Deutsche Bank

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Deutsche Bank's response to the European Banking Authority (EBA) Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 para. A 2 Regulation (E) No.575/2013

Dear Mr Farkas,

Deutsche Bank (DB) welcomes the opportunity to comment on the proposed Guidelines. We acknowledge the concerns of regulators that a migration of credit intermediation services from the highly regulated banking sector to the shadow banking sector may lead to an increase in risks to financial stability. However, we have a number of concerns with respect to the proposed Guidelines.

Our key concerns relate to:

Inconsistency with the large exposure framework – We strongly question the proposed aggregate limit of 25% for exposures to the shadow banking sector. It is inconsistent with the current large exposure regime, whereunder a limit of 25% applies for exposures to a single client. Sectoral concentration risk is neither in scope of the current large exposure framework, nor covered by the future framework of the Basel Committee on Banking Supervision (BCBS). Moreover, it cannot be assumed that all shadow banking entities (SBEs) are connected.

Definition – The proposed definition of shadow banking is too broad and risks creating a unilateral European approach to the treatment of SBEs:

- It is critical that the EBA does not introduce a regime that restricts the desired revival of the securitisation market;
- The focus should be refined and be on leveraged alternative investment funds (AIFs);
- Money Market Funds (MMFs) should also be automatically out of scope when the draft EU MMF regulation currently being finalised enters into force.

On the designation of equivalence for third countries, we suggest that this is done centrally at the EU level rather than left to national competent authorities in order to ensure a consistent approach to the treatment third countries by all EU Member States.

Level playing field and regulatory divergence – Where the definition of SBEs and designation of equivalence for third country regimes is subject to interpretation and inconsistent treatment there may be competitive distortions. Further, inconsistency may

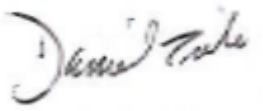
lead to regulatory gaps in spite of the objective of preventing a migration of activities to less regulated parts of the financial system.

Fallback approach – The fallback approach, and in particular Option 1, is unnecessarily punitive. Option 2 is preferable as it is better aligned with the rationale of the large exposure framework. An aggregate limit should not be applied to all exposures – even if it is not possible to apply the principal approach for some exposures.

Broader effects – Overall, it is important that the Guidelines are consistent with the objective of harnessing the funding potential of the shadow banking sector for the real economy. This objective is also persued by the Financial Stability Board (FSB) which wants to see shadow banking into a sustainable source of market based financing, and the European Commission, which has launched a Capital Markets Union initiative to diversify funding to the economy via capital markets financing.

Please let us know if we can provide any further information on the points above or on any other issue.

Yours sincerely,



Daniel Trinder
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Overarching comments

We share the concern that a migration of credit intermediation services from the highly regulated banking sector to the "shadow banking sector", i.e. entities outside a regulated framework, may lead to increased risks to financial stability. We support work continuing at international level to enhance financial stability and ensure a consistent approach.

However, we believe that the proposed large exposure limits – in particular the aggregate limit for exposures to the shadow banking sector in general – are an inappropriate mechanism to address the risks posed by exposures to the shadow banking sector. To directly regulate SBEs that provide credit intermediation services would be a much better solution.

Nevertheless, we recognise that the Capital Requirements Regulation (CRR) requires the EBA to issue guidelines "to set appropriate aggregate or tighter individual limits on exposures limits to exposures to SBEs which carry out banking activities outside a regulated framework". In doing so, we believe the EBA should take into account the following key points:

- Article 395 (2) CRR stresses that the EBA shall consider "whether the introduction of additional limits would have a material detrimental impact on the risk profile of institutions established in the Union, on the provision of credit to the real economy or on the stability and orderly functioning of financial markets". The data collection exercise undertaken by the EBA will be key in understanding that impact;

- The micro-prudential risk for institutions resulting from exposures to individual or connected SBEs are already addressed by the limitation of exposures to individual counterparties or groups of connected clients under the current large exposure framework of the CRR;

- The regulatory technical standards (RTS) regarding the treatment of transactions with underlying assets[1] already partially address the shadow banking issue, since they require a look-through to the ultimate underlying assets of a transaction. It would be inefficient to require a look-through to the underlying assets of, for example, a fund, and at the same time subject exposure to the fund to a special shadow banking regime; and

- Finally, the risk weights for many exposures to SBEs have already been increased under the CRR (see the provisions on the asset value correlation factor and the related distinction between regulated and unregulated financial sector entities). All this should be duly considered in the setting of limits on exposures to SBEs.

Moreover, we are concerned that the proposed Guidelines are not aligned with the rationale of the large exposure framework. The main goal of the large exposures regime is to prevent institutions from incurring disproportionately large losses as a result of the failure of an individual client or group of connected clients due to the occurrence of unforeseen events. However, geographic and sectoral concentration risks are not within

[1] Regulation (EU) No 1187/2014 of 2 October 2014 as regards regulatory technical standards for determining the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets.

the scope of the large exposures regime; rather they are addressed by other means such as concentration risk under Pillar 2. This approach is evident in the EU rules including the CEBS Guidelines, and reiterated in the BCBS large exposure framework of April 2014 that will apply from 2019.[2] Notably, an aggregate limit for all exposures to SBEs has little to do with setting limits for exposures to individual clients or connected clients in the sense of the large exposure regime. Instead such a limit would rather target the sectoral concentration risk to "shadow banking", which is clearly not in scope of the large exposure regime.

Lastly, we believe that the EBA proposals will result in a European definition of shadow banking. We urge the EBA to consider the consequences of such a precedent carefully. Moreover, unilateral European measures to tighten lending limits to this sector are likely to place European institutions at a competitive disadvantage. It would be preferable to introduce a definition of shadow banking only when a consensus regarding such a definition has crystallised at the international level. Nevertheless, given the EBA's stated intention to proceed with a limit, we would like to propose an approach that is aligned with the rationale of the large exposure framework and ensures as much consistency as possible with the work carried out by the FSB.

Equivalence

As noted in the cover letter, we have concerns with the proposed definition which may capture a number of regulated non-EU entities which are not shadow banks, with significant implications for EU banks' operations and the functioning of non-EU markets. We agree that it is important that there is an expectation that these entities be subject to robust prudential frameworks. However, it is not clear that the approach outlined is necessary, that sufficient consideration has been given to the implications of the way it is structured, or how the equivalence aspects of the proposals are intended to operate in practice.

The EBA has said, "the Guidelines focus on institutions' exposures to entities that pose the greatest risks both in terms of the direct exposures institutions face and also the risk of credit intermediation being carried out outside the regulated framework". It should be possible for the EBA to frame the requirement so that the regulated entities are not treated as SBEs unless there is a decision that equivalence is not achieved, and not while the assessment is pending. Alternatively, an approach which refers to implementation of global standards – especially where these are monitored by the global bodies – could go some, but not all, of the way to reducing the impact.

To illustrate the potential effect of the proposal with respect to the Asia Pacific region, the FSB Regional Consultative Group (RCG) Asia report[1] published last year demonstrates that banks continue to hold a large share of financial system assets, accounting for at least half of financial system assets in most jurisdictions. With respect to non-bank financial intermediaries, the FSB RCG Asia also states "that given the broad scope of the FSB's definition of shadow banking, if applied locally, such a definition would cast the net wide and capture a substantial portion of non-bank financial institutions (NBFIs), many of

[2] See p. 12 of the CEBS Guidelines on the implementation of the revised large exposures regime of 11 December 2009, and p. 3 of the BCBS large exposure framework of April 2009.

[1] http://www.financialstabilityboard.org/wp-content/uploads/r_140822c.pdf

which may not pose systemic risks or may be already regulated for prudential purposes." This would also be true of the EBA's proposal.

On the basis of the comments made at the EBA hearing on this consultation, our understanding is that EBA may in the guidelines specify that the designation of equivalence will be made on a case-by-case basis by national competent authorities. We have reservations with this approach and in addition believe that it could lead to an unlevel playing field in Europe. The following considerations need to be taken into account when elaborating on any equivalence regime:

- Which authority/ies will be responsible for the assessment (which may potentially result in inconsistencies if at a national level);
- On what basis the equivalence assessment will be conducted – lessons from previous approaches emphasise the need to be proportionate and outcomes focused, and to refer to implementation of global standards which underpin EU legislation, rather than only that legislation;
- What the timetable will be for conducting such assessments; and
- Whether the scope of countries being assessed will be sufficiently comprehensive to fully reflect the range of counterparties and jurisdictions EU banks deal with across all of the sectors highlighted in the paper – e.g. banking, investments, insurance, etc. This aspect, combined with the timing of any decisions, may be constrained by the resources of the EU institutions which could have unnecessary negative impact – even if just short-term – on EU banks.

We suggest that if there is a need for authorities in the EU to make a designation of equivalence for this purpose, it should be done centrally at the EU level rather than left to national competent authorities, although it may be appropriate to draw on resources to complete this work to alleviate pressures. Such an approach would be in line with supporting a level-playing field.

Annex I - Answers to questions posed in the discussion paper

Question 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 are concerned that the EBA's definition of shadow banking exposures is too broad. The definition will moreover be difficult to implement in practice. In addition to the points on equivalence noted above, we make the following proposals regarding the scope of the regime:

Activity-based exemptions:

In general, we would like to refer to the recommendation of the FSB to judge financial entities' involvement in shadow banking "by looking through to their underlying economic functions rather than legal names or forms". The FSB defines a framework of five economic functions to which authorities should refer to when identifying the sources of shadow banking risks in non-bank financial entities[3].

The proposed definition combines entity and activity based approaches, but does not include a "materiality" clause. We think that the EBA should consider amending this. To align this to existing CRR requirements, in particular the definition of "unregulated financial sector entity" in Article 142 (5) CRR, we would suggest a clarification that relevant activities have to be the entity's main business. In any case, it should be clarified that when an entity undertakes credit intermediation activities only in an *ancillary* capacity to its core business, this will not lead to a classification as an SBE. Otherwise the borrowing and liquidity risk management of corporates (e.g. treasury functions) could be captured by the definition, or possibly even the entire corporate.

Broker/Dealers:

Broker/dealers subject to capital and liquidity regulation on a consolidated basis should not be covered by the definition of SBEs, in line with the FSB's regulatory framework for haircuts on non-centrally cleared financing transactions.[4]

[3] FSB Report „Strengthening Oversight and Regulation of Shadow Banking. Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities" from 29 August 2013, page 2 and 3 (the FSB Report)

[4] FSB report "Strengthening oversight and regulation of shadow banking: regulatory framework for haircuts on non-centrally cleared securities financing transactions" of 14 October 2014. Banks and broker-dealers subject to adequate capital and liquidity regulation on a consolidated basis are out of scope of "non-banks" (p. 7 section 3.1).

Funds:

Due to the broad definition of AIFs it is important to distinguish between the different types of AIFs. AIFs can pursue very different investment strategies and be set up as professional or retail funds. Hence, the AIF universe ranges from classical retail funds such as mixed funds which deviate only slightly from the UCITS rules in terms of their investments (also set up for professional investors) to highly leveraged hedge funds or closed-ended vehicles investing e.g. in infrastructure or private equity. Therefore we would like to refer to Article 111(1) of Regulation (EU) 231/2013 (AIFMD Implementing Regulation). The focus could be on AIFs whose leverage exceeds three times its net asset value according to the commitment method. This would help to align the different regulations that are focusing on the regulation of and the relationship with SBEs.

Further, as a general remark, the definition / criteria regarding SBEs are not relevant for UCITS and the majority of AIFs, given the rationale that "shadow banks are generally not subject to prudential regulation, do not provide access to deposit guarantee schemes to investors and do not have access to central bank liquidity"[5]. To illustrate:

- Investment funds (UCITS as well as AIFs) are fully funded by the own capital of their investors. Therefore, there is no need for capital requirements;
- Deposit guarantee schemes are not necessary for investment funds, as the assets of the investment funds (securities as well as cash) are segregated from the manager's assets and held in custody by the respective depositary. In case of a manager's insolvency, the assets of the investment fund are fully protected and do not contain any risk which could require a deposit guarantee scheme. This is already implemented for AIFs (Directive 2011/61/EU) and will be implemented for UCITS with UCITS V (Directive 2014/91/EU); and
- Investment funds require no central bank liquidity. Liquidity as well as liabilities towards counterparties and investors are monitored on an ongoing basis and dealt with as part of the internal liquidity and risk management. Especially as investment funds are required to align the investment strategy, the liquidity profile and the redemption policy of the fund.

Portfolio Management and Advice:

In recital 9 the EBA lists the relevant banking activities and mentions also "Portfolio Management and Advice". Due to this reference, portfolio management and advice are also treated as credit intermediation activities. Portfolio management and advice are investment services regulated under the MiFID framework. These services are primarily performed by asset managers being authorised investment firms subject to a separate set of prudential rules. In addition, portfolio management and advice may also be provided by other qualified market participants such as fund managers authorised for the purpose of collective portfolio management under the UCITS Directive or AIFMD, or also by credit institutions. Therefore portfolio management and advice are not comparable to bank-like activities. On the contrary, these services do not require a banking license and are thus attributable to the securities sector.

Securitisation:

It is critical that the EBA does not introduce a regime that restricts the desired revival of the securitisation market. Article 395 (2) CRR specifically requires the EBA to consider

[5] Page 4, paragraph 5 of the Consultation Paper

the economic impact of the limits proposed, e.g. “on the provision of credit to the real economy or on the stability and orderly functioning of financial markets”. At a minimum, we think that the types of high quality / “SST securitisations” (simple-transparent-standard) which are the subject of BCBS and EC consultations should be excluded from the shadow banking exposure definition.

UCITS/MMF UCITS:

We agree that non-MMF UCITS should be excluded from the scope of the regime. We also suggest excluding all UCITS from the scope of the regime (including MMF UCITS). UCITS are highly regulated funds with well established governance frameworks and clearly defined investment limits. The Guidelines state that certain entities could be excluded from the definition on the basis that they are "subject to an appropriate and sufficiently robust prudential framework". This is certainly the case for UCITS, both MMFs and non-MMFs.

The fact that MMFs tend to be substantially larger than other non-MMF UCITS does not change the fact that they need to comply with stringent requirements (laid down in the UCITS Directive) relating to liquidity, investments, risk measurement, exposure and use of derivatives. In addition prominent risk warnings need to be included in the funds' offering documents relating to the risks of investing in those products, including the potential for fluctuation of the Net Asset Funds (NAV).

UCITS MMFs can only invest in money market instruments which hold one of the two highest available short-term credit ratings by each recognised credit rating agency, or, if the instrument is not rated, it is of an equivalent quality as determined by the UCITS. There are specified limits on the maturity dates of instruments and they must provide daily NAV and price calculations and provide daily subscription and redemption of units/shares.

If UCITS MMFs are included in the definition of SBEs, this might inadvertently create a sub-category of UCITS which would be regarded as less robust than other forms of UCITS and that could have repercussions for the UCITS brand. If it is felt that further legislation needs to be implanted to address issues specific to UCITS MMFs, it would be better to achieve this in the context of the work which is currently being undertaken by the EC relating to MMFs, rather than indirectly through a shadow banking measure.

Notwithstanding the above, any requirements on MMFs should automatically be dis-applied as soon as the EU draft regulation[6] currently under discussion takes effect.

Question 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.

Assessing the effectiveness of processes and control mechanisms on specific exposures is only possible if the scope of exposures under review has been clearly defined. This is currently not the case; therefore the assessment may potentially be undermined by regulatory arbitrages / differences in interpretation.

Secondly, the eight criteria highlighted for the principle approach do not necessarily constitute proof of a “robust framework“. For example, if a fund is considered as a “low risk“ fund and well regulated under an appropriate framework, a bank‘s internal risk

[6] http://ec.europa.eu/internal_market/investment/docs/money-market-funds/130904_mmfs-regulation_en.pdf

management processes may rely on the regulatory control framework and oversight of investment managers/custodians for certain aspects (e.g. concentration ratios). Based on the satisfactory assessment of the aforementioned regulatory framework, a bank already following a risk based approach might legitimately not deem it necessary to gather information and it may therefore not be possible to produce evidence to demonstrate compliance with the strict definition of the criteria.

Question 3 & Question 4: 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. 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.

The oversight arrangements set out in the draft Guidelines might be appropriate for a bank without a risk management approach based on aggregate industry exposure*, i.e. an approach that considers exposures to hedge funds, corporates etc.* However, for banks already applying a comprehensive risk based industry sector approach, this additional requirement would duplicate work and create overlaps.

As we have outlined in the overarching comments section, given that the SBEs are subject to: i) individual large exposure limits, ii) look through approach to the ultimate underlying assets of a transaction as well as iii) the limitation of exposures to individual counterparties or groups of connected clients under the current large exposure framework of the CRR, an aggregate limit would not add any additional benefits to the current framework. This could also result in operational challenges around carving out specific parts of a portfolio (e.g. Non MMF UCITS Funds).

As explained above, the definition of SBEs is too broad and therefore does not allow for the definition and establishment of a meaningful aggregate limit. For example, taking together Emerging Market banks with SPVs, Hedge Funds, non UCIT MMFs etc results in a very heterogeneous portfolio, the constituents of which, even in a stressed situation, is highly unlikely to impact an institution at the same time or in the same way. It is unclear how a bank would set a strategy and define a risk appetite for such a diverse group.

Question 5: 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?

If the fallback approach is maintained, of the two, Option 2 would be preferable as it is better aligned with the rationale of the large exposure framework to prevent institutions from incurring disproportionately large losses as a result of the failure of an individual client or group of connected clients due to the occurrence of unforeseen events[7]. Accordingly, where the institution knows that SBEs are not interconnected in the sense of the large exposure regime, it should not be required to apply an aggregate limit to all exposures – even if it fails to apply the principal approach for some exposures.

[7] The rationale of the large exposure framework is to prevent institutions from incurring disproportionately large losses as a result of the failure of an individual client or group of connected clients due to the occurrence of unforeseen events. In contrast, geographic and sectoral concentration risks do not fall into the scope of the large exposures regime and are addressed by other means such as concentration risk under Pillar 2.

Option 2 – contrary to Option 1 – is better aligned with the approach of the RTS regarding the treatment of transactions with underlying assets where an aggregation of exposure in the "unknown client" bucket is only required for those exposures for which an institution fails to meet the specific principal requirements of the RTS. In addition, this type of approach is also taken for requirements outside the area of large exposures that relate to comparable concentration / systemic risk topics, such as for instance investments in financial sector entities for purposes of capital deductions (see the respective RTS on the look-trough to such exposures[8]). Accordingly Option 1 should also be ruled out for sake of consistency.

Also, on the basis that one of the purposes of the fallback approach is to provide an incentive to institutions to become more sophisticated (para 31), Option 2 provides a greater incentive:

- In the example on page 25, the institution which is able to calculate individual limits for C and D is still subject to the aggregate limit of 25 under Option 1;
- The institution is only allowed to use these limits for C and D under Option 2; and
- In a situation where an institution knows at the outset it will not be able to calculate exposures under the principal approach for all of its SBE counterparties, Option 1 does not provides less of an incentive for the institution to become sufficiently sophisticated to develop limits for any of the counterparties –i.e. in the example provided, if the institution knew it could not apply the principal approach to A but that it could become sufficiently sophisticated to apply the principal approach to B, Option 1 provides less of an incentive because the aggregate limit will still be set to 25.

Question 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 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?

We strongly disagree with the assumption that the proposed aggregate 25% for exposures to the shadow banking sector is consistent with the current large exposure limit. It is true that the proposed aggregate limit refers to the same percentage. However, this is not a sign of consistency. Using the same percentage for an *aggregate* limit to the whole shadow banking sector as the one currently used for the large exposure limit of Article 395 CRR that relates to *individual* counterparties or group of connected clients clearly indicates that the proposed percentage is much too low for an aggregate limit. This is also illustrated by the fact that where EU prescribes aggregate limits, they are much higher. The most relevant example is the previous aggregate large exposure limit under Directive 2006/48/EC, which was set at 800% of own funds.[9] Even taking into account that this aggregate limit related to all types of exposures, it clearly illustrates that an aggregate limit should not be set at 25% (mirroring the limit for exposures to individual clients), but should rather be in the three-digit-range.

Geographic and sectoral concentration risks do not fall into the scope of the large exposures regime and are addressed by other means such as concentration risk under Pillar 2. At the European level, this was stressed in the past in e.g. the CEBS Guidelines, and at the international level, this is currently reiterated in e.g. the BCBS large exposure

[8] See the EBA's final draft regulatory technical standards on own funds [Part 3] of 13 December 2013.
[9] See Art. 111 (3) of Directive 2006/48/EC.

framework of April 2014. The proposed Guidelines should not introduce elements that conflict with the existing policy framework for large exposures, as well as the framework of the BCBS that will apply from 2019.

Moreover, we think that the assumption on which such an aggregate limit to the shadow banking sector is based, i.e. that all exposures to SBEs could be connected, is erroneous. Taking into account the proposed broad definition of shadow banking, the requirement that all of an institution's counterparties, anywhere in the world have to be grouped together and treated as posing a single risk to the firm is excessive.

Such an approach is particularly inappropriate in combination with the proposed Option 1. An institution would be forced to apply an aggregate limit to its exposures to the SBEs just because it fails to meet the requirement of the principal approach for just one exposure. For example: An institution has 1.000 exposures to SBEs, and is able to prove that 999 of them are not connected in the sense of the large exposure regime, but fails to apply the principal approach for its exposure to the one remaining SBE. In this case it would clearly be excessive to require that the institution treats all 1.000 exposures as interconnected. This also illustrates that if an aggregate limit is to apply at all, this is only possible in combination with Option 2.

In setting limits, the EBA should also consider the developments regarding shadow banking at the international level, as explicitly required by Article 395 (2) CRR. It is correct that the FSB suggests that the limits on the size and nature of a bank's exposures to SBEs should be enhanced. However, the FSB at the same time refers to the existing 25% EU limit for large exposures to individual clients or group of connected clients an example for adequate limit setting.[10]

Moreover, we think that the EBA's cost-benefit analysis does not consider the potentially large impact that an aggregate limit of 25% combined with Option 1 could have on the EU banking sector. The draft Guidelines state "there would be costs for some banks" and that "they might need to change their processes". Such an aggregate limit would for a number of banks – based on their current portfolio – most likely lead to a breach of the limit, and would require a discontinuation of the related business, if it is not possible to apply the principal approach to all exposures. The introduction of tighter limits on bank's activities could in fact increase the provision of credit intermediation services by the shadow banking sector (e.g. due to the fact that banks which are currently active in the fund sector would be cutting down this line of business).

[10] See FSB, Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the FSB, October 2011, in particular Recommendation 2, p. 18: "For example, in the EU there is a limit of 25% of capital for an exposure to an entity or a group of entities. However, in other jurisdictions, the limits are often different."