

EBA/CP/2015/06

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Consultation Paper

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

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1. Responding to this Consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 19 June 2015. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

The EBA has a mandate to develop guidelines to set appropriate aggregate limits or tighter individual limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395(2) of Regulation (EU) No. 575/2013 (CRR).

Article 395(2) of CRR reads: *'EBA shall, in accordance with Article 16 of Regulation (EU) No 1093/2010, taking into account the effect of the credit risk mitigation in accordance with Articles 399 to 403 as well as the outcomes of developments in the area of shadow banking and large exposures at the Union and international levels, issue guidelines by 31 December 2014 to set appropriate aggregate limits to such exposures or tighter individual limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework.'*

In developing those guidelines, 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 global financial crisis has revealed previously unrecognised fault lines which can transmit risk from the shadow banking system to the regulated banking system, putting the stability of the entire financial system at risk.

From a micro-prudential perspective, shadow banks are generally not subject to prudential regulation (or are not subject to the same standards of prudential regulation as core regulated entities such as institutions), do not provide access to deposit guarantee schemes to investors, and do not have access to central bank liquidity. To the extent that shadow banks carry out bank-like activities, exposures to shadow banks are therefore inherently risky - and thus worthy of specific limits, to be set by institutions as part of their internal processes, for individual exposures.

Macro-prudentially, institutions' exposures to shadow banks could be of concern for different reasons. Here, institutions' exposures to shadow banks undertaking bank-like activity may lead to regulatory arbitrage concerns, and worries that core banking activity may migrate systematically away from the regulated sector 'into the shadows'. In order to seek profits, institutions may still actively seek ways to arbitrage the rules by funding risky shadow banks.

To minimise the risks posed to institutions arising from their exposures to shadow banking entities, the Guidelines lay down requirements for institutions to set limits to their individual exposures to shadow banking entities (alleviating primarily the micro-prudential concerns expressed above) and to the shadow banking sector in its entirety (alleviating macro-prudential concerns).

In the absence of a definition in the CRR of the terms 'shadow banking entities', 'banking activities' and 'regulated framework' it has been necessary to develop a definition of those terms

for the purposes of the guidelines. The definitions proposed aim at capturing entities that are not subject to appropriate prudential supervision and therefore pose the greatest risks and are in line with the previous EBA Opinion and Report on the perimeter of credit institutions¹.

In prescribing the approach institutions should adopt for the purposes of setting appropriate individual and aggregate limits for exposures to shadow banking entities, these guidelines will establish a harmonised approach for mitigating the risks identified above. These guidelines will also help inform the Commission's work in relation to its report on the appropriateness and impact of imposing limits on exposures to shadow banking entities under Article 395(2) of the CRR.

¹ The Opinion and Report are available here: <http://www.eba.europa.eu/-/eba-publishes-an-opinion-on-the-perimeter-of-credit-institutions>.

3. Background and rationale

3.1 General background

1. Shadow banking can complement traditional banking by expanding valuable access to credit in support of economic activity or by supporting market liquidity, maturity transformation and risk sharing thereby supporting growth in the real economy. For example, various types of non-bank funds have been stepping in (often as intermediaries for insurance companies and pension funds) to provide long-term credit to the private sector while banks have been repairing their balance sheets and retrenching from certain activities². Moreover, in the euro area, recent data shows that lending by shadow banks as a proportion of total lending is rising³. Research also suggests that shadow banking often enhances the efficiency of the financial sector by enabling better risk sharing and maturity transformation and by deepening market liquidity⁴.
2. However, the global financial crisis has revealed previously unrecognised fault lines in the shadow banking system which put the stability of the financial system at risk. These include a heavy reliance on short-term wholesale funding and a general lack of transparency which masked the increasing amounts of leverage, maturity and liquidity transformation in the run-up to the crisis, and in turn increased the vulnerability of shadow banks to runs. The subsequent fire sale of assets by shadow banks helped spread the stress to the traditional banking system.
3. A number of international regulatory initiatives relating to shadow banking are in progress. For example, in April 2011 the Financial Stability Board (FSB) published Recommendations to Strengthen Oversight and Regulation of Shadow Banking⁵ and in April 2014 the Basel Committee on Banking Supervision (BCBS) published a revised supervisory framework for measuring and controlling large exposures, which includes exposures to shadow banks⁶. At the EU level, the Commission has adopted a proposal for a regulation aimed at increasing transparency of certain transactions outside the regulated banking sector⁷. Additionally, work

² See IMF Global Financial Stability Report, April 2014 available here: <http://www.imf.org/external/pubs/FT/GFSR/2014/01/index.htm>.

³ See IMF Global Financial Stability Report, October 2014 available here: IMF Global Financial Stability Report, October 2014 and the Financial Stability Board's Global Shadow Banking Monitoring Report 2014 available here: <http://www.financialstabilityboard.org/2014/11/global-shadow-banking-monitoring-report-2014/>.

⁴ Claessens, Stijn, Zoltan Pozsar, Lev Ratnovski, and Manmohan Singh. December 2012. "Shadow Banking: Economics and Policy." IMF Staff Discussion Note SDN/12/12, International Monetary Fund, Washington.

⁵ The FSB's Recommendations are available here: <http://www.financialstabilityboard.org/2011/10/financial-stability-board-publishes-recommendations-to-strengthen-oversight-and-regulation-of-shadow-banking/>.

⁶ Supervisory framework for measuring and controlling large exposures - final standard, Basel Committee on Banking Supervision, Bank for International Settlements, April 2014.

⁷ Proposal for a regulation of the European Parliament and of the Council on reporting and transparency of securities financing transactions, European Commission, January 2014.

has been undertaken to analyse the scope of the perimeter of credit institutions in the EU the results of which are set out in the EBA's Opinion and Report on the perimeter of credit institutions⁸ and at the international level, work led by the BCBS is underway on accounting and regulatory approaches to consolidation. The FSB is also conducting intensive monitoring of the shadow banking sector⁹.

3.1.1 Concerns regarding shadow banks

4. Whilst some activities carried out by shadow banks can have beneficial effects as regards the financing of the real economy and fostering growth, they also generate a number of specific risks from a prudential viewpoint that may warrant regulatory attention.
- *Run risk and/or liquidity problems:* Shadow banks are potentially vulnerable to runs (withdrawal of deposit-like assets due to panic, early redemptions due to a confidence crisis) and/or liquidity problems (liquidation of assets at fire sale prices), stemming from credit exposures, high leverage and liquidity and maturity mismatches between assets and liabilities. These risks are usually exacerbated because shadow banks do not have sectoral liquidity backstops and are subject to less robust and comprehensive prudential standards and supervision.
 - *Interconnectivity and spillovers:* Shadow banks tend to be highly correlated and interconnected to the regulated banking sector due to ownership linkages, explicit and implicit credit commitments and as direct counterparties. In times of stress this can, directly or indirectly, generate systemic risks through contagion effects both between shadow banks or between such entities and the regulated banking sector, leading to a flight to quality and fire sales of assets.
 - *Excessive leverage and procyclicality:* The maturity mismatch and liquidity risks are exacerbated by shadow banks' ability to engage in highly leveraged or otherwise risky financial activities. Highly leveraged structures are more likely to become insolvent in the case of unexpected negative events due to inadequate loss-absorbing capacity, abrupt deleveraging and inability to rollover financing needs. The crystallisation of such events can trigger a confidence crisis in the regulated banking sector, leading to severe impairment of funding sources.
 - *Opaqueness and complexity:* The opaque and complex nature of governance and ownership structures of shadow banks and their relationships with the regulated banking sector constitute vulnerabilities, since during period of stress, investors tend to retrench and flee to safe, high quality and liquid assets. The inherent agency problem, caused by the separation of financial intermediation activities across multiple shadow banks, also contributes to vulnerabilities in the financial system. There is also a lack of disclosure

⁸ The EBA's Opinion and Report are available here: <https://www.eba.europa.eu/-/eba-publishes-an-opinion-on-the-perimeter-of-credit-institutions>.

⁹ See for example the FSB's Global Shadow Banking Monitoring Report 2014 as referred to in footnote 2.

(regarding collateral, assets or value thereof) due to their activities being unregulated or subject to light touch prudential regulation.

3.1.2 Legal mandate and definitions used

5. The EBA has the mandate under Regulation (EU) No. 575/2013 (the CRR) to issue guidelines to set limits on institutions' exposures to shadow banking entities.

6. Article 395(2) of the CRR reads as follows:

“EBA shall, in accordance with Article 16 of Regulation (EU) No 1093/2010, taking into account the effect of the credit risk mitigation in accordance with Articles 399 to 403 as well as the outcomes of developments in the area of shadow banking and large exposures at the Union and international levels, issue guidelines by 31 December 2014 to set appropriate aggregate limits to such exposures or tighter individual limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework.

In developing those guidelines, 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.”

7. In the absence of a definition in the CRR of the terms ‘shadow banking entities’, ‘banking activities’ and ‘regulated framework’, for the purposes of the Guidelines, the EBA defines shadow banking entities as entities that:

- a. are carrying out credit intermediation activities, defined as bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities; and
- b. are not within the scope of prudential consolidation nor subject to solo prudential requirements under specified EU legislation (or equivalent third country legal frameworks). Entities referred to in Article 2(5) and Article 9(2) of Directive 2013/36/EU (CRD) are also not to be regarded as shadow banking entities.

8. This approach follows that set out in the EBA’s Opinion and Report on the perimeter of credit institutions. In particular, the Guidelines do not prescribe an exhaustive list of activities that fall within the scope of credit intermediation activities. Instead, the description of ‘credit intermediation’ adopted in the aforementioned Opinion and Report¹⁰, which follows the approach prescribed by the FSB, has been adopted as this best describes the types of activities undertaken by shadow banking entities. The FSB has identified the four key features of credit intermediation as: (a) maturity transformation (borrowing short and lending/investing on longer timescales); (b) liquidity transformation (using cash-like liabilities to buy less liquid

¹⁰ See footnote 8.

assets); (c) leverage; and (d) credit risk transfer (transferring the risk of credit default to another person for a fee). Examples of entities carrying out credit intermediation include money market funds, special purpose vehicles engaged in securitisation transactions, securities and derivatives dealers and companies engaged in factoring, leasing or hire purchase.

9. In order to assist institutions in identifying entities that are carrying out credit intermediation activities, the Guidelines make clear that entities carrying out one or more of the activities listed in the following points of Annex 1 of the CRD shall be automatically regarded as carrying out credit intermediation activities: points 1 (taking deposits and other repayable funds), 2 (lending), 3 (financial leasing), 6 (guarantees and commitments), 7 (trading for own account or for account of customers in specified forms of financial instrument), 8 (participation in securities issues and the provision of services relating to such issues), 10 (money broking), and 11 (portfolio management and advice). However, this should not be taken as an exhaustive list of activities within the scope of 'credit intermediation'. Rather, this approach simply confirms specific cases in which entities are to be positively identified as carrying out credit intermediation activities for the purposes of the Guidelines.
10. The second limb of the definition of shadow banking entities for the purposes of the Guidelines carves out certain entities from the scope of the definition (and therefore from the scope of the Guidelines). These are entities that are subject to an appropriate and sufficiently robust prudential framework. For example, under this approach credit institutions, investment firms, insurers and entities established in third countries which are subject to prudential requirements which are considered to be equivalent to those applied in the Union are out of scope. Furthermore, entities subject to consolidated prudential supervision (whether as a result of EU legislation, applicable national legislation, or an equivalent third country legal framework) are out of scope.
11. As such 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 (see further below). These entities include unregulated financial sector entities such as special purpose entities and special purposes vehicles (SPEs and SPVs) not covered by consolidated prudential supervision.
12. As regards funds, these tend to engage in maturity and liquidity transformation and are generally regarded as outside the traditional banking sector.¹¹ Therefore, *prima facie*, they should be in scope of the definition of shadow banking entity.
13. However, some funds are regulated pursuant to prudential frameworks similar to those applied to credit institutions and investment firms. In particular, in the EU the UCITS Directive (Directive 2009/65/EC) prescribes a robust set of requirements under which undertakings for collective investment in transferable securities, and their managers, operate. These include

¹¹ For example, see the FSB's Global Shadow Banking Monitoring Report 2014.

requirements on the asset manager (initial capital, own funds and internal control requirements) and the managed funds (e.g. limits to leverage and concentration). Therefore, such funds do not pose the same level of risk to institutions in terms of credit and step-in/bail-out risk (e.g. due to reputational, franchise and other risks) as unregulated funds.

14. Notwithstanding these requirements it is proposed that all money market funds (MMFs), regardless of whether they operate under the rules of Directive 2009/65/EC, should be within the scope of the definition of shadow banking entity for the purposes of these Guidelines. This is because, as acknowledged by the European Commission in its proposal for a regulation on money market funds¹² (under negotiation), the average size of a MMF far exceeds the average size of a UCITS fund and, as acknowledged by the FSB and other institutions such as the International Organisation of Securities Commissions and the European Systemic Risk Board¹³, the systemic risks posed by such funds (in particular having regard to their interconnectedness with the banking sector) have not been addressed to an adequate degree through existing regulatory measures. Therefore, at this stage (in particular, pending agreement on the Commission's legislative proposal) the EBA proposes to include all MMFs within the scope of the definition of shadow banking entity. As such, all funds would be considered as falling in the scope of the definition of shadow banking entities except if they are non-MMF UCITS (and third country firms subject to equivalent requirements). All MMFs (being UCITS or AIFs), all AIFs and unregulated funds would fall in scope.

15. This approach is consistent with the approach described in the EBA's Opinion and Report on the perimeter of credit institutions¹⁴ and the general focus of the policy debate on shadow banking within the European Union and in international contexts¹⁵.

3.1.3 Relation to other parts of the European rulebook

16. The Guidelines complement the general large exposures framework (Part Four of the CRR). Exposures to shadow banking entities are subject to the general large exposures framework.

17. On 27 November 2014, the Commission Delegated Regulation (EU) No 1187/2014 of 2 October 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council as regards regulatory technical standards for determining the overall exposure to a

¹² The Commission's proposal is available here: http://ec.europa.eu/finance/investment/money-market-funds/index_en.htm.

¹³ IOSCO's recommendations are available here: <http://www.iosco.org/news/pdf/IOSCONEWS255.pdf>.

The ESRB's recommendations are available here: https://www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB_2012_1.en.pdf?c9daf560cb3d72433ca237604eda38af.

¹⁴ See footnote 8.

¹⁵ For example, see the Commission's (2013) Communication on shadow banking: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013DC0614&from=EN>, the IMF's 2014 Global Financial Stability Report: <http://www.imf.org/external/pubs/ft/gfsr/2014/02/> which includes at Chapter 2 an assessment of the size and riskiness of shadow banking around the globe, and the Financial Stability Board's 2014 Global Shadow Banking Monitoring Report available here: <http://www.financialstabilityboard.org/2014/11/global-shadow-banking-monitoring-report-2014/>.

client or a group of connected clients in respect of transactions with underlying assets entered into force. This Regulation applies to all exposures through transactions with underlying assets, thus also including exposures that are within the scope of the Guidelines.

18. In addition, the EBA is considering updating the Guidelines on the identification of groups of connected clients under Article 4, Para. 1, No. 39 Regulation (EU) No. 575/2013, including providing greater clarity on how institutions and special purpose vehicles can be economically interdependent.

19. The Guidelines should be read in conjunction with supervisory powers under Supervisory Review and Evaluation Process (SREP) and Pillar 2. The articulation between these Guidelines and Pillar 2 is further developed in the following section.

20. Finally, the Guidelines are developed having regard to the Commission's mandate under Article 395 of the CRR to 'assess the appropriateness and the impact of imposing limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework' by 31 December 2015.

21. In developing the Guidelines, the EBA is also mindful of other European and international workstreams in the area of shadow banking and large exposures. These include:

- An assessment, by the Commission of the current scope of application of the EU banking prudential rules, as part of the Commission's broader workstream on shadow banking¹⁶. The EBA provided an opinion on this matter, at the request of the Commission, in November 2014¹⁷.
- Work by the BCBS, on the scope of consolidation for prudential regulatory purposes to ensure all banks' activities are appropriately captured in prudential regimes. A public consultation on the proposals is expected by the end of 2015.
- A peer review, to be launched by the FSB in 2015, regarding its member jurisdictions' implementation of the FSB's policy framework for shadow banks, as well as the results of the FSB's fifth shadow banking monitoring exercise in late 2015¹⁸.

3.1.4 Rationale for limiting shadow banking exposures

22. Potential risks could arise from institutions' exposures to shadow banks from both a micro-prudential and a macro-prudential perspective.

¹⁶ [Shadow Banking – Addressing New Sources of Risk in the Financial Sector](#), Commission, 4 November 2013

¹⁷ [Opinion of the European Banking Authority on Matters Relating to the Perimeter of Credit Institutions](#), EBA/Op/2014/12, 27 November 2014

¹⁸ [Updated G20 Roadmap towards Strengthened Oversight and Regulation of Shadow Banking in 2015](#), G20

23. From a micro-prudential perspective, banking activities such as maturity and liquidity transformation are inherently risky. For this reason, institutions are subject to close prudential regulation, must participate in state-backed deposit insurance systems, and have access to central bank liquidity facilities. Shadow banks are generally not subject to prudential regulation (or are not subject to the same standards of prudential regulation as core regulated entities such as institutions), do not provide access to deposit guarantee schemes to investors, and do not have access to central bank liquidity. To the extent that shadow banks carry out banking activities, exposures to shadow banks may therefore be inherently risky - and thus worthy of specific limits, to be set by institutions as part of their internal processes.
24. Macro-prudentially, institutions' exposures to shadow banks could be of concern for different reasons. Here the focus is the role that institutions' funding of bank-like activity amongst shadow banks may play a part in increasing systemic risk across the financial system. One concern is that institutions' funding of large amounts of bank-like activity amongst shadow banks may result in an amplification of the credit cycle. Such a concern may arise from the observation that the flow of funds into shadow banks tends to be volatile. Moreover, the sharp accelerations of credit-flows (and implicit exposures) into shadow banks can result in volatile (and potentially unsustainable) credit flows into the real economy. An aggregate limit on institutions' exposures to the shadow banking sector could play a role in reducing the volatility of such flows.
25. Institutions' exposures to shadow banks undertaking bank-like activity may also lead to regulatory arbitrage concerns, and worries that core banking activity may migrate systematically away from the regulated sector 'into the shadows'. A range of regulations are now in place to address some of the arbitrage risks relating to shadow banks that were observed during the financial crisis. For example, the risk-weights on various forms of shadow-banking exposures have increased. Nonetheless, as the regulatory regime for institutions tightens, the pressure for bank-activity to be carried out elsewhere in the financial system increases. In order to seek profits, institutions may still actively seek ways to arbitrage the rules by funding risky shadow banks - which would then use the funds to lend money onwards to the real economy. Specific limits to the exposures institutions have to the shadow banks and to the shadow banking sector in its entirety may therefore be justified as a backstop against this risk.
26. Notwithstanding these micro-prudential and macro-prudential risks, EBA recognises that banking activities by some shadow banks can play a valuable role in providing alternative sources of funding to the real economy. Excessively reducing the availability of institutions' funding to shadow banks could therefore interfere with the flow of funds into the real economy. Moreover, the regulatory bodies, in the EU and at the global level, are still in the process of assessing the balance of risks and benefits that institutions' funding to different types of shadow banks represent. It is therefore considered to be premature to use the Guidelines to introduce a quantitative limit to institutions' exposures to shadow banks at the individual exposure or aggregate level. Instead, the proposed intervention is designed to place the responsibility on the banking sector to demonstrate that the risks highlighted above are

being managed effectively, in particular by improving, where necessary, the due diligence carried out before taking lending decisions, for instance to identify if the counterparty is carrying out credit intermediation and its regulatory status. Moreover, the approach aligns with the Commission's obligation to report in late 2015 on the potential merits of a legislative proposal to set a specific quantitative limit of some description at a later date.

27. Under the proposal put forward, institutions shall implement effective processes, as well as set aggregate and individual limits under the principal approach for limits. The limits will be set using criteria which are laid down in the Guidelines.
28. The rationale of the principal approach is to make sure institutions have sufficient information about their counterparties in the shadow banking sector to make an informed decision about their exposures to the shadow banking sector in general, as well as to any individual exposure to shadow banking entities. It shall be noted that there is no necessary sequence for the setting of limits: i.e. institutions do not have to set the aggregate limit first and then individual limits, nor the opposite. They have to set both aggregate and individual limits, in any order.
29. Institutions that cannot use the principal approach for limits as a result of their inability to take into account all the criteria, due to either an insufficient level of information about the activities of shadow banking entities to which they are exposed, or to the lack of effective processes to use that information, shall use a simpler approach ('the fallback approach') involving a set aggregate limit of 25%. Institutions would not be able to choose to use the fallback approach – this would prevent regulatory arbitrage.
30. One way to understand this 25% limit is to consider that in the absence of sufficient information, all exposures to shadow banking entities could be connected. Based on this rationale, the outcome of the fallback approach is to apply the 25% limit laid down under Article 395(1) of the CRR for groups of connected clients to the aggregate exposure to the shadow banking sector. However, this calibration has not been tested by an impact assessment at this stage; if needed, the approach might be refined on the basis of the data collection and also taking into account comments from industry participants during the consultation. At this stage, based on preliminary reasoning as explained in an example included as an explanatory box below¹⁹, it would seem that this 25% limit may be conservative.
31. The purpose of the fallback approach is twofold: it creates certainty about the possibility of setting a limit for any institution; in particular, less sophisticated institutions may not be able to apply all of the relevant criteria to use the principal approach. In that sense, the limit in the fallback approach can be seen as a way to ensure that non sophisticated banks apply a sufficiently tight limit to their exposures to shadow banking entities. But the conservative nature of the limit in the fallback approach can also work as an incentive for institutions to become more sophisticated in order to be able to apply the criteria.

¹⁹ See Page 23 below.

32. The CP proposes two versions of the fallback approach:

- a. Under the first option, the fallback approach has to be used for all exposures to shadow banking entities, when the institution is unable to apply the principal approach, even if this inability to apply the principal approach only concerns part of the exposures to shadow banking entities. At least in some cases (see example in the explanatory box) this 25% aggregate limit would be more conservative than the principal approach. If this is the case, the fallback approach could become an incentive for the institution to use the principal approach. Providing such an incentive would entail prudential benefits as the principal approach is only possible if the institution acquires sufficient relevant information about its counterparties to make an informed decision about its internal limits (that may be checked by the competent authority).
- b. The second option would entail using the fallback approach only for those exposures for which the principal approach could not be used. If there is only one exposure for which the principal approach could not be used, then the limit under the fallback approach would only apply to that exposure. In order not to make this method too lenient, those exposures where the principal approach cannot be applied should however still be included in the shadow banking sector for the purposes of the aggregate limit under the principal approach.

33. This second option would be similar to the method used under the RTS on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets. The fallback approach would in that case be more conservative when information is missing for a lot of exposures as the 25% limit of the fallback approach would be more likely to be binding. Conversely, it would be less likely to be binding in cases where the principal approach could be used for all but a few exposures. In addition, this option would be more complex operationally.

34. It can be argued that both approaches provide incentives for institutions to gain sufficient information about exposures to use the principal approach. The preliminary view of the EBA is that those incentives would be stronger in the case of Option 1 and that this approach should therefore be the one included in the final Guidelines.

35. An example and description of the circumstances for the use of the approaches are described in the explanatory box below²⁰.

36. Two preliminary conclusions may be drawn from the example presented in the explanatory box:

²⁰ See Page 23 below.

- a. If the Option 2 is followed, the fallback approach is not necessarily more conservative than the principal approach. If Option 1 is used, then the fallback approach can be more conservative than the principal approach.
 - b. Furthermore, it does not appear that Option 2 could be more conservative than Option 1.
37. Comments are sought on those two approaches and especially regarding potential benefits of Option 2 that may have been overlooked so far.
38. All in all, the approach proposed in these Guidelines requires institutions to set risk tolerance levels for exposures to shadow banking entities within their overall business model and risk management framework, under the supervision of the competent authority. In this regard, it is recognised that some institutions may have a higher risk appetite for these types of exposures and this can be accommodated within the Guidelines once risks arising from these exposures are identified and appropriately mitigated. As such, this proposal is a first step to address the potential risks stemming from exposures to shadow banking entities. The EBA also intends to collect data about exposures to shadow banking entities in order to inform further work to be done on the topic by the Commission in accordance with its mandate under the last subparagraph of Article 395(2) of the CRR. As part of this mandate, the Commission may choose to propose imposing mandatory limits to exposures to shadow banking entities that are tighter than the limits currently laid down for large exposures in general. In any case, the EBA expects the final guidelines to be a useful input to the Commission's report.
39. Under this approach, competent authorities will retain the ability to take supervisory measures to address any risks arising from exposures to shadow banking entities, as appropriate, and in particular to assess and challenge the internal limits and risk mitigation plans set by institutions.
40. The competent authorities' assessment will be guided by the SREP under Article 97 of the CRD and in particular the technical criteria for the supervisory review and evaluation of exposure to and management of concentration risk by institutions under Article 98 of the CRD. Where it is deemed appropriate, consideration shall be given to the assignment of potential Pillar 2 requirements on specific institutions and where necessary, competent authorities may also impose additional requirements under Article 104 of the CRD where the risks arising from excessive exposures to shadow banking entities are not appropriately mitigated. The Guidelines aim to provide a more structured basis for supervisors to make such Pillar 2 judgements within the supervisory review process in relation to shadow banking exposures.
41. The combination of the chosen approach within the Guidelines with the parallel option for supervisors to apply Pillar 2 measures in certain cases will allow the right balance to be found between allowing institutions to set their risk appetite for exposures to shadow banking entities whilst also ensuring that their exposure does not result in excess risk to the financial system.

4. 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

In between the text of the draft guidelines that follows, questions can be found on specific aspects of the proposed text, which respondents to the public consultation should consider in their responses.

Status of these Guidelines

This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC as subsequently amended by Regulation (EU) No 1022/2013 (*‘the EBA Regulation’*). In accordance with Article 16(3) of the EBA Regulation, competent authorities and financial institutions must make every effort to comply with the guidelines.

Guidelines set out the EBA’s view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. The EBA therefore expects all competent authorities and financial institutions to whom guidelines are addressed to comply with guidelines. Competent authorities to whom guidelines apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

Reporting Requirements

According to Article 16(3) of the EBA Regulation, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by dd.mm.yyyy. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form provided at Section 5 to compliance@eba.europa.eu with the reference

'EBA/GL/2014/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities.

Notifications will be published on the EBA website, in line with Article 16(3) of the EBA Regulation.

Title I - Subject matter, scope and definitions

Subject matter

1. These guidelines provide guidance to institutions regarding the methodology that should be used by them, as part of their internal processes and policies for addressing and managing concentration risk arising from exposures to shadow banking entities. In particular, this guidance entails setting an aggregate limit on exposures to shadow banking entities which carry out banking activities outside a regulated framework, as well as tighter individual limits to exposures to such entities.

Scope

2. These guidelines fulfil the mandate given to the EBA under Article 395(2) of Regulation (EU) No 575/2013 ('Capital Requirements Regulation' or 'CRR') to issue guidelines to set appropriate aggregate limits to exposures to shadow banking entities which carry out banking activities outside a regulated framework or tighter individual limits on exposures to such entities.
3. They also build in particular on Articles 73 and 74 of Directive 2013/36/EU ('Capital Requirements Directive' or 'CRD'), that require institutions to have sound, effective and comprehensive strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they considered adequate to cover the nature and level of the risks to which they are or might be exposed, as well as effective processes to identify, manage, monitor and report such risks and adequate internal control mechanisms; and Articles 97 and 103 of CRD, which establish that competent authorities must review the arrangements, strategies, processes and mechanisms implemented by institutions to comply with CRR and CRD, and evaluate the risks to which the institutions are or might be exposed, and that they may apply the supervisory review and evaluation process ('SREP') to institutions which are or might be exposed to similar risks or pose similar risks to the financial system.
4. These guidelines apply to exposures to shadow banking entities as defined below.
5. These guidelines are addressed to competent authorities as defined in point (2) of Article 4 of the EBA Regulation and to institutions. Competent authorities should ensure that institutions apply these guidelines.

Definitions

6. For the purposes of these guidelines, and in addition to the definitions provided in the CRD/CRR (and in particular the definition of exposures pursuant to Part Four of the CRR), the following definitions apply:

-Credit intermediation activities means 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, 11.

-Exposures to shadow banking entities means the exposures to shadow banking entities pursuant to Part Four of the CRR with an exposure value equal to or in excess of 0,25 % of the institution's eligible capital.

-Excluded undertakings means:

(1) undertakings included in consolidated supervision on the basis of the consolidated situation;

(2) undertakings not included in consolidated supervision but which are supervised on a consolidated basis by a third country competent authority pursuant to the law of a third country which applies prudential and supervisory requirements that are at least equivalent to those applied in the Union;

(3) undertakings which are not within the scope of point (1) and (2) but which are:

(a) credit institutions;

(b) investment firms;

(c) third country credit institutions if the third country applies prudential and supervisory requirements to that institution that are at least equivalent to those applied in the Union;

(d) recognised third country investment firms;

(e) financial institutions authorised and supervised by the competent authorities or third country competent authorities and subject to prudential and supervisory requirements comparable to those applied to institutions in terms of robustness;

(f) entities referred to in points (2) to (23) of Article 2(5) of the CRD;

(g) entities referred to in Article 9(2) of the CRD;

(h) insurance holding companies, insurance undertakings, reinsurance undertakings and third-country insurance undertakings and third-country reinsurance undertakings where the supervisory regime of the third country concerned is deemed equivalent;

(i) undertakings excluded from the scope of Directive 2009/138/EC on the taking up and pursuit of the business of insurance and reinsurance in accordance with Article 4 of that Directive;

(j) institutions for occupational retirement provision and institutions within the meaning of point (a) of Article 6 of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, and third country institutions carrying out equivalent business and subject to prudential and supervisory requirements comparable to those applied to institutions within the meaning of point (a) of Article 6 of Directive 2003/41/EC in terms of robustness shall be treated as exposures to institutions;

(k) undertakings for collective investment in transferable securities:

(i) within the meaning of Article 1 of Directive 2009/65/EC (as amended);

(ii) established in third countries where they are authorised under laws which provide that they are subject to supervision considered to be equivalent to that laid down in Directive 2009/65/EC;

except undertakings that invest in financial assets with a residual maturity not exceeding two years (short term assets) and have as distinct or cumulative objectives offering returns in line with money market rates or preserving the value of the investment (MMFs);

(l) central counterparties (CCPs) as defined in point (1) of Article 2 of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories established in the EU and third country CCPs recognised by ESMA pursuant to Article 25 of that Regulation.

-Shadow banking entities means undertakings that:

(1) carry out one or more credit intermediation activities;

(2) are not excluded undertakings.

The general approach proposed by the EBA is to exclude from the scope of the definition of 'shadow banking entities' entities that are subject to an appropriate prudential framework either as a result of prudential consolidation or, where entities are not within the scope of consolidation, certain sector-specific prudential frameworks which are deemed to cover for the risks posed by the bank-like activities of the entity. With regard to funds nevertheless, non-MMFs UCITS established in the EU (and those established in third countries where equivalent supervisory requirements apply) would be excluded. Said differently, all funds would be considered as falling in the scope of the definition of shadow banking entities except if they are non-MMF UCITS (and third country firms subject to equivalent requirements). All MMFs (being UCITS or AIFs), all AIFs and all unregulated funds would fall in the scope.

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).

Title II – Requirements regarding limits to exposures to the shadow banking sector

Institutions should comply with the general principles referred to in paragraph 1 below, as well as set limits as referred to under paragraphs 3 and 4, as applicable.

1- Effective processes and control mechanisms

Each institution should:

- a) Identify its individual exposures to shadow banking entities, all potential risks to the institution arising from those exposures, and the potential impact of those risks.
- b) Set out an internal framework for the identification, management, control, and mitigation of the risks outlined in letter a). This framework should include clearly defined analyses to be performed by risk officers regarding the business of a shadow banking entity to which an exposure arises, the potential risks to the institution, and the likelihood of contagion stemming from these risks to the entity. Those analyses should be performed under the supervision of the credit risk committee, which should be duly informed of the results.

- c) Ensure that risks outlined in letter a) are adequately taken into account within the institution's ICAAP and capital planning.
- d) Based on the assessment conducted under letter a), set the institution's risk tolerance/risk appetite for exposures to shadow banking entities.
- e) Implement a robust process for determining interconnectedness between shadow banking entities, and between shadow banking entities and the institution. This process should in particular address situations where interconnectedness cannot be determined, and set out appropriate mitigation techniques to address potential risks stemming from this uncertainty.
- f) Have effective procedures and reporting processes to the management body regarding exposures to shadow banking entities within the institution's overall risk management framework.
- g) Implement appropriate action plans in the event of a breach of the limits set by the institution in accordance with paragraphs 3 and 4 below.

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.

2- Oversight by the management body of the institutions

When overseeing the application of the principles referred to above as well as the application of the principal approach, the institution's management body should, on a regular predetermined basis:

- a) Review and approve the institution's risk appetite to exposures to shadow banking entities and aggregate and individual limits set in line paragraphs 3 and 4 below;
- b) Review and approve the risk management process to manage exposures to shadow banking entities, including analysis of risks arising from those exposures, risk mitigation techniques and potential impact on the institution under stressed scenarios;
- c) Review the institution's exposures to shadow banking entities (on an aggregate and individual basis) as a percentage of total exposures and expected and incurred losses;
- d) Ensure the setting of the limits referred to in these guidelines is documented, including any changes to them.

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.

Principal approach

3- Setting an aggregate limit to shadow banking entities

Institutions should set an aggregate limit to its exposures to the shadow banking sector relative to their eligible capital. When setting this limit, each institution should take into account:

- a) its business model, risk management framework as outlined in paragraph 1 b) above, and risk appetite as outlined in paragraph 1 d) above;
- b) the size of its current exposures to shadow banking entities relative to its total exposures and relative to its total exposure to regulated financial sector entities;
- c) interconnectedness as outlined in paragraph 1 e) above.

4- Setting individual limits on exposures to shadow banking entities

Independently from the aggregate limit, and in addition to it, institutions should set tighter limits to their individual exposures to shadow banking entities. When setting those limits for their internal assessment process, the institutions should take into account:

- a) The regulatory status of the shadow banking entity, in particular whether it is subject to any prudential or supervisory requirements;
- b) The financial situation of the shadow banking entity including, but not limited to, its capital position, financial leverage and liquidity position;
- c) Information available about the portfolio of the shadow banking entity, in particular non-performing loans;
- d) Available evidence about the adequacy of the credit analysis performed by the shadow banking entity on its portfolio, if applicable;
- e) Whether the shadow banking entity will be vulnerable to asset price or credit quality volatility;
- f) Concentration of credit intermediation activities relative to other business activities of the shadow banking entity;
- g) Interconnectedness as outlined in paragraph 1 e) above;
- h) Any other relevant factors identified by the institution under paragraph 1 a) above.

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.

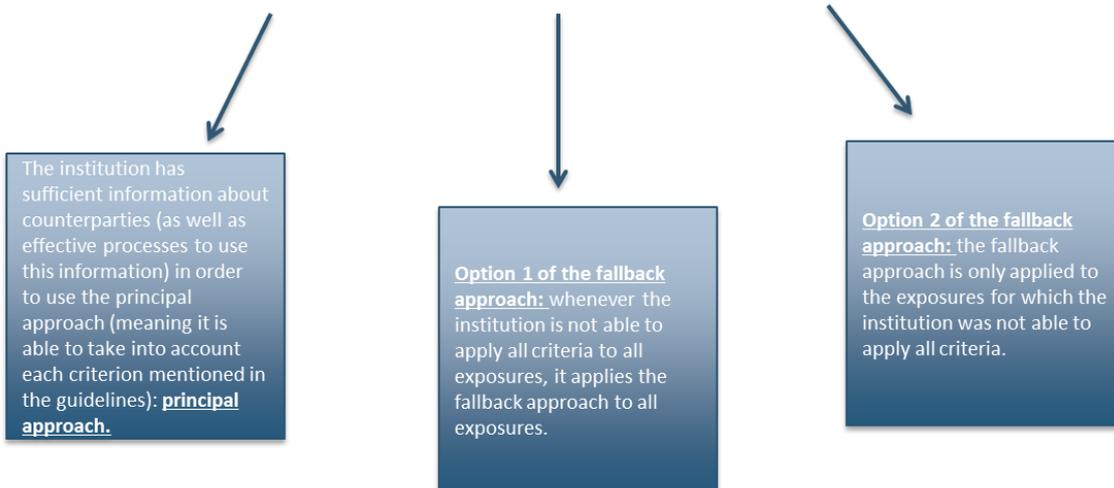
Fallback approach

If institutions are not able, due to either an insufficient level of information about the activities of shadow banking entities to which they have exposures or to the lack of effective processes to use that information, to apply the principal approach set out above, they should apply a limit of 25% of their eligible capital to their aggregate exposures to shadow banking entities as defined by these guidelines.

Explanatory box:

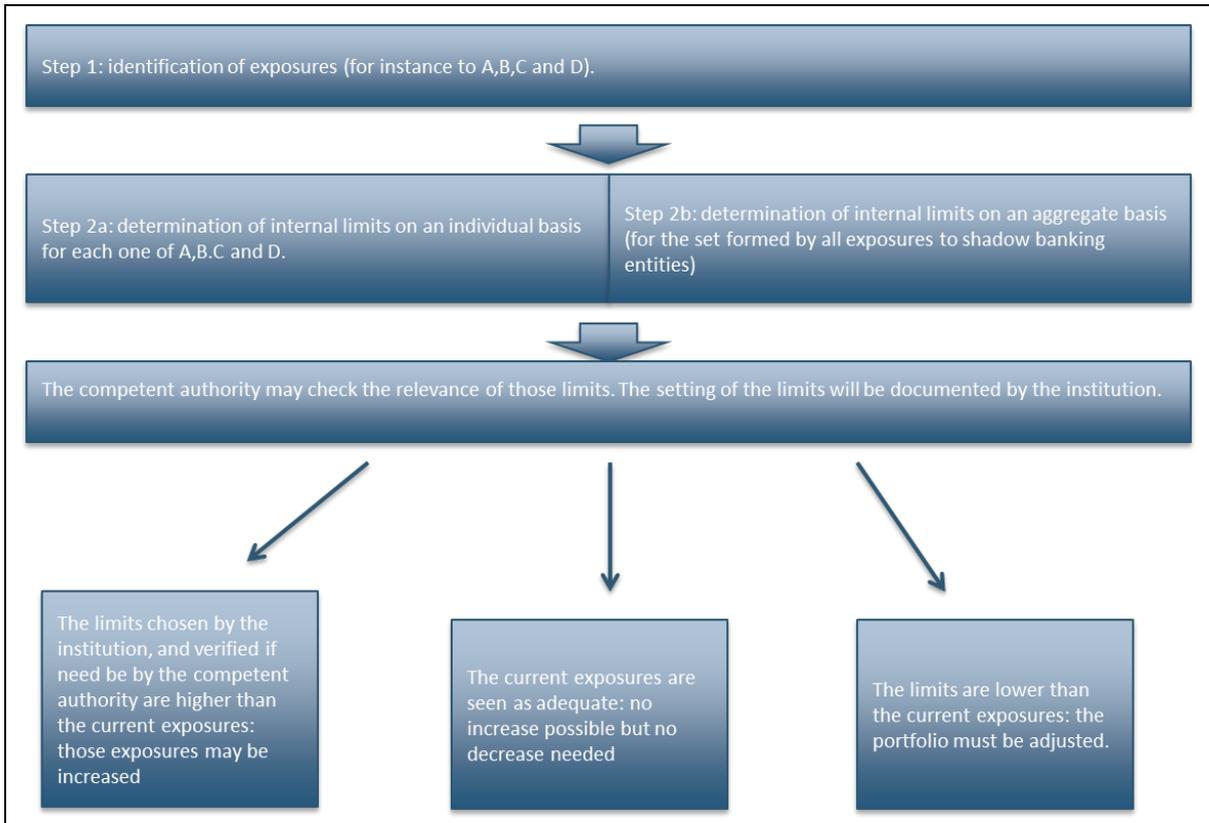
1. The interplay between the principal and fallback approach is illustrated below:

The approach to be used depends on the ability of the institution to use the principal approach. Only if the institution is unable to use the principal approach should it be using the fallback approach.



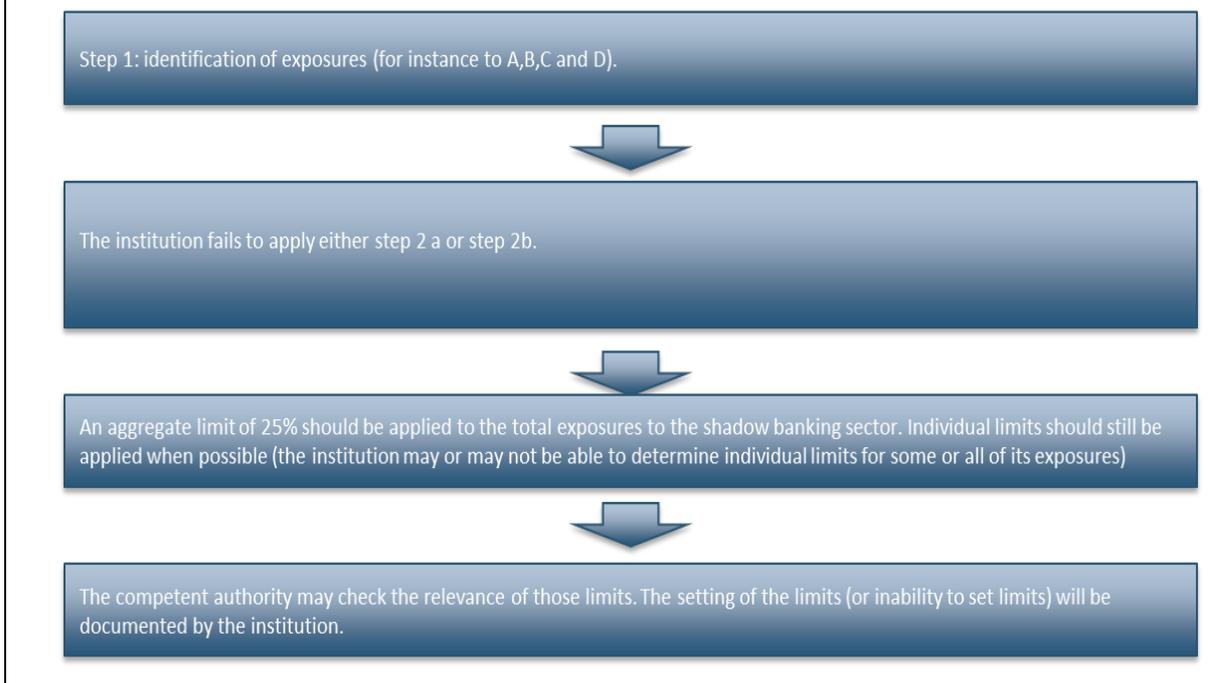
2. It is useful to detail the way each approach would work, starting with the principal approach, and assuming as an example that the institution has exposures A, B, C, and D to shadow banking entities:

Figure 2: principal approach



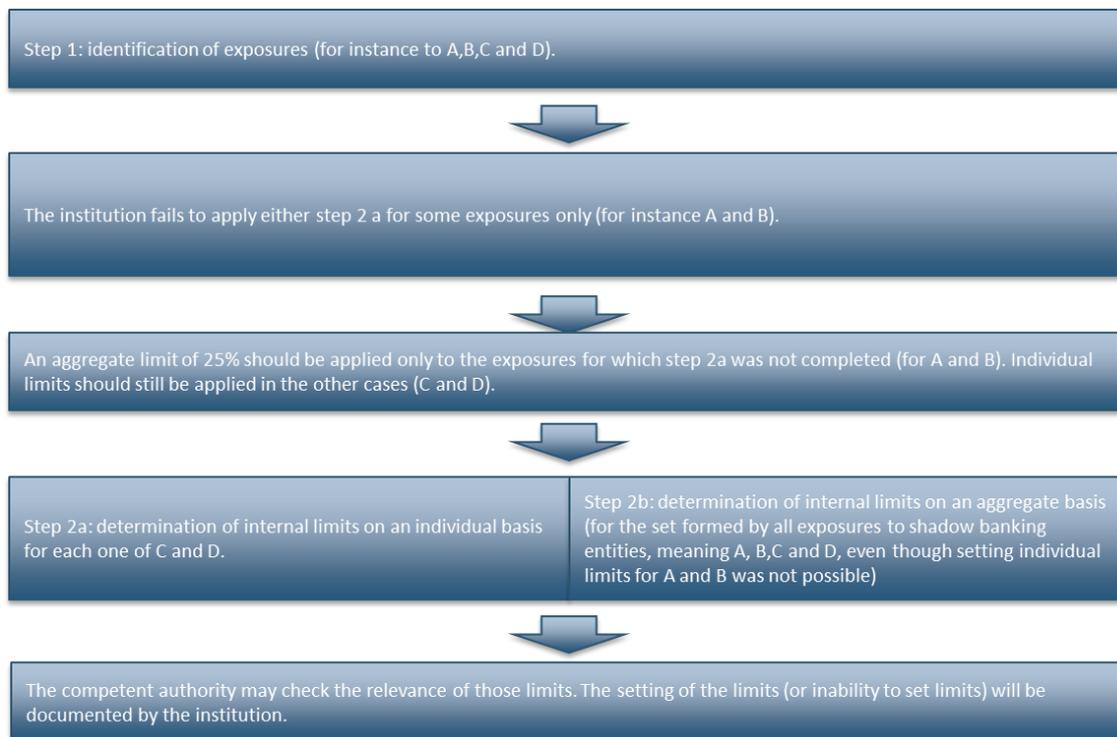
3. The fallback approach would function in the following way under option 1:

Figure 3: fallback approach under option 1



4. The fallback approach would work in a different way under option 2:

Figure 4: fallback approach, option 2



5. In order to compare those approaches in practice, an numerical example could be used:

Limit set for (Name of the counterparty)	Setting limits under the principal approach (as a % of eligible capital):	Setting limits under the fallback approach (as a % of eligible capital): Option 1	Setting limits under the fallback approach (as a % of eligible capital): Option 2
A	10	?	?
B	11	?	?
C	14	14	14
D	15	15	15
AGGREGATE LIMIT (principal approach)	50	Not applicable	50
AGGREGATE LIMIT (fallback approach)	Not applicable	25	25, only applicable to A and B
Resulting maximum size of the portfolio	50	25	Min (50, 25+14+15) = 50

6. On the basis of this example, it seems that Option 1 is more conservative than Option 2. Hence, the EBA's preliminary view is that Option 1 should be chosen.

7. In case Option 2 would be considered, the EBA could still choose to impose a different

limit than 25%. In particular, a tighter limit could be chosen in order to make the approach more conservative.

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?

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?

Title III – Final provisions and implementation

Institutions should comply with these guidelines, and competent authorities should implement them by incorporating them into their supervisory processes and legal frameworks by xx of xxxx of 20xx.

5. Accompanying documents

5.1 Draft Cost-Benefit Analysis / Impact Assessment

5.1.1 Problem identification

The interconnectedness between the (regulated) banking sector and shadow banking entities and the specific risks posed by shadow banking entities to the stability of the financial system provide the motivation for action to be taken with regard to institutions' exposures to shadow banking entities.

Under the current regulatory regime, exposures to shadow banking entities are already subject to limits under the general framework for large exposures. However, the general framework for large exposure can be supplemented by provisions that would be specific to the monitoring and limiting of exposures to shadow banking entities, given the risks they might entail. To set such framework, there is a set of decisions to be made, regarding the scope of the application of the Guidelines (GL) (in particular the definition of shadow banking entities) and the limits to be set.

5.1.2 Policy objectives

The present GL are intended to fulfil the regulatory objectives of (a) mitigating micro-prudential risk (i.e. risks posed to institutions as a result of their exposures to shadow banking entities), (b) mitigating macro-prudential risks (e.g. financial stability), and (c) mitigating regulatory arbitrage risks, i.e. between the regulated and unregulated parts of the financial system. To achieve the regulatory objectives the GL target specific and operational objectives. Precisely, the GL aim to specify the scope of the application (specific objective), the definition of shadow banking entities (operational objective to meet the specific objective of the scope of application) and the types of limits which might be set (specific objective).

The legal mandate in Article 395(2) of the CRR, requires the EBA to issue guidelines to set appropriate aggregate limits to shadow banking exposures or tighter individual limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework, taking into account any material detrimental impact on the provision of credit to the real economy or on the stability of financial markets.

5.1.3 Options considered

First set of options (specific): scope of application / definition of shadow banking entities

The mandate of the CRR requires the EBA to set limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework.

As a starting point, the EBA considers that 'shadow banking entities' should be interpreted as entities carrying out the following types of activities: 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, 11. This is consistent with the approach adopted in international (in particular FSB) and European contexts.

As for the interpretation of 'regulated framework', two key elements were considered: (i) the scope of prudential consolidation, and (ii) specific solo prudential and conduct regulatory frameworks.

First, as regards the treatment of ***entities within the scope of prudential consolidation*** the following options were considered:

- a. **Option 1:** Entities which are subject to solo prudential requirements and belong to the same group with the institution concerned should be outside of the definition of shadow banking entities;
- b. **Option 2:** Entities which are within the scope of prudential consolidation and belong to the same group with the institution concerned should be outside of the definition of shadow banking entities regardless of whether the entity concerned is subject to solo prudential requirements;
- c. **Option 3:** Entities which are within the scope of prudential consolidation shall be outside the definition of shadow banking entities regardless of whether: (a) the entity is in the *same* group as the institution concerned, or (b) the entity is subject to *solo* prudential requirements.

Preferred option: Option 3 is preferable as any such entities carrying out credit intermediation activities (irrespective of whether they are institutions or other regulated or unregulated entities) would be subject to prudential requirements as a result of prudential consolidation thereby mitigating any risks posed by the bank-like activities carried on by those entities. As such, these entities should not be regarded as being 'outside a regulated framework' and therefore should be carved out from the definition of shadow banking entities.

Second, for those ***entities that are not within the scope of prudential consolidation***, the EBA considered different types of regulatory frameworks. In particular, three options were considered:

- a. **Option 1:** Institutions subject to the CRD/CRR and equivalent third country and national *prudential* frameworks should be carved out from the definition of shadow banking entities (**the narrow approach**);
- b. **Option 2:** Institutions subject to the CRD/CRR and equivalent third country and national *prudential* frameworks and entities subject to *prudential frameworks for specific forms of regulated entity* (and equivalent third country prudential frameworks should be carved out from the definition of shadow banking entities (**the intermediate approach**);
- c. **Option 3:** Entities subject to any regulatory framework (of a *prudential* or *conduct* nature) under Union law and equivalent third country and national law for *institutions and other regulated entities* should be carved out from the definition of shadow banking entities (**the broad approach**).

Preferred option: Having regard to the objectives identified in the section above, the focus of the policy debate on shadow banking in Union and international contexts, the need for EBA to act in a manner that is consistent and coherent with Union initiatives in the field of financial regulation, and the need for EBA to adopt a risk-based proportionate approach to regulation, the EBA considers that the intermediate approach (Option 2) is the only reasonable approach to interpretation for the purposes of the GL i.e. such that entities covered by the frameworks listed in the definition of ‘excluded undertakings’ should not be regarded as ‘outside a regulated framework’. Under that approach, such a ‘regulated framework’ is understood as a robust prudential regulation framework where credit risk is adequately addressed.

Under the narrow approach (Option 1) all entities carrying out credit intermediation outside the regular banking system, including those that are not generally regarded as part of the shadow banking system and are subject to robust prudential requirements that the Union co-legislators have already set to mitigate risks having regard to the permitted business activities of those entities (see further below), would be within scope of the definition of shadow banking entities. Therefore such a broad scope would be inconsistent with the requirement set out in Article 395(2) CRR ‘to take into account the outcomes of developments in the area of shadow banking and large exposures at the international levels’. It would also result in a wide application of the GL which could unduly impede the provision of credit to the real economy (again, see Article 395(2) CRR). The broad approach (Option 3) on the other hand would carve out of scope entities that are, for example, subject to a light touch or no prudential regime which may fail to mitigate effectively risks posed by the carrying out of credit intermediation by the entity concerned.

The proposed approach, however, would focus on those entities that are not subject to an appropriate prudential framework thereby concentrating on those entities that pose the greatest risks both in terms of the direct exposures institutions face and more widely as regards the incentives for credit intermediation to be carried on outside the regulated framework.

Turning specifically to the treatment of funds, these tend to engage in maturity and liquidity transformation and are generally regarded as outside the traditional banking sector. Therefore, *prima facie*, they should be in scope of the definition of shadow banking entity. However, some funds are regulated pursuant to prudential frameworks similar to those applied to credit institutions and investment firms. In particular, in the EU the UCITS Directive (Directive 2009/65/EC) prescribes a robust set of requirements under which undertakings for collective investment in transferable securities, and their managers, operate. Therefore, such funds do not pose the same level of risk to institutions in terms of credit and step-in/bail-out risk (e.g. due to reputational, franchise and other risks) as other forms of funds. For this reason, and following the logic outlined above, it is proposed that certain UCITS established in the EU (and those established in third countries where equivalent supervisory requirements apply) should be carved out from the definition of shadow banking entities. Other funds should remain within the scope of the definition of shadow banking entities.

Second set of options (specific): Establishment of limits

After assessing the objectives of the limitation to be developed and the concerns to be addressed, EBA has identified three possible policy options (see 1 to 3 below).

1) Option 1: Explicit tighter limits on exposures to shadow banking entities under Pillar 1

Setting tighter limits (i.e. a large exposure limit lower than the current 25% of an institution's eligible capital after taking into account the effect of credit risk mitigation measures) on exposures to individual shadow banking entities would be a very direct way to limit the regulated banking sector's exposures to shadow banking entities. When setting such individual limits different types of shadow banking entities, activities or instruments could be considered.

However, such approach would not satisfactorily meet the requirement as set out in Article 395 para. 2 of the CRR as the Large Exposures framework within CRR is not a risk-based regime. Article 389 of the CRR explicitly defines "exposure value" for the purpose of large exposures as the accounting value (after certain adjustments) without applying risk weights or degrees of risk. Thus, the Pillar 1 rules on large exposures do not differentiate between degrees of riskiness but rather recognises low risk by (fully or partially) exempting certain kinds of exposures from the upper Large Exposures limit.

Given the above, the EBA does not propose setting GL on the Large Exposures framework that impose explicit limits lower than the current 25% of an institution's eligible capital on individual types of shadow banking exposures.

2) Option 2: Individual limits to be set by institutions

It is possible that exposures to shadow banks may be higher risk than other types of exposure. Banking activities such as maturity and liquidity transformation are inherently risky. For this reason, institutions are subject to close prudential regulation, must participate in state-backed deposit insurance systems, and have access to central bank liquidity facilities. Shadow banks are

generally not subject to prudential regulation (or are not subject to the same standards of prudential regulation as core regulated entities such as institutions), do not provide access to deposit guarantee schemes to investors, and do not have access to central bank liquidity. To the extent that shadow banks carry out banking activities, exposures to shadow banks may therefore be inherently riskier than other types of exposures - and thus worthy of specific limits, to be set by the banks as part of its internal processes.

This approach could be understood as forming part of the Pillar 2 framework. It has to be noted that concentration risk is clearly identified as a core part of the Supervisory Review Process within the Capital Requirement Directive.²¹ Where a concentration risk to shadow banks was identified, then a capital add-on, or additional obligation on a bank's funding / liquidity structure may be warranted.²²

3) **Option 3:** Aggregate limits to the shadow banking sector to be set by the institutions

The interconnectedness between the shadow banking and the regulated banking sector, plus the tendency for shadow banking entities to engage in excessively leveraged or otherwise risky activities, calls for management of exposures not only to individual shadow banking entities, but also to the shadow banking sector in general.

Banks may have an incentive to shift activities to the shadow banking sector in response to more stringent capital requirement. Also, periods of low real interest rates may fuel such a tendency as demand from institutional cash pools for alternative investment opportunities grows and the 'search for yield' phenomenon accelerates funds into the shadow banking sector. An overall back-stop limit, together with improved identification of large exposures connected to the shadow banking sector would help safeguard that the regulated banking sector, preventing it from overly fuelling the growth of the unregulated shadow banking sector (thus getting overly interlinked and exposed).

The EBA sees that an aggregate limit to the shadow banking sector will result in a net benefit to the economy. From a macro prudential perspective, this approach should ensure that the shadow banking sector remains able to provide credit to the real economy without creating excessive risks to financial stability (including spillover risk).

The institutions would set their aggregate limit to the shadow banking sector, in the same way as described in Option 2. If this principal approach cannot be applied, a fallback approach would be applied, where a set limit (25%) would be applied for the aggregate exposures to shadow banking entities. The following technical specifications are considered as fallback solutions:

²¹ See Directive 2013/36/EU – Section III, Article 98.1.b

²² It should be noted that in the Basel Capital Framework (and the CRD), concentration risk is not fully addressed in the context of Pillar 1. For credit risk it is assumed that IRB portfolios are perfectly diversified. Any resultant underestimation of risk should be corrected by addressing the concentration risk and allocating capital, where necessary. See the EBA guidelines on concentration risk for details: <https://www.eba.europa.eu/documents/10180/16094/Concentration.pdf>

Option 3a: Institutions must apply the fallback approach for all exposures to shadow banking entities, even if the institution's inability to apply the principal approach concerns only parts of the exposure.

Option 3b: Institutions must apply the fallback approach only for those exposures, for which the principal approach cannot be applied. Those exposures are still to be included in the shadow banking sector for purposes of the aggregate limit under the principal approach.

Preferred option: After deliberating all pros and cons from a prudential perspective, EBA proposes to combine Options 2 and 3a. Institutions should set both an aggregate limit to their exposure to the shadow banking sector and, where needed and on the basis of their knowledge of their counterparties, set tighter limits to individual shadow banking entities. In addition, institutions unable to gather relevant information about individual counterparties from the shadow banking sector would be subject to an aggregate limit of 25% of their aggregate exposures to the shadow banking entities.

In addition, for the purposes of the application of the guideline, institutions could either:

Option 1: only consider exposures with a value equal to or in excess of 0.25 % of the institution's eligible capital or

Option 2: consider all exposures to shadow banking entities

Option 1 is consistent with other EBA products in the area of large exposures²³ and would slightly alleviate the burden for institutions and is therefore proposed as the preferred option.

5.1.4 Cost-benefit analysis

Although the conduct of an extensive cost-benefit analysis is not meaningful and possible at this stage, the cost of the above specifications would be limited. There would be costs for some banks, if their information about their counterparties in the shadow banking sector is insufficient as they might need to change their processes.

Some financing companies are subsidiaries of a banking group, and as such will be prudentially regulated at a group consolidated level. If such financing companies are outside the scope of the proposed GL, but other standalone financing companies (i.e. those not part of any banking group) are within scope, anti-competitiveness issues ("no level playing field") may arise as a consequence.

Benefits would partially be of a macro prudential nature and would be difficult to quantify.

There is need for additional data collection to estimate the current level of exposures to shadow banking entities (according to the specifications provided above) and what would be the economic impact after applying the GL.

²³ EBA Final Draft Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Art. 390(8) of Regulation (EU) No 575/2013.

5.2 Overview of questions for Consultation

Respondents are invited to comment in particular the following questions.

Questions:

- 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).

- 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.**

- 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.**

- 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.**

- 5. Do you agree with the fallback 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 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?

- 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?**