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Client Alert

Bank Advisory

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New Capital Standard for Fund Investments May Be More Onerous Than Volcker Rule

The Basel Committee on Banking Supervision on December 13, 2013 approved an amendment to Basel II risk-weights for fund investments. The new standard increases risk-weights for fund investments. The new Basel standard, if adopted by national banking supervisors, will apply to an internationally active bank. In the United States, it would extend to a bank holding company that controls a US bank, including one controlled by a foreign bank, and to the bank holding company's subsidiaries and affiliates. Basel I, II and III require banking organizations to meet prescribed risk-weighted minimum capital requirements determined by dividing the banking organization's capital by its risk-weighted assets. The higher the asset risk-weight, the more capital a banking organization must maintain to meet capital adequacy requirements. The new standard may prove to be another deterrent for banking entities seeking to acquire or maintain fund investments in addition to the final rules issued on December 10, 2013 by the US financial agencies to implement the Volcker Rule limits on permissible investments in private equity and hedge funds.

Starting January 1, 2017, this new capital standard will require banking organizations in home countries adopting the Basel standard to have at least one dollar of regulatory capital for each dollar invested in a fund, unless a risk-weighting of the fund's actual investments or those permissible under the fund's mandate is possible and produces a lower risk-weighting. Risk-weighting of a fund's assets, however, must include a charge for the fund's leverage that will result in the same dollar-for-dollar capital requirement for investments in funds treated as "highly leveraged." Not surprisingly, commenters on the proposed version of the new standard called it "punitive."

Banking entities are putting considerable time and effort into working toward bringing their fund investments into conformance with the Volcker Rule and the requirements of the newly issued final implementing rules. They may do well concurrently to consider how the capital hurdle of this new Basel Committee standard may affect a decision to maintain fund investments.

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The new Basel standard for fund investments came into being with virtually none of the industry and public attention given the Volcker Rule. It was proposed by the Basel Committee in July 2013 and, after consideration of the six lone comments received, was issued in its final form on December 13, 2013. By contrast, the Volcker Rule proposed rules elicited more than 18,000 comments, including at least 600 letters that the US financial agencies found to present unique comments for their consideration.

Covered Funds

The Volcker Rule limitation on fund investments applies only to private equity and hedge funds as defined in the Volcker Rule and related final rulemaking. The new capital standard applies to *all* types of funds. The Basel Committee does not define "fund." The standard was proposed as part of the work of the Basel Committee and the Financial Stability Board to address shadow banking. The Basel Committee, however, purposely decided to apply the standard more broadly to all funds with the goal of attaining a consistently applied capital requirement for all fund investments. The standard does not distinguish between private funds and regulated funds, such as mutual funds or open-end investment companies. The final rules to implement the Volcker Rule, by contrast, exempt regulated funds from application of the Volcker Rule fund investment prohibition.

This new standard does permit national supervisors to exempt a limited universe of regulated funds. The Basel Committee exempted from its new requirement funds whose holdings consist solely of zero risk-weighted government or other debt obligations and any investments in funds that offer significant subsidies to attract bank investment as part of a government program that oversees and sets limits on the level of permissible bank investment in these funds (such as a government-sponsored fund to invest in low-income housing mortgages). It is presumed that securitizations will not be subject to the new funds standard as the Basel Committee has treated them separately.

No De Minimis Exclusion

The new fund investment standard does not provide any de minimis investment exemption. The Volcker Rule does, permitting a 3 percent investment in funds organized and offered by a banking entity notwithstanding the fund investment prohibition. The new standard, by contrast, applies to any investment in a fund held by a banking entity regardless of the banking entity's percentage interest in the fund or the amount of bank capital that the investment represents. The Basel Committee did not adopt commenter suggestions that the standard apply only above a materiality threshold, such as 5 percent of Tier 1 capital, or that its capital requirements not apply to funds with aggregate asset levels qualifying as "small" funds under applicable fund laws and regulations. The new standard, therefore, will apply to the risk-weighting of permissible de minimis investments under the Volcker Rule.

Banking Book versus Trading Book

For now, the standard applies only to those fund investments held in the banking book. The Basel Committee has indicated the intent to adopt a similar standard for fund investments held in the trading book as part of its ongoing fundamental review of the trading book with the goal of avoiding disparate treatment of assets. Presumably the capital required for trading book fund investments would be determined on a net basis with any short positions netted from long positions held, as one commenter has suggested.

Fall-Back Approach

The requirement of one dollar of required capital for each dollar of fund investment is the maximum required risk-weight, termed the "fall-back" approach. This maximum or fall-back requires a 1250 percent risk-weighting of fund investments. A 1250 percent risk-weight is tantamount to a 100 percent capital requirement as it is the equivalent of the Basel III minimum total risk-weighted capital requirement of 8 percent. This level of capital charge is reserved for the riskiest investments and puts investments in any fund in the same risk category as first-loss positions in securitizations. The cost of the capital required to support a fund investment is made more expensive by the standalone minimum common equity capital requirement created by Basel III. All other things being equal, at least 55 percent of the amount invested in a fund subject to the fall-back standard will have to be supported by an equivalent amount of common equity capital to allow a banking entity to meet the 4.5 percent minimum common equity requirement. The level of required common equity coverage increases if the relevant national supervisors implement the new Basel III conservation, countercyclical and systemic buffers that also are to be made up solely of common equity capital.

Alternatives to Fall-Back Approach

The fall-back approach may be avoided if a banking entity is able to risk weight its investment based on a "look-through" to the fund's underlying investments or, failing that, based on the fund's mandate of permissible investments. These risk-weighting methods could allow a banking entity to avoid the full brunt of the 1250 percent fall-back risk-weight, but complying with either of these alternatives is not simple and may not yield the anticipated capital savings if a fund is "highly leveraged" based on the fund's total assets-to-total equity. These methods are akin to the risk-weighting currently used by banking entities permitted to use internal modeling under the Basel II advanced approaches. The new standard, however, adds significant information and systems hurdles to be met for a banking entity to be able to use the methods. It also requires that risk-weights be adjusted upward to take into account the fund's leverage, which could work to bring risk-weights calculated under either of these two methods to the 1250 percent maximum risk-weighting, negating any benefit from applying either method.

Look-Through Approach

The look-through approach requires a banking entity to determine the risk-weight of its fund investment as if the banking entity held the fund's assets directly. The banking entity's pro rata share of each of the fund's underlying investments, including any off-balance sheet derivatives or other exposures, would be risk weighted using the same risk-weights that would apply if those assets were held directly by the banking entity. For example, the banking entity's pro rata share of any cash or government bonds held by the fund would be assigned a zero risk-weight, but any forwards would receive a 100 percent risk-weight applicable to the underlying equity position. Look-through risk weighting may be used only where the banking entity has access to "sufficient and frequent information" about the fund's underlying investments and that information is verified by a third party independent from the fund, such as the fund's investment manager or custodian bank. Information is deemed to meet this requirement only if a fund's financial reporting is at least as frequent as the banking entity's own financial reporting and provides sufficient granularity to calculate risk-weights of the fund's assets. It may be that a banking entity will be able to meet these tests where the banking entity is the sponsor of the fund in which it holds an investment. It is less clear if that will be the case for investments in non-sponsored funds.

A 20 percent surcharge is added to any risk-weights under the look-through approach that are determined using third party calculations. The applicable risk-weight, therefore, would be 1.2 times the risk-weight otherwise applicable to the fund's underlying assets. The Basel Committee points out that third party assistance may be needed where the banking entity does not have sufficient information to calculate the risk-weights of underlying fund assets on its own, but does not address concerns that the surcharge may work to discourage banking entities from seeking such help.

Mandate-Based Approach

Where the information necessary to apply the look-through approach is not available, a banking entity would be required to seek to apply the mandate-based approach. This approach requires risk weighting a fund investment based on the fund's permissible investments as set out in its mandate or the regulations governing the fund. The banking entity would assume that the fund's assets are invested to the maximum extent permitted by the fund's charter or regulations in those assets carrying the highest risk-weight. The approach requires the risk-weighting of maximum permissible on-balance sheet investments and off-balance sheet derivative exposures, and as to the latter would be based on replacement cost plus a charge for counterparty credit risk calculated at 115 percent of replacement cost. The Basel Committee uses the example of an equity-index fund whose mandate is to replicate an equity index and that is permitted to offset its balance sheet investment with equity futures. The resulting risk-weight for the fund would be 202.3 percent. That includes a 100 percent risk-weight for the assumed investment of all fund assets in equities replicating the index, plus a 100 percent risk-weight of an assumed perfect hedge of those equity positions with equity futures, plus a counterparty credit risk charge equal to 2.3 percent, i.e., 115 percent of the 2 percent counterparty credit risk charge applicable to futures cleared by a qualifying central counterparty.

Fund-of-Funds Treatment

The two approaches provide for investments in a fund-of-funds that itself invests in other funds. The look-through approach requires the banking entity to apply the fall-back 1250 percent risk-weight to its pro rata share of any funds held by the fund-of-funds. The mandate-based approach requires that any fund held directly by the fund-of-funds be risk weighted based on the respective mandates of that fund. Any tertiary funds (i.e., fund held by a fund in which the fund-of-funds has made an investment), however, would be risk weighted at the 1250 percent fall-back level.

Required Leverage Adjustment

The risk-weight calculated under either the look-through or mandate-based approach must be adjusted to reflect the fund's underlying leverage. The Basel Committee calls underlying leverage "one of the main drivers of risk related to equity investments." The leverage adjustment adopted in the new standard reflects that point of view.

The fund's total assets-to-total equity is the chosen measure of a fund's leverage. To come up with the appropriate leverage charge, a banking entity is required to multiply the fund's leverage ratio times the fund's average risk-weighted assets. A fund's average risk-weighted assets are the risk-weighted assets determined under the look-through or mandate-based approach divided by the fund's total assets. The leverage adjustment can have the effect of increasing significantly the required risk-weight of a fund investment. If the fund's average risk-weight is 50 percent and the fund's total assets-to-total equity ratio is 5, the banking entity would be required to apply a 250 percent risk-weight to the fund investment. If, however, the fund's leverage ratio is 15 instead of 5, the applicable risk-weight would be 750 percent. The adjustment is capped at the lesser of the actual calculated leverage adjustment or the 1250 fall-back risk-weighting. Any fund investment that has a 100 percent average risk-weight would be subject to the 1250 maximum risk-weighting if the fund's leverage ratio equals or exceeds 12.5, as would be the case if the fund's equity is less than 8 percent of total assets.

Given the amount of capital that the new standard requires to support fund investments, banking entities may do well to factor that cost into their consideration of how best to bring their fund activities into conformance with the Volcker Rule. It remains to be seen how the Federal Reserve Board and the other US banking supervisors will implement this new risk-weight standard. Will smaller banking organizations be exempted? Any banking organization investing in an equity mutual fund would do better to invest directly rather than through a fund. Finally, it would be interesting to learn the Basel Committee's real rationale for this rule. It goes well beyond concerns with the shadow banking system, unless mutual funds are now regarded as being in the shadow. The Basel Committee should undertake a cost benefit analysis of its rules and set out the impact of the rule on financial markets.

We would like to add a cheerful thought for the new year. The Basel Committee should take a step back and rest for a few months and focus on ascertaining the impact of its actions over the past year.

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