Draft EBA Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework

A response by the British Bankers' Association

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Introduction

The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking enabling us to represent our members domestically, in Europe and on the global stage. Our network also includes over 80 of the world's leading financial and professional services organisations. Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

The BBA is please to respond on behalf of its members to the EBA's limits on exposures to shadow banking entities consultation.

Key messages

The fallback approach

The inclusion of a 'fall back' approach runs the risk of setting a de facto aggregate limit of 25% as it is unlikely banks will be able to meet their data requirements, which would enable them to use the principle approach by 1 January 2016. This in itself could pose a macro-systemic risk if most or all banks use the fall back approach from day one. The guidelines also risk being inconsistently applied by supervisors which may have different national appetites for encouraging or limiting the shadow banking sector.

The proposed figure of 25% for a firm's aggregate exposures to the shadow banking sector is overly onerous, and lacks a robust policy underpinning and quantitative testing. It is based on an erroneous assumption that, in the absence of sufficient information, all exposures to shadow banking entities could be connected. In view of the very broad definition of shadow banking that the EBA proposes, it is inappropriate that all of a firm's counterparties, anywhere in the world, which may be considered to conduct any activity involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar, would be grouped together as posing a single risk to the firm.

If a fall back approach is nevertheless kept, then an appropriate limit, much higher than 25%, would need to be considered; most likely a whole number multiplier of a firm's capital base. We therefore consider it essential that a full EU QIS is undertaken before such a limit is set. A QIS would also address our serious concerns with regards to the impact limits may have

on the supply of credit to SMEs and hampering growth as well as restraining recent efforts to revive the securitisation market.

Notwithstanding these comments, we are deeply concerned by the 'fallback approach', and the timing of the implementation. If banks were to be given a longer timeline that would enable them to carry out internal assessments to get the data that allows them to take up the principle approach, then the entire need for the fallback approach falls away. Any further development of the guidelines should await the outcome of the EBA's data collection exercise and a thorough impact assessment has been undertaken. The impact assessment should also take into account the impact of an overarching portfolio constraint. The timeline that follows the impact assessment needs to consider the potential destabilising effects of the introduction of these rules; for instance, if too short firms are more likely to take the cautious fallback approach so as not to fall foul of the rules, in turn leading to withdrawal of finance.

In addition, national supervisors should be required to issue clear initial guidance on the guidelines so that expectations aren't developed in an ad hoc manner. There is a risk of different supervisors implementing the guidelines differently in each country which could pose operational difficulties for firms.

The need to regulate shadow banking itself

We understand the EBA's concern with regards to the banking sector's exposure to shadow banking and the objective of the guidelines to address this. However, we do not agree that limiting exposures is the ideal approach. Our view is that the large exposures regime is not intended to deal with concentration risk, and is therefore not the correct approach to dealing with the risks set out in the consultation paper. As discussed above, further work should be carried out to better understand the impact of setting sectorial limits, and an assessment of other means to better address risks associated with shadow banking e.g. direct regulation. We understand the EBA intends to carry out a data collection exercise; as a result further development of these guidelines should be deferred until such an exercise is completed.

We strongly believe that the comprehensive collection of regulatory reforms the banking industry is currently implementing should be more than sufficient to regulate exposures to shadow banking. For example we would cite regulations around derivatives (mandatory clearing, margin for non-cleared OTC derivatives), SFTR, the FSB's recommendations for a global approach to the regulation of shadow banking and interconnectedness between banks and shadow bank, MMF regulations, AIFMD, UCITS, and the capital and liquidity requirements detailed in Basel III.

The key issue is the regulation of shadow banking entities themselves. Focusing on the exposure to shadow banking entities does not actually reduce the systemic risk and potential weaknesses of the entities themselves. This is a priority, and should be considered in tandem with any regulations considering the relationship between banking and the shadow banking sector.

Please see the Annex below for other issues arising from the consultation paper.

The BBA would be happy to assist in any way we can regarding these matters.

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Annex

Questions:

1.Do you agree with the approach the EBA has proposed for the purposes of defining shadowbanking 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).**

With respect to the definition, it should be clear that this covers entities whose main business is credit intermediation. The entity is only engaged in credit intermediation activities if it is acting in a bank-like capacity; if it is receiving rather than providing credit intermediation services, it should not be considered as acting in a bank-like capacity. This is consistent with the established definitions of shadow banking and the provisions of the CRR.

As regards what should be excluded from the definition, we support the exclusion of UCITs. We would also argue for the exclusion of exposures to entities which carry out treasury functions for corporate groups and securitisations and funds where the look through approach is used. Including securitisation SPVs under the EBA's shadow banking limits potentially draws in a wide range of arrangements which does not appropriately identify a systemically risky shadow banking activity.

We are concerned that the consultation paper does not take into account the MMF regulation and SFT transparency regulations currently under negotiation. In particular, many MMFs operate under the rules of the UCITS Directive, the remainder of which are governed by AIFMD. This significantly reduces the risks of MMFs. Furthermore, the changes to stress testing and liquidity requirements will also play a role in substantially increasing the robustness of MMFs. The overall MMF framework of MMFs will be strengthened, and this should be taken into account by the EBA. We argue that MMFs should be excluded from scope.

The definition should also be clearer on third country equivalence. Specifically it is unclear which 3rd country equivalence the EBA intends to utilise for the purposes of ascertaining which entities are subject to prudential regulation on a solo or group basis. Currently there exists 3rd country equivalence for the treatment of credit risk provisions under the CRR. In particular, the European Commission decision in respect of Article 152 covers entities which would be considered 'regulated financial sector entities" under the IRB approach. This however only covers investment firms and credit institutions on an individual basis.

It is therefore important to ensure that for the purposes of these guidelines, excluded undertakings includes all entities which are subject to prudential regulation on a consolidated basis by regulators in equivalent 3rd countries, and this is not limited to the equivalence decisions made by the EC. In terms of 3rd country insurance entities, it is important to note there have been very few equivalence decisions made under Solvency 2. We would therefore propose that excluded entities includes insurance entities which are subject to bank like regulation in 3rd countries e.g. subject to solvency requirements, risk management, control requirements etc.

As a more general point, firms will not always have absolute transparency as to a client's investment and trading activities (e.g. if a client is conducting activities away from that firm, which may be confidential). As a result there will be occasions where they genuinely cannot make an absolute assessment as to a client's full activities. In these cases firms should be able to make reasonable assessments based on relationship with the client and information reasonably available to them, and categorise as a shadow banking entity/non-shadow banking entity accordingly. The EBA should acknowledge in its final guidelines that firms are only required to make the assessment on a best efforts basis.

Could the EBA also describe its rationale for excluding the *de minimis* approach, and clarify what is meant by this threshold (e.g. activities that are incidental to an entity's overall business)?

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.

Although we support the approach taken to allow firms to rely on their own internal framework and risk appetite to set internal limits we do not in general support aggregate limits as we do not consider this a sectoral risk. This could be better addressed via ICAAP/Pillar 2, which specifically covers concentration risk rather than the large exposure regime which is intended to address default of single/groups of connected counterparties.

In terms of assessment of risks arising from shadow banking entities, it is important that the principle of materiality is introduced here; "all potential risks" and "potential impact of those risks" is too broad. This will not only make it difficult for firms to identify all potential risks arising from those exposures, there would not be a consistent application across the industry.

It is also important that the requirement for establishing effective process and effective mechanisms should be applied on a consolidated basis only, so as to be consistent with firms' approaches to systems and control more generally and to ensure that the requirement is not disproportionately burdensome.

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.

While we broadly agree with the principles established in Title II section 2, the guidelines should adopt a phased implementation approach to avoid potential macro systemic risks if banks are not in a position to use the principle approach on 1st January 2016. This would give banks time to undertake an internal assessment for data enrichment in order to meet the principle approach.

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.

As per our comments above, we question the need for a 'fall back' approach, and ask the EBA to conduct an impact study.

We would also note that the EBA mandate for developing these guidelines as set out in CRR explicitly notes refers to setting either aggregate or individual limits; in proposing both aggregate and individual limits, in our view, the draft Guidelines go significantly beyond the CRR mandate. We strongly believe that aggregate limits should not be introduced and urge the EBA to reverse its proposal in this respect.

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?**

As per comments above we do not think it is necessary to have a fall back approach. If the EBA insists on introducing a fall back approach, option 2 is preferable. Option 1 is unnecessarily restrictive as it does not recognise that firms will have information on some of their exposures to shadow banking entities. As per comments above, under option 1 the limit would need to be considerably higher than 25%. Option 2 allows firms to use the principal approach and therefore provides incentives for firms to collect information on their exposures to shadow banking entities.

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?

Please see our comments under the key messages above.