M E M O R A N D U M

Date 2019-01-25 FI Ref. 19-1738

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FI's View on Preconditions for Mortgage-Based Business Activities

This is an updated version of FI's memorandum Preconditions for Mortgage-Based Business Activities *(*Förutsättningar för verksamhet med bostadskrediter *(Ref. 18-12623)) that was published on 5 July 2018.*

Summary

In Sweden, the traditional bank-based financing model for mortgages is currently being supplemented with new models where mortgages are being transferred to mortgage structures, e.g. alternative investment funds (AIF). These structures can be established by both banks and newcomers to the mortgage market[1].

Finansinspektionen (FI) takes a fundamentally positive view to greater competition and new, sound financing models for mortgages. For borrowers this can lead to higher customer value, for example through lower interest rates, a wider selection and better services. New models that spread risks to market participants other than banks and that reduce refinancing risks also help increase resilience in the financial system. In order to achieve these positive effects, however, new mortgage structures need to take into account borrowers' long-term needs and have stable, long-term financing that allows them to function even when the market is under stress.

In this memorandum, FI further develops its view on several preconditions to prevent new mortgage structures from leading to elevated risks for individual borrowers or the financial system.[2] FI will place special emphasis on these preconditions when assessing applications for authorisation and in its supervision of participants in the mortgage market.

The memorandum targets newcomers, banks and professional investors in mortgages. A previous version of this memorandum was published on 5 July

[1] In this memorandum, the term *newcomers to the mortgage market* (or simply *newcomers*) refers to market participants who issue mortgages but are not credit institutions. The term *banks* is used here as an umbrella term for credit institutions that conduct business in accordance with Regulation (EU) No 575/2013 of the European Parliament and of the Council or the Banking and Financing Business Act (2004:297). The term *mortgage providers* therefore includes both banks and newcomers.
[2] FI's view on risk-mitigating preconditions also applies to newcomers to the mortgage market who carry mortgages on their own balance sheet.

2018. This version has been revised and contains updates that clarify FI's view on risk-mitigating measures, in part for all mortgage providers and in part for banks in particular.

The preconditions are summarised below:

- Consumer protection rules apply regardless of which party is the creditor.
- Investors in mortgages should be professionals[3] with the ability to both assess the risks in the investment, including the credit risk associated with the mortgages, and make long-term commitments.
- The starting point is that the financing in a mortgage structure must have a fixed maturity of at least ten years. There may not be any conditions that allow investors to redeem the instruments earlier than ten years.
    - The maturity profile of the financing should show good distribution over time.
    - Market participants must continuously monitor and manage the liquidity risks in the structures and should assess other tools and arrangements that limit refinancing risks in more difficult market conditions.
- If a bank establishes a mortgage structure outside its group (hereafter referred to as *peribank structures*) that is not fully consolidated, the bank needs to assess and manage any flowback risks itself, for example within the framework of the bank's stress tests of capital and liquidity.

A fundamental point of reference is the fact that mortgages are large and important commitments for households. A well-functioning mortgage market therefore requires market participants to take on considerable responsibility to ensure that customers' long-term needs are met. This applies to market participants who provide mortgages as well as those who invest in mortgages.

The consumer protection rules apply to both banks and other market participants who issue or acquire mortgages. However, the category *other market participants who issue or acquire mortgages* is not subject to capital and liquidity requirements and other regulations that apply to banks. The requirement on longevity and robustness must therefore be met in some other way. FI makes the assessment that market participants can do this by limiting their refinancing risks through compliance with the preconditions specified above. This applies regardless of whether a mortgage structure is owned by a newcomer or a bank.

When a bank wants to establish a mortgage structure that lies outside of the bank's group, both the bank and FI need to consider additional aspects. One

[3] In this memorandum, the term *professional investors* refers to market participants with authorisation to conduct business on the financial markets and who work with investments at a professional level.

such aspect is which firms are considered to be covered by regulatory requirements that apply at group level, for example capital requirements. Another issue is related to potential flowback risks for mortgages the bank has issued to a borrower and then transferred to the new mortgage structure. Flowback risk refers to the risk that the bank will bring the loan back to its own balance sheet during periods of stress even though it has no obligation to do so.

FI is following the development of this market carefully and, if necessary, for example if the market grows considerably in scope or if the risks increase, will consider measures that limit the risks for both borrowers and the financial system. Where the development gives rise to risks not captured by applicable legislation, new regulation may be required.

Introduction

It is important for the economy that the mortgage market functions in a satisfactory manner. For most Swedish households, their home is their most important asset and their mortgage their single largest debt. Predictable and reliable access to loans in the form of mortgages is therefore an economically important function. An important issue in this respect is how mortgage activities are financed.

As the supervisory authority, Finansinspektionen (FI) is tasked with monitoring financial firms and actively promoting long-term stability and efficiency as well as good consumer protection on the financial markets. The mortgage market plays a central role in FI’s macroprudential assignment, which entails promoting financial stability and counteracting financial imbalances with the aim of stabilising the credit market. Risks associated with how mortgage activities are conducted and funded thus affect much of FI’s work.

The traditional model in Sweden is that banks issue mortgages and carry the mortgages on their balance sheets. Banks are subject to regulation and supervision, such as requirements on loss-bearing capital, stable financing and liquidity buffers, with the aim of ensuring that the critical functions provided by the banks can be maintained even during times of crisis. There are now new business models that supplement the existing structure.

Fundamental consumer protection regulations that apply to mortgages

Firms that offer mortgages must have authorisation from FI in accordance with the Mortgage Business Act (2016:1024) or the Banking and Financing Business Act (2004:297). These acts contain a number of rules that aim to protect the interests of borrowers. There are also rules in the Consumer Credit Act that protect mortgagors as consumers (2010:1846), which apply regardless of the party issuing the mortgage or carrying it on their balance sheet.

Firms that issue mortgages shall conduct their business in a sound manner. This means, for example, that a firm shall conduct its business honestly, fairly,

and transparently and take into consideration the interests and rights of the borrower. The business shall be based on information about borrowers' circumstances and special requirements as well as reasonable assumptions about the risks the borrower may face during the term of the loan. The firm must also maintain a sufficiently high level to the quality of its business to ensure that confidence in the market can be maintained. This means, for example, that the business must be organised and conducted in such a manner that it is possible to gain an overview of the firm's structure and position.

A fundamental requirement in the Consumer Credit Act is that lenders must observe generally accepted standards for granting loans. This means, for example, that the lender must consider borrowers' interests with due care and ensure that the borrower receives the requisite explanations and information. The requirements do not only apply to the initial lender but also to a firm that takes over the loan. This means that both the issuer of the loan and the party that later takes over the loan must have an organisation that protects the interests of the borrower and handles any issues that may arise during the term of the loan. Such issues may include if the firm needs to inform or explain to the borrower early repayment of the loan or how late payments are handled. It is therefore important for all firms involved to have the resources, knowledge and experience necessary to protect the interests of the borrower. It should also be clear for the borrower who to contact for questions related to or information about the mortgage.

The Consumer Credit Act also states that the lender must ensure that the borrower has the financial capacity to repay the loan in accordance with the loan agreement. This means, for example, that the term of the mortgage must be long enough to enable a borrower to pay back the loan during its term without needing to sell the home or borrow money from another lender. For most new mortgages, this means a long contractual maturity. The practice in Sweden is 30–50 years. In practice, many borrowers pay back their mortgages early, e.g. when they buy a new home. However, a decision to repay the loan should be the borrower's right and not an obligation.

The interest rate adjustment period is shorter than the term of the loan in all but a few cases. It is therefore important from a consumer protection perspective to limit the lender's possibilities for unilaterally raising the interest rate in conjunction with interest rate adjustments. The borrower could otherwise be pressured into early repayment of the loan due to the threat of a higher interest expense.

The main rule in the Consumer Credit Act is therefore that the lender may only raise the interest rate if this is specified in the agreement and increases can be justified through increased financing costs for the lender or other cost increases that could not be predicted when the loan agreement was entered into. However, for a mortgage with a maturity of at least ten years, the lender can introduce conditions in the agreement that the interest rate must be set so it

corresponds to the interest rate the lender applies to new loans when interest rates are adjusted.

Current market structure

The structure of the Swedish mortgage market has remained more or less the same for many years in that banks have been the primary mortgage provider and mortgages have been carried on their balance sheets. The mortgages are largely financed by issuing covered bonds, which normally have a maturity of five years. The fact that the banks' financing (liabilities) have a shorter maturity than the maturity of the loans (assets) means that the banks must perform maturity transformation.

Maturity transformation within the banking system normally allows for a larger supply of loans on the markets, which can increase the activity level in the economy and thus create economic added value. At the same time, maturity transformation introduces a vulnerability in that the banks are exposed to refinancing risks, i.e. they are dependent on regularly renewing their liabilities that fall due and keeping their deposits.

In order to increase the resilience in the critical functions they provide, banks are subject to special regulations in the form of, for example, capital and liquidity requirements. In addition, banks are to a certain degree protected in part by government insurance on household deposits and in part by the possibility of receiving liquidity support from central banks[4]. If these regulatory requirements and preventive measures are insufficient, and a systemically important bank is threatened by default, resolution regulations ensure that the bank, or at least its critical functions, can be maintained.

Market-based mortgage financing could be advantageous

Stable and efficient markets do not necessarily require that banks must carry out the financial functions that are important for a functional economy, such as the ability to make payments, save money and issue loans. Other market participants can carry out these tasks.

Over the past year, newcomers have arrived in the mortgage market. These newcomers do not finance mortgages through deposits, so-called repayable funds, from the public, and they are therefore not subject to capital or liquidity requirements. This means that they do not face the costs associated with these requirements when banks carry mortgages on their balance sheets. Neither are they subject to the rules on resolution and thus pay no resolution fee.

In connection with the arrival of newcomers to the Swedish mortgage market, several business models, some of which are completely new, have also

[4] Market participants other than banks subject to FI's supervision can receive liquidity support from the Riksbank depending on the nature of the situation.

emerged for financing mortgages. A trait shared by all of these new business models is that they are based on transferring mortgages to structures outside the banks' balance sheets.

This trend on the mortgage market can be attributed to several factors. In addition to the impact of the regulation, other important drivers are likely a high demand for loans from households, the low interest rates that the banks compensate for through high lending margins and good access to non-risk-adverse capital and financing. Mortgages as a product are also becoming standardised, which in combination with digitalisation and changed customer behaviour makes it possible to provide mortgages in a new way.

Mortgage providers with alternative financing models still represent only a marginal part of the Swedish market, but interest from both households and firms (that intend to apply for the required authorisation) appears to be large.

A mortgage market with a larger representation of market-based financing could be advantageous for individual borrowers. Greater competition can benefit borrowers, for example through greater selection and improved terms and conditions.

More mortgages financed through the market could also strengthen financial stability. Lending is today heavily dependent on a few systemically important banks. If credit and financing risks are distributed among more market participants that are professional and long-term, this could enhance the ability to carry losses, reduce systemic risks and thus increase the financial system's resilience in crises. By releasing mortgage financing to a greater extent from the other systemically important activities in the banks, this could also decrease the contagion risks in the financial system.

Potential risks with new business models

A mortgage market that lies to a greater extent outside the banking sector, however, can also introduce elevated risks if the new structures are not properly designed. A long-term approach and predictability on the mortgage market are of utmost importance for both individual households and the economy at large. This means that there must still be access to loans even in the event of financial shocks.

As mentioned above, the refinancing risks for banks that arise due to maturity transformation are managed through special regulation and, to some extent, government protection. When firms other than banks are carrying mortgages, there are no corresponding rules and tools. The question is therefore how new mortgage structures should be formed to benefit both the consumer interest and financial stability.

The new mortgage structures result in new forms of investment in mortgages, which most likely have higher credit and liquidity risk than covered bonds.

Demand among investors can thus be more likely to be affected negatively if risk appetite on the market were to wane. In other words, mortgage providers who largely rely on the new investment forms for financing could be particularly vulnerable if financing falls due during a period of severe shocks to the investment market for mortgages. This refinancing risk is greater for short-term financing. All else equal, this implies that new mortgage structures should have longer financing than the banks.

Refinancing problems in the new mortgage structures could otherwise threaten borrowers' continued access to loans under stressed market conditions. If the structure's financing costs increase, borrowers may face sharply deteriorating terms and conditions. In a crisis during which a mortgage provider is not able to raise the funds needed to continue to finance outstanding mortgages on reasonable terms, the provider may be forced to call in the loan. This could have a negative impact on individual borrowers if, for example, they are not able to get a loan from a different lender due to e.g. weakened personal finances or general uncertainty on the markets.

Problems on the markets for mortgage financing could in the same way lead to problems for the economy as a whole if new business models for mortgages gain a significant share of the market. If several mortgage providers were forced to terminate their mortgage agreements and cease issuing new loans, the access to credit would be restricted. If banks in such a situation would take over the mortgages of individual borrowers or entire mortgage portfolios from new mortgage structures, their capital needs would increase. In the presence of shocks on the financial markets, there is no guarantee that the banks would have the financial capacity to take over the loans to the required extent. This in turn would potentially further restrict the credit supply in an already weak market, and thus could deepen an economic recession. It could also mean that many new borrowers will not receive new loans for financing the purchase of their homes.

The possibility of maintaining stable and predictable access to mortgages, which is a systemically important function, could be weakened if new business models are not robust and sustainable even in the long run. If large volumes of loans are financed via such business models, refinancing problems could lead to a less stable supply of credit for the entire economy.

Risk-mitigating measures for market-based mortgage financing

Rules that fundamentally aim to create resilience and maintain confidence in both individual firms and the system at large often also lead to stronger consumer protection. They are supplemented by additional rules that aim to safeguard the interests of individual borrowers, for example via the duty of care that rests on the lender.

There has not been any need for special requirements to limit the refinancing risks attributable specifically to mortgages in a system where the banks provide

the mortgages and hold them on their balance sheet. These risks are covered by the general liquidity requirements that are already imposed on the banks. However, where mortgages are issued or financed by market participants who are not subject to the regulations that limit refinancing risks, the vulnerability in the business models needs to be managed separately.

The consumer protection regulations normally require that mortgages have long contractual maturities. Borrowers have the *option* of early repayment, for example to switch to a new bank or to buy a different home, but they also have the *right* to keep the loan until it falls due. It is therefore important to have a business model that is robust, so borrowers can trust that the loan will be financed for its entire term.

The refinancing risk that arises is primarily linked to the actual maturity of the borrowers' mortgage agreements. The average actual maturity for Swedish mortgages in recent years has been approximately seven years. The fact that this figure represents an average and refers to a period characterised by high economic growth and a strong housing market with rising prices and high turnover entails two important aspects. First, there are borrowers who hold their loan longer than seven years. Second, it is probable that the average maturity on mortgages could be significantly longer during weaker periods on the housing market. Turnover on the housing market could go down during these periods, for example due to general uncertainty and lower house prices, which could result in borrowers holding onto their mortgages longer. In this case, the average maturity of the mortgages would increase.

This means that the maturity of the financing in a mortgage structure should reflect the mortgages' *expected* maturity and take into account that the maturity may need to be extended during a downturn in the economy and house prices. To limit the annual refinancing need in the structure, it is important to have stable and long-term matching between assets (mortgages) and liabilities (issued investment instruments).

Using this as its starting point, FI believes that the maturity for the financing of mortgages in new mortgage structures should be at least ten years. This requires investors in mortgages to be professional, take a long-term approach, be able to assess the credit risks in the investment and be willing to forego liquidity in the mortgage investment.

There are professional investors with long-term commitments in their operations that thus have the capacity to hold long-term (and less liquid) assets – particularly insurance companies and pension funds. Mortgage providers, by turning to these kinds of investors, can raise financing that reflects the expected maturity of the mortgages. If the new mortgage structures grow in scope, this would also potentially lower the maturity imbalances in the financial system as a whole and thus reduce some systemic risks. In other words, on the plus side, financial solutions with long maturities *both* protect borrowers *and* reduce the risks to financial stability.

Furthermore, it is important for mortgage providers with new mortgage structures to manage their liquidity risks on an ongoing basis and be prepared to take special measures in the event of a crisis.

Mortgage providers can prevent risks to some extent by spreading the maturities of their financing evenly over time and conducting relevant stress tests. They should ensure already at the design stage that they can manage liquidity risks in their mortgage structure and are able to make contractual repayments to investors. Regular stress tests should take into consideration the structure's liquidity profile, investor behaviour, credit risk in mortgages and the market for mortgage assets, and how other market participants can be expected to react in stressed market conditions.

In a drawn-out crisis, market participants may need to have access to alternative financing forms for their mortgage structures. This type of contingency planning can be achieved in different ways, for example through a contractual possibility to defer repayments to investors or utilise contractual credit facilities at a bank. In other words, for example, a manager of an alternative investment fund who invests in mortgages should consider if there are grounds for inserting conditions into the fund rules that allow the manager to apply tools and arrangements for managing redemption during more difficult market conditions.

Peribank structures

Several banks are showing an interest in establishing new mortgage structures. For peribank structures, some special issues and risk assessments will arise.

Consolidation and capital adequacy

An important driver behind the banks' interest in financing mortgages through new structures instead of holding them on their own balance sheets is the possibility to avoid capital requirements.

The regulatory framework for banks contains requirements that apply to the entire group to which the bank belongs, even if the requirements do not apply to an individual firm within the group. One example is the capital requirement. For banks, the question therefore arises about which firms are considered to be included in the consolidated situation for the bank's financial group and thus are also subject to capital requirements. The responsibility for assessing the scope of the consolidation normally rests with the competent authority in the country where the group's parent company is domiciled.

In Appendix 1, FI presents its assessment that consolidation should occur when a parent bank directly or indirectly owns an alternative investment fund (AIF), as defined by Swedish association law, that acquires loans from the parent

bank. However, it cannot be ruled out that there are peribank structures that do not require consolidation.

Flowback risk

If the banks were to create a peribank structure in a way that does not require full consolidation, and thus is not subject to capital and liquidity requirements and other requirements imposed on banks, the mortgage structure may still give rise to risks that must be assessed and, where necessary, prevented.

From the bank's perspective, there can be incentives in a crisis for the mortgage fund to voluntarily take back the mortgages to its own balance sheet or in some other way provide support to the fund even though there are no contractual obligations for it to do so. Banks normally have in interest in long-term customer relationships and historically have been prepared to go to great lengths to try to prevent credit losses and protect their reputation among investors in the market. This was evident, for example, during the most recent financial crisis.

It is fundamentally positive that banks are able to support the peribank structures – but this applies on the condition that the bank has the capacity in the form of capital and liquidity to manage the effects that arise as a result of the support. The bank's decision to provide support could otherwise place it in an exposed situation, particularly if this occurs under already stressed conditions for the bank itself or the entire banking system. The flowback, by extension, could lead to the bank being forced to reduce other types of lending. If the market for new mortgage structures were to grow considerably in scope, and several banks were to take similar action, this could have an impact on the access to credit in the economy at large.

Therefore, it is essential from both a micro- and a macroperspective for banks to design their structures in line with the general preconditions that apply to all mortgage providers. An important part of this is that the financing must have a fixed maturity of at least ten years with a maturity profile that shows good distribution. In the event of peribank structures, there is otherwise a risk that refinancing risks in the structure will be transformed into so-called flowback risks for the bank. FI believes that banks themselves should assess and manage already from the start any flowback risks, for example within the framework of their stress tests of capital and liquidity.

If a bank sets up structures that do not meet these preconditions, FI will need to consider taking measures within the framework of Pillar 2, for example through a higher capital requirement, to avoid the bank being undercapitalised for any flowback.

Conclusions

FI considers a development on the mortgage market that contributes to greater customer value through increased competition to be fundamentally positive. New financing models for mortgages that are well-designed can also lead to improved financial stability.

A well-functioning mortgage market must have responsible participants who can offer stable financing for their customers in the long term. The rules aim to foster a mortgage market with a high degree of consumer protection, controlled risk-taking and stability in the credit supply, even during periods of financial uncertainty. It is FI's assignment to ensure that the new development does not introduce risks that could have negative effects on individual borrowers or the mortgage market as a whole.

The following preconditions will be in focus during FI's authorisation assessments and supervision of all participants in the mortgage market.

- Consumer protection rules regardless of the creditor.
- Investors in mortgages should be professionals with the ability to both assess the risks in the investment, including the credit risk associated with the mortgages, and make long-term commitments.
- The starting point is that the financing in a mortgage structure must have a fixed maturity of at least ten years. There may not be any conditions that allow investors to redeem the instruments earlier than ten years.
    - The maturity profile of the financing should show good distribution over time.
    - Market participants must continuously monitor and manage the liquidity risks in the structures and should assess other tools and arrangement that limit refinancing risks in more difficult market conditions.
- For peribank structures that do not require full consolidation, the bank needs to assess and manage any flowback risks itself, for example within the framework of its stress tests of capital and liquidity.

When designing new mortgage structure, market participants should submit a clear description of the following to FI, in addition to the other information required by the regulations:

- how the duty of care is observed during the entire maturity of the mortgages
- contractual maturity of a mortgage
- information to borrowers when transferring mortgages
- follow-up of credit matters following transfers
- the structure's longevity and any process for transfer to a new structure
- the design of the financing according to the preconditions listed above

Concluding remarks

FI assumes that market participants are conducting business in a manner that adequately limits risks to both borrowers and the financial system. FI will assess this and intends to carefully follow the market's scope and risk level.

In the future, new issues may arise that must be assessed, and risks may arise that need to be prevented. FI will use the regulatory tools required to ensure a stable mortgage market. If the market were to grow such that a very large portion of the mortgage stock is financed by new structures, FI will not rule out that a need may arise for additional risk-mitigation measures. Where the development gives rise to risks not captured by applicable legislation, new regulation may be required.

Finally, FI needs to be able to perform effective and risk-based supervision of all participants on the mortgage market. When the market changes, new focus areas may emerge that need to be supervised. For example, the need for ensuring a good credit assessment and compliance with the duty of care obligation even when loans are transferred in cases where the original lender does not keep any own risk. FI is carefully following the mortgage market and will further develop and strengthen its supervision if necessary.

Appendix

Introduction

In its dialogues with market participants, FI has noted questions regarding its assessment of the consolidation need in a potential structure where a parent bank directly or indirectly owns an alternative investment fund (AIF), as defined by Swedish association law, that acquires mortgages from the parent bank. In other words, it is not a question about AIFs in general.

The regulations clearly state clearly that asset management companies (for example a manager of alternative investment funds) must be included in the consolidation. In this appendix, FI describes its interpretation of whether the regulation prescribes that even the AIF must be consolidated.

Applicable rules on consolidation

The undertakings that are to be included in the consolidation are set out in the Capital Requirements Regulation (CRR).[5] Article 18 of the CRR states the following:

> *The institutions that are required to comply with the requirements referred to in Section 1 on the basis of their consolidated situation shall carry out a full consolidation of all institutions and financial institutions that are its subsidiaries or, where relevant, the subsidiaries of the same parent financial holding company or mixed parent financial holding company.*

In other words, the regulation requires full consolidation of all institutions and financial institutions that are subsidiaries. The regulation thus establishes two preconditions for consolidation to occur, namely

1. that the undertaking is an institution or a financial institution, and
2. that the undertaking is a subsidiary.

Consolidation can occur using different methods. The starting point for subsidiaries is full consolidation (i.e. all assets and liabilities on the undertaking's balance sheet are taken up in the consolidated situation).

Articles 18.2–18.6 of the CRR state that consolidation may also be required for joint ventures or associates or if the parent bank has a significant influence over or the same management as the institution or the financial institution. In cases where ownership amounts to or exceeds 20 per cent of the shares in the

[5] Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms.

institution or the financial institution, it is FI's practice to apply consolidation. Consolidation can then occur, depending on the circumstances, through full consolidation, proportional consolidation or the equity method[6]. Article 18(8) states that ancillary services undertakings may need to be consolidated.

It is not difficult to determine which undertakings are subsidiaries. An AIF in which a bank is the majority shareholder should be a subsidiary to the bank. Determining whether or not such an AIF should be consolidated then becomes a question of whether it is an institution or financial institution.

What is an institution or a financial institution?

It is namely clear that an institution is a credit institution (a bank or a credit market undertaking) or an investment firm. The definition of a financial institution is more complex. The CRR defines "financial institution" as the following:

> *an undertaking other than an institution, the principal activity of which is to acquire holdings or to pursue one or more of the activities listed in points 2 to 12 and point 15 of Annex I to Directive 2013/36/EU, including a financial holding company, a mixed financial holding company, a payment institution within the meaning of Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market (23), and an asset management company, but excluding insurance holding companies and mixed-activity insurance holding companies as defined in point (g) of Article 212(1) of Directive 2009/138/EG.*

In other words, the definition lists a number of types of undertakings that are or are not financial institutions. It can be noted that it is clear than an asset management company, i.e. the company managing an AIF or another fund, must be consolidated if it is a subsidiary to the bank. It is also clear that, for example, insurance holding undertakings are not financial institutions.

However, there are several types of undertakings defined in the CRR that but that are not expressly mentioned in the definition of financial institution, for example, insurance undertakings, reinsurance undertakings and collective investment undertakings or funds (which include alternative investment funds (AIF) according to Directive 2011/61/EU on Alternative Investment Fund Managers).

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[6] In simplified terms, the equity method is when the participations in an associate are initially reported at cost in the consolidated financial statements and taken up in the consolidation situation in accordance with the capital adequacy regulations. The financial statements/// are then adjusted to reflect the owner's share of the associated undertaking's profit or loss.

The question of whether or not an insurance undertaking is to be included in the consolidation has been answered by the European Banking Authority (EBA) in a Q&A document on its website.[7] There, the EBA states that insurance undertakings should not be included in the consolidation since their principle activity is not listed as an activity in the list in Annex 1 to Directive 2013/36/EU (CRD4).

Given this background, it appears that undertakings are not exempt from the definition of "financial institution" because they have been specifically defined in the CRR or they are subject to their own regulation with their own capital adequacy regulations (Solvency). It thus appears that the issue of whether an AIF is a financial institution or not depends on the AIF's principle activity. This interpretation appears to be supported in another Q&A where the EBA stated that so-called UCITS funds are not be considered financial sector entities as long as they do not pursue any of the activities listed in points 2–12 and 15 of Annex I to CRD4.[8] A financial sector entity is namely a financial institution.[9]

The list of activities in Annex I to CRD 4 states, for example, the "lending including, inter alia: consumer credit, credit agreements relating to immovable property, factoring, with or without recourse, financing of commercial transactions (including forfeiting)". There are also other points in the list that could be applicable. It does not expressly state if "lending" only refers to the original loan provision or if it also includes the acquisition of loans.

It is FI's assessment that there is no crucial difference in this context between providing the original loan or later entering as a lender through acquisition of claims. An AIF whose principle activity is to acquire loans from the parent bank and manage them therefore pursues lending and is thus a financial institution.[10]

Conclusion

It is possible from a supervision perspective to argue both for and against whether an AIF that is a subsidiary to the bank should be included in the consolidation. In general, FI makes the assessment, given the background of the formulation of the regulation, that there is currently no possibility for granting exemption from the consolidation to an AIF that is a subsidiary to a bank and whose principle activity is to acquire loans from the bank. The same assessment applies in the situation where the AIF is an associate to the bank.

[7] Q&A 2013_383.
[8] Q&A 2015_2383.
[9] The definition of "financial sector entity" is set out in Article 4(1)(27) of the CRR.
[10] Because it is its assessment that this kind of AIF constitutes a financial institution, FI does not go into more detail into the question of whether it could be a related undertaking.

However, the effect of consolidation is not the same if it occurs through different methods. Fundamentally, full consolidation applies to subsidiaries, while the equity method is normally applied to associates.

This question is being discussed within the EU. It is therefore possible that changes will be made to the consolidation rules or additional information will be published in conjunction with a revision of the CRR or when producing technical standards for consolidation methods.