German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on EBA's Consultation Paper "Draft Regulatory 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 CRR" EBA/CP/2013/07

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Contact:
Michael Engelhard
Telephone: +49 30 20225-5331
Telefax: +49 30 20225-5325
E-Mail: michael.engelhard@dsgv.de

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

Coordinator:
German Savings Banks Association
Charlottenstrasse 47 | 10117 Berlin | Germany
Telephone: +49 30 20225-0
Telefax: +49 30 20225-250
www.die-deutsche-kreditwirtschaft.de

Comments on EBA’s Consultation Paper “On the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets” as per 16 August 2013

1. General comments

We appreciate the opportunity to comment “On the determination of the overall exposure to a client or a group of clients in respect of transactions with underlying assets“ published by the European Banking Authority (EBA). In this comment letter we would like to adopt the same wording as the EBA in its draft standard: We would like to use the term “transaction" in order to designate the same exposures with respect to underlying assets as the ones to which the EBA’s draft standard refers.

Maintaining the existing relief solutions for granular transactions
In line with the present CEBS Guidelines on large exposures, a look-through may be waived if the transaction is sufficiently granular i.e. if the largest exposure amounts to less than 5% of the total transaction. In such an event, only the transaction shall be considered as a borrower. Under the EBA’s current proposals, this *de minimis* rule for granular transactions should be deleted without any replacement. We strongly object to the plans to abandon the granularity threshold. Instead, we would like to suggest maintaining the existing relief for granular transactions. This also applies to the derogation concerning partial granularity. The existing waivers are indispensable for banks. A look-through of highly diversified transactions would be linked to considerable costs without providing supervisors with any substantial decision-relevant information. Abandoning the derogation rules could lead to unwelcome market distress. This is due to the strong utilisation of the large exposures limit of the "unknown client”.

In this regard please cf. also our responses to questions 3 and 4 for a more detailed discussion.

Protection of *Bona Fide* Expectations
The date scheduled for first-time application by banks of the new rules for treatment of transactions with underlying assets is as of day 20 after publication of the RTS in the Official Journal of the European Union. Hence, we assume that the effective date will be some time during the first half of next year. Transitional rules are not envisaged.

As a result, this would also call into question the “Treatment of exposures to schemes with underlying assets according to Article 106(3) of Directive 2006/48/EC“, Indent 75 of the CEBS Guidelines or, moreover, the grandfathering of rights granted thereunder (c.f. Part II). According to this, transactions which were acquired prior to 31 January 2010 shall be eligible until 31 December 2015 for treatment under the rules that were in effect prior to the enactment of the CEBS Guidelines. Also in Germany, this derogation was taken into account during the national implementation of the CEBS Guidelines. Consequently, the Guidelines were transposed and became applicable supervisory practice as far as all German banks are concerned. Hence, maintaining the transitional rules envisaged by the CEBS is strongly recommended already on the grounds of bona fide expectations.
Furthermore, the present draft RTS contains numerous provisions that deviate from existing provisions promulgated by the CEBS Guidelines. The proposed, more stringent amendments are of a complex and comprehensive nature. Within banks, investment firms and securities firms, their implementation would involve major operational and technical changes.

Last but not least, there will be a need for comprehensive grandfathering rules and appropriate transitional deadlines in order to allow banks a gradual familiarisation with the new rules and so as to avoid market distress due to *ad-hoc* sales.

Under the current proposals the existing granularity threshold or any other kind of materiality threshold shall no longer be an option; this is but one example for a deviation from the principle based approach applied to date. What is more, since their implementation in the short term would be unfeasible, such new principles accompanied by changed requirements would require a certain amount of lead time. Hence, there will be a need for adequate transitional deadlines. Dropping or even lowering the granularity thresholds or any other materiality thresholds would create major issues: Already for technical reasons and on the grounds of data protection (e.g. as far as retail exposures are concerned), applying the look-through is unfeasible in the short term. As a result, there would be a strong utilisation of the ”unknown client". In order to ensure compliance with the large exposures limits, many banks would be forced into *ad hoc* sales of highly fungible investments which presently make a positive contribution towards profitability and risk diversification. This might result in corresponding market distress. Deleting a granularity threshold would not only incur higher look-through costs. What is more, it would tend to lead to a reduction in transactions with underlying assets and it would trigger direct acquisitions of individual positions of the corresponding asset class. More specifically, capital market oriented funding of retail and SME exposures (e.g. consumer lending, credit card exposures etc.) by means of securitisations would be rendered almost unfeasible. As a result, the diversification effect from investments in transactions with underlying assets will grind to a complete halt. Generally, the direct acquisition will lead to higher concentration risks due to the fact that the divested transactions will not be replaced again in their entirety. At this juncture, the marginal costs for acquisition and monitoring play a major role.

Hence, we feel it would be at least appropriate to issue a grandfathering rule for existing transactions concluded prior to the effective date of the RTS shall and must remain eligible for treatment under the rules on the look-through approach issued in the various jurisdictions on the basis of the CEBS Guidelines.

The introduction of a transitional or, moreover, grandfathering clause is furthermore entirely compatible with the provisions under the CRR and with the EBA's mandate. Art. 390 (8) CRR gives the EBA its mandate, of specifying in greater detail the criteria and methods for establishing the total exposure. This mandate’s wording contains an element of plurality. Hence, under the mandate the EBA is entitled to employ a differentiated set of criteria and methods depending on the transaction type or the timing of the transaction’s closing.

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2. Specific comments

Article 4

Article 4 deals with funds of funds transactions or, moreover, (multi-tier) securitisation positions and requires that the look-through approach be applied without exception to the last layer of underlying assets. This approach would lead to a situation where the look-through approach would even have to be applied to such transaction's positions which – as far as materiality is concerned - are irrelevant and the break-down of which would not lead to any meaningful information on the aggregation of large exposures. We feel it is appropriate to drop the look-through requirement as of a defined materiality limit. This especially applies to transactions in which, for instance the investment guidelines of the mandate ensure a sufficient degree of diversification.

In order to make this proposal feasible for the purposes of practical implementation on the ground, this limit could be designed in a way that a look-through may only be waived if the value of the underlying of such a transaction stays below a certain limit, for instance, if it stays below 1.25 % of the bank's eligible own funds. The track record of this kind of materiality threshold in Germany is positive. Hence, in order to accommodate this additional rule, we suggest a corresponding amendment to Article 4.

Article 5

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

On principle, the language on the treatment of funds and securitisations is sufficiently clear. Also the various examples provided to illustrate this treatment are helpful. However, this only applies in an unqualified manner to transactions in which the bank acts as an investor. Yet, it remains unclear what the policy will be if the bank makes liquidity facilities available or if it acts as a counterparty in a swap transaction. In our understanding, at this point, *in lieu* of considering the underlying counterparties, it will merely be necessary to consider the structure of the transaction (e.g. the SPV) as a borrower. We would welcome a clarification.

Furthermore, we would appreciate an explanation as to the treatment of hybrid investments, e.g. Credit Linked Notes (CLN) within the meaning of the RTS: A CLN typically features two credit risks: One credit risk derives from the issuer and one credit risk derives from the underlying reference assets.

In addition to this, the handling of ABCP programmes featuring a complete risk coverage by the liquidity bank (so-called fully supported programme) remains opaque. Here, the liquidity bank covers each and any default risk of the underlying. As a result, in their risk assessment, investors' prime focus is on the liquidity bank. A look-through of the underlying assets would not only distort the actual risk assessment, it would also ignore the actual risk bearer, i.e. the liquidity bank. Hence, we would like to advocate in favour of an alternative regulatory choice, i.e. waiving the look-through in those cases where the risk is being absorbed by a third party. Instead, it should be possible to add the liquidity bank's securitisation position as an exposure.

Furthermore, we would appreciate a clarification as to how collateral provided should be handled.

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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?

Regarding the calculation of a counterparty's maximum loss within a securitisation pool, the present draft RTS opts for the most conservative of all possible approaches. This is based on an assumed borrower default after which the subordinated tranches were already exhausted due to the default of other borrowers. As a consequence, similarly this means that the result envisaged under the RTS will only be correct in this theoretical case. In all other possible scenarios the statement of the actual credit risk would be a clearly excessive. Evidence to support our view consists, for instance, in example 3, RTS:

(i) Under the calculation approach, the bank shall assign an exposure of 10 monetary units to borrower A. This presupposes that the first loss and the mezzanine tranche have already been exhausted.
(ii) However, if all borrowers were to default at the same time (which equally presents a worst case scenario) the losses would be distributed on a *pro rata* basis to all investors and the loss resulting from borrower A would merely amount to 5 monetary units.
(iii) On the other hand, the loss would amount to zero if borrower A defaulted as one of the first which would mean that these losses would have to be absorbed by the subordinated tranches.

Also example 4 would lead to a distorted picture. Under the presentations in the RTS, an exposure of 15 monetary units would be assigned to borrower A. However, this ignores the fact that, in the event of a default of A, the loss will first of all be absorbed through the first loss tranche. As a result, A's initial exposure will be reduced from 25 to 15. Consequently, the maximum remaining loss for the bank which participates in the senior tranche with 1/5, amounts to three. On aggregate, this would mean that a more appropriate exposure of 13 should be added to A .
Furthermore, the RTS calculation approach would lead to wrong results in cases where, for instance, the bank is respectively fully invested into the senior tranche and into the first loss tranche (50 senior, 20 first loss). Based on a tranche by tranche assessment, borrower A would have to be assigned an exposure of 45: 1*min(25;50) + 1*min(25;20). Consequently, the risk would be strongly exaggerated.

Hence, the risk mitigating effect of subordinated tranches shall and may not be ignored. Whilst the concerns aired by the EBA (and at the time also by the CEBS, i.e. that past losses will potentially only be taken into account with a certain delay (paragraph 85) and that a reduction of the credit mitigation might trigger the large exposures limit) are plausible at least on theoretical grounds, their actual relevance in practice will eventually boil down to adequate risk management processes (this has also been pointed out by the CEBS). It is part and parcel of these risk management processes that the impairment test of the credit enhancement will be more closely monitored during times of crisis. As a result, especially during times in which there is a risk that entire tranches will be exhausted over a relatively short period of time, the likelihood that there will go unnoticed and not be detected in a timely manner is fairly low.

Hence, we hold the view that the introduction of haircuts for first loss tranches and for mezzanine tranches could avoid seriously excessive risk statements whilst simultaneously considerably reducing banks' implementation costs. At the same time, this would mitigate the risk of a sudden violation of the large exposures' limits (which, in actual practice, is fairly remote anyway) along with potential perverse incentives.

However, also alternative methods would be conceivable: For instance recognition of credit enhancement merely for the N largest borrowers or a recognition of the credit enhancements for all borrowers on the basis of their share in the portfolio. An alternative regulatory choice the EBA might wish to consider reads as follows: *Pro rata* recognition of the credit enhancement as a proportion of the subordinated tranches (compared to those in which the bank has positions) in the entire securitisation. This would accommodate the EBA's concerns that banks might only become aware of the exhaustion of subordinated tranches after a certain time delay. After all, more likely than not, even with a certain delay, one would become aware of any ongoing exhaustion before the subordinated tranches have been exhausted completely.

Article 6

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.

On principle, EBA's view that a complete look-through is the most risk sensitive approach is understandable. However, we are of the opinion that - in line with the overall design of the CEBS Guidelines' – there is no need for a strong top-down approach. Choosing the approach should remain part of banks' discretion. The CEBS Guidelines (paragraph 68) explicitly request that "institutions should, whenever feasible, use the more risk sensitive approaches and should be able to demonstrate to the competent authorities that regulatory arbitrage considerations have not influenced their choice".

At least there need to be safeguards so as to ensure that the materiality aspect is taken into account sufficiently even if and when a hierarchy is being stipulated. Also the EBA recognises this, on principle. For instance, on page 10 of the Consultation Paper under item b) the EBA points out that a look-through on an ongoing basis might be waived due to cost reasons. Hence we kindly request complementing article 6(3) to include this aspect by adding "or it is too costly to identify the obligor"; as an alternative regulatory choice we propose a clarification that the language under Article 6(1) "all reasonable steps" has to be interpreted in keeping with the materiality aspect.

Along with the complete look-through and adding the exposure completely to the "unknown client" counterparty, also a partial look-through should be an option. Consequently, only the unidentified counterparties would have to be added to the "unknown client". The rationale behind the large exposures regime consists in an identification of cluster risks. Hence, it is difficult to comprehend why the complete transaction - despite partial knowledge of the underlying assets - would have to be added in its entirety to the "unknown client" if individual business positions are known. This would lead to an exaggeration of the "unknown client" risk. As an alternative regulatory choice the EBA might wish to consider adding merely the intransparent part to the "unknown client".

In line with the present CEBS Guidelines, a look-through may be waived if the transaction is sufficiently granular i.e. if the largest exposure amounts to less than 5% of the total transaction. Under the EBA's current proposals, this *de minimis* rule for granular transactions should be deleted without any replacement.

We strongly object to the proposed abandonment of the granularity threshold. The existing rule is in line with the rules-based approach and is an essential facilitation that is fit for purpose. The EBA harbours concerns that individual banks might abuse their freedom concerning the choice of methods for the purposes of regulatory cherry picking. However, these concerns shall and must not lead to a situation where the entire banking industry will be faced with regulatory cherry picking allegations and pre-emptive penalisation. Hence, we strongly reject the sweeping allegations underlying the EBA proposals.

The introduction of a granularity threshold was already a matter of intense debate during the consultation of the CEBS Guidelines. Back then, the banking industry clearly emphasised that applying a look-through approach in each and every case (i.e. also to highly diversified portfolios) is unjustified under the materiality principle and also from the point of view of risks. In its regulatory framework, the CEBS accommodated this concern by introducing of 5% threshold. Notwithstanding the foregoing, a bank has to be able to demonstrate that its abstention from the look-through approach is not motivated by regulatory cherry picking (cf. above). As a result, prudential concerns have already been taken into account sufficiently.

The rationale for the fact that the EBA now plans to abandon the granularity threshold altogether is difficult to comprehend. Whilst on page 10, the EBA points out that experience in individual jurisdictions allowed the EBA to conclude that a more stringent approach is necessary to ensure that all relevant transactions are captured, the EBA fails to provide specific evidence to support its view in the form of examples. At least the national supervisor in Germany had a positive experience with the application of the 5% threshold. We also feel that the danger of banks engaging in regulatory cherry picking by entering several transactions thus deliberately bypassing the large exposures threshold is a rather academic concern. Besides, the decision to invest in a transaction is based on several criteria (e.g. yield, contribution to the asset allocation). It is not motivated by whether this will trigger a threshold for transactions liable for the look-through approach (i.e. regulatory bypassing / cherry picking).

Hence, we see a compelling need for maintaining a granularity threshold. Deleting the granularity threshold would lead to a distorted view: The large exposures threshold would be triggered excessively under the synthetic counterparty "unknown client". Whilst not limited to, this would especially be the case if and when a bank invests into several granular transactions which it subsequently aggregates and adds to the "unknown client". Hence, banks would be forced into reducing certain positions. Alternatively, they might have to refrain from investing into certain products (e.g. exposure purchase agreements and ABCP programmes). This could lead to unwelcome market distress; the latter is particularly true given that heterogeneous market liquidity levels would lead to a need to reduce potentially highly liquid and profitable securities featuring an excellent risk diversification. Whilst not limited to, this particularly affects the securitisation of loans and exposures to small and medium-sized entities (SMEs) as well as to retail clients potentially resulting from mortgage lending transactions, automotive finance, leasing or credit card transactions.

However, it might similarly affect rather small loans to large corporations. In the absence of the introduction of an appropriate materiality threshold, the lack of these instruments’ fungibility could incur difficulties in funding these loans.

Furthermore, guaranteeing a look-through of transactions with underlying assets subject to credit risk will not always be possible. This is due to data protection restrictions and / or technical reasons. At least in the case of retail clients, more likely than not, it will be illegal to divulge any personal data. This is owed to data protection reasons. What is more, there are a number of transactions where a look-through involve disproportionately high costs. Whilst not limited to, this particularly applies to dynamic portfolios: Due to the fact that their composition changes frequently, they make a contribution towards risk diversification. In this respect, a look-through would incur considerable costs in the absence of any additional, substantial improvement in decision-relevant information. Granular portfolios only make a minor contribution towards the total risk profile of a bank. Hence, a complete look-through of granular transactions appears unjustified. Also on the grounds of practicality, especially when it comes to extremely short terms to maturity, it is not always possible to obtain all information necessary for a look-through. Notably with regard to highly diversified portfolios, the effort involved in a look-through on an on-going bears no relation to the risk.

In addition to this, a complete look-through of securitisations is already impossible on the grounds that the corresponding information on the underlying exposures are not available due to existing standard market practices back then; also, requesting such information *ex post* from banks in their capacity as investors is not an option, either. Whilst Article 409(2) CRR calls for the so-called loan level reporting on the part of issuers (meaning that sponsors and originators have to ensure in particular that future investors will have unhindered access to each and any materially relevant data on the creditworthiness and the performance of a securitisation transaction's individual underlying exposures) this provision has only been in effect since 31 December 2010 and applies to securitisation transactions carried out after 1 January 2011.

In its ongoing consultations concerning international large exposure rules, even the Basel Committee is currently contemplating a granularity threshold of 1% of the transaction volume. Notwithstanding the foregoing, we feel that this value is excessively low. On principle, we would like to maintain the existing threshold, i.e. 5% of the transaction volume. Also, the current facilitations should be maintained with a view to the partial granularity of a transaction.

We have difficulties in comprehending the rationale behind EBA’s rationale proposed concerning cluster risks which are supposed to hide in numerous transactions and hence would require aggregation. This notion is not borne out by any practical evidence. The granular transactions are based on loans from SME and retail clients. For instance, this is about student loans, automotive finance or credit card exposures. This selection of borrowers already illustrates that they do not appear in a large number of transactions. Also, it would be highly unlikely in the event of e.g. RMBS transactions that a private constructor funds 10 different real estate properties through 10 different banks which will then be securitised in the form of 10 different transactions and will eventually be acquired by a single bank. Hence, a mandatory look-through of well diversified portfolios is unconstructive.

Furthermore, given the combined effect of the look-through requirement, materiality and granularity we feel that there is a need for an optional combination of methods, i.e. a partial look-through only of those positions that exceed the materiality / granularity threshold. The combination of methods particularly ensures that, on the one hand, the part relevant under the large exposures regime will be made transparent whilst, at the same time and on the other hand ensuring that the look-through effort bears a meaningful relation to the decision-relevant information obtained.

Furthermore, we feel that maintaining the structure based approach is appropriate.

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.

On principle, we are of the opinion that maintaining the existing granularity threshold of 5% of the transaction volume is appropriate.

However, it would also be possible to employ alternative approaches. Given that large exposures (i.e. cluster risks within the supervisory meaning) are defined as a share of eligible own funds, the granularity threshold could be defined not with regard to the transaction volume but with regard to the maximum effect for equity based large exposures thresholds (e.g. 1% of eligible own funds). This would ensure that only those transactions would have to undergo the laborious look-through approach which are material from the bank's point of view. A preliminary analysis of the investment fund holdings in the savings banks sectors indicates that already a granularity threshold of 1% of eligible own funds would mean that 20 – 25% of the funds would no longer be granular. However, a granularity threshold that is predicated on banks' own funds would still incur major costs for the financial industry. Due to the heterogeneous own funds levels available within the acquiring banks, investment fund companies would invariably have to ensure a complete look-through and would have to keep the full set of relevant data in place which would then be drawn upon individually by the acquiring banks. As a result, designing funds which are granular *per se* would become virtually impossible. Especially in view of the fact that the operational costs for determining the default risk should be kept within reasonable bounds, the granularity threshold should remain geared towards the fund's assets; after all, the latter ratio is equally valid for all investors alike and can be processed by all parties involved without any difficulties.

Furthermore, in defining granularity thresholds, qualitative aspects have to be taken into account (e.g. the type of the underlying assets, securitisations or contractual design of transactions). Hence, in the event of good creditworthiness ratings, for instance the default rates for RMBS evidence that a mandatory breakdown of said transactions is not helpful. Whilst not limited to, this is owed to the fact that *de facto* there is no material default risk.

In this context, one corollary worth considering would be a more risk adequate design of the aggregate counterparty "unknown client". For instance, it would be possible to break the "unknown client" down into several sub-categories which would then respectively fall under the large exposures rules separately.

This breakdown could, for instance, be based on the exposure classes under the credit risk standard approach (CRSA) or other risk features that are consistent with internal risk management (public counterparties, retail clients, SMEs, corporates). In such cases, it could thus be ensured that the combination of individual sub-categories will not add up into a material “single risk” that could jeopardise the bank’s going concern. Such a risk based differentiation would thus also be in keeping with the basic rationale behind the large exposures rules.

Look-through in the trading book

Under recital 9, the EBA clarifies that the proposed rules on the treatment of exposures from underlying assets shall also be applied to trading book transactions. Especially for trading book transactions, the materiality and the granularity threshold is of paramount importance. A comprehensive and time-consuming look-through of products held over a short period of time for trading purposes will be virtually impossible for the bank. Hence, there is a vital need to exempt granular trading book transactions from the scope of application of the look-through approach. Otherwise, banks could no longer hold products with underlying counterparties in the trading book. However, at any rate, alternative approaches should be applied to trading book transactions. For instance, it would be possible to apply a look-through approach only to products the exposure amount of which exceeds a certain threshold or if the utilisation of the “unknown client” already amounts to more than 50%.

Transitional rule

In banks and investment firms as well as securities firms, deleting or significantly reducing the existing granularity or materiality thresholds in the short term whilst simultaneously implementing the corresponding mandatory look-through would not be feasible. IT projects enabling the look-through were initialised on the understanding that the CEBS Guidelines shall grant grandfathering until the end of 2015.

In order to allow stakeholders a gradual familiarisation with the new rules and in order to avoid market distortion due to *ad hoc* sales, comprehensive grandfathering rules and transitional periods are indispensable. Furthermore, we would like to draw attention to the need for an appropriate transitional period / grandfathering regime pointed out in our comments above (c.f. 1. General Comments).

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.

From our point of view, a mandatory monthly breakdown of transactions would incur unjustified costs if and when the level of the respective investment is not material (from the point of view of the bank). Besides, with a view to the rationale behind the large exposures regime - instead of having to renounce a look-through in the absence of up-to-date information on the portfolio’s composition - it would appear more appropriate if a bank reverted to published - albeit perhaps slightly older - data for the look-through. Hence, the required frequency for a look-through should depend on the degree of volatility inherent in a transaction’s composition as well as on the published information already available. If it appears necessary at all to specify a predefined window of time, we suggest merely stipulating that a look-through will have to take place at least annually.

Article 7
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?

We would appreciate a clarification that in cases in which the structure of a transaction does not present any additional risk position, there will consequently be no need for reporting the structure of such transaction.

In Germany, most of special funds held by institutions are Alternative Investment Funds (AIF) covered by the AIFMD although they submit to the investment restrictions of the UCITS Directive. In fact, these are undertakings with equivalent requirements to those under the UCITS Directive. The only difference is that the marketing of these funds is limited to institutional investors (cf. Article 284 of the German Investment Act "Kapitalanlagegesetzbuch"). Therefore, transactions in special funds or undertakings established in EU-member states which apply the UCITS requirements should also be considered as transactions which do not constitute an additional exposure.