

**BVI’s position on the Draft Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 379 of the proposed Capital Requirements Regulation**

Reference: **EBA/CP/2013/07**

BVI<sup>1</sup> welcomes the opportunity to comment on the suggestions for specification of the determination of the overall exposure in respect of transactions with underlying assets as presented by EBA in the consultation paper at hand.

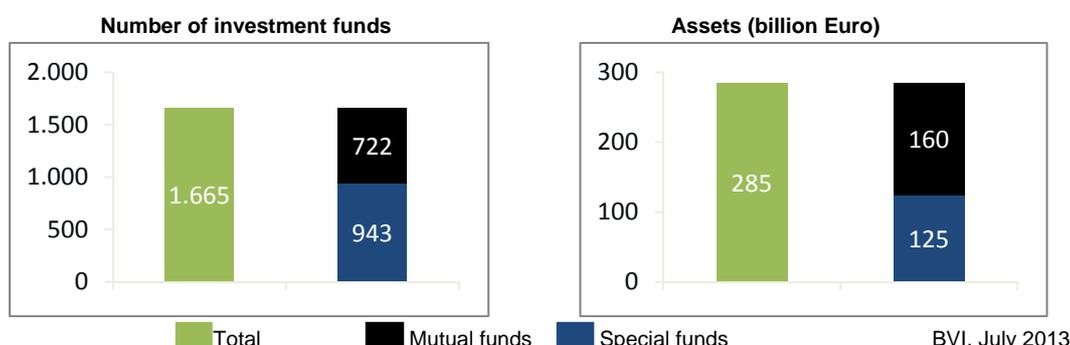
**Key issues**

Before turning to detailed remarks on the questions for consultation, we would like to draw EBA’s attention to our key issues and concerns.

**I. Impact on the German investment funds industry**

BVI members are German asset managers providing management services to regulated and supervised collective investment undertakings (CIUs). The number of CIUs held by banks and other institutions subject to CRD is rather large (around 14 percent of all German investment funds). These CIUs are very much affected by this consultation paper.

According to a survey among our members, 37 investment management companies manage about 1600 funds with assets under management totaling 285 billion Euros subject to the large exposure limit on credit regimes. These are about 720 mutual funds as well as 940 “special funds” which are only eligible for institutional investors. All figures refer to the total value of the funds assets. In particular, the stake in the mutual funds held by banks or other institutions is much lower because they are eligible for a number of investors (cf. retail or other institutional investors).



<sup>1</sup> BVI represents the interests of the German investment fund and asset management industry. Its 78 members currently handle assets of more than EUR 2.0 trillion in both investment funds and mandates. BVI enforces improvements for fund-investors and promotes equal treatment for all investors in the financial markets. BVI’s investor education programmes support students and citizens to improve their financial knowledge. BVI’s members directly and indirectly manage the capital of 50 million private clients in 21 million households. BVI’s ID number in the EU register of interest representatives is 96816064173-47. For more information, please visit [www.bvi.de](http://www.bvi.de).

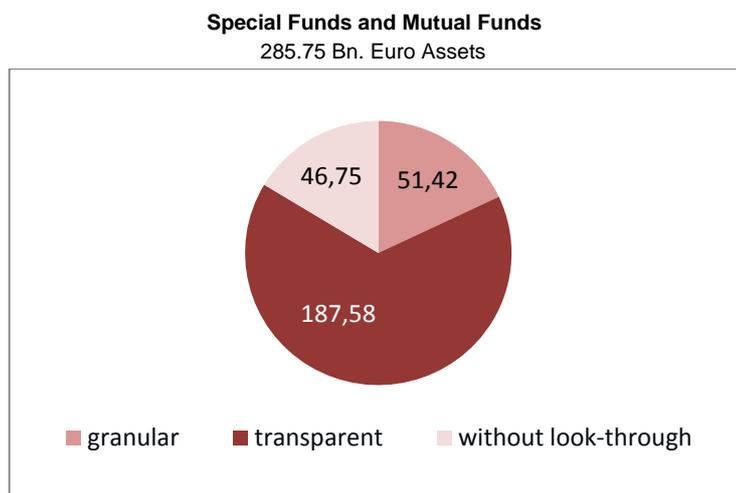


## II. Look-Through Approach

In Germany, a large exposure regime within the meaning of the CEBS Guidelines (Guidelines on the implementation of the revised large exposure regime, 11 December 2009) is in place. Accordingly, institutions apply the full look-through approach, the partial look-through approach or the approach of unknown exposures for the treatment of exposures to schemes with underlying assets (cf. para. 74 of the CEBS Guidelines). In order to support institutions which invest in CIUs in fulfilling their obligations vis-à-vis the supervisory authority, investment management companies inform the institutions of the portfolio composition of the funds managed by them.

As we understand the Consultation paper, EBA proposes a look-through approach with full transparency of the underlying assets of the CIUs without exception or alternative approaches. In particular, the granularity principle shall not apply according to which a scheme may be considered sufficiently granular if its largest exposure is smaller than 5 % of the total scheme. This tightening of requirements as proposed in the Consultation paper would have serious consequences for the German fund industry.

As shown in the following overview, more than half of the funds held by institutions are currently regarded as fully transparent. The remaining part of the funds make use of the granularity criterion (hereinafter called “granular”) or the institution does not look-through with the effect that the investment management companies don’t make the current composition of the funds available to the institutions and the fund unit is to be regarded as a single risk and is being considered as one unknown client (hereinafter called “without look-through”).

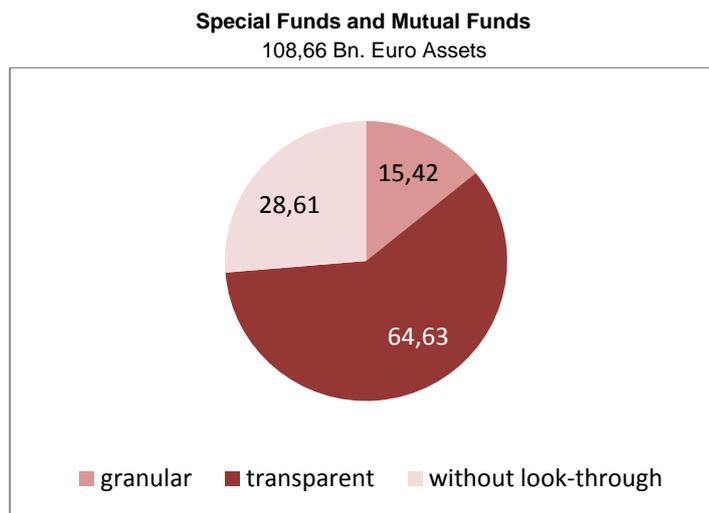


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If in 2014 a full transparency regime is being applied, our members would not be able to adapt to new processes at short notice for these granular funds or funds without look-through. This process would result in high efforts for the investment management companies. In particular, smaller and midsize investment management companies do not have the necessary IT capacities to make the full current composition of the funds available to the institutions.



Moreover, according to a survey among our members, they manage about 750 funds with assets under management totaling more than 100 billion Euros which invest in other (target) funds. Currently, over 44 percent of these funds of funds make use of the granularity principle or the investment management company does not look-through at the underlying assets of the target funds. The following overview demonstrates that situation.



BVI, July 2013

However, in the majority of cases, the investment management company which manages the fund of fund requires information about the composition of the underlying assets of the target funds by other investment management companies which manage the target funds. Our survey indicates that the managers of bank held CIU's require information from about 530 external investment management companies of target funds. The required information is often not publicly available or will be available only at a later point in time (e.g. information in annual reports of the funds).

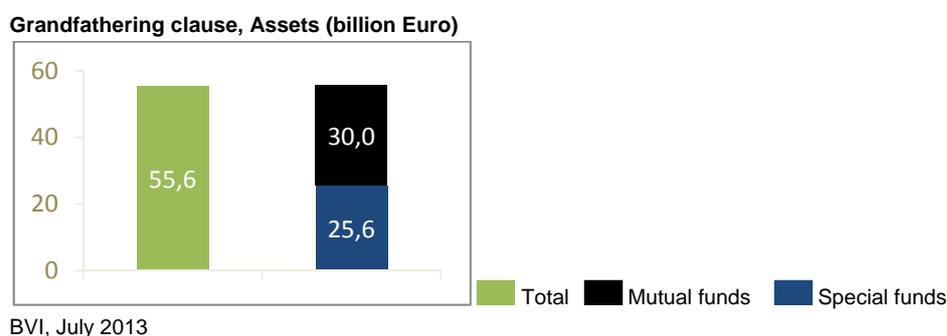
In most cases of mutual target funds, a realtime or prompt detailed disclosure of individual positions of the underlying assets of the funds is not available because the mandatory principle of equal treatment of the fund's investors has to be taken into account. According to the requirements of the UCITS and AIFM Directives, investment management companies manage these investment undertakings in accordance with the principle of equal treatment, i.e. neither of the investment undertakings or the investors of such investment undertakings will receive preferential treatment to the disadvantage of other investment undertakings or investors. The equal treatment must be ensured at all levels of management of the investment undertaking, in particular in the portfolio management, transactions in eligible assets, accounting and controlling. Reporting the composition of the CIU to one investor only would constitute a breach of the equal treatment requirement. Therefore, in cases where a full transparency is not possible, the target fund can only partially be made transparent.

**We would therefore highly appreciate if alternative approaches for fund schemes (such as the granularity principle or other additional approaches, see below our answers to question 2) can be applied. However, in cases that EBA will maintain on a full look-through approach, a transitional period must be granted because our members are not be able to adapt to new processes at short notice for granular funds or funds without look-through.**



### III. Transitional Arrangements

We request EBA to specify a clear transitional provision in accordance with the grandfathering clause in the CEBS Guidelines. CEBS proposes that until 31 December 2015, institutions may treat schemes acquired before 31 January 2010 according to the treatment of schemes that was required prior to the implementation of the Guidelines. The German supervisor BaFin has implemented this grandfathering clause. As a result, many institutions make use of the grandfathering clause. According to a survey among our members, 329 investment funds (45 mutual funds and 284 "special funds" which are only eligible for institutional investors) with assets under management totaling 55.6 billion Euros fall within the current exception.



If the present grandfathering regulation were to be overwritten by the upcoming RTS of the European Commission, the implementation of the new treatment of schemes with underlying assets will lead to high cost for the investment management companies as they will need to change the current procedures. Our members would not be able to adapt to new processes at short notice. This process would result in high efforts for the data centers which are handling large exposures data.

Lastly, there is no contradiction to the requirements of the CRR. According to Article 521 (2) c) of the CRR, the CRR shall apply from 1 January 2014, with the exception of the provisions of the CRR that require the ESAs to submit to the Commission draft technical standards. EBA shall submit the draft RTS to the Commission by 1 January 2014 (cf. Article 390(8) of the CRR). Therefore, these RTS do not apply from 1 January 2014, because of the additional period within which the Commission adopts the RTS and the European Parliament or the Council may object to RTS.

Moreover, according to Recital 88 of the CRR, the Commission should review the relevant exemptions for large exposures by 31 December 2015. Pending the outcome of that review, Member States should continue to be allowed to decide on the exemption of certain large exposures from those rules for a sufficiently long transitional period. The same should also apply to the cases under the grandfathering clause in the CEBS Guidelines.

### IV. Convergence of RTS and proposals of the Basel Committee

We would like to point out that the Basel Committee on Banking Supervision has also presented a proposal on supervisory framework for measuring and controlling large exposures. According to the consultation document of the Basel Committee, a special treatment for fund schemes is proposed. This approach differs from EBA's proposals. Therefore, EBA should aim for a high level of coherence between Basel and EU rules.



## Specific comments

With regard to the questions for consultation raised by EBA, we would like to remark the following:

**Q1: *Is the treatment provided in Article 5 sufficiently clear and do the examples provided appropriately reflect this treatment?***

We strongly disagree with the proposed approach how institutions shall calculate the relevant exposure value of a transaction in CIUs. As pointed out above, the full look-through approach would have serious consequences for the German fund industry. Therefore, we urge EBA to maintain the granularity principle or other alternative approaches (see our answer to question 2) for transactions in CIUs.

In this context, we strongly disagree with EBA's concerns that defaults of the fund's underlying assets may happen simultaneously, or in a very short period of time, leading to the effect that full transparency is necessary. CIUs are subject to strict regulatory requirements. They are either regulated under the UCITS Directive 2009/65/EU or fall under the scope of the Directive on Alternative Investment Fund Managers 2011/61/EU. In all cases, a strict liquidity management process and very high requirements on risk management are in place. Moreover, requirements already exist to monitor the liquidity management of underlying collective investment undertakings in which CIUs invest. Strict investment limits are provided for investments in target funds, in particular, mutual funds may only invest up to 20 per cent of the value of the fund in units of a single target fund (cf. Article 55 of the UCITS Directive).

Furthermore, the proposed regulation is not necessary. According to Article 390 (7) of the CRR an institution shall assess its underlying exposures taking into account the economic substance of the structure of the transaction and the risks inherent in the structure of the transaction itself, in order to determine whether it constitutes an additional exposure. In order to tackle this issue, the current granularity approach focuses on economic substance and structural risks and has established itself as a well functioning compromise between risk calculation and risk handling. The experience of the previous years, particularly after the renewal of the large exposure regime under the CEBS Guidelines, also increased the awareness of banks as investors.

Finally, the opportunity to invest in CIUs is restricted by the capital requirements of the CRR. Full transparency in order to fulfill the large exposure regime would result in further restrictions which may not be appropriate.

**Q2: *Is there an appropriate alternative way of calculating the exposure values in the case of securitisations, which would be compatible with the large exposures risk mitigation framework as set out by the draft CRR?***

In addition to the full look-through approach, we propose the following alternative approaches:

### a) **Partial look-through of the CIU**

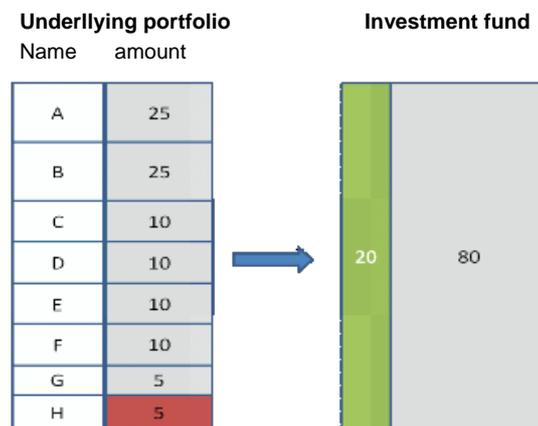
As we understand the consultation paper, EBA proposes a look-through approach with full transparency of the underlying assets of the CIUs without exception or alternative approaches. In particular, EBA proposes that the fund transaction of the institution as a whole should be regarded



as a single risk and should be considered as “unknown client” if the underlying assets cannot be made transparent.

In our view, a certain maximum level of partial non-transparency of the CIU should be allowed, since in some cases full transparency is not always possible (in particular in cases for “funds of funds”). In such cases a partial look-through at the underlying assets of the CIU should be allowed. In this case the investment management company makes the composition of the funds asset available to the institutions. Only the part of the underlying assets of the fund which cannot be made transparent is to be regarded as a single risk. Hence, not the fund transaction as a whole is to be regarded as a single risk, but only the non-transparent assets of the CIU should be considered as “unknown client”.

The following example illustrates how institutions should calculate the relevant exposure value:



The example is based on a transaction with a total volume of 100. The transaction consists of 8 underlying exposures. There is no look-through possible to the underlying asset “H”. The pro-rata ratio for the institution’s exposure to the transaction is 1/5 (20/100). The institution assigns an exposure:

- 5 to underlying A and B ( $1/5 \cdot 25$ ),
- 2 to underlying C to F ( $1/5 \cdot 10$ ),
- 1 to underlying G ( $1/5 \cdot 5$ ) and
- 1 to underlying H ( $1/5 \cdot 5$ ) which is considered as pro-rata ratio “unknown client”.

## b) Granularity principle

As pointed out above, in cases of transactions in CIUs, there are not sufficient reasons to depart from the granularity principle established by CEBS. Therefore, we propose to maintain the granularity approach in such cases. This means that a scheme may be considered sufficiently granular if its largest exposure is smaller than 5 % of the total scheme.

However, we acknowledge that the Basel Committee’s proposal provides for a granularity threshold of 1 % of the total value of the transaction. In our view, a reduction of the granularity threshold from 5 to 1 per cent, as proposed in the Consultative Document of the Basel Committee, is not appropriate in case of CIUs.



The 1 per cent limit will already be met by the cash positions held by the funds. Derivative instruments would increase the proportion of the granular holding even further. An evaluation based on the gross asset value per unit amplifies this effect. Even without taking into account cash positions and derivatives, a 1 per cent limit is too much subject to market fluctuations. As a result, the administrative effort on the investor reporting level for our members resulting from the reduction of the 5 per cent limit would exponentially increase the mandatory transparency since a multiple has to be created as a counterparty. At the same time, because of the relatively small batch sizes of CIUs in the total securities holding of the bank, the limits per CIU counterparty in relation to the liable equity are negligible. This means the fund has to be made transparent under disproportionate effort, as the following example shows:

A midsize bank with liable equity of 100 Mio € buys several units of a mutual fund into an own securities account for the amount of 10 Mio €. Today, the retail fund is deemed granular which means that there are at least 20 different counterparties in the holding. Thus, each counterparty can be accounted for 0.5 Mio €. Looking at this size in relation to the liable equity of the bank, one can calculate 0.5 per cent of the liable equity. This is much less (by 50 per cent) than the 1 per cent envisaged in the Consultative Document. In this light, the current limit of 5 % is fully sufficient.

By evaluating the principle of granularity, one also has to recognize that mutual fund investments by banks are often held directly, and these investments do not constitute a concentration of risks in the first place. Still, in exceptional cases the investment management companies provide a large exposure report with “look-through” information so that the investor can choose if he wants to use the basic approach or the look-through approach for the reporting.

### **c) Materiality threshold**

In cases of funds of funds or funds which invest in assets representing securitisation positions, the full look-through approach needs to be accompanied by the introduction of an adequate materiality threshold.

The German supervisory authority BaFin also requires a look-through to the underlying assets as a basic principle. This is because such a look-through enables a full picture to be obtained of the risk concentration: if applicable, an institution should add positions held indirectly through the scheme to positions with the same counterparty that already exist as a result of other credit relationships. However, the BaFin has implemented a materiality threshold of 1.25 percent of the liable equity capital of the institution for each target funds in which a CIU is invested. The following practical example presented by our members illustrates the situation:

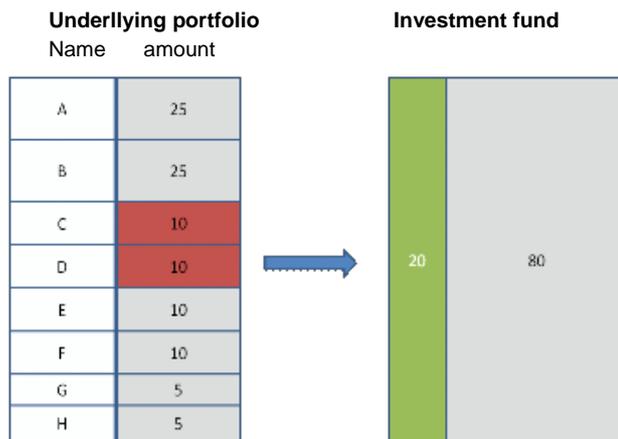
A midsize bank with liable equity of 100 Mio € buys several units of a CIU into an own securities account for the amount of 10 Mio €. The CIU invest in two target funds, each of which with 10 percent of the value of the CIU (1 Mio € per target fund), and other securities such as shares or bonds, which are underlying assets as totaling 58 borrower units (corresponding to an average composition of funds with securities strategies). By reason of the comparable diversification of the target funds' underlying assets, in case of each target fund the figure is about 17,200 € (1 Mio € / 58 borrower units) or 0.0172 percent of the relevant liable equity capital of the institution (17,200 € / 100 Mio €). The average figure for the CIU per underlying assets which are not target funds is about 138,000 € (8 Mio € / 58

borrower units) or 0.138 percent of the relevant liable equity capital of the institution (138,000 € / 100 Mio €).

The example demonstrates that the average exposure of each borrower unit of a CIU is about 172,400 € or 0.1724 percent of the relevant liable equity capital of the institution. However, the benefit to gain insight into such large exposure positions by no means justifies the effort needed to do the full look-through into the underlying assets of the target funds.

Therefore, we propose the introduction of a materiality threshold of 1.25 percent of the liable equity capital of the institution for each target funds in which a CIU is invested. In such cases, the following example illustrates how institutions should calculate the relevant exposure value:

The example is based on a transaction with a total volume of 100. The transaction consists of 8 underlying exposures. The underlying assets "C" and "D" are target funds or assets representing securitisation positions. The pro-rata ratio for the institution's exposure to the transaction is 1/5 (20/100). The institution assigns an exposure:



- 5 to underlying A and B ( $1/5 \cdot 25$ ),
- 2 to underlying C and D ( $1/5 \cdot 10$ ), which is considered as pro-rata ratio "unknown client"
- 2 to underlying E and F ( $1/5 \cdot 10$ ),
- 1 to underlying G and H ( $1/5 \cdot 5$ ).

There is no look-through necessary to the underlying assets "C" and "D" if the unit of the target fund or the unit of assets representing securitisation positions held by the CIU accounts no more than 1.25 percent of the relevant liable equity capital of the institution.

Only in cases where the unit of the target fund or the unit of assets representing securitisation positions held by the CIU accounts more than 1.25 percent of the relevant liable equity capital of the institution a full look-through into the underlying assets of the target fund is necessary. Otherwise, the fund transaction of the institution as a whole should be regarded as a single risk and should be considered as "unknown client".



**Q3: Would the application of requirements provided by Article 6 (3) and (4) imply unjustified costs to the institutions? Would the introduction of a materiality threshold be justified on a basis of a cost-benefit analysis? Please provide any evidence to support your response.**

**Q4: Keeping in mind that such materiality threshold would need to be sufficiently low in order to justify that all unknown underlying assets of a single transaction would be assigned to this transaction as a separate client, what would be the right calibration? Would the reference value (the institution's eligible capital) be appropriate for this purpose? Please provide any evidence to support your response.**

As described above, the benefit to calculate large exposure positions by no means justifies the effort needed to do the full look-through into the underlying assets of the target funds. In particular, investment management companies have to provide the relevant data of the underlying assets of the funds to the institutions with considerable effort even though some data are not relevant for the large exposure regime. The consequences of a full look-through process are numerous:

- expenditure on staff,
- Investment management companies need huge IT capacities to make the full current composition of the funds available to the institutions.
- In cases of funds of funds, investment management companies have to require information on the composition of the underlying assets of the target funds from other investment management companies which manage the target funds. As stated above, our survey indicates that the managers of bank held CIU's require information from about 530 external investment management companies of target funds. The required information is often not publicly available or rather will be available only at a later point in time (e.g. information in annual reports of the funds). Therefore, in some cases investment management companies of the target funds made data available against a fee.
- High efforts for the data centers which are handling large exposures data.

**Q5: Would the requirement to monitor the composition of a transaction at least monthly, as provided by Article 6 (5), imply unjustified costs to the institutions? Please provide any evidence to support your response.**

We disagree with EBA's proposal that an institution shall monitor the composition of the transaction on a monthly basis. That implies in case of CIUs investment management companies have to inform the institutions about the portfolio composition of the funds on a monthly basis. Otherwise, institution could not implement a monitoring process which considered underlying assets of the CIUs.

However, according to EBA's final draft technical standards on supervisory reporting requirements (EBA-ITS-2013-02, 26 July 2013), institutions shall report information on large exposures to clients with a quarterly frequency. In our view, the implemented reporting process also indicates a monitoring process. Therefore, it should be appropriate if the requirement to monitor the composition of a transaction should be at least quarterly in order to establish convergence with the reporting requirements. This should apply even more in light of Art. 394 of the CRR, according to which reporting shall be carried out at least twice a year.



Lastly, according to Article 309 (8) of the CRR, EBA shall only develop regulatory technical standards to specify the conditions and methodologies used to determine the overall exposure and the conditions under which the structure of the transaction does not constitute an additional exposure. There is no regulatory competence to establish requirements of any monitoring process.

***Q6: Are there other conditions that could be met by the structure of a transaction in order to not constitute an additional exposure according to Article 7?***

Examples given in Article 7(2) of the Draft RTS only include UCITS and undertakings established in a third country with equivalent requirements. Undertakings established in the EU with equivalent requirements would not be covered. Therefore, we propose extending the examples given in Article 7(2) of the Draft RTS to investments in AIFs as defined in Article 4(1)(a) of the AIFM Directive 2011/61/EU where the fund rules do not allow a leverage higher than the limit set in Article 51(3) of the UCITS Directive 2009/65/EC. According to Article 128 (1)(b) of the CRR, these kinds of AIFs are investments that are expressly not associated with particularly high risks.

In Germany, most of special and mutual funds held by institutions are AIF covered by the AIFMD although they submit to the global exposure restrictions of the UCITS Directive. Therefore, transactions in AIFs as defined in Article 4(1)(a) of the AIFM Directive where the mandate of the fund does not allow a leverage higher than allowed by the UCITS Directive 2009/65/EC should also be considered as transactions which do not constitute an additional exposure.