework.

（2） Impact on the fund market's functions as a financial intermediary

While this revision is considered to intend to enhance the transparency of hedge funds, the side effects on other types of funds (e.g. private equity ("PE") funds (including acquisition funds, corporate reconstruction funds and venture funds in this letter) and infrastructure-related funds[2]) should also be taken into consideration.

Specifically, we have a concern that, if banks require funds to provide "sufficient and frequent information" which "is verified by an independent third party" in accordance with the proposed look-through approach, the funds' socially-significant functions as a financial intermediary may be undermined due to the following reasons:

(i) Funds' management cost increases, thereby losing their investment attractiveness.

(ii) Financing capacity or incentive to cover medium- to long-term risks decrease although these are essential for business revitalisation/industry development purposes.

The CD proposes to tackle the shadow banking issue by revising the regulation for banks. This approach is not however considered to fully achieve the fundamental objective, namely that of enhancing the transparency of whole hedge funds' market. Further, the proposed requirements will impose excessive burdens on funds other than hedge funds, even though their investment targets have economic substance and they play socially significant roles. In this regard, the look-through approach should be reviewed by carefully assessing whether banks can obtain such information (see our specific comment 1); and the BCBS should take into account that overly conservative risk-weight should not be applied so as to avoid undermining risk sensitivity in the case that such information is unavailable (see our specific comment 2.)

- (Specific comment 1) Relaxation and clarification of the requirements for the look-through approach and the mandate-based approach.
- (Specific comment 2) Expanding interpretation of the mandate-based approach and increasing options for applicable approaches.

(https://www.preqin.com/docs/reports/2012_Preqin_Global_Investor_Report_Hedge_Funds_No_Bleeds.pdf)

[2] Infrastructure-related funds ("infrastructure funds") are a fund which invests in and finances projects related to infrastructure such as electricity, transportation and water supply/sewerage.

2. **Establishing a sufficient preparation period and measures to mitigate the impact of drastic changes**

It is considered that the establishment of a framework for verification of information by an independent third party cannot be achieved solely by bank's efforts because such action may impose additional costs and operational burdens on funds. Taking these external factors into consideration, the BCBS is requested to provide a sufficient preparation period before the implementation of the revised framework.

Further, it is expected that the level of capital charges will change significantly because the revised framework may result in prohibiting all approaches currently allowed at the discretion of each jurisdiction. This may prompt banks to withdraw their investments and thereby may adversely affect investees' funding ability. It is, therefore, requested that the BCBS give due regard to such a possibility or market impact, and provide transitional arrangements (e.g. grandfathering) to mitigate the impact of radical changes effective over an adequately sufficient period.

Specific comments

The BCBS's proposed framework is simple yet excessively conservative in that it requires all banks to apply a risk weight of 1,250% to their exposures to all funds that do not satisfy the following two conditions.

Condition a.: The requirement on frequency and verification of information regarding the underlying exposures of the fund under the look-through approach. (Paragraph 12) Condition b.: The requirement on investment mandate which enables the calculation of the maximum risk weight. (Paragraphs 17 to 19)

As suggested hereinafter, the BCBS is requested to review these conditions to make them more reasonable in the context of market practices, or to consider expanding the interpretation of the mandate-based approach or allowing an additional approach.

1. **Relaxation and clarification of the requirements under the look-through approach and the mandate-based approach**

(1) The look-through approach

Frequency of obtaining the information regarding the underlying exposures of the fund / Verification by an independent third party

In the following two cases, the requirement regarding the frequency of obtaining the information related to the underlying exposures of the fund should be relaxed. (The following cases assume that banks' financial statements are published on a quarterly basis and the frequency of obtaining the information required under the CD is quarterly.)

(i) In general, data on existing PE funds, infrastructure funds, real estate funds, etc. have not been verified by a third party on a quarterly basis. This is because assets that they hold are not complicated and the benefit of frequent verification, the aim of which is to ensure the transparency of underlying assets, does not outweigh the cost incurred. (Especially this is true of the case of relatively newly-established funds with unstable profitability.)
Whilst third-party verification may not be performed on a quarterly basis, on the basis that underlying assets are not typically subject to frequent turnovers and are relatively noncomplex in nature, up to date information regarding such underlying assets can be appropriately complemented based on audited financial statements and information on acquisition and disposition of underlying assets during a certain period. In light of and in line with such market practices, the condition a. should be considered to be satisfied by the annual audit for these types of funds, provided that they are capable of appropriately identifying the latest information on the underlying assets.

(ii) Similarly, passive funds that aim to achieve the performance linked with major indices widely recognised in the financial markets[3] should be deemed as satisfying the condition a. by having their financial information audited annually provided that tracking errors are checked or other procedures are performed to verify that actual investments are in line with the stated investment policies. We believe this type of check ensures the high transparency of investment components, prices and investment policies.

[3] For example, representative stock indices of major countries such as the S&P500, NY Dow, Nikkei 225 and DAX

Regardless of the above, the BCBS is respectfully requested to develop rules with a certain degree of flexibility concerning independent third party verification, taking into account the legislative and business customs unique to each jurisdiction.

(2) The mandate-based approach

Scope of subsequent layers

Conduits established for certain purposes (e.g. tax purpose) with the following attributes do not constitute a fund of funds and thus should not be counted as one of "layers" of funds.

(i) A conduit having the same composition of the underlying assets and the same risk as its parent fund.

(ii) A conduit having the same investment policies as its parent fund and which does not make investment decisions on its own.

2. Expanding interpretation of the mandate-based approach and allowing an additional approach

The BCBS is requested to consider the options of allowing (1) a flexible interpretation under the mandate-based approach and (2) an additional approach (i.e. "the market-based internal model approach") between the mandate-based approach and the fall-back approach as discussed below.

These options are proposed to permit using risk-sensitive calculation methods which are "valid" based on facts or granular information even if the above conditions a. and b. are not met.

(1) The application of the mandate-based approach based on the reasonable and conservative estimation of the underlying asset composition

Especially, in the case of some funds that are generally marketed through private placement such as PE funds, infrastructure funds and real estate funds, in particular, investors can estimate the "expected maximum risk-weight" from the agreed but not explicitly articulated purpose of launching such funds, solicitation materials, and its most recent asset composition.

In such a case, it is recommended that the mandate-based approach be applied as illustrated below, taking into consideration the "reasonable and conservative estimation

of the underlying asset composition."

- In the case where the bank is aware that fund's investments in "assets which attract 400% or more of risk-weight (e.g. certain securitisation exposures)" is limited, and when it is highly probable that the average risk weight the fund applies is less than 400%, the bank may apply a 400% risk weight to all of its investments in such a fund.

This approach gives consideration to constraints on information availability and at the same time requires a sufficiently conservative level of "capital charge that substantially reflects existing risks." We believe that this is a useful option which balances "affinity for practices" and "risk assessment."

(2) Proposed intermediate approach: "the market-based internal model approach"

It is proposed that the BCBS allows applying the market-based internal model approach to those funds having either of the following characteristics (i) or (ii), similarly to the current approach allowed to apply for equity exposures:

A fund which,

(i) is subject to a daily calculation of its net asset value ("NAV"), has similar features of cancellation/disposal as physical stocks, and is readily saleable by splitting into individual listed stocks, or

(ii) is subject to a weekly calculation of its NAV, and the appropriateness of which is ensured through periodic audits or due diligence

This approach enables a risk assessment based on a highly-transparent net asset value that factors in the correlation between securities included in the fund portfolio, and can be subject to an assessment on its reasonableness through back testing or similar methods. Therefore, we believe this is considered to be a highly reliable measurement approach.

If this approach is not allowed, we are concerned that a slight difference in the form of investment may result in inconsistent and significantly different capital charges. For example, if a bank holds multiple listed stocks directly, the market-based internal model approach can be applied to them separately as equity exposures, whereas if the bank holds the same listed stocks indirectly

through a fund, the bank may need to apply the risk weight of 1,250% when the aforementioned conditions a. and b. are not met.

Given that the floor is provided in paragraph 347 of the Basel II Capital Accord[4], the appropriate conservatism is assured for this approach to be introduced as an intermediate between the mandate-based approach and the fall-back approach.

Our responses to the BCBS's 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 support Option 1 for the following reasons:

- Under Option 1, the total risk-weighted assets assumed by the investors equal to the total risk-weighted assets of the underlying assets. Therefore, it is considered that the investors are subject to appropriate risk-weighted assets which reflect the economic effect of leverage.
- Under Option 2, on the other hand, the total risk-weighted assets assumed by the investors are derived by multiplying the total risk-weighted assets under Option 1 by the leverage multiplier ("*Lvg*".) As a result, Option 2 will impose on investors capital requirements that exceed the original total risk-weighted assets of the underlying assets. Regardless of the level of leverage, the aggregate risk borne by all funding sources cannot exceed the original total risk of the underlying assets. Accordingly, such a treatment is not considered to be reasonable.

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

It is requested that the BCBS take into account not only UL but EL when it finalises "the introduction of a cap" specified in paragraph 30 of the CD.

[4] BCBS (June 2006) International Convergence of Capital Measurement and Capital Standards -A Revised Framework Comprehensive Version-