

---

## The Authors



Scott Warner



Oleg Lebedev

## Abstract

The European Banking Authority (“EBA”) published a consultation paper on shadow banking entity exposure limits on 19 March 2015. A public hearing was held in London on 18 May. Comments on the draft guidelines were due by 19 June, and 48 responses have been published. The EBA intends to finalise its guidelines by the end of 2015. It defines “shadow banking entities” as those that carry out credit intermediation activities (bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities) and are not defined excluded undertakings (those subject to an appropriate prudential framework either as a result of prudential consolidation or certain sector-specific prudential frameworks). In the UK, the National Savings Bank, the Commonwealth Development Finance Company Ltd, the Agricultural Mortgage Corporation Ltd, the Scottish Agricultural Securities Corporation Ltd, the Crown Agents for overseas governments and administrations, credit unions and municipal banks are not to be regarded as shadow banking entities. Additional entities are specified to be excluded for other European countries. 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 on their individual exposures to shadow banking entities and on the sector in its entirety. The consultation asked specific questions about the approaches for defining shadow banking entities, establishing processes and control mechanisms, oversight arrangements, aggregate and individual limits, and for two options regarding a fallback approach and limit.

---

## Regulatory Background

In April 2011 the Financial Stability Board (“FSB”) published recommendations to strengthen oversight and regulation of shadow banking. In January 2014 the European Commission adopted a proposal for a regulation on reporting and transparency of securities financing transactions outside the banking sector. 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 banking. Work has been undertaken by the EBA to analyse the scope of the perimeter of credit institutions. Work led by the BCBS is underway. The FSB is conducting intensive monitoring of the shadow banking sector. The European Banking Authority (“EBA”) published its consultation paper<sup>1</sup> on shadow banking entity exposure limits on 19 March 2015.

According to the Capital Requirements Regulation<sup>2</sup> Article 395.2, by 31 December 2014 the EBA was to issue 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. In developing those guidelines, it was to 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.

In addition, by 31 December 2015 the Commission is to assess the appropriateness and the impact of imposing shadow banking entity exposure limits, submitting a report to the European Parliament and the Council of the EU, together, if appropriate, with a legislative proposal on such limits.

---

## Shadow Banking

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. Lending by shadow banks as a proportion of total lending is rising.

<sup>1</sup> 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, EBA, 19 March 2015.

<sup>2</sup> Corrigendum to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, EU, 30 November 2013.

However, 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. Shadow banks are generally not subject to prudential regulation. To the extent that they carry out bank-like activities, exposures to them are inherently risky. Institutions' exposures to shadow banks may lead to concerns that core banking activity may migrate systematically away from the regulated sector into the shadows. Institutions may seek ways to fund risky shadow banks. Specific risks generated by and regulatory concerns regarding shadow banks include: run risk and/or liquidity problems, interconnectivity and spillovers, excessive leverage and procyclicality, and opacity and complexity.

---

## Credit Intermediation

The four key features of credit intermediation are maturity transformation (borrowing short and lending/investing on longer timescales), liquidity transformation (using cash-like liabilities to buy less liquid assets), leverage, and credit risk transfer (transferring the risk of credit default to another person for a fee). 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.

---

## Limit Requirements

Institutions should comply with the general principles of effective processes and control mechanisms. There should be adequate oversight by the management body. They should set an aggregate limit on shadow banking sector entities relative to their eligible capital. Independently from the aggregate limit and in addition to it, they should set tighter limits on their individual exposures to shadow banking entities.

---

## Principal and Fallback Approaches

The EBA considers it premature to use the guidelines to introduce a quantitative limit to institutions' exposures to shadow banks at the individual exposure or aggregate exposure level. Instead, the proposed intervention is designed to place the responsibility on the banking sector to demonstrate that the highlighted risks are being managed effectively, in particular by improving, where

necessary, the due diligence carried out before taking lending decisions. Under the proposal, institutions shall implement effective processes, as well as set aggregate and individual limits under the principal approach for limits, using criteria which are laid down in the guidelines. Institutions that cannot use the principal approach, as a result of their inability to take into account the full set of criteria, are to use a simpler fallback approach involving a set aggregate limit of 25% – it must be noted that institutions would not be able to opt for this approach. In the absence of sufficient information, all exposures to shadow banking entities could be connected, and the fallback approach applies the Large Exposures limit. This calibration has not been tested by an impact assessment at this stage. Two versions of the fallback approach are being proposed. Under the first option, it must be used for all exposures to shadow banking entities when the institution is unable to apply the principal approach, even if that inability concerns only part of the exposures to shadow banking entities. The second option entails using the fallback approach only for those exposures for which the principal approach could not be used. The second is similar to the method used under the EBA's Regulatory Technical Standard on the determination for Large Exposures purposes – which is the overall exposure to a client or group of connected clients in respect of transactions with underlying assets.

---

## Public Hearing

The EBA's hearing was devoted to four topics: the approach to the definition of shadow banking entities, the principles to establish effective processes and control mechanisms and appropriate oversight arrangements, the criteria to determine aggregate and individual limits and the fallback approach.

---

## Consultation Responses

A large number of respondents submitted comments by the deadline. One representative party, the Banking Stakeholder Group, raised several general concerns: there is a potential danger that the overall regulatory regime that is applied to banks may unnecessarily distort competition between them and the shadow banking sector; there should be a common definition of shadow banks and consistent application of regulation and supervision between countries, and the proposed rules may have the unintended consequence of undermining the fluidity of securitisation schemes. The latter has been a priority for the EBA and the European Commission in recent times.

---

## How We Can Help

Avantage Reply is a specialised management consultancy delivering initiatives in many areas including shadow banking. Our capabilities include regulatory interpretation and implementation of business and technology change in the financial industry. We would be happy to discuss these EBA guidelines with you and help you determine the impact of the proposed changes on your business.

---

## Contacts

### Avantage Reply (Amsterdam)

The Atrium | Strawinskylaan 3051  
1077 ZX Amsterdam  
Netherlands  
Tel: +31 (0) 20 301 2123  
E-mail: [avantage@reply.com](mailto:avantage@reply.com)

### Avantage Reply (Rome)

V.le Regina Margherita, 8  
00198 Roma  
Italy  
Tel: +39 06 844341  
E-mail: [avantage@reply.it](mailto:avantage@reply.it)

---

### Avantage Reply (Brussels)

5, rue du Congrès/Congresstraat  
1000 Brussels  
Belgium  
Tel: +32 (0) 2 88 00 32 0  
E-mail: [avantage@reply.com](mailto:avantage@reply.com)

---

### Avantage Reply (Turin)

Via Cardinale Massaia, 83  
10147 Torino  
Italy  
Tel: +39 011 29101  
E-mail: [avantage@reply.it](mailto:avantage@reply.it)

---

### Avantage Reply (London)

38 Grosvenor Gardens  
London SW1W 0EB  
United Kingdom  
Tel: +44 (0) 207 730 6000  
E-mail: [avantage@reply.com](mailto:avantage@reply.com)

---

### Xuccess Reply (Berlin)

Mauerstrasse 79  
10117 Berlin  
Germany  
Tel: +49 (30) 443 232-80  
E-mails: [xuccess@reply.de](mailto:xuccess@reply.de)

---

### Avantage Reply (Luxembourg)

46a, avenue J.F. Kennedy  
1855 Luxembourg  
Luxembourg  
Tel: +352 26 00 52 64  
E-mail: [avantage@reply.com](mailto:avantage@reply.com)

---

### Xuccess Reply (Frankfurt)

Hahnstrasse 68-70  
60528 Frankfurt am Main  
Germany  
Tel: +49 (0) 69 669 643-25  
E-mail: [xuccess@reply.de](mailto:xuccess@reply.de)

---

### Avantage Reply (Milan)

Via Castellanza, 11  
20151 Milano  
Italy  
Tel: +39 02 535761  
E-mail: [avantage@reply.it](mailto:avantage@reply.it)

---

### Xuccess Reply (Hamburg)

Brook 1  
20457 Hamburg  
Germany  
Tel: +49 (40) 890 0988-0  
E-mail: [xuccess@reply.de](mailto:xuccess@reply.de)

---

### Avantage Reply (Paris)

5, rue des Colonnes  
75002 Paris  
France  
Tel: 33 (0) 1 71 24 12 25  
E-mail: [avantage@reply.com](mailto:avantage@reply.com)

---

### Xuccess Reply (Munich)

Arnulfstrasse 27  
80335 München  
Germany  
Tel: +49 (0) 89 - 411142-0  
E-mail: [xuccess@reply.de](mailto:xuccess@reply.de)