

BAI comments on the CRR revision following the Basel-IV implementation regarding „Subordinated debt, equity and other capital instruments“

Introduction:

Bundesverband Alternative Investments e.V. (BAI) is the cross-asset and cross-product lobby association for the alternative investment industry in Germany. BAI perceives itself as a catalyzer between professional German investors from all sectors and suppliers of Alternative Investment products (private equity, infrastructure, private debt, liquid alternatives, etc.), and lobbies that German institutional and professional investors are able to diversify their investment with regard to Alternatives better and more easily. BAI is promoting a broad diversification which includes Alternative Investments as indispensable, in particular in terms of safeguarding long-term retirement pensions and the provision of money for example for the construction, maintenance, and development of public infrastructure and renewable energies.

BAI-members are recruited from all areas of the Alternative Investments' industry, e.g. asset managers, investment companies, banks as well as service providers. At present, BAI counts about 250 national and international member companies and is growing continuously.

In the course of the ongoing CRR review we have been in a constructive dialogue with both the EBA and as well the EU Commission and now would like to summarize and specify our arguments for an **appropriate and differentiated risk weighting of investments into specific types of alternative investments under CRR** as we are concerned about initial considerations presented on this topic which would be very onerous for relevant banks trying to maintain a diversified portfolio including alternative investments.

Executive Summary:

The Basel financial market regulation launched in response to the financial crisis and has since been improved. The Capital Requirements Regulation II (CRR II) is in force since 28 June 2021. The main change was a significant tightening of look-through requirements. If no look-through is possible, a Fall-Back Approach (FBA) with a risk weight of 1250% has to be applied. If CRR reports are supplied externally and are classified as third-party calculations, an external audit must be carried out and a risk surcharge of 20% is applied if third-party calculations are not disclosed. However, to follow Basel III, additional adjustments regarding risk weights have to be implemented. A general increase of equity exposures of 67%, from a 150%-risk weight to a 250%-risk weight, is proposed. For “speculative unlisted” assets even an increase from 150% to 400% risk weight is planned.¹

In our perception these possible risk weightings would place a massive burden on the banking sector.

¹ BAI and SOF 2020, Association for Financial Markets in Europe 2021.

In this paper, we would like to show that the planned uniform weighting of various investments that fall under private equity does not reflect their actual risk.

- **We argue for a stronger differentiation according to actual risk**, in line with previous adjustments in the Solvency legislation.
- **Also, terminology should be sharpened and “speculative unlisted equity exposures” restricted to clearly definable high-risk investments.**

Furthermore, we want to point out the value non-liquid assets in the banking sector have, especially regarding risk diversification. From our perspective, large-scale shifts could rather harm the stability of the banking sector.

- Therefore, we would like to put up for discussion that the **introduction of stricter capital requirements is linked to a granularity measure**. If there is sufficient diversification, there would be no need for regulation that goes beyond CRR II.

We advocate for a pragmatic approach - the effects of CRR II first to be analysed in detail before the further tightening of capital requirements. These should only be undertaken if a balanced cost-benefit calculation has been carried out and a weighting is given according to the actual risks.

In the following, first we give a short overview on private equity in the planned CRR III regulation and then **would like to elaborate on the two main areas that underpin our demands: diversification and risk distribution**. Additionally, three further fields are briefly discussed with regard to the possible new regulation: we argue **the risk weighting for inside-group equity exposures significantly harms capital market integration**, that **higher risk weights for private equity is a substantial obstacle for ESG targets** and the **total effect of regulatory capital requirements on risk reduction is not completely clear**.

1. Private equity in the CRR III legislation

From our understanding, corporate private equity, as well as other private capital subclasses - project investments, structurally similar to private equity, such as real estate equity and infrastructure equity – fall under article 49 of the CRR III regulation if they do not fall under one of the two exceptions. **Equity exposures are defined “on the basis of the economic substance of the instrument. They include both direct and indirect ownership interests, whether voting or non-voting, in the assets and income of a commercial enterprise or of a financial institution that is not consolidated or deducted” (article 49)**. Therefore, a uniform risk weight of 250% is assigned to them, in the case they are not **“speculative unlisted equity exposures” with 400% RW (article 51)** or if national supervisors **“allow banks to assign a risk weight of 100% to equity holdings made pursuant to national legislated programmes that provide significant subsidies for the investment to the bank and involve government oversight and restrictions on the equity investments” (article 52)**.² Our argumentation in the following will be based on the claim that this regulation does not sufficiently distinguish between sub-categories and that delimitations and definitions are unclear.

² Basel Committee on Banking Supervision 2017, p.15-17.

2. Diversification

In addition to the adequate coverage of risks, we believe that it may also play a role to push banks out of illiquid investments to separate commercial and investment banking. Therefore, we want to argue that this is in contrast to the benefits diversification has on the banking sector and point out the necessity to consider diversification.

During the ongoing low interest period, Depot-A is facing an increasing relevance for banks, with particularly high importance of alternative investments. A CFIN/Steinbeis-Hochschule study accounts for an expected doubling of the alternatives share (real estate, infrastructure, private equity, private debt) of banks in Depot-A. However, growth is already hold back by high costs in the areas of reporting and regulation³. Therefore, we would like to point out the high importance illiquid assets do have for banks and the financial sector in the current macroeconomic environment.

CRR II acknowledged the use of private equity in a well-diversified portfolio, applying a RW of 190% under the IRB simple method (article 155)⁴. In line with AFME, we argue this aspect of diversification is not sufficiently taken into account under CRR III, leading to unjustified-high risk weights.⁵

According to Preqin data⁶, with the median net IRR of 14.4%, corporate private equity is the private capital class with the highest return, ahead of real estate with 12.2% and far ahead of infrastructure and private debt, with 9,2% and 8.8% respectively. This supports the argument that private equity is a valuable asset class in a bank's portfolio in times of low interest rates and economic crisis. Especially in times of difficult economic circumstances caused by the ongoing Covid-19 pandemic, private equity showed a high level of resilience and positive development. The long-term orientation of private equity, the comparably low correlation with standard market indices, and its nature to constantly search for new value opportunities in a changing environment, makes it more resilient regarding exogenous shocks.⁷ According to the BAI Investor Survey 2020⁸, the share of alternatives is expected to be increased from 22% to 26% in the next 3-5 years. The expected return on private equity is the highest among all alternative asset classes, with 9%⁹. Therefore, we argue any regulatory change that would unduly restrict private equity would be negative for the overall welfare and economic development.

Diller and Jäckel (2015) show that diversification is the main tool to reduce risk in private equity, similar to public equity. Empirically they show that already a portfolio with 20 funds reduces the risk of losing any capital over the holding period to only 1.4%. With 50 funds in the portfolio, the risk can be minimized to almost zero. In another example, they indicate that an investor with a portfolio of 50 funds after 5 years has only a 0.8% risk of not receiving the interim NAV or book value over the remaining lifetime of the funds. These results give evidence that diversification can lead to far smaller risks in private equity than frequently assumed.¹⁰ This can also serve as an argument that the subtype of private equity, in this case fund of funds, has substantial influence, which will be referred to later on.

³ CFIN and Steinbeis-Hochschule 2021

⁴ Boos et al. 2016, Band 2, p.567.

⁵ Association for Financial Markets in Europe 2021, p. 16.

⁶ Preqin 2021.

⁷ KPMG 2021.

⁸ BAI 2020.

⁹ In contrast to the Preqin figure above, which referred to historical figures, this is an expected development.

¹⁰ Diller and Jäckel 2015.

Also, Lossen (2006)¹¹ examines empirically the role of diversification in Private Equity and distinguishes between methods of diversification. He makes out a decline of the rate of return of Private Equity Funds with diversification among financing stages but increasing returns in the case of diversification between industries. This seems to be driven by the top companies in the sample, which profit the most. However, diversification across time or cross-country is not connected to private equity returns in the sample.

In light of the cited studies, we would like to **highlight the importance of illiquid assets for banks** and would like to emphasize the **importance of diversification in their valuation**. We would suggest to **emphasize this aspect of diversification in the risk weighting in CRR III more strongly and to make the weighting possibly also dependent on the degree of granularity**.

3. Risk of private equity.

We argue the possible new risk weighting of private equity of 250%, or 400% respectively, is unjustified. Risk weightings should be proportional to the risk of a certain asset class.

3.1 Private equity vs. public equity

To compare the risk of private equity to other asset classes, it is necessary to deal theoretically with peculiarities in their risk assessment. They have typically unobservable market prices and are illiquid, contrary to public equity. Simply comparing returns with public equity, therefore, underestimates private equity's risk.¹² Also, Czasonis et al. (2020) argue mean-variance analysis of private equity leads to implausible observed volatility, because of serial collinearity. Observed values of a certain asset are linked to values in a previous period, leading to an underestimation of private equity risk. Investors alternatively propose to estimate private equity volatility as leveraged public equity volatility. Hypothetically, higher risks exist with private equity firms due to their higher leverage. However, Czasonis et al. (2020) find that expected and actual volatility differs, and in contrast to the hypothesis that leverage has a one-to-one link to volatility, they cannot find any effect in their data (December 1996 - September 2018, annualized). The observed private equity volatility is driven by serial dependence on a longer time horizon. Calculation of private equity volatility based on leverage multiplication leads to drastic overestimation compared to public equity. The authors could not find any significant relationship between leverage and volatility. As an explanation, they offer the stable character of leverage in the long run, compared to highly time-varying volatility. Also, their analysis showed that the effect of explicit leverage is distorted by implicit leverage, which several companies have. Furthermore, explicit leverage is influenced by multiple companies- and business-specific characteristics, which are connected to asset stability. Long-run private equity returns are shown to be an accurate approximation for private equity volatility to neutralize the effect of valuation smoothing, due to an approximation of the actual distribution of realized outcomes.

Empirically they find robust evidence that private equity volatility is similar to public equity volatility, independently of its higher leverage.

¹¹ Lossen 2006.

¹² Diller and Jäckel 2015.

They argue buyout fund managers could put up with higher leverage what leads to higher profits because they invest in companies with less risky underlying business activities. The actual volatility of public and private equity in their dataset 1996-2018 is pretty similar, with 17.8% and 15.4% on annual basis, respectively 17.6% and 17.0% on a triennial basis.¹³

However, private- and public equity face different risk weights. Public equity – share risk – has underlying market risk, with a different underlying risk weight calculation approach that causes difficulties regarding comparability. The capital requirement for public equity (shares) depends on the trading book used, therefore the total balance sheet, as well as the risk bucket of shares in the portfolio and the intra-bucket correlation structure. Sample calculations for small-, middle and large trading books with exemplary portfolios show possible capital requirements. The capital requirement under the small trading book is calculated with the standard credit risk approach which would mean a risk weight of 100%. For middle trading book portfolios, the current market risk standard approach is used what means an effective risk weight of 200%. The sample portfolio under the large trading book has an effective capital requirement equal to a risk weight of 280%. However, this figure is at the upper end of possible risk weights¹⁴.

Accordingly, the risk weighting for public equity is highly differentiated, depending on various risk factors, which is in enormous contrast to the planned uniform weights for private equity.

3.2 Corporate private equity and different private capital classes

As mentioned above, from our understanding, corporate private equity, as well as real estate equity and infrastructure equity – fall under article 49 of the CRR III regulation, if they do not fall under one of the two exceptions. However, according to Preqin data, corporate private equity, infrastructure equity and real estate equity have different risk profiles. Preqin uses data from 2008 to 2017¹⁵, where return is proxied with the median net IRR, and risk using the annualized standard deviation of net IRR, a measure for volatility. Corporate private equity has 14.5% volatility, infrastructure equity 11.1% and real estate equity has 10.3%.

Therefore, we would like to suggest that a differentiation be made here regarding corporate private equity and different private capital classes. Also, we would argue for a stronger differentiation and specification with regard to corporate private equity and project-related equity investments.

3.3 Sub-categories of Corporate Private Equity

Another aspect of criticism, we want to lay our focus on, is the lack of differentiation among corporate private equity. Even though private equity as an asset category consists of numerous subgroups with different characteristics, the planned regulation does not sufficiently differentiate.

Again, we use the Preqin dataset for the vintage years 2008-2017¹⁶ to compare volatilities among corporate private equity subgroups. Early-Stage corporate private equity shows the highest risk with

¹³ Czasonis et al. 2020.

¹⁴ Andrae and Hetmanczyk-Timm 2017; PwC 2017.

¹⁵ Preqin 2021.

¹⁶ Preqin 2021.

18.4% volatility, followed by Venture Capital with 17.9%. On the other hand, Fund of Funds and Secondaries have comparably very low risk, with 6.3%, respectively 6.9%. Though, the returns of the high-risk and low-risk private equity categories do not vary that much: The high Early Stage and Venture Capital categories have 17.5% and 14.4% median net IRR and the low-risk categories Fund of Funds and Secondaries have 13.0% and 16.1%. However, Prequin data seems to have comparably lower volatility due to autocorrelation and a lack of smoothing.

Weidig et al. support the claim that Fund of Funds considerably reduce the risk of private equity, compared to individual funds with their empirical results. The standard deviation of venture capital substantially decreases for the Fund of Funds investments. So, the study shows similar results compared to the Prequin study.¹⁷ This is in contrast to the “look-through” process introduced in CRR II, which requires that the risk weight of a fund is determined by the combined risks of the underlying assets. The study of Diller and Jäckel (2015)¹⁸ mentioned above, also supports the claim of substantial risk reduction in the case of private equity fund of funds.

Therefore, we want to point out the importance to distinguish risk weights between Venture Capital, Fund of Funds and Buyout.

3.4 Venture Capital and “speculative unlisted equity exposures”

Another category that we would like to highlight separately regarding the CRR III regulation is venture capital. The Basel III agreement assigns a risk weight of 400% to speculative unlisted equity exposures (article 51): **“unlisted equity exposures” - “defined as equity investments in unlisted companies that are invested for short-term resale purposes or are considered venture capital or similar investments, which are subject to price volatility and are acquired in anticipation of significant future capital gains”**. Though, there is an exception for “investments in unlisted equities of corporate clients with which the bank has or intends to establish a long-term business relationship and debt-equity swaps for corporate restructuring purposes”¹⁹, **the categorization is imprecise from our perception**. In this context Invest in Europe argue that it is not clear whether both, investments in venture capital, as well as investments in private equity, fall under the category of “speculative unlisted equity exposures”.²⁰ They refer to the EBA, where the previous risk weight of 150% under CRR II for an “item associated with particularly high risk”, was assigned to: “(a) investments in venture capital firms; (b) investments in AIFs [...]; (c) investments in private equity; (d) speculative immovable property financing.”²¹ Following this, private equity and venture capital would be assigned with risk weights of 400%, which would mean a huge obstacle for their usage. From our understanding private equity in general does not fall under article 51 due to its typical long-term orientation. However, in line with AFME and the EBA's guidelines of January 2019, we would therefore argue, that **a narrower definition for venture capital and private equity would be necessary**, to account for quantifiable categories as “the purpose of investment, business age, turnover and profitability”²². In the context of the current wording, the 400% risk weight to speculative unlisted equity seems rather arbitrary.

¹⁷ Weidig et al. 2004.

¹⁸ Diller and Jäckel 2015.

¹⁹ Basel Committee on Banking Supervision 2017, p. 17.

²⁰ Invest Europe 2019, p.1.

²¹ EBA 2019b, p.3.

²² Association for Financial Markets in Europe 2021, p.16.

Also, from our perception, **the definition of “speculative unlisted equity exposures” requires sharpening.** Invest in Europe²³ refer to EBA’s suggestion for “items associated with particularly high risk” as exhibiting risk levels which are common for “obligors or transactions of the same exposure class”²⁴. Especially, Invest in Europe argues, the definition should exclude unleveraged and closed-ended funds. Also, they argue that the “look-through” process introduced in CRR II would mean that funds of funds including “speculative unlisted equity exposures” are proportionately assigned to the 400% risk weight. This allocation for diversified and long-term-oriented investments completely counteracts the idea of risk compensation for particularly risky investments.

The EC organized a public consultation regarding Basel IV implementation, and the definition of speculative unlisted equity exposures is subject to multiple criticisms.²⁵ Regarding the definition, there is still an ongoing discussion.²⁶

4. Capital market integration

AFME argues decentralized banking groups with holdings on financial subsidiaries are significantly evolved in the new risk regulation because inside-group equity exposures have to be weighted with 250%. This can be regarded as an obstacle for cross-border investments and consequently for the European capital market integration.²⁷

Inline, the BSG argues that the target of a capital market union requires more equity investments, especially for tech firms, instead of further increasing the capitalization of already adequately capitalized banks. **Therefore, an increase in the risk weighting could act as friction for equity investments.**²⁸

EBA's quantitative analysis of the estimated impact of CRR III, under conservative assumptions, accounts for an average 24.4% increase in the minimum capital requirement for full implementation of Basel III.²⁹ **This means a potentially substantial impact on the European banking system.**

5. ESG and CRR III

In response to the threat of climate change, the European Green Deal launched by the EU came into force in July 2021. The objective is a greenhouse gas-neutral economy by 2050, for which 1.8 trillion euros will be made available from the next seven-year budget.³⁰ Alfonso-Ercan (2020)³¹ and Indahl and Jacobsen (2019)³² argue that private equity has a central role to play in advancing ESG goals.

As private equity investments can directly influence management, there is a potentially very large impact on targeted sustainability strategies and private equity can play a central role in decarbonisation

²³ Invest Europe 2019, p.7.

²⁴ EBA 2019b, p.14.

²⁵ Monetary Authority of Singapore 2021.

²⁶ Feridun and Özün 2020, p. 21.

²⁷ Association for Financial Markets in Europe 2021, p.16.

²⁸ Banking Stakeholder Group and EBA 2020.

²⁹ EBA 2019a.

³⁰ Europäische Kommission 2021.

³¹ Alfonso-Ercan 2020.

³² Indahl and Jacobsen 2019.

strategies. Though, ESG-goals are integrated into the Basel-regulation³³, this may be counteracted due to the new risk-weighting.

6. Has regulatory capital made banks safer?

Finally, we would like to take a closer look at the fundamental question of whether higher capital ratios make banks generally safer. A study by Dautović (2019), published by the ECB, shows empirically that **significant increases in capital are significantly linked to an increase in average risk weight. In order to be competitive despite stricter capital requirements, banks substitute investments with relatively riskier ones.** This is driven especially by wholesale funded banks. Results even tend to the view that the positive effect of more equity for resilience might be counteracted by the negative effect of riskier assets.³⁴ However, we are aware that other scholars, such as Hellwig argue for a positive effect³⁵ and the whole Basel-regulation is based on the idea of more resilience with stricter equity requirements.

7. Conclusion

We argue for a pragmatic approach to firstly evaluate the impact of the CRR II-implementation. Furthermore, to sharpen the CRR III regulation in the sense that a distinction is made between different sub-categories of private equity, depending on their actual risk. From our perception more differentiated regulation with more precise definitions of individual terms is necessary, especially in the case of “speculative unlisted equity exposures”. In order to promote the aspect of diversification, it would be conceivable to introduce a granularity measure and to enforce stricter capital requirements to apply only if there is not a certain degree of diversification.

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³³ Association for Financial Markets in Europe 2021.

³⁴ Dautović 2019.

³⁵ c.f. Hellwig 2010.

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The Bundesverband Alternative Investments e.V. (BAI) is the asset class- and product-spanning representation of interest for Alternative Investments in Germany. Our goals:

- We are improving the level of public awareness for alternative strategies and asset classes.
- We are creating internationally competitive and attractive (regulatory) conditions for the investment in Alternative Investments.
- We are representing the interests of the industry to politics and regulators.
- We are serving as a catalyst between professional German investors and recognized worldwide providers of Alternative Investments products and services.
- We are supporting scientific research in the field of Alternative Investments.

Founded 1997 in Bonn, Germany, the association's members are resident in any field of the professional Alternative Investments Business. Around 250 national and international companies are members of the BAI.

We advocate for a competitive environment for investments in AI, especially with a view to securing German old-age provision. It is our core responsibility to accomplish legal reforms and the development of case law on behalf of our members and their investors.

For that purpose, BAI is contributing to several legislative procedures and consultations on a national and European level, and is participating as expert in hearings. Discussions with representatives from industry and federal and state government are taking place on a regular basis in Berlin and Brussels. We are maintaining an intense dialogue with political institutions as well as supervisory bodies (German Supervisory Authority BaFin, German Central Bank Bundesbank, ESMA, EIOPA, IOSCO) and work towards a better understanding of our industry's concerns in legal and regulatory practice.