European Banking Federation

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EBA Consultation Paper on Limits on exposures to shadow banking entities (EBA/CP/2015/06)

General Comments

The aim of the draft guidelines is to provide more detailed rules on how credit institutions should handle their risk management towards large exposures on shadow banking entities. We support the idea of minimising uncertainty in the area and mitigating any specific risk arising from significant exposures to shadow banks. However, the EBF would like to highlight the following areas of concern in the EBA's proposed approach:

Definition of Shadow Banking

The proposal and the definition of shadow banking entities is still too wide and nebulous and therefore not only run the risk of creating uncertainty and inconsistency but also putting administrative burden on financial institutions without any proven added value. Furthermore, with the proposed wide definition there might be large companies or group of connected clients with insignificant activity in the shadow banking sector, but still captured by the new requirements due to a total exposure, where the predominant amount is lending to e.g. manufacturing, exceeding the threshold. There ought to be a certain magnitude of sizable bank-like activities for the requirements in the guidelines to apply to.

It is clear that these guidelines should serve as complementing guidance regarding large exposure regime. But there is a need to align the content and the specific requirements with already existing principles even more. Any individual limit as a complement to an aggregate limit on these exposures should for example be tied to a group of connected clients to which an institution has a large exposure, not a specific entity. The large exposure regime is built on the principle that a group of connected clients is a common risk.

We consider that securitisations by non-banks should be excluded from large exposures to shadow banking entities. The level of regulation around securitisation makes this a highly regulated financial product and should therefore be out of scope here.

Large Exposures is not a risk based regime – Pillar 2 is the right place to assess additional risks

Furthermore, the EBF notes that the large exposures framework under the CRR is not a risk-based regime as it does not depend on the client's risk (the exposure value compared to the 25% limit is not risk weighted). As such, introducing limits on individual exposures based on the client's risk, hampers the "non-risk" principle.

In our opinion, this conclusion also applies to the "non-explicit" approach considered in the guidelines. The proposed guidelines do not set a lower regulatory hard limit ("explicit approach"), but require banks to comply with additional requirements for SBE to maintain the current limit. These additional requirements allied to a special validation under SREP for SBE, imply different treatments between limits for SBE and limits for non-SBE (due to risk perception), which creates a contradiction with the regime's non-risk principle.

Direct focus on Shadow Banking Risk

Although we support the need to restrict exposures to some entities, due to the systemic risk associated, we do not agree with an approach based on stricter limits. In our opinion, the limitation of exposures could reduce, at some extent, the systemic risk, but will not address or mitigate the true weaknesses of those entities. This can only be achieved through the development of a fundamental and robust regulation designed for shadow banking entities.In this work existing and planned regulatory regimes need to be accounted for. Moreover, attempts to improve transparency of SBE already planned should be acknowledged.

Potential Duplication of Pillar 2 Assessment

In the context of the overall large exposure regime under Part Four of the CRR, Article 395(2) states that the purpose of the guidelines is to set appropriate aggregate limits on large exposures or lower limits on individual exposures to shadow banking entities. However, the draft guidelines plan to set special Pillar 2 requirements which will apply exclusively to exposures to shadow banks. These additional requirements in paras 1 and 2 in Title II are not necessary, in our view, since they are either already legally enshrined in the implementation of the CRD IV rules relating to Pillar 2 or are covered by the EBA's new SREP guidelines. Moreover, the use of Pillar 2 measures in such a complex context will most probably result in very heterogeneous implementation, thus endangering level playing field among banks operating cross-border. Please also see our reply to Question 2.

Need to balance financial stability concerns with financial growth agenda

At the same time, the draft guidelines in their present form fail to fulfil a substantial aspect of the mandate set out in Article 395(2). This tasks the EBA with examining possible adverse implications for the risk profile of European institutions, the provision of credit to the real economy or the stability and orderly functioning of financial markets. This aspect of the mandate, though of key importance, has hardly been reflected in the guidelines.

We consider it essential, against this backdrop, to first conduct a careful impact assessment to evaluate the effects of any restrictions on lending caused by tighter limits. We are particularly concerned that the highly conservative option 1 of the fallback approach may be inappropriate in the context of the European Commission's jobs and growth agenda. Only based on a careful impact assessment will the European Commission be in a position to weigh the suitability of stricter limits on exposures to shadow banking entities. Our perception is that the costs of option 1 will outweigh the benefits and it should hence not be included in the final guidelines (para 34).

In addition to first assessing potential impact of the EBA's currently proposed approach, the EBA also should consider other options which might prove more suitable from a cost-benefit perspective. Simpler approaches would significantly reduce the administrative burden which the guidelines will inevitably generate.

Individual vs aggregate limits

Furthermore, Article 395(2) of the CRR does not say that different individual limits have to be introduced for each exposure to shadow banking entity; it only mandates EBA to set individual limits. The mandate neither says that both individual and aggregate limits have to be set. It would be perfectly possible to introduce only one or the other.

Need for higher materiality threshold

Overall the draft guidelines presently do not adequately reflect the fact that the intention of lawmakers in introducing limits to large exposures in Article 395 CRR was to address exposures to clients or groups of clients which exceed 10% of a bank's eligible capital. With this in mind, the proposed materiality threshold of 0.25% should be substantially raised. In addition it is to say that Article 395 CRR, where the mandate to the EBA is given, is about limits and not about procedures how to treat certain exposures. Procedures like the look through approach are described in Art. 390 CRR.

The consultation paper sets out no timetable for implementing the guidelines. It is essential, in our view, to allow all involved sufficient time. We believe the deadline for compliance should be no earlier than 31 December 2016.

Answer to specific questions

Q1: Do you agree with the approach the EBA has proposed for the purposes of defining shadow banking entities? In particular:

- **Do you consider that this approach is workable in practice? If not, please explain why and present possible alternatives.**
- **Do you agree with the proposed approach to the exclusion of certain undertakings, including the approach to the treatment of funds? In particular, do you see any risks stemming from the exclusion of non-MMF UCITS given the size of the industry? If you do not agree with the proposed approach, please explain why not and present the rationale for the alternative approach(es) (e.g. on the basis of specific prudential requirements, redemption limits, maximum liquidity mismatch and leverage etc).**

The EBA proposes that its guidelines should cover exposures to shadow banks equal to or exceeding 0.25% of a bank's eligible capital. This threshold is far too low in our view. On top of that, the focus is supposed to be on risks associated with large exposures to shadow banking entities. Individual limits should therefore only apply – if at all – to exposures which reach or exceed the definition of large exposure. Should the EBA wish to deviate from the requirements of Article 395, the guidelines should apply only to exposures exceeding 300 million euros.

Is important for supervisors to recognise that establishing effective processes and IT systems for identification and control of exposures to shadow banking undertakings within the scope of the

Guidelines will be a complex task, also for banks that will use the fallback approach. We therefore suggest that additional proportionality is considered so that systems for the identification and control of shadow banking exposures according to the proposed guidelines on shadow banking should only apply when the business model analysis of the SREP (and ICAAP) indicates that shadow banking exposures may potentially constitute a material portion of the activity of the bank in question.

Furthermore, we consider the criteria for defining shadow banking entities (SBEs) somewhat nebulous and are concerned that this may give rise to inconsistency in the application of the guidelines. An exposure to an entity or a group a connected entities should only be classified as a shadow banking exposure if the shadow banking activities has a certain magnitude, both in real terms but also in relation to other activities carried out by these entities. The risks associated with shadow banking, which the proposed guidelines should mitigate, are only present in these entities. A definition based on "principal activity" or something similar is also in line with other definitions in CRR e.g. financial institution, financial holding company and ancillary services undertakings. Also, the AIFMD defines all non-UCITS funds as AIFs. Given this, presumably all unregulated funds would already fit within AIFs, which the EBA already proposes to be deemed an SBE. The definition of unregulated financial entities more generally ought to be clarified also in this regulatory initiative. Specifying the criteria regarding credit intermediation activities in more detail or drawing up a central register would also bring greater transparency and clarity.

We do not support the inclusion of the following entities under the SBE perimeter:

UCITS Money market funds (MMFs):

MMFs represent an important source of short-term financing for governments, corporates and financial institutions. In Europe, around 20% of short-term debt securities issued either by governments or by the corporate sector are held by MMFs. MMFs hold around 40% of short-term debt issued by the banking sector.

The main reason outlined in the consultation text for the definition of the UCITS MMFs as SBE is based on the high average size of MMFs industry and that the systemic risk posed by these funds has not been adequately addressed in existing regulation

We would, however, argue the contrary, all MMFs are regulated. The vast majority of MMFs - around 80% of the assets and 60% of the funds - operate under the rules of the UCITS Directive. The rest of the MMFs operate, since July 2013, under the rules of the less stringent AIFMD.

Moreover, compared to other funds, UCITS MMFs have to comply with an additional layer of specific MMF product rules:

- In pursuance of supervision and regulatory convergence efforts CESR, the predecessor of ESMA has, in May 2010, issued extensive guidelines on MMF (CESR 10/049);
- Later, on September 2013, the European Commission published a legislative proposal for a specific Regulation on Money Market Funds which is currently being discussed. The proposal introduces common standards to increase the liquidity of MMFs as well as to ensure the stability of their structure. Uniform rules are introduced to ensure a minimum level of daily and weekly liquid assets. A standardized policy is established to permit the fund manager to gain a better understanding of its investor base. Common rules are also introduced to guarantee that MMFs invest in high quality and well diversified assets of good credit quality. These measures aim to ensure that the liquidity of the fund is adequate to face investors' redemption requests.

All put together, UCITS MMFs are investment funds more heavily regulated and with significantly lower risk than “classical UCITS”. The fact that these funds account for a large portion of banking activities should not be considered as a sufficient reason to define them as SBE. The inclusion of these funds under the scope of SBE will lead to a conceptual conflict between the pure definition of SBE and the entities chosen to be included in that list.

We advocate the exclusion of all UCITS (being non-MMF or MMF) from the scope and for an increase in the resilience of the MMFs, without imposing adverse effects on the role of intermediation of the EU banks in financing the EU economy.

AIFs

In terms of challenges to the collection or provision of information to supervisory authorities, most European investment funds, be they UCITS or nationally regulated funds, already provide comprehensive information to the authorities, their investors and the wider public. The Alternative Investment Fund Manager AIFM Directive (AIFMD), in force since 2013, brings the quality of supervisory monitoring to an even higher level by imposing ambitious reporting requirements on managers of alternative investment funds:

- Supervisory reporting is mandatory for most Alternative Investment Funds (AIFs) on a quarterly basis and will includes detailed information on portfolio composition, principal exposures and most significant counterparty concentrations, risk profile and liquidity management.
- The AIFMD reporting provides helpful data for assessing the interconnectedness between banks and other financial entities.
- These requirements have been developed with the specific aim of enabling supervisory authorities to effectively monitor systemic risks associated with AIF management.

As a consequence, except for those funds relying on a significant leverage, AIFs should also be excluded from the scope of shadow banking.

Should the EBA proposed guidelines remain unchanged, the distribution of AIFs, which serve the purpose of the credit institution’s capital preservation and diversification, hence making credit institutions more resilient, would be massively hampered. Furthermore, we see no specific justification for including as SBE certain closed-ended and unleveraged AIFs, European Venture Capital Funds (EuVECAs), European Social and Entrepreneurial funds (EuSEFs) and European Long Term Investment Funds (ELTIFs). These provide useful and much needed financing to the EU businesses and economies. As such, given the wide ranging AIFs we urge the EBA to investigate on how AIFs, with reduced leverage could be excluded from the scope of SBE based on a pre-specified risk metric.

ELTIFs

European Long-Term Investment Funds (ELTIFs) are a new fund framework for which an EU regulation was just published in the EU Official Journal. ELTIFs are designed for investors that want to invest in long-term projects, and are an important part of the EU’s initiative to spur the economy via the Capital Markets Union. The ELITF brand, like UCITS, is heavily regulated by the recently passed regulation. Among other things, there are strict requirements on eligible assets that require investment in generally illiquid assets that require a long-term commitment. Moreover, there are strict rules on investors. However, by law, ELTIFs are a variant of an AIF. Thus, ELTIFs would be considered SBEs. Should such be the case, the ELTIF brand would be crippled because of the proposed limits to exposure to banks.

Credit institutions of third countries:

On page 18, it is mentioned that third country institutions can be excluded from SBE definition if "*the third country applies prudential and supervisory requirements to that institution that are at least equivalent to those applied in the Union*". It is not clear if these countries are restricted to the countries listed in the EU "Implement Act on Equivalence", published on December 2014.

Assuming this understanding as correct, we do not agree that third country banks, not listed in the mentioned act, should be considered as shadow banking entities. We highlight that major banks in other non-EU countries are subject to prudential regulation by their central authorities, which include rules regarding maturity and liquidity transformation, leverage limits, concentration limits and capital requirements limits.

The non-equivalence with the level of supervision/prudential requirements in the EU does not mean that, banks in these non EU countries, are not subject to strict rules and, as such, should not be classified as shadow banking entities.

Q2: Do you agree with the approach the EBA has proposed for the purposes of establishing effective processes and control mechanisms? If not, please explain why and present possible alternatives.

We are opposed to the idea of introducing additional Pillar 2 qualitative requirements, like the ones in Title II paras 1 and 2, explicitly for shadow banking entities. The qualitative Pillar 2 requirements set by CRD IV have already been implemented in full in national law. It is not clear why these guidelines should set requirements aimed specifically at shadow banks when the same requirements already apply to all borrowers anyway and are already enshrined in various other EBA guidelines (e.g. those on internal governance, SREP). The requirements in Title II, paras 1 and 2 would create unnecessary additional administrative work since separate frameworks, policies and reporting systems would need to be developed specifically for shadow banking entities and these would be subject to separate scrutiny by supervisors and auditors. There would be no corresponding benefit.

The guidelines give the impression that shadow banking entities pose a special, specific type of risk. This is not the case. Like any other borrower, a shadow banking entity basically has the potential to generate various types of risk for the lending bank (credit risk, market risk, operational risk, etc.). It is already an established principle in risk assessment that the creditor needs to understand and be aware of the opportunities and risk of the transaction and the activities run by the debtor. Knowing the customer is essential to understand these aspects and this is nothing specific for an SBE.

Also, it is excessive, in our view, to assume that shadow banking entities by their very nature have a correlation of one and thus pose a high level of concentration risk. This automatically puts shadow banking entities on a worse footing than other borrowers, such as corporates, which is not appropriate. It therefore makes little sense to require separate management processes and control mechanisms to be developed for shadow banking entities. Nor would this be feasible, since the shadow banking sector is far too heterogeneous for the application of uniform processes and mechanisms.

Banks are naturally required under Pillar 2 to identify, measure and manage concentrations of credit risk. Applied to shadow banking entities, this means that – as stipulated in Article 81 of CRD IV – the concentration risk arising from a shadow bank's links to other borrowers (group of connected clients) or through sectoral or geographic concentration has to be adequately managed. However, even the CEBS's Guidelines of December 2011 on the revised large exposure regime point out that only idiosyncratic risk should be addressed by the large exposure regime itself while geographic and sectoral risk should be dealt with under Pillar 2.

It is normal practice to set sectoral and geographic limits on credit risk under Pillar 2. Individual limits are set as part of banks' routine lending processes. The "hard" requirements of Pillar 1 and the large exposure regime already have a limiting effect in this context. Given the heterogeneity of the shadow banking sector, we believe it makes little sense to regard shadow banking entities as a single industry and place corresponding limits on a bank's exposure to them.

In any event, it should be made clear that, in point e), the process to determine the interconnectedness between shadow banking entities should include only the SBE to which the bank has exposures. An exercise to assess the correlation between the bank's exposures to SBE with other SBE in the market, not included in the bank's portfolio, would be impossible to perform as no detailed information exists in the bank (neither needs to be collected) for those remaining SBE.

Q3: Do you agree with the approach the EBA has proposed for the purposes of establishing appropriate oversight arrangements? If not, please explain why and present possible alternatives.

As outlined in our comments to question two, we do oppose the idea of introducing special qualitative requirements for SBEs only that are usually part of other regulation for pillar II. Risk management processes are reviewed by the management body on a regular basis. But this assessment covers the entire risk portfolio. In addition we would like to draw again the attention on the fact that SBEs should not be considered as a single risk category.

Furthermore, it might be on a too detailed and operational level to put demands on the institutions to "review and approve the management process to shadow banking entities." It is probably more relevant and sufficient that the Chief Risk Officer and Risk Control function have responsibility of such follow up and just report any deficiencies within the ordinary reporting scheme to the management body of the institution.

Q4: Do you agree with the approaches the EBA has proposed for the purposes of establishing aggregate and individual limits? If not, please explain why and present possible alternatives.

As explained above, we do not believe it makes good sense to set separate limits on exposures to shadow banking entities under Pillar 2 since the shadow banking sector is highly heterogeneous and no risk management benefits would ensue, which should always be a prerequisite for setting a limit. In any event, individual limits are already set for every client and group of connected clients as a result of routine lending processes or banks' strategies for managing credit risk.

Since it seems, however, that policymakers wish to set limits, we would suggest considering the following alternatives:

- Blanket aggregate limits for large exposures: this would make it superfluous to set individual limits specifically for shadow banks under Pillar 2. The regular Pillar 2 requirements would continue to apply, including to shadow banks. We believe an appropriate level for the aggregate limit would be

500% of eligible capital. This would mean that a bank's large exposures to shadow banking entities could not exceed five times the amount of its eligible capital.

- Lower individual large exposure limits: in this case we would suggest a general individual limit of 20% of eligible capital.
- If the above alternatives are not considered acceptable and the idea of establishing both individual and aggregate limits is retained, we consider it essential to drop the fallback approach.

The determination of interconnectedness between shadow banking entities, and between shadow banking entities and financial institutions, should be conducted only regarding direct linkages: when shadow banking entities form part of the bank credit intermediation chain, are directly owned by banks, benefit directly from bank support or when banks hold assets of shadow banking entities. Indirect linkages, such as for example the investment of banks and shadow banking entities in similar assets, or the exposure to a number of common counterparties, cannot be correctly assessed and therefore should be out of scope.

Improvements in data availability and granularity (capital, leverage, liquidity, portfolio composition, etc.) will be essential for adequately capturing the magnitude and nature of risks in the shadow banking system.

Q5: Do you agree with the fallback approach the EBA has proposed, including the cases in which it should apply? If not, please explain why and present possible alternatives. Do you think that Option 2 is preferable to Option 1 for the fallback approach? If so, why? In particular:
Do you believe that Option 2 provides more incentives to gather information about exposures than Option 1?

- **Do you believe that Option 2 can be more conservative than Option 1? If so, when?**
- **Do you see some practical issues in implementing one option rather than the other?**

If there is really a need for a technical fallback approach, what we doubt, we would support a fallback approach, based on option 2. SBE will be a very heterogeneous group with different business models, levels of disclosure and with different risk levels within their portfolios. Based on this heterogeneity, it does not seem appropriate that, if a credit institution gathers all required information for the majority of those entities but, for a small group of SBE, cannot obtain the information required to set a meaningful limits framework, all the bank's exposures to all SBE (regardless of the information obtained) should be perceived as an exposure to the "same client" and, as such, will be subject to a 25% aggregate limit.

It is understandable that the EBA wishes to create incentives to collect as much, and as complete, information as possible about shadow banking entities. But the proposed fallback approach ignores the materiality aspect which is part of every loan decision. There is no need for a "technical" fallback approach, in our view, because shortcomings in setting limits – whether on exposures to shadow banking entities or any other borrower – can be addressed under the SREP and additional capital requirements will put pressure on banks to eliminate them.

We are not clear on the rationale behind the EBA's preference for option 1. Naturally, this approach is the most conservative of all possible options. But a limit of 25% on all exposures to shadow banks is without doubt far too low. As things stand, banks may, in principle, lend up to 25% of their eligible capital to each shadow banking entity with which they do business. Option 1 would therefore significantly overstate the risks involved in lending to the shadow banking sector.

Option 1 does not provide incentives to develop a robust assessment process as the non-compliance with a principal approach for just one SBE exposure will lead to an overall limit to all SBE exposures. Even if, in these situations, banks decide to runoff the portfolios to the specific SBEs to which they cannot obtain the required information, this will lead to an increase of exposures to “principal approach compliant” SBE, which, on the other hand, will result in concentration risk challenges. Furthermore, option 1 could lead, on the short term, to swift systemic events resulting from the insolvency/ fire sale of assets from the SBE that cannot provide the necessary information of the banking sector.

The smoothing and mitigation of these risks can only be achieved through the development of specific regulatory regimes to SBE that allow them to redesign their operating/business models, with sufficient time for implementation. Any isolated measure that influence unilaterally banks’ behaviours, without allowing SBE to adapt, will always have the risk to trigger adverse movements, which will be substantially higher with option 1 (the potential deleveraging process will affect not only the specific SBE that do not provide the required information but all SBE entities/markets).

In summary, SBEs are different and will be at different stages of evolution, both features that are not controlled by banks. As such, the potential absence of information from specific SBE groups should not lead to restricted limits to other sophisticated SBE groups, as proposed under option 1.

Q6: Taking into account, in particular, the fact that the 25% limit is consistent with the current limit in the large exposures framework, do you agree it is an adequate limit for the fallback approach? If not, why? What would the impact of such a limit be in the case of Option 1? And in the case of Option 2?

First, the adoption of a principal approach requires not only the gathering of sufficient level of information but also the ability to effective use that information on the definition of a comprehensive set of limits. Second, we highlight that the compliance with the requirements stated in the principal approach include numerous points - from a) to c) for aggregate limits and from a) to h) for individual limits - being just one of them the interconnectedness.

We do not agree with the assumption mentioned on page 13 which states that “*in the absence of sufficient information, all exposures to shadow banking entities could be connected*” and so indicates that they should be understood as the same client. As such, although the information gathered could not allow the compliance with all specific rules of the principal approach under Title II, this does not mean that, based on the information collected, there is an inability to evaluate the interconnection between SBE and so, concluding that they are all connected. Moreover, this example also illustrates that the framework does not appropriately capture the risk of the exposure to the SBE thus calling for a different, simpler approach.

Due to the complexity of the principle approach, a comprehensive comparison of the principle and fallback approaches cannot be done making the assessment of the proposed 25 % limit for shadow banking exposures challenging. However, it is of paramount importance that subsidiaries to banking entities under consolidated supervision, as proposed in the draft Guidelines, are excluded from the limits according to the definition of shadow banking entities. Taking into account that the regular large exposure limit of 25 % of eligible capital applies to single clients or single group of connected clients, it very surprising that EBA is of the opinion that an aggregate limit of 25 % would be sufficient. In CRD II there was an aggregate limit for all large exposures (exposures exceeding the 10%-threshold) of 800 % of own funds. From that figure it becomes obvious that the proposed limit of 25% is far too low.

We propose that the 25% limit should be subject to quantitative impact studies that allow the development of an empirical and supported base for the calibration of that factor. As an alternative, we suggest that banks might have the possibility to segment SBE exposures between specific sub-groups for which they can proof that no correlation is observed, even if the remaining requirements are not totally fulfilled to design individual limits for each specific SBE.