BANKING STAKEHOLDER GROUP

CONSULTATION ON EBA/CP/2015/06 ON
"DRAFT EBA GUIDELINES ON EXPOSURE TO SHADOW BANKING ENTITIES WHICH CARRY OUT BANKING ACTIVITIES OUTSIDE A REGULATORY FRAMEWORK UNDER ARTICLE 395 PARA 2 REGULATION (EU) NO. 575/2103"

General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

London, 18 June, 2015

Foreword

The EBA Banking Stakeholder Group ("BSG") welcomes the opportunity to comment on the Consultation Paper EBA/CP/2015/06 "Draft EBA Guidelines on exposures to shadow banking entities which carry out banking activities outside a regulatory framework under Article 395 para 2 Regulation (EU) No. 575/2013"

This response has been prepared on the basis of comments circulated and shared among the BSG members and the BSG's Technical Working Group on Capital and Risk Analysis.

As in the past, the BSG supports an initiative that aims at harmonizing supervisory rules and practices across Europe, in order to ensure fair conditions of competition between institutions and more efficiency for cross-border groups. The BSG also expects these initiatives to facilitate data sharing between European supervisors and avoid reporting duplications for banks.

This response outlines some general comments by the BSG, as well as our answer to the question indicated in the Consultation Paper.

General comments

The BSG welcomes this consultation on the EBA's "Limits on exposures to shadow banking entities". The Consultation Paper is an addition to other existing measures (such as SFT rules, haircut and reporting rules, etc.) that are designed to reduce systemic risk migration from the (largely unregulated) Shadow Banking sector to the highly regulated banking sector.

It is widely accepted that Shadow Banks of various sorts played an important role in the recent global banking crisis and that there were flaws in the way that such institutions operated and the links between the banking and shadow banking sectors. However, many of these flaws have since vanished as markets and institutions have reacted.

As a point of perspective, we also note that regulated banks are already subject to "large exposure" rules irrespective of whether this relates to positions vis a vis banks or Shadow Banks. Furthermore, general capital requirements have been tightened. Overall, these measures are likely to reduce the activity of banks vis a vis non-banks in general and Shadow Banks in particular.

The shadow banking landscape includes a heterogeneous set of institutions which cover a wide range of business activities and different business structures, and its size and functions can vary significantly between countries and markets. The shadow banking sector has a function in parallel with, and as a complement to, the banking system but on the other hand can create complexity and systemic risks. In addition, there is a risk of an undesirable risk- transfer from the directly regulated sector to the shadow banking sector. The risk related to the shadow banking sector can to some extent be mitigated through indirect regulation: for example, limitations for institutions to securitized assets, or as direct regulation towards shadow banking entities as example through AIFMD. Even if the indirect approach might have an impact in mitigating the risk in some areas, the view of BSG is that a more robust long term solution includes a regulation covering the Shadow banking entities and its intermediation activities.

Before considering the specific questions raised in the Consultation paper, we emphasise three general concerns. Firstly, there is a potential danger that the overall regulatory regime that is applied to regulated banks may not be sufficiently competitively neutral as between institutions conducting essentially similar business and that this may unnecessarily distort competition between the regulated banking sector and the less-regulated institutions in the Shadow Banking sector.

A second concern is that regulatory agencies and national authorities should have a common definition of what is meant by "shadow banks", and that regulation and supervision of the relationship between banks and Shadow Banks should be applied consistently between countries. This also raises issues of competitive neutrality as between different national regulatory regimes.

Thirdly, the proposed rules outlined in the Consultation Paper may have the unintended consequence of undermining the fluidity of securitisation schemes that are currently proposed under the Capital Market Union: this may again produce regulatory inconsistencies.

Replies to 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.**

In the FSB 2014 Global Shadow Banking Monitoring Report, the shadow banking sector is defined as credit intermediation involving entities and activities outside of the regular banking system or, as other market participants prefer, as "market based activity. This is a very broad definition and, in addition, the term carries a negative image. However, often this activity with non-bank financial institutions is carried out with institutions which are highly regulated, such as UCITS or insurance

companies. Whereas the Consultation Paper proposes increased control mechanisms towards shadow banking entities, a clear and operational definition is of great importance.

In this context wee again emphasise the need for a common global definition of Shadow Banking.

The approach of defining entities that is out of scope for the definition of shadow banking is relevant and easy to adopt. In addition, the exposures towards UCITS are to a large extent already restricted by limits contained in the CRR. The most relevant approach for defining shadow banking entities seems to be by reference to the activities performed. Some of these are listed in the proposal with reference to CRD annex 1. There is, nevertheless, considerable room for different translation of entities and activities in scope and the definitions still involve a high degree of subjectivity. Exposures to funds that are not considered as excluded undertakings should be possible to be treated by a look through principle where possible. It is also unclear how the exposure towards entities with mixed business lines should be treated in this context. As an example, should the total exposure towards an entity with some kind of shadow banking activity be considered as shadow banking in total when defining limits and interconnectedness?

The definition is broad and may generate a high number of "positives" which could lead to an additional operational risk and disproportionate burden in terms of policies and control mechanisms given that there would likely be only a relatively small overall risk reduction in the banking sector .

The view of BSG is that the threshold of 0,25 % is too low and the process of maintaining, monitoring and reporting these can be excessively administratively burdensome and disproportionate, considering turnover in portfolios and interconnectedness but also with consideration of the fall back approach option 1 or option 2.

- **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.).**

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.

The process will require specific instructions, monitoring and reporting requirements that are directly related to entities defined as shadow banking. Risk related to concentration, interconnectedness and specific risk towards specific entities is already an integrated part of the credit risk monitoring entity within most institutions and the need to set specific restrictions, at an institutional level towards a broad category of companies sorted into the category shadow banking, could be questioned. The definition of shadow banking entities includes intermediate activities, but in many cases this may be the only common denominator.

The proposed specific requirement for Shadow Banking entities related to Pillar 2 can be questioned since the Pillar 2 requirements are already defined and in use already.

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.

It could be questioned if there is a need to have a specific process for exposures defined as being within the shadow banking definition. Risks, limits and risk appetite are an integrated part of the credit risk monitoring and reporting process. However, we agree in principle with the arrangements.

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.

An aggregated limit only has relevance if there is a defined interconnectedness between two or more entities in scope for the definition of shadow banking. There are potentially less combined risk and interconnectedness in exposures towards totally different shadow banking activities in different countries compared to some other interconnections which already should be considered following the large exposures regulation. Besides, the indirect interconnectedness is difficult to assess in practice: for example, if there are holdings by other institutions. With reference to no. 18 of the consultation it is stated that EBA is considering updating the "Guidelines on the identification of groups of connected clients under Article 4, Para. 1, No. 39 Regulation (EU) No. 575/2013, including providing greater clarity on how institutions and special purpose vehicles can be economically interdependent."

The view of BSG is that the review and updating of that Guideline should be undertaken in parallel with the guideline on Shadow Banking. Furthermore, the indirect interconnectedness is to some extent already addressed in the BCBS paper “Supervisory framework for measuring and controlling large exposures”, April 2014. Even though the Basel Paper considers the identification of additional risk imposed by third parties by the structure the bank invests in: as an example, in the case of an originator, fund manager, liquidity provider or credit protection provider, there are remaining difficulties to identify all those connections. Furthermore, the Basel paper remains vague in the case of structured finance products.

Q5. Do you agree with the fall back 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 fall back 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?**

The view of BSG is that option 2 is the preferred option since the requirements for the main part of exposures are fulfilled and should not be affected by a small number of exposures where the criteria are not met. It would be to presume a very close linkage between normally rather heterogeneous entities that is treated as directly connected. The most conservative outcome of the different options should not be the main reason for preference and could basically be affected by just one minor exposure. However, a technical fall back is not necessarily the only approach to address shortcomings, as in the SPREP and by capital add on.

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 fall back 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.

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Submitted on behalf of the EBA Banking Stakeholder Group

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