

Question ID

2024_7189

Legal act

Regulation (EU) No 575/2013 (CRR)

Topic

Credit risk

Article

132c

Paragraph

1

COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations

Not applicable

Article/Paragraph

NA

Name of institution / submitter

Invest Europe

Country of incorporation / residence

Belgium

Type of submitter

Industry association

Subject matter

Treatment of bridge financing in the calculation of the risk weight (RW*)

Question

As the objective of Article 132c (1) CRR, as amended by Regulation (EU) 2019/876 – CRR2, is to “calculate the risk-weighted exposure amount for their off-balance-sheet items with the potential

to be converted into exposures (...)", should the calculation of RW^* actually exclude short-term liabilities (e.g. bridge financing)?

Background on the question

Art. 132c „Treatment of the off-balance-sheet exposures to CIUs" defines a calculation method to project the current level of risk from balance sheet items of a CIU to off-balance-sheet items, such as the outstanding commitment of a CIU. Hence, this method intends to estimate an ex-ante risk proxy (i.e. RW^*) for future on-balance-sheet exposures, representing a long-term expectation of the risk level of the CIU portfolio. For a closed-end CIU (such as an AIF), this corresponds to the assumption that outstanding commitments will be invested in portfolio assets with a similar risk profile (i.e. $RWAE/E$) and with a similar effective leverage ratio (i.e. A/EQ) as the current portfolio. For this definition of the effective leverage ratio, however, short-term liabilities can inadvertently distort RW^* : in the early investment phase of a CIU (such as an AIF), when EQ is low and the outstanding commitments are still large, short-term bridge financing facilities are frequently employed to pre-finance capital calls from equity investors. Bridge financing facilities are solely used for liquidity management and quickly redeemed (usually during a period less than 12 months) by planned investor capital calls. The outstanding commitments serve here as main collateral. Including bridge financing in the calculation of RW^* can a) lead to an overstatement as A/EQ becomes large, and b) lead to strong technical fluctuations of A/EQ over time due to subsequent capital calls.

Consequently, including short-term bridge financing in the calculation of RW^* may scrutinize its purpose to reflect the ex-ante long-term risk-weighted exposure of a CIU. Furthermore, the resulting capital requirements for off-balance-sheet exposure may be largely overestimated and even exceed the total collateral (i.e. the outstanding commitments), which is in contrast to the generally low risk associated with bridge financing.

This can be illustrated by the following example:

1. Calculation of capital requirements for a cash CIU

Consider a CIU with a low-risk strategy (focused on short-term cash investments only) making successive investments during the investment period. Assume following conditions: Fund size (F) is 100 mn EUR. During the investment period, the CIU will make ten subsequent investments of size 10 mn EUR. The risk weight (RW) of the assets is 20%, the Credit Conversion Factor (CCF) stands at 50%, and the core capital ratio (CCR) is 8%. For the sake of simplicity, let the exposure (E) equal the asset value (A) and the open commitment ($oC = F - A$). Then the capital requirements for balance sheet items are $CR(BS) = RW \cdot A \cdot CCR$ and for off-balance-sheet items are $CR(oBS) = RW^* \cdot CCF \cdot CCR \cdot oC$. There are two scenarios with equivalent asset exposure A at a given valuation date:

- In Case 1 subsequent investments are directly redeemed by planned capital calls. EQ increases by 10 mn EUR, and the off-balance sheet items oC decrease by 10 mn EUR.
- In Case 2 subsequent investments are partially financed via a bridge financing facility and subsequently redeemed at a date before the next investment. EQ first increases by 0.5 mn EUR (oC decreases by 0.5mn EUR), then EQ (oC) increases (decreases) by another 9.5 mn EUR when capital is called from investors.

In Case 1, the effective leverage ratio A/EQ always equals 1 and hence RW^* equals 20%. The sum of capital requirements $CR(BS) + CR(oBS)$ will increase linearly over time until the CIU is fully invested

(see Fig. 1). This state reflects the long-term, fully risk-exposed portfolio with capital requirements equal to $CR(BS) = 20\% \cdot 100 \text{ mn EUR} \cdot 8\% = 1.6 \text{ mn EUR}$.

In Case 2, however A/EQ and hence RW^* will vary strongly over time. When the first investment is made $A/EQ = 10/0.5 = 20$ (hence $RW^* = 400\%$), which amounts to off-balance-sheet capital requirements $CR(oBS) = 400\% \cdot 50\% \cdot 8\% \cdot 99.5 \text{ mn EUR} = 15.92 \text{ mn EUR}$. This amount well exceeds both the asset value $A = 10 \text{ mn EUR}$ and the collateral of the used bridge financing facility of 9.5 mn EUR. When the subsequent redeeming capital call takes place, $CR(oBS)$ drops back to 0.7 mn EUR (as in Case 1). For all subsequent investments, this oscillating scheme is repeated, albeit less pronounced (see Fig. 1 for a visual presentation).

Both cases 1 & 2 represent investment paths with a similar economical risk. While the CIU balance sheet for Case 2 is different due to the use of bridge financing, their risk-weighted asset exposures are identical and so are the on-balance-sheet capital requirements. However, for the calculation of the off-balance-sheet capital requirements, Case 2 strongly diverges from Case 1, despite having an identical expectation of the long-term portfolio composition. This stems from the periodic oscillations of RW^* due to short-term liabilities which are being projected onto the open commitment. As a result, the capital requirements during the investment phase of a CIU may periodically and strongly deviate from the long-term, maximally expected capital requirements (see [image](#))

Crucial here is a clear distinction between the definition of *leverage* and *bridge financing*. Art. 4 (1) (v) of Directive 2011/61/EU defines *leverage* as “any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means”. Moreover, AIFMs will not employ *leverage* within the meaning of Art. 6 (4) of Regulation (EU) No 231/2013 which states “AIFMs shall exclude borrowing arrangements entered into if these are temporary in nature and are fully covered by contractual capital commitments from investors in the AIF”.

Hence, the articles above lead to a clear distinction of bridge financing, i.e. the borrowing arrangements of the AIF should be timely limited (e.g. repayment within a period less than 12 months) and fully covered solely by outstanding investor commitments.

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Final answer

The risk weight of an off-balance sheet item with the potential to be converted into an exposure in the form of units or shares in a CIU as defined under Article 132c(1)(a) should reflect the risk of the off-balance sheet item *for the situation that it will be drawn*. Consequently, for the formula in Article 132c(1)(a) CRR, the accounting value of assets (A_i) and of equity of the CIU (EQ_i) should be determined for the situation when the off-balance sheet item will be drawn.

This means in case the CIU has financed assets via bridge financing, the accounting value of assets of the CIU corresponding to the bridge financing is decreased by those amounts of bridge

financing that are immediately repaid once the same amount is drawn from the off-balance sheet item, but the accounting value of assets of the CIU corresponding to equity is increased by the same amount because the drawn amount increases the accounting value of assets of the CIU, whereas any other bridge financing will remain reflected in the accounting value of assets of the CIU corresponding to the bridge financing until actually repaid.

The accounting value of the equity of the CIU is increased by the drawn amount of the off-balance sheet item.

Status

Final Q&A

Answer prepared by

Answer prepared by the EBA.
