Consultation

Draft Regulatory Technical Standards on criteria for the identification of shadow banking entities under Article 394(4) of Regulation (EU) No 575/2013

Register of Interest Representatives
Identification number in the register: 52646912360-95

Our ref

Ref. DK: EBA RTS

Ref. DSGV: 7715/10

Contact: Mr Thorsten Dicke-Wentrup

Telephone: +49 30 20225- 5425

Fax: +49 30 20225 5405

E-Mail: thorsten.dicke-wentrup@dsgv.de

Berlin, October 21, 2021

The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent almost all German banks.

Coordinator:
German Savings Banks Association
Charlottenstrasse 47 | 10117 Berlin | Germany
Telephone: +49 30 20225-0
Fax: +49 30 20225-250
www.die-deutsche-kreditwirtschaft.de

The German Banking Industry Committee is pleased to participate in the public consultation on "Draft Regulatory Technical Standards on criteria for the identification of shadow banking entities under Article 394(4) of Regulation (EU) No 575/2013".

I. General remarks

Ensure harmonisation of content and timing with EBA guidelines

We welcome the fact that the Draft Regulatory Technical Standards (RTS) on criteria for the identification of shadow banking entities under Article 394(4) of Regulation (EU) No 575/2013 (EBA/CP/2021/30) of 26 July 2021 (referred to in the following as the "draft RTS") are based on the EBA Guidelines on limits on exposures to shadow banking entities (referred to in the following as the "EBA guidelines").

For reasons of consistency, we consider it to be vital for both sets of regulatory requirements to be based on the **same definition of "shadow banking entities", the same exceptions and the same definition of "credit intermediation activities" and "banking services and activities"**. The EBA itself states that "these draft RTS rely to a great extent on the EBA guidelines to ensure a consistent implementation". We would also like to point out in this context that CRR II only refers to "banking activities" in Article 394(2) and Article 305(2) and does not add any reference to "services". We also suggest that a uniformly selected term should be used in the course of the necessary revision of the EBA guidelines.

In light of what we view as an essential requirement for harmonisation, we would have expected that a revision of the aforementioned EBA guidelines would be launched at the same time as the draft RTS in order to ensure consistency in terms of content and timing. To enable an efficient IT implementation and to avoid unnecessary effort due to diverging definitions (cost of compliance), we expect that the timing of the entry into force of the future RTS will be coordinated with the correspondingly revised EBA guidelines. **We strictly reject any time lag between the two documents and** hence – even only temporarily – **different definitions**.

For the purpose of limiting shadow banking entities, a **materiality threshold** of 0.25 per cent was introduced in the EBA guidelines for the identification of exposures to shadow banking entities, and this currently still refers to "eligible capital" (see paragraph 11 of the EBA guidelines). This sensible materiality threshold should also apply to the reporting of exposures to shadow banking entities in order to provide relief to the institutions.

To preserve consistency with the EBA guidelines, it should also be clarified that any membership of a shadow banking entity in a group of connected clients (GCC) is irrelevant under point 39 of Article 4(1) of the CRR and that only a **single borrower approach** is relevant with regard to settling the question of whether there is an exposure to a shadow banking entity. See in line with this interpretation the EBA feedback on the EBA guidelines consultation, page 53: "The EBA clarifies that these guidelines only apply to exposures to individual shadow banking entities, and do not require the creation of groups of connected clients".

The EBA Q&A 2013_572 should also be reconsidered in this respect. It states that the exposure amount for determining the 10 largest exposures to "unregulated financial sector entities" (now referred to as "shadow banking entities") that are part of a GCC is the aggregated, total amount of the exposures to all entities within the GCC, including exposures to entities within this group that are not "unregulated financial sector entities" (in other words shadow banking entities).

Clarify interaction with look-through requirements

A major issue of substance that is not adequately clarified by the RTS relates to the interaction with Article 390(7) of the CRR in conjunction with Regulation (EU) No 1187/2014. In the same way as the EBA guidelines, in the case of look-through transactions, the **shadow banking entity test** can **only** relate to the **relevant look-through transaction** itself and not to the underlying exposures. Including, for example, certain fund constructs in the scope of the RTS as proposed by the EBA would otherwise often prove to be futile if – as is normally the case – the exposure value for the transaction is zero because the fund shell does not entail any additional risk to be limited for large exposure purposes.

II. Answers to questions

Question 1: Do you agree with the conditions of Article 1 paragraph 2 for identifying an entity as a non-shadow banking entity? Please provide reasons if you do not agree with any of the conditions or have comments with regard to any of them.

As the definition of a shadow banking entity will be governed by an EU regulation in future, we believe that – in contrast to EBA guidelines – the opportunity for interpretation based on the prudential purpose is limited. Accordingly, the term "shadow banking entity" should be defined precisely and consistently.

We welcome the fact that the definition of shadow banking entities in the draft RTS is generally based on the EBA guidelines. However, there is a risk that there will be two different definitions of a shadow banking entity in the course of implementation. We believe it is vital to have a uniform definition of shadow banking entities and thus substantively consistent rules for identifying shadow banking entities for large exposure reporting under Article 394(2) of the CRR as well as for defining limits for risk exposures to shadow banking entities under the EBA guidelines. To ensure absolute consistency, it is imperative for the EBA guidelines to be aligned with the RTS requirements. Any diverging definitions would be avoided if the EBA guidelines were to refer to the new RTS or adopt their definition. This also applies not least in light of the equivalence provided for in Article 3(1) of the draft RTS for institutions from third countries that apply a supervisory regime based on at least the Basel core principles for effective banking supervision (see also General remarks on the harmonisation of the RTS and EBA guidelines content and timing).

We agree that exposures to financial institutions should not be treated as exposures to shadow banking entities as long as such financial institutions, pursuant to Article 119(5) of the CRR, are supervised and authorised and subject to comparable requirements of those applicable to institutions (see Recital 1). In Germany, German *Bürgschaftsbanken* (guarantee institutions) and German financial services institutions that provide finance leasing (Finanzierungsleasinginstitute) would not therefore be classified as shadow banking entities (see also explanatory comments by the German Federal Financial Supervisory Authority on CRR QA 52-17/003 of 22 August 2017 and 52-17/004 of 15 August 2017[1]). However, we do not consider this exception to be adequately covered by the wording of Article 1(2) or (3) in the draft RTS.

[1] See https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Auslegungsentscheidung/EBA_QA/ea_CRR_kreditrisiko_52_17_003.html and https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Auslegungsentscheidung/EBA_QA/ea_CRR_kreditrisiko_52_17_004.html

The wording of Article 1(2) of the draft RTS is restrictive because it explicitly refers to the European legal acts referred to in Annex I. With regard to the European directives also referred to in Annex 1, the words "with any of the legal acts referred to in Annex I **or their transposition into national law**" should therefore be added as a minimum.

According to Recital 2, entities that are part of a non-financial group, whose principal activity is to carry out credit intermediation activities for entities within the group should also not be identified as shadow banking entities. We agree with this. However, we do not consider this exception to be adequately covered by the wording of Article 1(2) or (3) in the draft RTS.

Additionally, an exemption should be provided for exposures from own securitisation transactions so as to create corresponding legal clarity. This is relevant if the originator sells exposures to a securitisation special purpose entity for the purpose of securitisation and the originator subsequently acquires the asset-backed securities so as to pledge them afterwards to the central bank to participate in monetary policy operations. In this case, legal title to, but not beneficial ownership of, the exposures is transferred to the securitisation special purpose entity: the credit risk remains economically with the originating institution because of the amount of the retained tranche. These securitisation special purpose entities are also normally consolidated in accordance with IFRS 10. Nor is there any default risk for the institution from acquiring and holding the asset-backed securities, since any losses from holding a large first loss position are in any case borne by the originating institution. These securitisation special purpose entities are not shadow banking entities in connection with a proprietary securitisation transaction in an interpretation based on the purpose of the regulatory requirement. It would be helpful to clarify this to ensure consistent treatment in institutional practice.

Question 5: In general, what are your views on the treatment of funds in these draft RTS? Do you agree with the approach adopted in these draft RTS, that follows the approach in the EBA Guidelines on limits on exposures to shadow banking entities, or alternatively should it be extended to capture those funds as shadow banking entities?

We welcome the fact that the approach in the draft RTS with regard to funds follows the approach in the EBA guidelines on limits on exposures to shadow banking entities.

We support the conclusion in paragraph 73 in the Background and rationale in the draft RTS that funds structured as UCITS and their asset managers are subject to strict regulatory requirements with regard to own funds requirements, risk management and governance in accordance under the UCITS Regulation[2]. In the context of leverage limitation, we would also like to refer to the "cover rule" under Article 51(3) of the UCITS Regulation, which effectively constitutes a 100% capital cover requirement for derivative transactions. Derivatives may only be entered into to the extent that they can be settled from the fund's own resources. In our view, this allows UCITS to be treated as heavily regulated entities and also included in the list of examples in paragraph 13 in the Background and rationale in the draft RTS.

We also support the conclusion in paragraph 74 of the Background and rationale in the draft RTS that alternative investment funds (AIFs) and their asset managers are also subject to strict regulatory

[2] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

requirements under the AIFMD[3] and should not therefore generally be identified as shadow banking entities. Accordingly, we consider the criteria of lending and "substantial leverage" (AIFMD commitment leverage greater than 300% of the net asset value (NAV)) to be relevant and appropriate assessment bases for the identification of AIFs as shadow banking entities.

Question 6: What would be the advantages and disadvantages of taking a broader approach with respect to the scope of funds included as shadow banking entities?

Investment funds are already subject to extensive monitoring and limits under the CRR, taking into account the look-through to the underlying exposures. Risks inherent in the structure are excluded when a fund is structured as a UCITS in compliance with point (a) of Article 7(2) of the UCITS Regulation or an AIF in compliance with section 83(6) of the German Investment Code (KAGB). Accordingly, under the CRR, consideration of the risks from the underlying exposures in the large exposure regime is normally sufficient in the case of funds.

A broader classification of funds as shadow banking entities would lead to additional large exposure limits again at the level of the funds themselves (fund shell) and hence additional management and reporting of a risk that is already excluded. This would be run counter to the existing treatment in the CRR and the objective of more proportionate design of regulatory requirements. Such unnecessary requirements must be avoided (see also General remarks on "Clarify interaction with look-through requirements").

Question 7: What are your views with regard to the consideration of money market funds as shadow banking entities?

According to paragraph 89 in "Background and rationale" in the draft RTS, the EBA considers treating money market funds (MMFs) as shadow banking entities until the ongoing reforms to tackle the vulnerabilities identified with MMFs are in place before reassessing the current policy stance. We understand this approach in principle and welcome the fact that the EBA will subsequently reassess the treatment of MMFs. We expect Article 1(4) of the RTS to be amended swiftly following the reforms.

Question 8: Do you face any difficulties identifying whether an alternative investment fund (AIF) should be considered as a shadow banking entity?

No, there are no difficulties identifying whether an AIF constitutes a shadow banking entity because the EBA guidelines have already been implemented. The identification of the extent of the fund's lending activity and capturing the commitment leverage under the AIFMD as a reference point of "substantial leverage" have proven to be effective. Limiting the AIF commitment leverage to 300% of the NAV has become established practice among asset management companies.

We do not consider any change to these criteria for classifying AIFs as shadow banks to be necessary or expedient and therefore welcome the proposal to retain these criteria.

[3] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

Question 9: Have you got any specific comments with regard to AIFs and in particular, with points (b) and (c) of Article 1 paragraph 5?

The use of the term "exposures" in point (c) of Article 1(5) of the draft RTS is not sufficiently specific and too broad, as it would cover all exposures and thus – contrary to the objective – all AIFs would be captured again. Instead, either the wording "grant loans or purchase third party lending exposures onto their balance sheet" from Background and rationale, paragraph 75, or the wording "originate loans or purchase third party lending exposures onto their balance-sheet" used to date in the EBA guidelines should be used to define the lending activities of AIFs.

When structuring real estate transactions for real estate funds in the form of AIFs, it may be advantageous for the fund to grant shareholder loans to a property company held by the fund (see section 240 of the German Investment Code (KAGB)). It should be clarified that granting such shareholder loans is not covered by the requirement in point (c) of Article 1(5) of the draft RTS. Point (c) of Article 1(5) of the draft RTS refers to originating exposures to third parties.

In addition, it should be clarified that the wording "from its rules or instruments of incorporation" also includes those cases in which the investment restrictions according to point c of Article 1(5) of the draft RTS already result from the applicable legal requiremenst for the respective AIF.

Question 10: Do you agree with the description of banking services and activities as included in Article 2 of the draft RTS? Have you got any specific comments regarding any of the points included?

To avoid a situation where, for example, companies in the real economy that grant loans to individual employees or to companies in which they are invested and that are not subsidiaries, would be classified as shadow banking entities, point (b) of Article 2 of the RTS should be worded as follows: "any service or activity involving maturity transformation, liquidity transformation, leverage or credit risk transfer in the **ordinary course of business**".

It is our general understanding that, to be identified as a shadow banking entity, maturity transformation, liquidity transformation, leverage or credit risk transfer must be undertaken to an extent that is material and thus characterises the relevant business model of the company in question. This materiality concept should be anchored more prominently in the RTS. We are therefore asking for the definition of a shadow banking entity to be clarified in Article 1(1) to the effect that, as a general rule, only those companies whose principal activity is the provisioning of "banking services and activities" within the meaning of Article 2 and that are not excluded from the definition of a shadow banking entity under Article 1(2) or (3) will be identified as shadow banking entities. This would make it easier to identify shadow banking entities and help reduce the number of doubtful cases.

In addition, we urge inserting an additional paragraph into Article 1 that gives the competent supervisory authorities the discretion to exempt other entities. In Germany, for example, German factoring institutions are currently not identified as shadow banking entities, since although they do conduct maturity transformation, the German supervisory authorities say they do it to an insignificant extent that is not worth mentioning. This classification should be preserved. Another application in Germany for the exercise of discretion would be the *Mittelständische Beteiligungsgesellschaften* (SME investment

companies), for example. Not identifying them as shadow banking entities is advisable because they provide SMEs with equity and quasi equity instruments with the objective of regional economic development and counter-guaranteeing the funds provided.

We also suggest explaining the term "leverage", which in the German language version of the current EBA guidelines is translated as "*Verschuldung*", in greater detail in the recitals. In our view, this can only refer to the sort of leveraged financing that is typical for hedge funds, for example, but not to high levels of debt or high debt ratios of companies in the real economy. In this respect, the term "*Verschuldung*" used in the German version can lead to misinterpretation.

Question 11: Do you agree with the possibility granted under paragraph 1 of Article 3 to prevent the identification of a bank in a third country as a shadow banking entity in the absence of an equivalence decision under Article 391 of the CRR?

We expressly welcome the fact that third-country institutions will not be identified as shadow banking entities if the institution has satisfied itself that the third-country institution in question is authorised and supervised by a supervisory authority that applies banking regulation and supervision based at least on the Basel core principles for effective banking supervision.

When it comes to operational implementation, however, the general reference to verification of compliance with the "Basel core principles for effective banking supervision" is difficult.

This is illustrated by the following example.
For example, based on the overview published by the Basel Committee on Banking Supervision (BCBS) (see https://www.bis.org/bcbs/implementation/rcap_jurisdictional.htm?m=3%7C14%7C656%7C60), the question of whether or not Russian banks should be classified as shadow banking entities cannot be answered unequivocally.

According to the BCBS "Summary of member assessments", Russia, South Africa, Mexico and Turkey would have a comparable implementation status for the minimum regulatory standards. The conclusion, from our perspective, is that Russian institutions would also not be shadow banking entities.

However, only South Africa, Mexico and Turkey are explicitly mentioned in the European Commission's implementing decision 2021/1753 of 1 October 2021 on the equivalence of the solvency and supervisory regimes in third countries and territories under the CRR.

To ensure consistent treatment in practice and reduce the verification effort for institutions, we would therefore welcome the publication by the EBA of a list of the relevant third countries that apply banking regulation and supervision based at least on the Basel core principles for effective banking supervision.

Additionally, for the purposes of Article 3(1) and (2) of the draft RTS, we are in favour of generally treating all OECD countries as equivalent. This should apply both to institutions and to other financial institutions from OECD countries.

Question 12: Have you got any comments regarding the approach set out in paragraph 2 of Article 3 for other entities established in third countries to prevent their identification as shadow banking entities?

See also question 11, final paragraph.