Deutsches Aktieninstitut

EBA's Proposed Definition of Shadow Banking poses Risks to the Real Economy

Non-Financial Companies and their In-House Financial Services Companies Must Not Be Regarded as Shadow Banks by Supervisory Authorities

Position Paper on "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", 18 June 2015

On 19 March 2015, EBA published a consultation paper on draft 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).

For the first time, this paper defines the term "shadow banking entities" for the purpose of supervision in the European Union.

Specifically, EBA regards banking entities as undertakings that (1) carry out one or more credit intermediation activities; (2) are not excluded undertakings whereas credit intermediation activities are defined as bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities. These activities include at least those listed in the following points of Annex 1 of the CRD: points 1 to 3, 6 to 8, 10 and 11 (Title 1, para 6, 7 and 8 of the Draft Guidelines).

From Deutsches Aktieninstitut's[1] point of view this **definition** is not only **extremely wide.** It also **goes beyond the scope of activities that has been identified by the Financial Stability Board (FSB) as potentially bearing systemic risks** and thus may require closer observation. The Financial Stability Board has focused its work on shadow banking on specific market players or financial activities, such as money market funds (and other huge asset managers) and securities financing transactions.

EBA refers to Annex 1 of the CRD. This means that the **following activities will be automatically (!) regarded as shadow banking**:

- taking deposits and other repayable funds (point 1),
- lending (point2),
- financial leasing (point 3),
- issuing guarantees and commitments (point 6),
- trading for own account or for account of customers in specified forms of financial instruments (point 7),

1 Deutsches Aktieninstitut (identification number: 38064081304-25) represents the entire German economy interested in the capital markets. The about 200 members of Deutsches Aktieninstitut are listed companies, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt, Brussels and in Berlin. This position paper is based on discussions in the working committee on corporate treasury/corporate finance consisting of representatives of the treasury departments of German non-financial companies.

- participating in securities issues and providing of services relating to such issues (point 8),
- money broking (point 10), and
- portfolio management and advice (point 11)

This automatism is always applied unless the respective market participants/entities are explicitly excluded according to Title 1, para. 7.

Non-financial companies and in-house financial services companies, however, are not among the excluded entities of Title 1, para. 7. As a consequence, **EBA's guidelines may also be applied directly to non-financial companies and their in-house-financial services companies.** Examples of those activities are the pooling of cash reserves and the re-allocation of funds in a group treasury centre, the centralisation of derivative transactions with external parties for hedging purposes for the group and/or the subsidiaries of the group as well as the access to external capital markets through specialised finance subsidiaries. All these intragroup activities of industrial groups have in common that the respective transactions are initiated between group subsidiaries and a central unit or a central unit is involved in initiating transactions for its group companies. This group internal centralisation decreases the volume of external financial relations to the banking system because netting effects within in a group can be exploited by centralisation. Such intragroup operations are industry standard practices and neither create additional risks for the group as a whole nor do they increase the interconnectedness with banks and the financial system (and thus do not pose a systemic risk). They simply increase operational efficiency: external transactions are done by those group entities entitled to do them (e.g. treasury unit) and redistributed to the internal units requiring such services.

Furthermore, industrial companies which provide financial (or intermediation) activities only in order to support their operative business (e.g. leasing) so that the respective activities are not their main, but an ancillary activity, may be regarded as shadow banks as well.

It is important that the definition of shadow banks addresses the potentially relevant activities in a way that is proportionate and appropriate to the level of risk involved. Therefore, industrial companies and their in-house financial services companies should not be qualified as shadow banking entities because normal intragroup activities are inappropriately deemed a (potential) shadow banking activity.

The EU legislator has acknowledged that intragroup transactions are necessary for aggregating risks and managing liquidity within a group structure. The legislator has also acknowledged that the submission of intragroup transactions of non-financial companies to strict regulatory requirements would seriously hamper the efficiency of risk and liquidity management processes of industrial companies (see also recital (38) of Regulation (EU) No 648/2012 (European Markets Infrastructure Regulation/EMIR). Against this background EMIR exempts intragroup OTC derivative transactions from the clearing obligation and margining requirements for non-centrally cleared transactions as long as the clearing thresholds are not crossed. In the same way, Art. 2 (1) (b) of Directive 2014/65/EU (MiFID II) deliberately waives the application of its provisions in full with regard to investment services exclusively provided for parent undertakings, for subsidiaries or for other subsidiaries of the parent undertaking. The EU legislator also recognizes that (i) transactions in derivatives which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity and (ii) intragroup transactions that serve group-wide liquidity or risk management purposes shall not be considered when determining the extent to which ancillary activities constitute a minority of activities at a group level for MiFID II purposes (cp. Art. 2 (4) fifth subparagraph of MiFID II).

However, not only directly applicable regulatory requirements (like EMIR or MiFID II) would have adverse effects on intragroup risk and liquidity management activities of industrial companies.

The same holds true for requirements imposed on credit institutions that may indirectly affect industrial companies should they – e.g. due to their treasury financing activities – qualify as shadow banks. Such activities of non-financial companies are, thus, rightly not regarded as banking activities according to law and supervisory practice.

The new EBA proposal contradicts this fundamental decision. **As a consequence, non-financial companies and their in-house financial services companies may fall under the exposure limits set out in the consultation which would have a negative impact on their relationships and dealings with banks although they are not the target of the intended measures.**

In addition to this indirect effect, EBA is about to take over at least partly the role of the legislator because it defines the term "shadow banking" with a rather functional focus. The international debate, however, is still focusing on certain concrete activities that can be clearly identified and addressed, if necessary. We believe that this is a more suitable approach. **We are, therefore, also concerned that EBA's proposal will prejudice further political discussions on potential future regulation of shadow banking** which would then directly and negatively affect non-financial companies**.**

Against this background, **the definition of "shadow banking" has to exclude group internal financial transactions of non-financial companies and their in-house**

financial services companies. This should be done on a general basis as it is for example codified in German law. Otherwise and taken literally, every non-financial company with group internal financial transactions would in future count as a shadow bank for regulatory purposes – a result that cannot be in the interest of the European economies.

In addition to that, **non-financial companies and their in-house financial services companies should be excluded completely from the scope of the definition of shadow banking activities**, even if they perform certain external intermediation activities. As for example laid down in our response to the FSB consultation on shadow banking,[2] external intermediation activities (if there are any) of non-financial companies do not pose a systemic risk that would justify further regulation, because these activities always have a clear link to the operative business. Accordingly, the nature of these external intermediation activities is always ancillary.

2 Deutsches Aktieninstitut's Position Paper on the FSB's Consultative Documents "Strengthening Oversight und Regulation of Shadow Banking", 14 January 2013

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