

## The Authors



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## Abstract

On the 14<sup>th</sup> of December 2015, the European Banking Authority (“EBA”) issued final guidelines for *Limits on exposures to shadow banking entities*, outlining how financial institutions are to manage limits on shadow banking exposures<sup>1</sup>, effective from 1<sup>st</sup> January 2017.

As an indicator of how many banks could be affected, the EBA performed data analysis with an example shadow banking sector limit of 25%. Under this analysis, a third of banks<sup>2</sup> were over the example limit, with large ‘Group 1’ banks<sup>3</sup> having proportionally larger exposures to shadow banks. The definition of shadow banking entities has since been restricted.

The 65 banks surveyed by the EBA in Luxembourg, Germany, France and the United Kingdom had average shadow banking exposures of between 40% and 80% of eligible capital<sup>4</sup>.

Custodian banks and asset servicing institutions will be particularly upset by the lack of a custody-related services exemption in the final guidelines, as requested by practitioners in response to the EBA Consultation Paper.

<sup>1</sup> These guidelines come from the Capital Requirements Regulation (“CRR”) requirement that the EBA issue guidelines to set appropriate limits for “entities which carry out banking activities outside of a regulated framework”, as per Article 395 (2) of the Capital Requirements 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 Text with EEA relevance.t

<sup>2</sup> As per pages 63-64, *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*, which is available on <https://www.eba.europa.eu/regulation-and-policy/large-exposures/guidelines-on-limits-on-exposures-to-shadow-banking>. 65

## Shadow banking entity definition

Shadow banking has historically been poorly defined and one of the challenges the EBA has faced is in establishing the boundaries of what constitutes a shadow banking entity or shadow banking activity. These boundaries have been challenging to pin down, and, consequently, the spectrum of firms captured by the EBA has been a moving target. The range of entities captured by the EBA for its 2015 data collection exercise has now been reduced, after feedback from industry.

The EBA definition is detailed, but, in general, includes entities that carry out ‘banking-like activities’, but which are not regulated under the jurisdiction of a regulatory body. Funds are very much in the spotlight within the definition chosen by the EBA, and shadow banking funds include, broadly speaking, all Money Market Funds and non-UCITS funds, with Alternative Investment Funds (“AIFs”) exempt if they have low leverage and do not deal in loans.

Shadow banking, as the EBA concedes, performs a number of socially and economically beneficial activities, bringing capital to the real economy, driving growth and oiling the wheels of international finance. Therefore excessive enforcement of control over shadow banking could be potentially economically detrimental.

## What is the risk in Shadow Banking?

Shadow banking entities are less restricted in their activities than regulated banking entities, in particular since banks have had their wings clipped after the global financial crisis. Areas of concern for the 70 trillion euro shadow banking sector<sup>5</sup> include reduced regulatory requirements, a lack of protection mechanisms for investor capital and lack of access to central bank liquidity facilities. Other risks concerning the EBA include potential ‘runs’ on shadow banking entities, the potential that liquidity issues could trigger ‘fire sales’ of assets, strong interconnectedness with the regulated banking sector, high leverage, procyclicality and a lack of transparency.

institutions out of 184 had an exposure of over 25% (example limit) of eligible capital on aggregate exposures to shadow banking entities (exposures only included when over 0.25% of eligible capital), once CRM and exemptions had been applied. Note that the EBA has since restricted the definition of shadow banking entity.

<sup>3</sup> Group 1 banks are defined as internationally active European banks with more than 3 billion euros of Tier 1 capital.

<sup>4</sup> Average exposure after exemptions and CRM (% of eligible capital) per reporting institution, as outlined in the EBA’s *Report on Institutions’ Exposures to ‘Shadow Banking Entities.’*

<sup>5</sup> As stated in the Financial Stability Board’s November 2015 report *Global Shadow Banking Monitoring Report 2015*.

Systematic risk concerns also exist. With increased pressure on regulated entities and consequently less core banking activity being performed within the regulated sector, capital is both pushed (through reduced profitability in regulated activity) and pulled (by the existence of greater opportunity) into the shadow banking sector. Some regulators are concerned that through potentially over-regulating the banking sector, capital will take the path of least resistance and flow in increasing amounts to the shadow banking sector. As shadow banking is highly correlated and interconnected with regulated banking, this means that potentially destabilising activities are occurring beyond the control of supervisors and regulators.

One significant change in thinking regarding shadow banking is the introduction of the shadow banking 'run' concept. Institutions such as asset managers used to be considered as systemically safe as their investments are paid for with invested cash, in contrast to the leveraged investments made by banks with guaranteed deposits. Now, with assets under management having grown dramatically against a backdrop of reduced liquidity, and, with the market dynamics revealed during the global financial crisis, there are concerns that a sharp drop in asset prices could cause fund redemptions, further depressing asset prices with a positive feedback mechanism in the a similar way as a run on a bank.

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## Challenges of implementing limits

While identifying shadow banking entities using the EBA definition will pose some challenges, it is the measurement of shadow banking entity interconnectedness that will pose particular challenges to firms with shadow banking exposures.

Dependent on the availability of information on shadow banking exposures and the effectiveness of the institution's processes, there are two approaches that can be used to calculate exposure to shadow banking entities, the 'Principal' approach and the 'Fall Back' approach. For both approaches, a *de minimis* hurdle is utilized, whereby only shadow banking exposures greater than 0.25% of an institution's eligible capital are included.

Under the Principal approach, individual and aggregate limits are set for shadow banking exposures, whereas, under the Fall Back approach, a single limit is set for shadow banking exposures in aggregate. In instances where an institution has sufficiently effective processes and control mechanisms or oversight for part of its shadow banking exposures, a mixture of the two approaches is to be used.

While self-determined limits are still presented as guidelines and so are not necessarily more restrictive than the existing large exposure limits, the Commission may well impose mandatory limits and therefore it is advised to establish processes which are able to manage the current guidelines in addition to potential mandatory limits, should they be implemented.

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## Actions for firms

- Identify the entities to which your firm has exposures greater than 0.25% of your eligible capital and determine which are shadow banking entities, as per the EBA definition;
- Assess the risks arising from these shadow banking exposures and establish a risk appetite for these exposures;
- Implement an internal framework for the management of the above risks and ensure that this is integrated in ICAAP and capital planning;
- Assess the processes, control and oversight surrounding these processes to determine to what extent they are suitable for the Principal approach;
- Establish adequate processes for determining the interconnectedness of shadow banking entities;
- Set individual and aggregate limits for shadow banking exposures using the Principal and Fall Back approaches, as appropriate;
- Implement effective procedures, reporting processes and management information, making sure to establish adequate procedures to be ready for any breach of the above limits;
- Ensure that oversight is adequate and suitably documented; and
- Audit the above to ensure compliance by the end of 2016.

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## What we can do

Avantage Reply is uniquely placed to deliver the above, with impeccable risk management, change management and system implementation credentials. Avantage Reply's extensive experience in implementing the required processes, controls and oversight required by the large exposure regime, gained at a number of institutions, allows for efficient and effective implementation of the shadow banking guidelines such that they are 'future proof', ready for further iterations of European Shadow Banking regulation.

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