



## European Banking Industry Committee

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European Banking Federation (EBF) • European Savings Banks Group (ESBG) • European Association of Cooperative Banks (EACB)  
European Mortgage Federation (EMF) • European Federation of Building Societies (EFBS)  
European Federation of Finance House Associations (Eurofinas)/European Federation of Leasing Company Associations (Leaseurope)  
European Association of Public Banks (EAPB)

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### **Technical changes to the CRD: collective investment undertakings in the IRB approach**

Dear Mr Pearson,

We would like to thank you for your letter dated 21 January 2008 agreeing to put the European banking industry's proposal for revising the treatment of collective investment undertakings (CIUs) in the IRB approach onto the agenda of the CRD WG meeting on 22 February 2008. We are happy to outline our "alternative approach" in more detail, as requested. Essentially, we propose that the CIU perform the look-through for the financial institution on the basis of IRB approach parameters. We should like to begin by briefly explaining why we see a need to revise the present rules. We will then outline our alternative approach in more detail and conclude by addressing the concerns about this approach which have been expressed by some regulators.

#### **Need to revise the current rules**

In the view of the European banking industry, the current procedural requirements in Art. 87(11) CRD are so onerous for both CIUs and banks as to make the approach unfeasible. The complete integration of a fund's underlying exposures into the internal rating and risk management systems of the investing banks, as now envisaged by the CRD, would be impracticable in virtually all cases. A continuous automated exchange of data between the CIU and bank would be needed. The purchase or sale of every single position for the fund would first have to be checked against the availability of data at the bank. This procedure would necessitate disproportionately high expenditure by the banks, particularly on IT, without any corresponding improvement in evaluating risk compared to calculations by a third party. Nor do the alternative procedures described in Art. 87(11), second subparagraph, and Art. 87(12) CRD lend themselves to practical use since

they grossly exaggerate credit risks and could consequently not be included in the banks' internal risk management system in an appropriate manner.

In summary, all the procedures currently envisaged by the CRD make it uneconomical for banks using the IRB approach to invest in funds. The major adverse effects on the financial industry that we anticipate are set out in detail in Annex I, point 2 of CRDTG paper 009/08. Based on our information, investments in the European Community worth hundreds of billions of euros, if not more, will be affected.

## **Alternative approach proposed by the European banking industry**

The calculation by a third party (in this case the CIU) would proceed as follows:

1. The CIU checks which assets and issuers in the fund have an external rating assigned by one or more rating agencies which are recognised as ECAIs and have been designated by the CIU for use for all their funds. A list is drawn up of the rated assets and their ratings.
2. The CIU assigns probabilities of default (PDs) to the external ratings of these assets. The PDs are assigned using a single mapping scheme for all investors based on default data published by the rating agency. The minimum PD for an item in the central government exposure class in the IRB approach is 0%.

As under the standardised approach, external ratings may only be used if the CIU has designated a credit rating agency. Such designations should generally be made if it is possible to do so. For time and cost reasons, however, CIUs cannot consider every rating or combination of ratings used by one of their investors.

3. For every asset for which it has determined a PD using the procedure described in steps 1. and 2., the CIU calculates the IRB approach risk-weighted exposure amount and the expected loss (EL) using the risk weights specified in the CRD. The calculation of the risk-weighted assets according to the IRB approach also has to take account of further parameters, particularly loss given default (LGD) and exposure at default (EAD). The algorithms specified in the CRD are applied for this purpose irrespective of whether or not the investing bank uses the foundation or advanced IRB approach.
4. If an asset has no external rating and thus no PD derived from an external rating, the procedure depends on whether or not it is in the equity exposure class.

- For equity exposures which have no external rating and thus no PD derived from an external rating, the simple risk weight method described in Annex VII, Part 1, points 19 to 21 is applied.
- For assets which do not belong to the IRB approach equity exposure class and which have no external rating and thus no PD derived from an external rating, the procedure is as follows:

The real estate portfolio in a real estate fund is assigned a risk weight of 100%. All other assets are divided into their standardised approach exposure classes and assigned the corresponding standardised approach risk weight. Exposures which would normally be assigned a risk weight of 150% are given a 200% weighting.

5. The CIU assigns the credit risk exposures underlying the invested assets to the relevant standardised and IRB approach exposure classes and calculates an average risk-weighted exposure amount and an average expected loss rate for each exposure class. These amounts are notified to the banks.

No special treatment is applied to assets which an individual investor is permitted under the partial use rules to value temporarily or permanently using the standardised approach. The CIU draws up a single reporting system for all investors and tries to calculate PDs for as much of the fund portfolio as possible.

6. If, after netting foreign currency assets and liabilities, more than 10% of the fund is denominated in foreign currency, the CIU breaks down the assets in the fund by currency and calculates the proportion of each foreign currency in the fund. It determines open foreign exchange positions, i.e. assets and liabilities in each currency are offset against one another (reflects the standardised approach).
7. The CIU sends the banks the average risk-weighted exposure amounts and expected loss rates at least once every three months at the end of the quarter. Details of any foreign currency positions in the fund will also be provided. The earliest date which may be used for calculating the figures is the 15<sup>th</sup> of the final month in a calendar quarter if this is a bank working day, or the next bank working day if it is not.
8. An certified public accountant must confirm the accuracy of the CIU's calculations three months at the latest after the end of the financial year.
9. The banks must observe the following minimum qualitative requirements when managing the credit risk associated with the CIU:
  - The bank must include the risk in its internal risk management system in a way which adequately ensures that risks will be identified, evaluated, managed, monitored and communicated.

- Internal risk management must ensure that the main credit risks arising from investment funds can be recognised at an early stage, completely captured and duly recorded (identification).
- Every bank must establish effective methods of assessing the credit risks associated with investment funds on a first-time, routine or ad-hoc basis (evaluation).
- The bank must put suitable measures in place to ensure that credit risks arising from investment funds can be limited (management and monitoring).
- Management must be informed about the risks associated with investment funds at suitable intervals (communication).

10. Should there be any indication that these rules are being abused, the competent authority can withdraw permission for the bank in question to use the alternative approach.

Conclusion: The method outlined above would avoid the need for excessive procedural requirements for CIUs and investing banks which make investment in funds uneconomical. On top of this, it is a method which could be applied to all kinds of investment fund and all types of relationship between CIUs and investing banks. It could also be used if the CIU and investing bank were not part of the same group and did not share an IT system.

### **Concerns which have been expressed by some regulators are groundless**

The proposed alternative approach ensures investments in funds and direct investments largely receive equal treatment as far as capital requirements are concerned. Competitive distortions are thus avoided. The capital requirements themselves remain more or less unchanged compared to an approach where it is the bank which performs the look-through procedure. Even in the unlikely event of a bank exploiting the rules for the purposes of capital arbitrage, the European banking industry takes the view that this would constitute an abuse of the alternative approach within the meaning of point 10. The European banking industry's sole objective is to make procedural requirements less onerous, not to gain capital relief. From a practical perspective, the CIU is the only party in a position to carry out the look-through procedure.

The minimum qualitative requirements described in point 9 will ensure that banks are able to identify, evaluate, manage, monitor and communicate the credit risk associated with an investment fund in its capacity as a financial instrument in its own right – or, in other words, perform appropriate internal risk management. In our view, these minimum requirements may be considered equivalent to those for the IRB approach under Annex VII, Part 4 CRD and will thus prevent the feared “minimum requirements arbitrage”. They permit appropriate risk management on the basis of information provided by the CIU and application of the relevant investment principles (including side-letters, if applicable) even if the bank does not perform

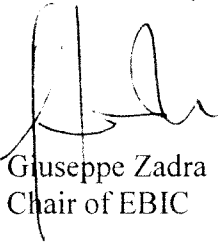
the look-through procedure itself. The criteria for robust governance arrangements set out in Art. 22 CRD are therefore also satisfied. Inclusion in the ICAAP would also be possible.

Our approach treats a fund as a financial instrument in its own right and with its own risk characteristics. It is integrated in this capacity into the banks' internal risk management processes. This is in line with the second subparagraph of Art. 87(12) CRD, under which CIU exposures may be included in the bank's internal risk management even if it does not itself apply the look-through approach and instead receives only aggregated risk data from a third party.

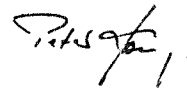
In contrast to the procedures described in Art. 87(11), subparagraph 2 and Art. 87(12), subparagraphs 1 and 2 CRD, our alternative approach allows the risks associated with a fund to be determined realistically using the IRB approach PD and LGD parameters. Moreover, unlike the look-through procedure currently envisaged in Art. 87(11), subparagraph 1 CRD, our method is feasible to use in practice.

We look forward to discussing this "alternative approach" with you at the meeting of the CRDWG on 22 February 2008.

Yours sincerely,



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Chair of EBIC



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Chair of the EBIC WG  
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