October 4, 2013

Mr. Wayne Byres
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel Switzerland

RE: BCBS Consultative Document "*Capital Requirements for Banks' Equity Investments in Funds*"

Dear Mr. Byres:

The Institute of International Finance (IIF), the Global Financial Markets Association (GFMA) and the International Banking Federation (IBFed) welcome the opportunity to comment on the Consultative Document "*Capital requirements for banks' equity investments in funds*" issued by the Basel Committee on Banking Supervision (BCBS) for comment by October 4, 2013.

General Comments on Consultative Document

We welcome the BCBS's decision to review the prudential treatment of banks' equity investments in funds by developing a revised capital regime and agree with the BCBS's analysis of the ambiguities and shortcomings of the existing regime. We agree that there would be benefit in an explicit, clear and coherent approach to the treatment of capital requirements for equity investments in funds.

We also support the BCBS's decision to look at all types of funds rather than "shadow banking funds". This is sensible and avoids a number of limitations in applying the term "shadow banking" to specific entities and in trying to make a precise distinction between "shadow banking entities" and "non-shadow banking entities"[1]. We hope that the BCBS will maintain this approach into the final version.

[1] For a more detailed explanation of the limitations of "shadow banking" as a term, please see pages 12-13 of the June 2012 IIF report: ""Shadow Banking": A Forward-Looking Framework for Effective Policy", available at http://www.iif.com/regulatory/

We believe that to be truly effective and beneficial, any approach adopted should:

i. Balance the need for a coherent framework for all types of funds with the need for **sufficient differentiation between specific types of funds**. The funds covered by the proposed approach have very distinct and diverse characteristics and risks. Their regulatory treatment varies both by types of funds and by jurisdiction, as do their disclosure and reporting requirements. An approach that might work for one type of fund might not necessarily work for another. It is clear that the BCBS recognizes the need for this as it underpins the three step approach proposed, but it needs to be kept in mind even within individual steps of that approach.

ii. **Incentivize** financial institutions to collect sufficient information on the underlying funds to properly understand and manage the risk of their exposures.

iii. Be **coordinated** with and avoid overlaps with requirements in existing regulation and with other regulatory initiatives, particularly the work of the International Organization of Securities Commissions (IOSCO) on funds and existing regulations on funds (such as UCITS).

iv. Consider the **impact** not just on financial institutions but more importantly on end-users of financial services and the wider economy, and particularly on access to finance for small and medium-sized enterprises (SMEs).

v. Above all, be **targeted and proportionate** to the risks, and use the least distortionary tool that still achieves the aim of effective risk mitigation. We believe Option 1 rather than Option 2 fits this principle with respect to factoring in fund leverage.

With all this in mind, we support the idea of the decision tree framework of the kind that the BCBS sets out in Annex 1 of the consultative document.

However for the approach to be truly effective, beneficial, targeted and proportionate, we recommend that the BCBS add a step at the start of the process. This step would be to establish a materiality threshold based on the size of each fund investment in relation to the bank's capital, below which funds would not be subject to the Look-Through Approach (LTA), Mandate-Based Approach (MBA) or Fall-Back Approach (FBA) but would instead be subject to a treatment similar to that outlined under footnote 27 and 31 of the Basel III framework: "*If banks find it operationally burdensome to look through and monitor their exact exposure to the capital of other financial institutions as a result of their holdings of index securities, national authorities may permit banks, subject to prior supervisory approval, to use a conservative estimate*."[2] The conservative estimate of banks' capital requirements for non-material investments in funds could be based on banks' own internal assessment of risks, subject to supervisory oversight, looking at a number of different factors (e.g., using the factors banks consider in doing due diligence before investing in a fund, the extent the fund is regulated, etc.).

[2] BCBS: "Basel III: A global regulatory framework for more resilient banks and banking systems", December 2010 (rev June 2011), footnotes 27 and 31

We suggest that the materiality threshold be set at 5% of a bank's Tier 1 capital, in line with the proposed Basel large exposure definition. Such a threshold would not only be consistent with the proposed Basel large exposure framework, but it would also mitigate the operational burden of applying the proposed approaches to banks' non-material investments in funds. We believe this would strike the appropriate balance between requiring banks to exert considerable effort to seek information on the funds' underlying and the financial stability benefits of capturing such information.

Another alternative would be to set the materiality threshold based on the size of the fund, such as is the case under the EU's Alternative Investment Fund Management Directive (AIFMD). This Directive for instance does not apply to "small" Alternative Investment Funds (AIF) with aggregate total assets of (a) less than €100 million; or (b) less than €500 million, subject to certain conditions and notifications.

In the Appendix, we have shown how the diagram in Annex 1 of the consultation document would be changed by this.

In addition, in order to achieve the objectives set out above, we believe that there are a number of parts of the proposed approach that could be improved. We have provided detailed comments below but there are four areas in particular:

i. **The scope of the framework**. As currently drafted, the framework includes all funds irrespective of size or regulated/unregulated status (including private equity and venture capital funds, on which see our comments below). We believe that this is unnecessary and hope that the BCBS will consider introducing some kind of materiality threshold below which funds are not included, as suggested above, or differentiation of treatment of funds based on the extent of regulation applied to the funds.
ii. **The incentives provided**. In a number of areas, we are concerned that the proposed approach provides incentives against looking through to exposures and penalizes the collection of information or the development of useful economic services. We discuss this further below, particularly on the treatment of funds of funds under the LTA and the MBA.
iii. **The 1250% risk weight** applied under the FBA and for banks' exposures to "other funds". This will result in a capital requirement that exceeds the amount of exposure, as we explain further below. Hence, the use of 1250% risk weight as a cap across the Basel standards should be revisited. In relation to investments in funds in particular, we believe that this risk weight is unreasonable given that (a) funds are typically portfolios of different exposures, with differing degrees of diversification, but with some diversification in almost all cases, and (b) especially where a bank has a portfolio of numerous such exposures, the portfolio effects should be taken into account.

iv. **The leverage adjustment**. We believe that Option 1 provides for an adequately conservative approach to incorporating leverage that is more commensurate with risks than Option 2.

A final general comment is that the consultation document does not indicate what the intended implementation timeline will be. We would be grateful for clarity on this and suggest that implementation be delayed until after finalization of the Current Exposure Method (CEM) review.

Specific Comments

A. Scope of application (paragraphs 7 and 8)

As noted above, we broadly support the application of the framework to banks' equity investments in all types of funds, though we would find it useful if a definition of 'funds' were to be provided. While the existing regime does not provide such definition, in the interests of promoting consistency of application across jurisdictions and in ensuring effective regulation, we would be grateful if the BCBS would consider providing one under the new framework.

We would also like to seek clarification on the treatment of off-balance sheet exposures. Paragraph 7 only states that the proposed framework applies to such exposures but there is no explanation how it will be applied. We presume some kind of credit conversion factor would be used. As such, we propose that credit conversion factors based on banks' internal estimates be used to be consistent with banks' drawdown experience on these exposures. If BCBS seeks comparability across banks, at the least, the standardized CCF should be used. In no case, however, should a 100% CCF be used because it does not reflect banks' historical drawdown experience in relation to funds.

We acknowledge that the defined scope of the proposed rules is that they apply to "banks' equity investments in funds that are held in the banking book". The proposal also notes the committee will look to ensure that consistent requirements are considered for trading book purposes as part of the fundamental review of the trading book. We welcome this commitment to ensure a consistent approach, but in doing so we would ask that the differing nature, and often, accounting treatment, of trading book activity be taken into account. In particular, we would expect that the exposures to which the approaches in the proposal would apply would be based on the net long position (i.e., the gross long position net of short positions in the same underlying exposure) in line with the treatment used for investments in the capital of banking, financial and insurance entities that are held in the trading book as set out in Basel III.

While we support a clear and coherent regulatory capital framework for banks' exposures to funds, such a framework should also be sufficiently reflective of and proportionate to the different

characteristics and risks of different funds. It should also be mindful of the impacts on end-users and the wider economy.

For the majority of funds, we agree that it will be possible to achieve this through the calculations of risk under the framework that the BCBS has proposed. However, as currently drafted, the scope also appears to include private equity (PE) funds, venture capital funds and direct lending funds. We recognize the need to ensure that banks are indeed adequately capitalized against the risk from such investments. For such funds though, we note that, due to the paucity of timely information on the underlying investments and the very infrequent nature of the reporting by PE fund managers on underlying assets, banks would not be able to use the LTA for such funds and would likely have to use the more conservative MBA or FBA of 1250% risk weight.

This could create disincentives against the acquisition of such funds and thus reduce demand for them. This in turn would reduce the amount invested by such funds in the wider economy and particularly in the funding of SMEs, where they play a critical role. European SMEs are particularly reliant on such financing both as start-ups and in financing further growth.

The application of a materiality threshold and the treatment outlined above for where funds fall below this threshold would help considerably.[3] In addition and as we detail in our comments on the MBA below, clarifying how the MBA will work would also help.

B. Scope of consolidation and deductions from capital (paragraph 9)

We have no comments on this paragraph.

C. Policy Framework (paragraphs 10-20)

a. The look-through approach (paragraphs 12-16)

We support the broad objectives of the LTA. Financial institutions should be incentivized to collect sufficient information on the underlying funds to properly understand and manage the risk of their exposures.

We also agree that a condition for use of the LTA should be that "*there is sufficient and frequent information provided to banks regarding the underlying exposures of the fund*." However, as suggested above, we believe that this should be subject to a materiality threshold, i.e., only banks' material investments in funds should be subject to the LTA or MBA or FBA, and hence subject to the conditions under the relevant approach. Investments below the threshold would be subject to the treatment outlined above.

[3] As noted above, above such a threshold, the three-stage decision tree of LTA, MBA and FBA would be applied.

We understand the rationale for the requirement to have information verified by a third party. However, we note that while EU Member States have such a requirement, it is not present in a number of other jurisdictions. We hope that the BCBS will consider making such verification optional rather than compulsory. At the very least, we suggest that the BCBS carries out an impact assessment of introducing such a requirement to evaluate whether the associated costs are proportionate to the risks that will be addressed.

As currently drafted, paragraph 14 states that "*banks applying the LTA must be able to further look through to every subsequent layer of the fund.*" But the last sentence of the paragraph states that "*banks will be required to apply a risk weight of 1250% to a fund's exposures to other funds.*" These are two contradictory statements. We assume that, as in the example in Annex 5, the 1250% risk weight is intended to apply only to cases where risk weight to an underlying fund's exposure is unknown, but would appreciate if this could be clarified in the text. In addition, even in such cases, we believe that it would be more logical to apply the MBA approach first and if and only if this is not possible should the 1250% risk weight be applied. This is more consistent with the general framework. If the 1250% risk weight applies to every subsequent layer of the fund, this would surely contradict the goal of incentivizing banks to have the capability to look through their exposures.

In the second paragraph of the second bullet of paragraph 15, the BCBS uses the phrase "neither the originator nor the sponsor". These terms are usually used in the context of securitization. Hence, it would be helpful if the BCBS would provide definitions of these terms in the context of funds. In addition, the same paragraph also states that banks should apply the ratings-based approach for securitization positions. This approach, along with the whole securitization framework, is currently being revisited. So a confirmation that this refers to the proposed revised ratings-based approach of the new securitization framework would be appreciated.

Furthermore, we have additional comments in regard to paragraph 16, in which the BCBS allows for 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) that uses a continuous risk weight function. We would be grateful if the BCBS could consider how exactly it would apply in such cases.

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 and just as robust, 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[4].

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.

Lastly on the LTA, in cases where a bank does not have all the information necessary to apply the LTA but has a more granular information than just the mandate of the fund (e.g., a fund's disclosure or prospectus might include information on the balance sheet composition of the fund), such information should be used to calculate the capital requirement for the banks' investment in the fund. While this appears to be allowed per footnote 6 under the MBA, we believe it is worthwhile to explicitly encourage firms to seek more detailed information where it is available and to differentiate between use of available balance sheet summary information and the often higher level, static portfolio summaries included in fund mandates. This could be an intermediate approach between LTA and MBA (an "MBA-plus approach") and has the advantage of resulting in a capital requirement that more accurately reflects the risks of the fund's underlying compared to the capital requirement resulting from the MBA. This would also be consistent with the goal of incentivizing banks to collect sufficient information on the funds' underlying to properly understand and manage the risk of their exposures.

b. The mandate-based approach (paragraphs 17-19)

While in principle, we support the option of a mandate-based approach (MBA), it is not clear to us how exactly it would be applied, and in particular the level of information that would be considered sufficient to be able to use the MBA. We would be grateful if the BCBS could clarify this and provide further examples.

Further, in paragraph 18(i), the proposal refers to the "*equity and securitisation positions described in paragraph 13*."(sic) We would be grateful if the Committee could confirm that it is in fact referring to paragraph 15.

Paragraph 18(iii) states that for counterparty credit risk exposures associated with the fund's derivative exposures, MBA requires banks to use the CEM. However footnote 12 notes that CEM is currently being reviewed and that the Committee may decide to review the treatment of a fund's derivative exposures under the MBA. Rather than review the treatment at a later point, we think

[4] For example, having an unqualified ISAE 3402 or SSAE 16 audit opinion, or having satisfied the conditions under UK PRA rule SYSC 8.1.8

that it would be much more effective to delay finalization of the proposals until the current review has been completed.

In paragraph 19, the proposals state that for funds of funds under the MBA, banks can only look through to the mandate of the second fund to determine the applicable risk weight. For subsequent layers, investments in other funds will be risk weighted at 1250%. Again, this seems to contradict the goal of incentivizing banks to look through their exposures. In our view, it is not clear why banks should not be allowed to look through to the mandate of the succeeding layers of funds, where this information is available.

c. The fall-back approach (paragraph 20)

We have a significant concern about the proposed risk weight of 1250%. In addition to the reasons cited above, applying a 1250% risk weight implies that funds have the same risks as first-loss positions in securitization, which is clearly not the case. Moreover, if banks are required to have a minimum capital ratio that is greater than 8%, which is the case in a number of jurisdictions, a 1250% risk weight would lead to a capital requirement that exceeds the amount of the exposure. More generally, Basel has introduced a number of buffers on top of the 8% minimum capital ratio which effectively increased the minimum. Again, this would lead to a capital requirement that would be more than the exposure amount. The 1250% cap, which is also used in other Basel standards, should therefore be revisited.

For investments in funds, we suggest applying instead a 400% risk weight or the risk weight based on the majority of the funds' holdings (the same as the existing approach to funds), whichever is higher. This still retains a reasonable level of conservatism while at the same time is consistent with the highest risk weight under Basel II's Simple Risk Weight Method for equity exposures. If this approach is taken, the leverage adjustment would also apply to FBA (not just to LTA and MBA), subject to an appropriate risk weight cap that ensures capital requirement does not exceed the amount of the exposure. As with the MBA, leverage could be taken into account through the maximum financial leverage resulting from the national regulation of the fund.

D. Incorporating Leverage into the Framework and E. Resulting capital requirements (paragraphs 21-29)

We appreciate the proposal's introduction of a leverage adjustment as an elegant, simple, yet risk-sensitive way to account for leverage in funds. We have a few comments on how the leverage adjustment is applied, however.

We understand the motivation for applying an appropriate measure of leverage to the risk weight derived from the standards. We do not understand however why national supervisors should be given the discretion to "*choose a more appropriate leverage metric if deemed appropriate*". This seems to go

against the whole aim of the exercise to promote an internationally consistent and coordinated approach on this issue, and we cannot understand why different leverage metrics would be needed between jurisdictions. This also contradicts the comparability objective of the BCBS, as discussed in its discussion paper *The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability* (July 2013). We therefore suggest that this be dropped or that the need for national discretion be more clearly articulated.

In paragraph 22, the proposals state that "*one of two options will be applied*" but it is not clear who will apply them and on which criteria. We suggest that in the interests of consistency and holding capital commensurate with risk, the BCBS opt for Option 1, which is more reflective of the risks of the funds' underlying exposures.

We do not agree that Option 1 deliver insufficiently conservative risk weights. In the example given in Case 2 of Annex 4, we do not consider 500% risk weight (from a starting point of 25%) as "insufficiently" conservative, especially given the low-risk nature of the fund's investments. The statement in Annex 4 about the insufficiency of the 500% risk weight for "such a highly leverage fund" seems to reflect the BCBS's desire to put more weight on leverage than the riskiness of the funds' portfolio.

Moreover, in many cases we believe that Option 2 results in an overly punitive risk weight. Option 2 generally results in the doubling of risk weights on the underlying exposures at leverage levels as low as 30%, which we believe to be overly conservative. For example, we have examined the two options in the context of entities registered with the SEC under the Investment Company Act of 1940 ("40-Act funds," the U.S. equivalent of a SICAV fund). Such funds are prudentially regulated and subject to strict leverage limitations. Often these funds hold public securities, such as equity or government debt. If such a regulated fund held \$20 of public equity and \$80 of government debt, the weighted average risk weight of the total exposure would be 60%, with no leverage. If the fund held 33% leverage (the maximum allowed for 40-Act funds), under Option 2 the risk weight for the exposure would more than double (to 134%), whereas Option 1 would result in a 90% risk weight. We do not believe that a prudentially regulated fund with 33% leverage is twice a risky as an unregulated one with zero leverage, especially where the underliers are so low risk.

F. Introduction of a cap

We have no comments on this section.

Annexes

As noted above, please see the Appendix to this letter for our suggested revision to the diagram in Annex 1 of the consultative document.

Conclusion

Once again, we welcome the BCBS's decision to review the prudential treatment of banks' equity investments in funds by developing a revised capital regime and agree that there would be benefit in an explicit, clear and coherent approach to the treatment of capital requirements for equity investments in funds. We hope that you will adopt the suggestions and requests for clarifications made in this paper and in particular, introduce a materiality threshold as a first stage.

Should you have any questions, please contact Jermy Prenio (jprenio@iif.com) at the IIF, Sally Scutt (sally.scutt@bba.org.uk) at the IBFed, and David Strongin (dstrongin@sifma.org) at GFMA.

Very truly yours,

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Appendix: Revised decision tree framework (Annex 1 of consultative document)