THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

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Dear Madame, dear Sir

RE: 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

ABOUT THE INVESTMENT ASSOCIATION

The Investment Association represents UK investment managers. We have over 200 members who manage more than £5 trillion for clients around the world. Our aim is to make investment better for clients so they achieve their financial goals, better for companies so they get the capital they need to grow, and better for the economy so that everyone prospers.

We cover every link in the investment chain:

- We work with investors, helping them to understand the industry and the options available to them. We know investing can seem daunting, so we work hard to make it clear and accessible.

- We work with investment managers, promoting high standards and the need to put clients first. Our work includes helping members to manage money efficiently and communicate effectively.

- We work with the companies we invest in, helping them to achieve better long-term results and, ultimately, greater returns for investors and the economy.

- We work with regulators and governments around the world. We've built close, trusting relationships with these bodies and play an active role in shaping the rules that govern the industry.

The Investment Association's purpose is to ensure that investment managers are in the best possible position to help people build resilience to financial adversity, achieve their financial objectives and maintain a decent standard of living as they get older. It is also to help investment managers maximise their contribution to economic growth through the efficient allocation of capital.

The Investment Association is a company limited by guarantee registered in England and Wales. Registered number 04343737. Registered office as above.

The Investment Association welcomes the opportunity to respond to EBA's proposals for guidelines on limits on exposures to shadow banking entities. We are mainly concerned about the definition of shadow banking entities proposed by EBA and our response is, therefore, focussed on question one. Our response to question one is attached to this letter.

Yours sincerely

Johannes Woelfing
Regulatory and Legal Specialist

RESPONSE FROM THE INVESTMENT ASSOCIATION

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).**

Our concerns with regard to the definition of shadow banks are not limited to the workability of the proposed approach. We are also concerned about the legal basis of EBA's proposals and the precedence this approach could set without taking into account the necessary level of detail.

Guidelines pursuant to Article 16 of the EBA regulation shall be issued in order to establish consistent, efficient and effective supervisory practices within the ESFS, and to ensure the common, uniform and consistent application of Union law. EBA guidelines are at no point subject to any control by a democratically legitimised body. At the same time guidelines are not open to any formal process of repeal.

Where provided for in binding European legislation, power may be conferred to the European Commission in order, either to determine the conditions of application of European legislation, or in order to ensure consistent harmonisation in the areas specifically set out in sectorial legislation. In terms of the EBA regulation, EBA would be tasked to draft regulatory or implementing technical standards in accordance with Article 10 or 15 of the EBA regulation, which then will be endorsed by the Commission. The power to adopt those technical standards is conferred upon the Commission directly by the Treaty on the Functioning of the European Union and at the same time severely restricted by the treaty (Article 290 and 291). In both cases the technical standards have to be technical, must not imply strategic decisions or policy choices and their content has to be delimited by the legislative acts on which they are based. It is completely out of question to take a decision on the scope of application of European legislation on the legal basis of Article 290 or 291 TFEU.

EBA is required by Article 395 Paragraph 2 CRR to develop guidelines, setting appropriate aggregate limits to large exposures or tighter individual limits on exposures to shadow banking entities that carry out banking activities outside a regulated framework. EBA is not empowered by CRR to define shadow banking entities. Setting a definition of shadow banking entities affects the rights of entities caught by the definition. This would not be possible on the legal basis of Article 290 or 291 TFEU and it can under no circumstances be subject to guidelines set by EBA without any democratic control.

We acknowledge that the CRR text requires EBA to draft guidelines without determining which entities might be subject to those guidelines. This is a serious flaw in the regulation, but it does not give EBA the legal power to set the rules that should have been set by democratically elected representatives. Since the European legislators failed to set a definition, the definition

of shadow banking has to be left national legislators or nationally legitimised authorities. EBA will have to limit their guidelines to the area set out in Article 395 Paragraph 2 CRR and only set the limits for exposures.

Even if EBA had the power to define which entities might be shadow banking entities we do have serious doubts about the definition proposed by EBA. According to EBA the definition of shadow banking entities consists of two elements, the activity carried out by the entity and the prudential regime it might be subject to.

With regard to the activity, EBA regards the activities listed in point 1 to 3, 6 to 8, 10 and 11 of CRD Annex 1 to be bank-like activities. In particular, the decision to equate activities described in point 11, portfolio management and advice, raises some questions.

In its report to the Commission on the perimeter of credit institutions EBA quotes its second survey for competent authorities, in which bank-like activities were described as activities within the scope of credit intermediation. According to EBA's own report the four key features of credit intermediation are:

(a) maturity transformation (borrowing short and lending/investing on longer timescales);

(b) liquidity transformation (using cash-like liabilities to buy less liquid assets);

(c) leverage; and

(d) credit risk transfer (transferring the risk of credit default to another person for a fee).

Portfolio management and advice are investment services and regulated by the MiFID framework. We cannot see how advice might be caught by the criteria. Recipients of advice might decide to engage in bank-like activities, but the service of providing advice does not cause any transfer of capital, assets or risk.

With regard to portfolio management we do have serious doubts whether it necessarily includes the activities listed above. If they happen at all, maturity transformation etc. will take place at the level of collective investment vehicles (or asset owners), not the manager thereof. (The decision as to what activities to undertake is, of course, determined by those end-customers, as expressed through an investment mandate. And, while that may entail leverage and counterparty risk, it by definition does not entail credit intermediation.) So, while the activities of the managing entities, as directed by customer mandates, will determine if the fund qualifies as a shadow bank, the managers themselves are in no case shadow banks. EBA seems not to differentiate between the portfolio managers and managed portfolios and it provides no comprehensible explanation why it is equating the management with bank-like activities.

Incidentally, paying someone else to take credit risk does not in our view denote banking on the part of the payer (otherwise all non-financial companies seeking export credit guarantees would constitute shadow banks).

Depending on the investment mandate of portfolio managers some funds might meet the economic criteria the FSB developed for the identification of shadow banking risks, but the vast majority of funds is unleveraged and a wide range of funds, UCITS or AIFs, is limited by strict investment mandates, which prevent bank-like activities.

European AIFMs, managing non-UCITS retail funds are often subject to additional national rules limiting their mandates and forbidding bank-like activities. By exempting those investment funds that are established in third countries and are subject to supervision equivalent to UCITS standards, EBA acknowledged that the investment activity of a fund has to be the determining factor for its classification as a shadow banking entity. It would be appropriate to grant this exemption not only to third-country funds, but also to investment funds subject to national regimes in Europe providing an equivalent supervisory regime.

EBA’s approach to define all collective investment undertakings except non-MMF UCITS as shadow banking entities lacks coherence and is far too broad.

Any authority seeking to develop a definition of shadow banking entities would, therefore, have to take the investment activities of collective investment undertakings into account and develop a much more granular approach to identify shadow banking entities.

Even under the assumption that portfolio management should be covered by the EBA guidelines, portfolio managers would still not qualify automatically as shadow banking entities.

Most asset managers performing portfolio management are either investment firms in accordance with Article 4 paragraph 1 point 2 CRR or are firms referred to in point (2)(c) of Article 4(1). Investment firms as defined in Article 4 paragraph 1 point 2 CRR are, according to article 2 paragraph 1 CRD, subject to CRD and according to Article 1 CRR subject to CRR. Firms referred to in point (2)(c) of Article 4(1) are pursuant Article 95 paragraph 2 CRD subject to prudential requirements of CRD IV or to the prudential requirements of CRD III. All portfolio managers subject to those prudential requirements are, therefore, according to EBA’s own definition, not shadow banking entities.

Apart from already being subject to prudential regulation, portfolio managers (as distinct from funds) will not become a contracting party towards third parties. (We do not think that it was the legislator’s intention to limit the exposure of CRD entities to portfolio managers. Entities subject to CRD, to the extent that they have exposure to asset management, would normally have exposures to funds, not to their managers.) Moreover, it is not only asset managers that are already subject to prudential requirements. Prudential requirements are also in place for most of the European collective investment undertakings.

The AIFM Directive prescribes own funds to cover risks arising directly from the AIF portfolios (e.g. credit, market, operational etc.) where the value of these exceeds certain thresholds. Additional own funds are required by the AIFMD to cover professional liability risks. EBA might regard those own fund requirements as not sufficient, but they are set by the European legislators and have to be taken into account.

Article 24 paragraph 4 AIFMD provides additional requirements to mitigate risks arising from leverage on a “substantial basis”. Those AIFMs are subject to strict reporting requirements on the overall level of leverage employed by each AIF, a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives, and the extent to which the AIF’s assets have been reused under leveraging arrangements.

This additional information allows national supervisors to closely monitor any potential for systemic risk and to react accordingly. National supervisors are empowered to set limits to leverage in accordance with Article 25 paragraph 3 AIFMD.

European AIFs are therefore subject to prudential requirements set by the European legislators and not shadow banking entities in accordance with EBA's own definition or following the FSB framework.

The European legislators are currently negotiating a legal framework for money market funds. It is fair to assume, based on the European Commission's proposal and the European Parliaments position that money market funds will be subject to a strict set of prudential requirements. Limiting the exposure to those funds now by the means of EBA guidelines, without knowing what the risk inherent in those funds might be, is premature.

We would as a consequence suggest that:

- the EBA guidelines (on limits on exposure to shadow banking entities that carry out banking activities outside a regulated framework, under Article 395 paragraph 2 CRR) should leave the definition of shadow banking entities to national supervisors;

- the EBA should provide national supervisors with guidelines for the identification of shadow banking entities which follow closely the FSB approach and which take into account the economic function and the actual activity of entities in question;

- the EBA should provide national supervisors with guidelines on adequate limits to the exposure to shadow banking entities, allowing national supervisors to adapt the limits to additional regulation like the MMF regulation or national regimes and the actual activities of any entity in question.