Verband der Auslandsbanken in Deutschland e.V.
Association of Foreign Banks in Germany

European Banking Authority (EBA)

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Consultation Paper EBA/CP/2015/06

Draft EBA Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 para. 2 Regulation (EU) No. 575/2013

Dear Madam or Sir,

We welcome the opportunity to comment on the draft EBA Guidelines on limits on exposures to shadow banking entities (the "draft Guidelines") and would like to share our thoughts with you. The Association of Foreign Banks in Germany represents more than 200 foreign banks, investment firms and investment management companies active in the German market. A lot of our members are German entities of foreign banks from non-EEA countries. They would be particularly concerned by the draft Guidelines, as we shall further explain below.

We welcome the draft Guidelines and think that they constitute an important step forward in the discussion whether and how risks to the financial sector and the economy as a whole stemming from shadow banking might be addressed appropriately. However, our analysis of the draft Guidelines has led to the conclusion that there are four critical issues that we think are not yet adequately dealt with:

- The definition of shadow bank entities should not cover non-EEA institutions which would qualify as credit institutions under CRR if they were incorporated in the EU. It should not cover such non-EEA institution's Union branches either, because these branches are subject to national supervision in the EU Member State where they are established.

Wolfgang Vahldiek

Association of Foreign Banks in Germany
Weißfrauenstraße 12-16
60311 Frankfurt am Main
Germany
Tel: +49 69 975850 0
Fax: +49 69 975850 10
wolfgang.vahldiek@vab.de
www.vab.de

- The criterion of equivalence of supervisory frameworks in third countries sounds plausible, but equivalence is both politically sensitive and complicated to assess and thus very difficult to implement for supervisors and credit institutions, as so far evidenced by the absence of any promising attempt to completely analyze all third country supervisory regimes. Instead, we propose a tailor-made approach for assessing non-EEA banks.

- The inclusion of entities which conduct business and services in the meaning of Annex 1 of CRD falls short of recognizing that such entities are subject to severe prudential regulation in many EU Member States, e. g. Germany.

- The proposed quantitative threshold for exposures to shadow banking entities is – contrary to the statement in the draft – actually inconsistent with the large exposure regime in CRR, because it does not reflect that according to Art. 395 (1) CRR, large exposures of 25 % of eligible capital are allowed to any debtor irrespective of its kind or nature. Lowering the threshold to 25% on an aggregate basis would pose material problems for trade finance and other kinds of credit to the real economy by EU subsidiaries of foreign non-EEA banks, because their intra-group exposures would be limited accordingly.

We will explain our concerns in more detail below in connection with our answers to the questions raised in the Consultation Paper.

If you require further information or wish to discuss any of the issues raised, we would be glad to hear from you.

Kind regards

Dr. Oliver Wagner Wolfgang Vahldiek

Answers to Consultation Paper EBA/CP/2015/06

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.).*

I. Treatment of foreign non-EEA banks

We do not think that non-EEA banks[1] are a part of the shadow banking sector. This would be a contradiction in itself. Banks are by definition not shadow banks. Also, they do not pose the same risks to the financial sector.

The CP correctly points out the points of concern with regard to shadow banking in 3.1. item 2 and in 3.1.1. However, the issues pointed out are generally not empirically observable in the case of foreign non-EEA banks.

The CP points out that the shadow banking system heavily relies on **short-term wholesale funding**. But this is not generally the case with banks, no matter in which jurisdiction they are localized, for they also have access to retail client deposits and central bank lending.

The shadow banking system is also understood to generally **lack transparency**. This is another issue that is not generalizable for foreign banks. The amount of leverage, maturity and liquidity transformation are known at least to home supervisory authorities, for this is common sense for all supervisory authorities around the world (no matter which stage of the Basel framework they apply).

Furthermore, the shadow bank system is understood to be vulnerable to runs, because they are dependent on **refinancing in the market**. This is not true for banks, as they have a liquidity backstop at their central banks, no matter in which country they are localized.

Moreover, the CP assumes that **fire sales** from the shadow banking sector have spread the stress during the last crisis. This is yet another issue that has not generally been observable with

[1] Our term „banks“ is meant to comprise undertakings which take deposits and grant loans and which would therefore qualify as credit institutions if they were established in the EU.

foreign non-EEA banks, at least not in a different manner than EU credit institutions. It would be inappropriate to blame foreign non-EEA banks for balance sheet reduction albeit EU credit institutions were doing the same.

In addition, it must be pointed out that foreign non-EEA banks are **leveraged**, but generally not higher (and often much lower) than EU credit institutions. This holds true no matter if the regulation applied in the home country is in line with Basel I, II or III. Foreign non-EEA banks are clearly **not "highly leveraged structures"** with "inadequate loss-absorbing capacities". That is another very important difference to the shadow banking sector which is not limited in leverage by any regulation or supervision at all.

Another point of concern the CP raises is **interconnectivity**. It states that the shadow banking sector is highly correlated and interconnected to the regulated banking sector (i.e. in the EU) due to ownership linkages, credit commitments and as counterparties. We cannot find this to be true to the same extent for foreign non-EEA banks. They are clearly not linked to the EU banking sector by ownership and, unlike SPV's, they do not rely on other bank's credit commitments for refinancing.

Finally, the **governance** of non-EEA banks is generally very similar to EU credit institutions. There is no evidence for opaqueness and complexity to the same extent as alleged to the shadow banking sector.

II. Treatment of Union branches of non-EEA banks

One remarkable effect of the shadow bank definition as proposed in the draft Guidelines is that it would cover **Union branches of non-EEA banks**. The reason for this is that these are not credit institutions in the meaning of CRR and they are not supervised according to rules agreed upon on a pan-European level.

However, it must be noted that Union branches of non-EEA banks are covered by **national supervisory law and supervision** in the Member States. E.g. in Germany, they are subject to the analogous application of CRR on a stand-alone basis. As a consequence we clearly oppose to the idea that Union branches of non-EEA banks be treated as shadow banks.

In addition, as far as we know, all EU national supervisory systems allowing for establishment of Union branches under national law require due diligence to be carried out by national supervisors as to the **quality of supervision of the respective head quarter** in its home country. Furthermore, the applicant has to demonstrate stability, viability, reliability and professional expertise of the head quarter, including as regards AML issues.

We would therefore propose to

- exclude Union branches of non-EEA banks from the definition of shadow banks, and
- exclude from the definition of shadow banks every non-EEA bank to whom the right to establish a Union branch in the EU was granted by national EU authorities.

III. The criterion of "equivalence"

The draft Guidelines include foreign non-EEA banks in the shadow banking sector if their home jurisdiction fails to meet the "equivalence" test. This means that if a non-EEA bank is subject to prudential and supervisory requirements that are at least equivalent to those applied in the EU, it is not regarded as a shadow bank, whereas if equivalence has not been determined yet, it would be treated as a shadow bank.

We highly recommend to abandon this approach and replace it. We would like to propose a workable and adequate alternative, which we outline below, for the following reasons:

A) The equivalence test is too complicated.

According to the Note to the Members of the European Banking Committee Accompanying the draft Commission Implementing Decision on the equivalence of the supervisory and regulatory requirements of certain third countries and territories for the purposes of the treatment of exposures according to Regulation (EU) No 575/2013 (EBC/05/2014), the operational standards for the assessment of the equivalence of supervisory and regulatory arrangements applicable to credit institutions comprises no less than 24 criteria distilled from 12 Directives and Regulations which are complicated to assess.

According to this Note, the equivalence test is designed to determine whether the relevant third country is able to achieve the same final objectives as the EU in terms of:
1) ensuring the stability and integrity of both the domestic and global financial system in its entirety;
2) ensuring effective and adequate protection of depositors and other consumers of financial services;
3) promoting cooperation between different actors of the financial system, including regulators and supervisors;
4) ensuring independent and effective supervision;
5) ensuring proper implementation and enforcement of relevant internationally agreed standards.

B) The equivalence test cannot be performed by EU credit institutions themselves.

This assessment framework tries to establish the quality of a financial system. It is clearly too much to handle the evaluation of a given bank on a stand-alone level. A full equivalence test of this kind cannot be performed by an EU credit institution for a given debtor/exposure. Either EBA or the Commission would have to commit to perform it. Given that there are 193 jurisdictions to assess, the task is largely overdesigned. Also, it is highly politically sensitive.

C) The equivalence test is interconnected.

The equivalence test is interconnected with a number of other issues regulated by CRR, so it cannot be done independently for the purposes of defining a shadow bank. Whereas it would be justified to apply stricter approaches in one area (e.g. the definition of an "institution" in the

meaning of Art. 107 (3) CRR or Art. 391 CRR), this would spill over to overly burdensome requirements for exposures to banks which are sound and solid but then deemed to be shadow banks.

D) Finally (and most importantly), the equivalence test leads to wrong results.

It rules out too many foreign non-EEA banks which cannot be said to be shadow banks. Even a Basel I supervisory regime effectively rules out the possibility that the bank is an unregulated entity running up massive leverage. So we think that a "Shadow bank test" should be designed to identify shadow banks in third countries with no overshooting.

E) We would like to propose the following alternative:

According to the CP, shadow banks can be said to pose specific risks. If we match these risks with measures in place to prevent them in case of a bank, we find criteria which can easily be assessed by credit institutions themselves. A full equivalence test for national supervisory and regulatory systems does not need to be conducted.

These risks are **liquidity problems** (which are closely connected to run risks), **excessive leverage**, **interconnectivity** and **complexity**.

We think that these risks are addressed and prevented in the banking sector by basically two characteristics that are non-existent for shadow banks and which are therefore key criteria for defining the difference between both of them. These characteristics are

- the bank has access to a central bank as a **lender of last resort,**
- the bank is subject to **prudential banking supervision** by public authorities.

A "shadow bank test" should therefore consist of two criteria which effectively rule out the possibility of accidentally including too many non-EEA banks:

1. Does the entity concerned have access to central bank lending?
2. Is the entity concerned subject to prudential supervision?

If these two criteria are met, the possibility of a shadow bank can efficiently be ruled out. Such a shadow bank test would be meaningful, specifically designed to meet the needs of Art. 395 (2) CRR and easy to perform on the basis of readily obtainable information. It could be conducted by EU credit institutions itself and would not require an EU-wide assessment exercise which has the disadvantages shown above.

In addition, credit institutions might assess whether a non-EEA bank is a member of a **deposit guarantee scheme** and/or whether it is a **public sector entity** in order to define appropriate exposure limits.

IV. Treatment of EU entities performing services listed in Annex I CRD

According to the Definitions section of the draft Guidelines, every entity which carries out one or more credit intermediation activities as listed in Annex 1 points 1 to 3, 6 to 8, 10 and 11 and which is not an excluded undertaking is to come under the definition of a shadow banking entity. This definition is **too broad even for EU-based entities**. Any definition must take into account the national regulation and supervision in place in the respective EU Member States. In the light of the situation in Germany, which is as follows, simplistic approaches would lead to severe problems:

First, undertakings that carry out

- **deposit taking** in the meaning of Annex 1 point 1 CRD IV (but do not carry out lending under point 2.),
- **lending** in the meaning of Annex 1 point 2 CRD IV (but do take deposits under point 1.), and
- services under Annex 1 point 6 CRD IV (**guarantees and commitments**)

are covered by § 1 para. 1 sentence 2 no. 1, 2 and 8 of the German Banking Act, respectively. They come under the German definition of a credit institution and are treated and supervised completely in line with CRD IV and CRR. It seems inaccurate to include them under the term of shadow banks.

Second, undertakings which carry out **financial leasing** in the meaning of Annex 1 point 3 CRD IV are covered by § 1 para. 1a sentence 2 no. 10 of the German Banking Act. They are supervised according to the German Banking Act. In the light of the supervision these undertakings are subject to, it would be inappropriate to include them in the definition of shadow banks, too.

To address this issue, we would like to propose the following:

If the basic approach to defining shadow banking undertakings was retained, we propose to at least introduce a counterbalance by a **corrective criterion**. Undertakings in an EEA Member State should not be deemed shadow banks if they are subject to a national regulatory regime and supervision which is in line with the basic principles of CRR.

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 broadly agree with EBA's approach. However, we think that a reference to the **principle of proportionality** should be introduced because the shadow bank entities are very different in nature. Some exposures warrant very high levels of due diligence, whereas other exposures could easily be demonstrated to be less risky and less complex. The intensity and frequency of monitoring carried out should vary accordingly.

But again, we think that the definition of shadow banking entities is not yet accurate and practicable (cf. our answer to Q1). If unchanged, this would lead to too many exposures being subject to the control mechanisms under Title II point 2. of the draft Guidelines.

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.

Loans to shadow banking entities carry different degrees of shadow bank-specific risks. There is a difference between monitoring the management of exposures to, e.g., an unregulated SPV conduit on the one hand and a big retail AIF under EU and national legislation and supervision on the other hand.

So we would like to propose not to force credit institutions to use a "one size fits all"-approach, which could lead to underestimating risk for the risky and over-allocation of risk management resources to the less risky exposures, but to introduce a **reference to proportionality** as regards the size and nature of the exposures concerned, relative to the credit institution's overall exposures and business model.

Furthermore, as long as the definition of shadow banking entities is too broad (cf. our answer to Q1), the oversight arrangements will cover too many exposures, distracting the risk management's resources from the risky ones.

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.

We agree with the approaches to setting aggregate and individual limits on exposures to shadow banking entities. Especially, we welcome the **principle of proportionality** being reflected in this approach.

However, at the current stage the definition of shadow banking entities is too broad (cf. our answer to Q1). This results in unnecessary additional burden in establishing aggregate and individual limits for exposures which could more suitably and proportionately be treated within the regular risk management process.

Q5: 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?*

Prior to discussing which of both options would be more conservative, it has to be made sure that both are in line with CRR. We think that this is not the case.

Option 1 does not reflect the basic presumption of the large exposure regime that limits can be set both on the aggregate level of all exposures concerned and/or on the individual level of each exposure. There is no way of interpreting the CRR as to allow for one exposure due to its characteristics "infect" another exposure so that the credit institution would be punished for having one "bad" exposure in the portfolio which then leads to a penalty for some or all other exposures.

This is also clearly not in line with the principle of proportionality, for a very small exposure could lead to a massive disadvantage with regard to large exposures which do not pose any problems.

Therefore, Option 1 has to be rejected and Option 2 chosen.

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?

Unfortunately we are in doubt whether the 25% limit is consistent with the current large exposure framework. Under Art. 395 (1) CRR credit institutions are allowed to allocate exposures up to **25% of eligible capital to one client** or a group of connected clients, irrespective of the client's nature or business. This is an unalterable decision by the legislator. There is no way of setting a quantitative limit to exposures to shadow banking entities below that 25%-limit without infringing the CRR. As the limit of 25% for shadow banking exposures is planned to cover all relevant exposures altogether, this means that on a single exposure level the limit would be decreased below the threshold set forth in Art. 395 (1) CRR.

If the definition of shadow banking entities is not changed, the 25% limit does not take into account the current situation of foreign banks in the EU and their exposures to other group institutions located in non-EEA countries. Foreign banks in the EU (and especially in Germany) have an important role in e.g. trade financing and financing cross-border investment activities as well as in cross-border payments. Their activities are important for credit to the EU real economy. Any further limitation to their exposures to their respective parent and/or group entities will have a detrimental impact.

Furthermore, if the 25% limit was chosen, exposures to non-EEA banks would be subject to stricter limits than exposures to any other "real economy"-undertaking, albeit the non-EEA banks are regulated and supervised entities. This is inappropriate and not acceptable.

As a consequence, we propose to set a fallback limit for overall exposure to shadow banking entities of between 50 and 100 % of eligible capital, so as to respect Art. 395 (1) CRR.