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Consultation response

EBA Guidelines on Limits to Exposures to Shadow Banking Entities

19 June 2015

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to provide our preliminary feedback on the **Draft EBA Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395§ 2 of the CRR.**

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Transparency Register, registration number 65110063986-76.

I. Overarching comments

AFME appreciates the efforts by the EBA to engage industry on the proposals relating to limits on exposures to shadow banking entities following the mandate included in the CRR. This model of engagement has proved useful in fleshing out the key considerations with regard to these Guidelines.

Although AFME does acknowledge the concern of policy makers that a migration of activity from the banking sector, which is highly regulated, to areas of the financial system which are less regulated, may lead to an increase in risks to financial stability, AFME questions whether these Guidelines are the most appropriate and indeed, the most effective, vehicle to deal with this issue.

It is also crucial that the context of the mandate outlined in the CRR is understood, and that this mandate is adhered to in a faithful manner. Article 395(2) of the CRR makes clear that the EBA shall issue Guidelines to set either appropriate aggregate limits or tighter individual limits on exposures to shadow banking entities. There does not appear to be any reason for the EBA to expand on this mandate and introduce both an aggregate limit and tighter individual limits and we would strongly urge the proposals to be amended to follow the mandate as drafted in the CRR.

Market based financing should not be compromised

Since the CRR was initially legislated, the policy objectives of legislators have evolved and the risks to the EU economy have changed. Political, regulatory and central bank initiatives are now underway to develop a framework of market based finance that can deliver economic growth in Europe. The European Commission's Capital Markets Union is the cornerstone to delivering this framework and care should be taken that the promotion and development of market based finance under the CMU umbrella is not unduly restricted by parallel regulatory initiatives. Consistent with the requirements of its CRR mandate (see second sub-paragraph of Article 395(2)), it is essential that the EBA examine the potential effects of its proposed Guidelines on real economy financing as this has not yet been considered in the impact assessment accompanying the draft Guidelines.

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Regulatory reform already addresses shadow banking risks

While we do understand that the CRR requires the EBA to examine the issue of introducing limits on banks' exposures to shadow banks, Article 395(2) requires that "the outcomes of developments in the area of shadow banking and large exposures at the Union and international levels" must be taken into account. Given the number and combination of regulatory actions that have already been taken to address risks posed by the shadow banking system and the precise content of the EBA's CRR mandate, we do not see any need for the EBA to introduce additional regulation in this area.

Firstly, a number of measures have been taken to explicitly address the interconnectedness between banks and shadow banks:

- The April 2014 Basel Large Exposure (LE) framework and the European Commission's Delegated Regulation No 1187/2014 of 2 October 2014 on exposures to transactions with underlying assets require banks to look through to the underlying assets of these structures. Indeed, the FSB has supported these measures as part of its Recommendations to Strengthen Oversight and Regulation of Shadow Banking[1], stating that "[they will] help control the contagion risks to banks arising from interconnectedness with the shadow banking system".
- The introduction of liquidity and funding requirements via the LCR and NSFR seek to ensure that banks will be less susceptible to liquidity and funding risks arising from funding provided by the shadow banking sector and other wholesale funding sources.
- Increases in risk weights for banks' exposures to unregulated financial sector entities were already included under the CRR, as well as higher capital requirements for banks' investments in the equity of funds.

Beyond the above measures, in 2009 and 2010 the EU adopted new capital rules for securitisations and re-securitisation and the Basel Committee has recently issued a fully revised capital framework for securitisations which will be implemented locally in due course. To further reduce contagion risks and improve transparency, derivatives reform has introduced mandatory central clearing for standardised derivatives, prudential requirements for CCPs and risk mitigation standards (collateral requirements) for non-centrally cleared contracts. The introduction of CVA requirements into the capital framework has also affected OTC derivative transactions with 'shadow banks'.

Additionally, the Leverage Ratio has already had impact on bank exposures to the other areas of the financial sector In particular, the punitive treatment of SFTs under the Leverage Ratio framework has distorted the economics such transactions, and therefore constrained banks' capacity to make funding available to these companies. In this context, we would urge the EBA to study further the impact of the Leverage Ratio on exposures to this sector.

In addition to the above measures, macro-prudential risks related to other areas of the financial sector have been or are being addressed through a significant number of key regulatory reforms. These include measures initiated at international level, and implemented in the EU in the following areas:

- FSB Recommendations to Strengthen Oversight and Regulation of Shadow Banking.
- Money Market Funds (MMFs): IOSCO recommendations and the forthcoming MMF Regulation in the EU which will improve the liquidity and stability of MMFs by imposing minimum levels of liquid assets, improving the valuation of their assets and introducing capital reserves.

[1] FSB, Strengthening Oversight and Regulation of Shadow Banking: An Overview of Policy Recommendations, August 2013.

- Securities Financing Transactions (SFTs): the FSB framework and the recently agreed EU Securities Financing Transactions Regulation introduces mandatory reporting for SFTs as well as consent and risk disclosure requirements for rehypothecation; minimum haircuts levels and methodologies are envisaged as a future enhancement.
- Alternative Investment Fund Managers Directive (AIFMD): this Directive increases the transparency and reporting requirements of these funds and requires them to introduce leverage limits, with competent authorities having the ability to impose hard leverage limits on these funds when necessary to ensure financial stability.
- Undertakings for the Collective Investment in Transferable Securities (UCITS) Directive– sets out operational and oversight requirements for these funds.

A Pillar 2 approach is preferable, but the proposed approach for aggregate limits has no prudential policy underpinning

Should the EBA ultimately conclude that action in this space is still necessary in spite of the significant reform that has already taken place, the introduction of any framework has to be operational from the point of view of banks. While the EBA's chosen emphasis on requiring firms to establish internal risk limits is a welcome improvement over other options initially envisaged, the EBA's approach to defining shadow banking exposures means that it will be extremely difficult for banks' to comply in practice with the expectations set out in the draft Guidelines. This is because the proposed definition of shadow banking given is so wide ranging that it risks bringing exposures to entities into scope even when credit intermediation is only a negligible part of their business.

The approach to defining limits should also be proportionate. We welcome the introduction of a threshold (currently proposed to be 0.25% of an entity's eligible capital) to ensure that the definition of shadow banking entities focuses on financial stability issues and does not unnecessarily target small and medium sized entities. However, we believe that the threshold is currently set at too low a level to effectively achieve this. Should the EBA proceed with the Guidelines, we recommend that the threshold be increased to 1%.

We are particularly concerned with the EBA's proposals for aggregate limits and the suggested fallback approach. Firms have traditionally managed their exposures to other areas of the financial sector through portfolio sub-components, with these exposures not considered to be sufficiently correlated as to require a single portfolio restriction. The EBA's fallback approach however supposes that all shadow banking exposures are correlated, yet its proposed calibration has not been supported by any data collection or impact assessment. Given the all-encompassing definition of shadow banking that is being proposed, along with the extremely high hurdle rate to qualify for the Principal Approach, banks will often have no choice but to adopt this overly conservative fallback approach. This could severely undermine the provision of credit to the real economy. Moreover, we expect these effects to be exacerbated if sufficient lead time is not provided to allow firms to deliver robust data enrichment and reporting mechanics.

In conclusion, it is our view the requirements surrounding aggregate limits are not based on a clear understanding of risks and impact. We strongly believe that they should not be introduced and urge the EBA to reverse its proposal in this respect.

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Impacts of a European precedent

Lastly, we would like to point out that the EBA should be aware that by issuing these Guidelines, it will be creating a European definition of shadow banking. We urge the EBA to carefully consider the consequences of such a precedent. Additionally, unilateral European measures to tighten lending limits to this sector are likely to place firms subject to these requirements at a competitive disadvantage.

II. Responses to the consultation questions

1. 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).*

We are concerned that the EBA's definition of shadow banking exposures is *far too broad*.

Credit intermediation should be the entity's *main* business

The EBA's definition, which combines entity and activity based approaches, will be highly difficult to implement in practice. Using entity types as means to generalise the types of activities is in principle appealing but does not take into account the wide range of diversity in underlying business models and activities that occurs in practice. Ideally, the definition should concentrate on activities (see below – alternative approach). Banks will not always have absolute transparency as to a client's investment and trading activities (e.g. if a client is conducting confidential activities away from that firm). For bona fide reasons, a bank may therefore not be able to make an absolute assessment as to a client's full activities.

It should therefore be clarified that when an entity undertakes credit intermediation activities in an ancillary capacity to their core business, it should not qualify as a shadow bank. Otherwise, the borrowing and liquidity risk management of corporates (e.g. treasury functions, etc.) would be captured by the definition, or that possibly the entire corporate would be captured. Pushing this type of example further, any corporate that lends money to its staff to purchase a season travel ticket could be considered to be carrying out credit intermediation activities.

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Existing exemptions should be maintained

The Guidelines should also clarify that any exposure already excluded from the LE framework under Article 400 of the CRR should continue to be exempt under the operation of the Guidelines. This would include, for instance, entities that are already aggregated with a sovereign for LE purposes or that are directed or otherwise controlled by a sovereign.

Exposures to transactions with underlying assets should be excluded

With regards to exposures to transactions with underlying assets as under CRR Article 390(7), as already pointed out above, we believe that the EC Regulation No 1187/2014 has sufficiently addressed the interconnectedness of banks' exposures to securitisations and exposure in the forms of units or shares in funds by requiring them to look through these investments and aggregate exposures to underlying single counterparties. This Regulation also sets out the conditions for when the structure of a transaction itself should constitute an additional exposure. We therefore think that funds and SPVs engaged in securitisation should be excluded from the definition of shadow banking exposures as this would amount to unnecessary regulatory duplication, where they would simultaneously be subject to look-through and shadow banking regimes.

We elaborate our thinking regarding securitisations and funds further below.

Securitisations

It is critical that the EBA does not introduce a regime that restricts the revival of the securitisation market. Securitisation has a crucial role to play in providing finance for "real economy" assets and is recognised by EU policymakers as being an important tool for this purpose in the context of the Capital Markets Union. Particularly when securitisations are considered to be "high quality securitisations" or "simple, transparent and standardised securitisations" as per BCBS and EU workstreams, their inclusion in the shadow banking definition would be contrary to current policy objectives.

Moreover, the broad definition including securitisation SPVs under the EBA's shadow banking limits potentially draws in a wide range of arrangements and does not appropriately focus on what is and is not an activity that involves shadow banking giving rise to systemic risk and justifying regulation.

Most of the global ABS market is made up of "traditional" term securitisations of real economy assets and a sizeable majority of such transactions are self-liquidating. This means that the investors' rights to repayment of principal are dependent on the securitised assets producing cash and, as a result, no material maturity transformation is involved, meaning this should not be considered shadow banking.

Similarly, in a multi-seller ABCP conduit, to the extent that such arrangements are not match-funded, it should be noted that the corresponding maturity mismatch is absorbed through the existence of liquidity lines provided by banks –meaning that there should be no maturity transformation at the level of the ABCP conduit itself and that these entities do not constitute shadow banking either.

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Funds

The inclusion of all AIFs and MMFs in the scope of the definition of shadow banking exposures is highly questionable. In its draft guidelines, the EBA hopes to address areas of concern such as 'credit intermediation being carried out outside the regulated framework', and 'unregulated financial sector entities' that are 'not within the scope of prudential consolidation nor subject to solo requirements under specified EU legislation'. Funds registered under the Alternative Investment Managers Directive (AIFMD) are not un-regulated or under-regulated funds. On the contrary, AIFs face a newly implemented and robust set of regulatory standards including authorisation rules, safekeeping through depository standards, enhanced transparency, detailed reporting rules, conduct of business rules, remuneration provisions, valuation rules, and leverage monitoring and intervention provisions for National Competent Authorities. Likewise, MMFs, which are largely registered as UCITS, as noted by the EBA, face not only similarly robust UCITS standards but will soon also be subject to an enhanced set of standards under the Money Market Funds Regulation (MMFR). Funds covered by the MMFR should clearly not be considered to be shadow banks.

Lastly, it is also not clear whether all the funds envisaged by the EBA's definition are effectively engaged in credit intermediation activities, for example, some funds are receivers rather than providers of credit intermediation. Treating all AIFs and MMFs as entities engaged in credit intermediation is a considerable oversimplification.

An alternative approach

A clear definition of shadow banking perimeter exposures is also necessary to avoid legal uncertainty and unnecessary overlap with existing level 1 EU legislation. To ensure harmonisation in the legislative framework in the EU, instead of introducing a new definition of shadow banking exposures, it would be vastly preferable to refer to the concept of "unregulated financial sector entity" set out in CRR Article 142 (5) as a starting point, particularly given that the current exercise is a level 2 initiative.

Ideally, the scope of the shadow banking sector should cover only those entities that carry out unregulated credit intermediation activities, and where these credit intermediation activities are the entity's main business. The definition of unregulated financial sector entity in Article 142 clearly integrates this concept of core or principal business and it must be retained in any final Guidelines.

The text of the draft Guidelines considers unregulated entities carrying out the activities listed in points 1-3, 6-8, 10 and 11 of Annex I of the CRD as being in scope. However, in practice, the description of these activities in Annex I may be insufficiently precise and/or not always constitute credit intermediation as defined by the FSB and the draft Guidelines (i.e. it is not a given that these activities always result in "bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities". It should therefore be made clear that counterparties that are engaging in the activities mentioned are not by default shadow banking entities and banks should assess whether credit intermediation activities are actually being conducted.

A more proportionate definition is also required

In order to focus the Guidelines on ensuring financial stability and to facilitate implementation and avoid unnecessarily targeting small and medium sized entities, the threshold for considering whether an exposure is a shadow banking exposure should be increased from 0.25% of an entity's capital base to 1%.

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Equivalence issues

We agree that entities that are subject to robust prudential frameworks (either directly or within a consolidated supervisory framework) should not be considered to be shadow banks. For instance, broker/dealers subject to capital and liquidity regulation on a consolidated basis, in line with FSB'sregulatory framework for haircuts on non-centrally cleared financing transactions[2], should not be covered by the definition.

It is however not clear how the equivalence aspects of the proposals are intended to operate in practice. For instance, who will be responsible for determining whether a particular regulatory framework is to be considered equivalent or comparable/of the same standard to banking-like regulation? There may very well be cases where prudential regulation for other financial sector entities *should* be different to bank-like regulation, for instance when such entities do not take deposits. There is a need to ensure that implementation of these Guidelines is not hindered by delayed timing, or absence, of equivalence assessments. Therefore, in line with the Pillar 2 process, and in the absence of any EU-wide equivalence determinations specifically for this purpose, firms should be responsible for determining equivalence for the purposes of the EBA Guidelines. A firm's assessment of equivalence would then be subject to a review by the National Competent Authority as part of the Supervisory Review and Evaluation Process (SREP).

2. 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 agree in principle with the proposed structure of risk in the context of the individual assessment of a particular obligor.

However, the degree to which firms will take a common approach to determining portfolio risk is not clear and indeed neither is how this will be supervised. In particular, the requirement in Title II Article 1 point (a) to "identify all potential risks [...] and the potential impact of those risks" is too broad and some form of materiality should be introduced.

We also consider that these Guidelines should only apply at the consolidated level. The rationale is three-fold:

- The usual large exposures limits set out in the CRR already apply to exposures of all types of counterparties and therefore this includes any counterparty that would be considered to be a "shadow bank" under the EBA's proposed definition. Those CRR rules already apply at both solo and consolidated levels and as such a sufficient backstop already exists within the current framework. As a result, any enhanced protection against single name concentration risk that would be provided by the EBA Guidelines can still be achieved by applying it at the consolidated level.
- The burden of the significant infrastructure, systems and processes that firms would need to put in place to comply with the Guidelines would be less onerous if applied at the consolidated level only.

[2] FSB report: "*Strengthening oversight and regulation of shadow banking: regulatory framework for haircuts on non-centrally cleared securities financing transactions*", 14 October 2014. Banks and broker-dealers subject to adequate capital and liquidity regulation on a consolidated basis are out of scope of "non-banks". (page 7 section 3.1)

- Application at the consolidated level only would make it easier for firms to manage the requirements within the ICAAP process as individual legal entities may have only a partial view of the phenomenon. Risk management processes aimed at creating senior management awareness are effective only when performed at consolidated level (group view) and when based on information provided by legal entities on shadow banking entities' identification and exposures. This is also in line with the Pillar II approach.

3. 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.

We agree with the need for a firm's management body to, in the context of shadow banking exposures, review and approve the firm's risk appetite and risk management process and ensure appropriate documentation, the effectiveness of which can then be attested to in the Pillar 2 process.

4. 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 think that the introduction of these Guidelines is warranted in general. We do however agree with the EBA that each institution should set its own risk tolerance/appetite for such exposures. This being said, we have significant reservations regarding the requirement for firms to set an aggregate limit to the entire shadow banking sector:

- Individual limits are a better fit with the philosophy of the Large Exposure regime which is designed to act as a backstop to individual client limits rather than to address sectoral credit concentration risk.
- Internal sectoral concentration limits are already set by firms and are monitored and challenged by supervisors in the context of Pillar 2. The difference between this approach and the proposed Guidelines is that the proposed definition of shadow banking exposures is "all encompassing" in nature and goes beyond reasonable sectoral definitions currently used by firms and approved by supervisors.
- Firms also monitor collateral and other portfolio concentrations as part of their internal risk management as well as for the existing capital processes, which further mitigates the need for an aggregate shadow banking limit.
- As pointed above, firms' will have significant difficulties in appropriately identifying shadow banking entities at an aggregate level and the supervisory interpretation is also likely to vary, creating unlevel playing field issues.
- The fallback method is not appropriate and is unduly punitive (see our response to Questions 5 and 6 below).
- Lastly, the EBA's mandate states that the "EBA shall [...] issue guidelines [...] to set appropriate aggregate limits to such exposures or tighter individual limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework". It is clear therefore that the CRR refers to setting **either** aggregate **or** individual limits. In setting out a combination of aggregate and individual limits, the draft Guidelines go significantly beyond the CRR mandate.

Industry therefore strongly urges the EBA to reconsider its proposed approach and to restrict its Guidelines to individual limits.

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5. 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?*

We do not agree with the fallback approach. The fallback approach, and in particular Option 1, are unnecessarily punitive. We consider that Option 2 provides greater incentives to gather information about shadow banking exposures.

See also our response to question 6 below.

6. 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?

The industry believes that the use of the 25% within the aggregate limit proposed under the fallback approach is inappropriate, overly onerous and lacking in robust policy underpinning and quantitative testing. Indeed, the EBA itself recognises that “this calibration has not been tested by an impact assessment at this stage” and “it would seem that this 25% limit may be conservative”.

The assumption on which it is based, i.e. that in the absence of sufficient information, all exposures to shadow banking entities could be connected, is erroneous. In view of the very broad definition of shadow banking that the EBA proposes, it is rather odd that all of a firm’s counterparties, anywhere in the world, which may be considered to conduct any activity involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar would be grouped together as posing a single risk to a firm.

The EBA should also carefully consider the consequences of this proposal. For instance, a limit of 25% applied sectorally is likely to lead to a need for exposure reductions by firms. Moreover, the use of the LE regime carries severely punitive measures for any breaches, including revocation of operating licences and would not be appropriate.

We are also very concerned that setting a fallback is setting an effective appetite benchmark for supervisors. Persuading an individual supervisor that an alternate measure is appropriate against this standard is likely to be extremely difficult. It will in effect become a de facto baseline.

In conclusion and as already stated earlier on in our response, we do not agree with the introduction of aggregate limits in the context of these Guidelines and the fallback approach in particular. In any event, an aggregate limit under any fallback approach would clearly to lend itself to a much higher limit than that which is imposed on individual level, and would have to be set at a whole number multiplier of the capital base.

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Sufficient time for implementation will be key, particularly if the fallback approach is maintained

Given that firms systems do not currently capture the shadow banking notion defined in the draft Guidelines, as the proposals stand, it is likely that most firms will overstate shadow banking exposures until they have managed to refine their datasets and achieve full data remediation based on investigation.

If the EBA maintains a fallback approach, it should only be considered after a realistic time period has been allowed to pass to allow for meaningful and robust roll-out. This could be achieved by way of a formal commencement date at a future point or by encouraging supervisors to be tolerant of internal appetite assessment based on (initially) imperfect and likely overstated positions.

For example, a firm may be able to only partially remediate its dataset by 30 June 2016 and a portion of its shadow bank positions could be overstated. Rather than reduce its exposures sectorally, the firm may tolerate higher appetite levels which would be revisited once progress on data remediation had been sufficient to allow the correct sizing of appetite for the exposures which are strictly within the EBA shadow banking definition.

Given the need to ensure consistent implementation across the EU, a formal commencement date which allows for system changes and data remediation would be strongly preferred. We suggest that implementation therefore be in line with the introduction of the April 2014 Basel Large Exposures framework.

If not handled sensitively, and with due regard to the system and reporting challenges these Guidelines will create, their introduction could have a precipitating effect that could destabilise financial markets.

III. Other issues

Future linkage between large exposure and shadow banking reporting

We call for the EBA to clarify that the Large Exposure and Shadow Banking Reporting requirements will remain distinct. We would not see any added value for competent authorities' risk assessment, if they were unified. Moreover, a single reporting framework would be extremely difficult to implement, given the different the underlying logics, scope, responsibilities and types of risks involved.

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