EACB Comments

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 CRR

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The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 31 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4.200 locally operating banks and 68.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 205 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 78 million members and 860.000 employees and have a total average market share of about 20%.

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Introduction

The members of the EACB welcome the opportunity to comment on the EBA draft GL on exposures to shadow banking entities.

Please find here below our answers to selected questions.

Answers to selected questions

Q.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 generally agree with the aim of the EBA draft GL to minimise risks which might arise from shadow banking entities. However, we see a need for some adjustments when it comes to the approach put forward for defining shadow banking entities in order to take in due account prudential requirements already in place and to avoid some unintended consequences:

- In general, it should be clarified that companies that are prudentially consolidated according to CRR, are excluded from the definition shadow banking, and that insurance undertakings under Art. 4(1)(27)(d)-(k) CRR should be explicitly kept out of scope. Thus a company can only be regarded as shadow banking when its main activity or essential business purpose is credit intermediation. In our view, also leasing and factoring companies are already well regulated and should not fall under the scope of the guidelines.
- If applied in a strict sense, the guidelines could lead to identify as shadow banking a number of activities which may also occur in “non financial” companies, especially for the purpose of liquidity management. For instance, a manufacturing company could at the same time raise funds and invest them (or buy securities) and thus engage, in a strict interpretation of the guidelines, in liquidity or maturity transformation. We would welcome a clarification that the said activities must be a part of the business model or a core activity.
- With regard to the aforesaid, we believe that a materiality threshold should be fixed. In fact, some cooperative banks count among their customers billing and cash collection centres, which act as settlement bodies on behalf of their members/customers (e.g. medical professionals, etc.). These billing centers create fairly large volumes of transactions (i.e. the billing of the patients/health insurers on behalf of the medical professionals) as pass-through entities or operating in some cases as factor (i.e. billing before expenses, thus involving in credit business). Nevertheless, the relevant volume of such factoring activities

quite low in relation to the volume of "business" otherwise generated. We believe that such activities would not have to be classified among shadow banking. In these cases it would help if the assessment would only focus on the core activities or introduce a threshold until which such activities would not be relevant for the assessment as shadow banking entity.

- According to the proposal also securitization special purpose vehicles (SPVs) are to be considered as shadow banking entities, provided that they do not fall under the consolidated supervision of a group. However, there are reasons to exclude also SPVs from the scope of the definition as these securitization vehicles are already subject to extensive regulatory rules both at the European level (e.g. Part 3, Chapter 5, and Part 5 CRR) as well as in the international context (e.g. the work being carried out by the BCBS and IOSCO), and new requirements are being discussed. Securitization transactions, and thus requirements for SPVs seem already adequately addressed (e.g. in terms of minimum deductible in securitized assets, regulatory limitations for the treatment of liquidity lines and credit exposures, etc.).
- Furthermore, we think that the definition of "shadow banking entities" is too broad, namely by associating it to "bank-like activities" on the basis of services such as "portfolio management" and "advice" (Annex 1 para. 11 CRDIV). These services are not specific banking activities, as they are mainly performed by asset managers. For asset managers neither portfolio management or advice raise the risks that EBA is intending to tackle and identify as credit intermediation, as they are carried out on a pure principal-agent basis. This means that possible risks – if any – only materialise within the client/fund portfolio but not at the level of the entity (the asset manager) performing the activities and would thus not affect its balance sheet. Moreover, the services performed by asset managers are subject to an already existing sector-specific prudential regulation and supervision. It thus seems reasonable to delete the reference to Annex 1 para. 11 of CRDIV when identifying shadow banking activities.
- Additionally, the definition of exposures to shadow banking entities would also comprise equity holdings by an institution in the scope of CRR over an asset manager. In this context, it is of utmost importance that EBA considers its measures as consistent and not contrary to the outcome of the legislative approach undertaken by CRR, the corresponding delegated acts and the strict regulatory requirements for asset managers and their stringent supervisory monitoring.
- Moreover, it needs to be clarified that financial holdings are not to be classified as shadow banks, since they are not involved in maturity and liquidity transformation (normally holdings in entities are financed by credit from the mother company).
- While these guidelines under Art. 395(2) CRR address exposures to shadow banking entities, there are similar entities which may fall either under 142(5) CRR as "unregulated financial sector entities" or under Art. 2(8), (9) EMIR as

“financial counterparty" and “non-financial counterparty”. Furthermore COREP reporting on leverage ratio also includes data on exposures on financial corporates that fall under Article 122 of the CRR. Our members would highly appreciate if the GL could clarify the relationship of those definitions (especially those under the CRR) and if and where their substance overlaps and come to a convergent solution. Clear and operational definitions are necessary to allow a correct and consistent reporting by institutions and to avoid creating unnecessary burdens.

- In addition, while in principle we support the exclusion of CIUs from the definition of shadow banking entities, we have strong concerns on the approach to exclude on the other hand only investment funds established in third countries on the basis of a UCITS-equivalent supervision (para. 6(3)(k)(ii) draft GL). It has to be born in mind that especially open-ended AIFs within Europe are often constrained by a UCITS-like investment policy. From our point of view this justifies for an equal treatment of these types of funds equivalent to their counterparts in third countries when it comes to the list of exclusions from the scope of EBA’s draft GL. In order to take into account potential sources of high risks exposures and considering the current debate on the Banking Structural Reform (BSR), we would recommend to include within the list of exemptions (para. 6(3)(k)) AIFs that do not use leverage on a substantial basis.
- Finally, also the current EU legislation on MMF should be adequately reflected within EBA’s draft GL. The aforementioned legislation aims to tackle risks possibly associated to MMF with a broad set of regulatory requirements. Accordingly, we would like to encourage EBA to include MMF UCITS in the scope of the list of excluded undertakings as far as they comply with these new rules.

Q.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.

Q.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.

To ensure a sufficiently qualified review of the institution´s risk appetite, the management body should be allowed to delegate necessary reviews to specialized employees who are not part of the management body such as the manager of the risk management and control function or a deputy.

Q.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.

We believe that separate aggregate and individual limits on shadow banks under Pillar II would not be appropriate, due to the heterogeneity of the shadow banking sector. Individual limits are already set as part of the regular credit process or are derived from the requirements of the credit risk strategy. Moreover, the regulatory requirement of a specified aggregate limit for shadow banks, independently of the threshold, i.e. 25%, is not appropriate. According to the proportionality principle and in carrying out their responsibilities as managers should sectoral limits the institutions will determine individually taking into account the business model, risk appetite and the materiality of risk positions, the appropriate and necessary limits. Such limits in fact depend heavily on the business model, and can not be addressed by a fixed criteria. It is up to the competent authorities as part of their supervisory work and in the context of SREP, verify the appropriateness of the limits imposed.

In addition, with regard to the requirements proposed under Title II Para. 4, the scope of the information to be collected seems very high, especially against a very low proposed materiality threshold of 0.25% of the eligible own funds. It would be extremely difficult to gather all the information required to set individual limits for exposure to shadow banking activities, and some of an institution's counterparties might not be thoroughly assessed in accordance with all the requirements illustrated in the consultation paper. In particular the implementation of requirements under (c),(d),(e),(f) seem impractical, as a full review does not seem feasible and the bank would have to rely solely on self-assessment by the shadow banking entity. At the very least Title II Para. 4 of the draft GL should clarify that the requirements are to be understood as that the information provided by a shadow banking entity is sufficient and the institution is not required to perform further assessments.

Q.5 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?

We understand that the intention is to provide an incentive to collect as many and complete information about shadow banking as possible. However, we notice that the concept of materiality, which is part of every credit decision, disappears. In our view there is no need for a "technical" fall-back approach since any shortcoming in the establishment of limits would be addressed as part of the SREP, and additional capital requirements could be imposed.

Q.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 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?

We do welcome EBA's effort in building up a methodology especially designed for shadow banking activities. Nevertheless we deem it as highly important to streamline this methodology with already existing regulatory regime.

In this context, all EBA's approaches (principal approach, fall-back approach Option 1 and 2) unfortunately do not seem to take into account already adopted requirements regarding the large exposure limit, namely Art. 7 of the Delegated Regulation 1187/2014. The aforementioned act stipulates that the underlying assets within an investment funds serve as the only reference for the large exposure limit provided that the "structure of a transaction" does not constitute an additional risk.

This comes true to a broad range of AIFs. In particular, the mandatory appointment of a depositary under rules equivalent to the UCITS Directive ensures that the AIF's cash flow can not be redirected to any untitled persons. Moreover, additional payments can not be required since payment titles are limited to the price per unit (NAV).

In return, all approaches by EBA determine the "structure of the transaction" as the only admissible reference irrespective as to whether it constitutes an additional risk or not.

Furthermore, we also have doubts on how to ensure practicability of these EBA's approaches in association with Art. 390(7) CRR. In case AIF would be limited by means of the "structure of a transaction" on the one hand, it would not be comprehensible on the other hand why Art. 390(7) CRR requires a look through approach for AIF and other investments. Since this look through approach serves as an assessment as to whether the "economic substance of the structure of the transaction" and the "risks inherent in the structure of the transaction" itself constitutes an additional exposure, the EBA approach would run counter. This look through approach also requires an assessment of the underlying of an AIF which of course would become meaningless in case that the current EBA methodology should take precedence.

Given that AIF and MMF-UCITS form a small subset of look-through instruments being subject to Art. 390(7) CRR but are currently envisaged as one of the very few (but highly regulated) financial instruments earmarked for the scope of the EBA draft GL, it is necessary to ensure an equal treatment of all look-trough instruments with the legislative outcome of CRR (Level 1) and the delegated acts.

We therefore strongly recommend to uphold to the methodology within Art. 7 of Delegated Regulation 1187/2014 when it comes to AIF and other investment funds. Otherwise AIF would be accounted twice: referring to the "underlying assets" according to the CRR and referring to the "structure of a transaction" according to the EBA's draft GL.