FLA RESPONSE TO THE EBA GUIDELINES ON BANKS' EXPOSURES TO SHADOW BANKING ENTITIES

BACKGROUND

1. The FLA is the leading trade association for the asset, consumer and motor finance sectors in the UK. Our members include banks, subsidiaries of banks and building societies, the finance arms of leading retailers and manufacturing companies, and a range of specialist lenders.

2. In 2014, our members provided new finance of almost €128 billion in support of UK economic growth and jobs. €95 billion was in the form of consumer credit, making an important contribution to the economy by allowing consumers to make essential household purchases including furniture, kitchen appliances, and more than three-quarters of all private new car registrations.

3. Over €32 billion was in the form of asset finance, mainly leasing and hire purchase, accounting for almost 27% of all UK investment in machinery, equipment and purchased software. This kind of finance is particularly popular with small businesses, because the chances of a successful application are higher than for any of the other main sources of finance.

QUESTIONS

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).***

4. We do not agree with the approach taken by the EBA and the European Commission (EC) which assumes that the risks posed by all entities deemed to be "shadow banks" are the same. As the work of the Financial Stability Board (FSB) has demonstrated, the term "shadow bank" covers a huge and diverse range of financial services products and regulatory policies should reflect that.

5. A majority of the FLA's member companies are non-banks. They all operate in the real economy and are already subject to a wide range of regulation, including the new UK Financial Conduct Authority's regime regulating the consumer credit markets. That regime applies not just to our members in the consumer markets but also to many firms in the business finance markets, because it covers lending to a large number of small businesses.

6. Our members support the social and financial well-being of millions of consumers and small businesses. Consumers enjoy a higher standard of living through the access responsibly-provided credit gives them to essential goods such as furniture, electrical equipment, clothing and motor vehicles. And asset finance (leasing and hire purchase) allows small businesses to access the funds they need for investment and growth. The European economy needs a healthy, vibrant credit market to generate growth and further inappropriate regulation would jeopardise that aim.

7. The consultation paper considers the risks associated with "shadow banks". We address each in turn below.

   - *Run risks and/or liquidity problems* – "runs" occur where there is reliance on short-term funding, which in practice is not a significant feature of funding for non-bank lenders. So long as the maturity profile of a company's debt is longer than that of its assets, it will self-liquidate without recourse to the capital markets or funding by moving into run-off. In consequence, non-bank lenders do not constitute a systemic risk of this kind.

   - *Interconnectivity and spillovers* – non-bank finance companies are funded through a variety of means including securitisation, syndicated bank loans, the capital markets, and parent company funding. This mix allows them to spread their risk so that they are not over-exposed. Moreover, Article 395 of the Capital Requirements Regulation (the basis for the proposed new guidelines) provides that "an institution shall not incur an exposure […], to a client or group of connected clients the value of which exceeds 25% of its eligible capital". Any risk of contagion from the failure of a specialised provider is therefore, in any case, already contained by existing EU prudential regulation.

   - *Excessive leverage and procyclicality* – this is not a feature of the markets in which FLA members operate. The FSB stated in its 2012 Global Shadow Banking

Monitoring Report that this effect often arises as a result of inter-connectedness (see above for why this does not apply).

- *Opaqueness and complexity* – non-bank finance companies are either “captive” companies (i.e. the finance arms of manufacturers or retailers) or independent companies which specialise in a single product or a range of products. Many of the parent companies of captive finance companies are well-known and their ownership structure can easily be checked on the public record, for example via Companies House in the UK.

8. The paper argues that “shadow banking” may have emerged to circumvent existing regulation (regulatory arbitrage). This is certainly not the case for non-bank lending to consumers and businesses, which came about largely in response to the needs of consumers (e.g. at the point of sale on the high street or in motor dealerships), and to provide businesses with a wider choice of funding channels than was available from traditional bank lenders.

9. There is no evidence that risks arising from non-bank lenders in this arena have ever endangered the financial system, even during the recent global economic crisis. There have been no Government bail-outs for such finance companies, and no public money has been put at risk. The non-bank lenders which *have* failed during this period have occasioned no threat whatever to the operation of financial markets, regulated banks, or consumers. In the event of such a lender becoming insolvent, its customers would not be at risk, because their credit agreement would continue; and the lender’s assets would be realisable in an orderly fashion over a relatively short timeframe for the benefit of creditors. In other words, credit differs in these important ways from other financial products, because the main risk lies with the lender rather than the consumer.

10. The FSB’s Global Shadow Banking Monitoring Report published in November 2012 (and based of the views of regulators from 25 jurisdictions) found that non-bank finance companies:

    - Played an important role in providing credit to the real economy, especially where they filled “credit voids that are not covered by other financial institutions.”

    - Did not pose significant systemic risks (this did not preclude monitoring of the risks).

11. The EBA’s blanket definition of shadow banking is unworkable, and would make it almost impossible for banks to assess their risk exposure because the scope is so wide. We urge the EBA to follow the approach already taken by the FSB, which is currently considering the risks posed by different types of firms, including finance

companies. Otherwise, the EBA risks unnecessary damage to important sectors of the economy, endangering recovery

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.

12. We support the EBA's view that it is premature to introduce a quantitative limit to banks' exposures at individual exposure or aggregate level, not least because the current definitions are so wide (see our response to Q1).

13. The elements listed for establishing effective processes and control mechanisms are current good practice amongst FLA members.

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.

14. Similarly, we support the EBA's approach in respect of the criteria for establishing appropriate oversight arrangements.

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.

15. We agree with the elements listed in the draft Guidelines. Where the paper refers to setting 'tighter limits to individual exposures', we would like clarification of what 'tighter' relates to. We are concerned that if, in future, banks were required to set quantitative limits on individual exposures, this would be unmanageable. This is because daily market fluctuations could result in a shadow banking customer inadvertently exceeding the prescribed limit. It would also involve costly changes to IT systems.

Q5. 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?***

16. We prefer Option 2, which is more flexible. Option 1 is unnecessary because it does not bestow any benefits on a bank which complies with some of the elements of the principle approach.

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?

17. Yes. It is important to have a consistent approach.

Edward Simpson
Head of Government Affairs
Edward.simpson@fla.org.uk
Tel: +44 20 7420 9654

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