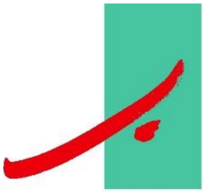

FEDERATION
BANCAIRE
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2015.06.19

FBF RESPONSE TO EBA CONSULTATION PAPER ON DRAFT GUIDELINES ON LIMITS ON EXPOSURES TO SHADOW BANKING ENTITIES WHICH CARRY OUT BANKING ACTIVITIES OUTSIDE A REGULATED FRAMEWORK (EBA/CP/2015/06)

I- General comments

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to comment on the EBA's Consultation on draft guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework. Please find our key messages below.

EBA's mandate

The EBA mandate is to consult on draft guidelines; we observe that the proposed draft could be seen as a technical standard with very restrictive criteria instead of guidelines. Due to the different legal nature of guidelines and technical standards, we are wondering if the EBA draft guidelines are consistent with the terms of reference and the mandate given by the CRR. Furthermore, Article 395(2) of the CRR does not say that different individual limits have to be introduced for each exposure to shadow banking entity; it only mandates the EBA to set individual limits. In addition, the mandate does not say that both individual and aggregate limits have to be set. It would be perfectly possible to introduce only one or the other.

Definition of shadow banking and third country recognition

Defining shadow banking by exclusion leads to accidentally including within the scope activities that are not related to it. We believe it is thus necessary to review the list of excluded undertakings and ensure that activities not explicitly mentioned on the list yet otherwise regulated and/or submitted to adequate risk management and oversight are also outside the definition of shadow banking. For instance, third country credit institutions should be excluded given the existing regulatory frameworks applicable to banking activities, as well as Alternative Investment Funds (AIFs) and Money Market Funds (MMFs), which also fall (or will soon) under the scope of regulatory frameworks.

Although we acknowledge the concern of policy makers relating to shadow banking, we question the methodology which consists in limiting the consequences (increasing bank regulation with additional exposure limits) rather than dealing with the causes (lack of shadow banking regulation).

Undertakings supervised in a third country applying prudential requirements at least equivalent to those applied in the Union are excluded from the scope of shadow banking. However, the EBA does not provide any indication on the list of countries that satisfy those requirements. The Commission has issued an Implementation Decision in December 2014 (2014/908/EU), establishing lists of countries presenting regulations equivalent to the European Union one (please refer to the annex of this paper). However, this list appears too strict in the context of shadow banking. For example, on the basis of this list, an exposure towards a bank from South Korea or New Zealand (OECD countries) would fall within the shadow banking scope.

We would like to emphasise again that the Commission's list is overly restrictive and cannot be considered a satisfactory mean to effectively identify shadow banking activities. In addition, this list provides no information on insurance companies for example, although adequate regulations do exist outside the European Union.

International coordination

We believe it is necessary to ensure **proper coordination with existing international work on shadow banking**.

The Basel Committee released in April 2014 standards on "Supervisory framework for measuring and controlling large exposures" applicable as at 1 January 2019; these include monitoring of shadow banking per the FSB 2011 recommendations to strengthen oversight and regulation of shadow banking. The April 2014 framework also has an impact on exposures measurement[1] hence on proposed limits, difficult to assess at this point in time. The Basel Committee did not retain the option of setting a limit on shadow banking; an alternative treatment has been preferred, consisting in establishing transparency on underlying assets of securitization and funds vehicles. This approach corresponds to the principles of the large exposures framework published by the Commission in its Delegated Act 1187/2014[2]. Given this background, we believe it is questionable to set up a double process aiming at mitigating the same risk.

The FSB also published in October 2014 a "Global Shadow Banking Monitoring Report". In addition, the European Commission published a green paper on Capital Market Union that encourages the development of market-based finance, including activities that may be considered by the EBA as shadow banking, as an alternative to financing by banks: we would expect a consistent approach from European Authorities on the subject. Last but not least, the G20 monitors shadow banking progress as part of its global mandate.

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[1] By using a unique exposure measure for OTC derivatives (i.e. SA-CCR) and by imposing to report the secured exposure on the collateral issuer.

[2] This follows EBA/RTS/2013/07 "EBA FINAL draft Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 390(8) of Regulation (EU) No 575/2013", published on 5 December 2013.

Large exposures vs. sectorial risk

We do not understand the reference to existing large exposure limits and in particular the proposal for an aggregate limit on shadow banking entities. While a sector approach is not applied elsewhere when dealing with large exposures, this aggregate limit would consist in introducing a sectorial risk, as shadow banking would be de facto treated as a self-standing sector. Moreover, relying on a sectorial approach combining heterogeneous activities such as banks, investment firms, funds, hedge funds and securitization vehicles, appears questionable.

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As a general principle, we believe it is sensible to consider that all banks are regulated hence fall outside the scope of shadow banking.

The EBA seems to be starting a policy debate on a subject matter that has been widely discussed already by proposing guidelines not reflective of the level of maturity reached by global stakeholders. Moreover, the EBA does not seem to be adequately accounting for its own work on increasing banks' ability to look through and assess vehicles and transactions underlying exposures (as per Commission Delegated Act 1187/2014, see above).

Also numerous operational issues have not been addressed within the EBA's consultation: implementation schedule, level of the reporting (consolidated vs. solo), consistency with other calculation methods (exemptions, look-through process …).

Lastly, the EBA seems to be addressing an issue mostly relevant to American institutions[3]. The "Haut Conseil de Stabilité Financière[4]" (HCSF) stated in its annual report[5] published on June 10 that the size of shadow banking in France remains limited (representing around 15% of the overall banking sector at end 2014) and largely regulated. We welcome the HCSF report's conclusions. We look forward to comparable analyses from European and international stakeholders to ensure adequate level playing field and proportionality are maintained at all times across jurisdictions where shadow banking exists.

Please find our detailed feedback within our answers to the EBA's questions below.

II- Answers to questions related to the consultation

1. 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.**

[3] Remarks by Stanley Fischer Vice Chairman Board of Governors of the Federal Reserve System, http://www.federalreserve.gov/newsevents/speech/fischer20150330a.pdf, 30 March 2015.
[4] The HCSF, created by the 26 July 2013 Banking law, is in charge of monitoring financial stability in France and may set, where necessary, the systemic risk buffer, the countercyclical buffer, in addition to any other measure mitigating macro-prudential risk.
[5] http://www.economie.gouv.fr/files/hcsf_rapport_annuel_062015.pdf

- **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).**

We find the approach proposed by the EBA complex to implement. We believe that the definition of shadow banking should be based on an explicit list of types of entities or activities, as opposed to a definition by exception.

We also believe the list of excluded undertakings is too restrictive and remains unclear at this stage:

- There is no information on what would be considered "prudential and supervisory requirements that are at least equivalent to those applied in the Union". Clarification from the EBA on what a regulated entity consists of would be welcome.
- If we refer to the Implementing Decision 2014/908/EU on the equivalence of the supervisory and regulatory requirements of certain third countries and territories, banks from only 17 countries outside the EU (see annex) would be excluded from the scope of shadow banking. This would mean, for example, that Korean banks and Turkish banks would be considered as shadow banking entities. This doesn't seem justified by any economic investment rationale.

The definition proposed by the EBA does not consider any proportionality in the definition of shadow banking activities ("*Shadow banking entities means undertakings that carry out one or more credit intermediation activities*") i.e. : any undertaking carrying these activities on an ancillary basis would be covered by this definition. We assume that this is not in the intention of the EBA to cover such entities. Thus we suggest that the EBA modifies its definition as follows:

"*Shadow banking entities means undertakings that carry out, <u>as their main business</u> (…)"*

We also suggest the EBA to clarify whether the identification of an activity as shadow banking should include at least one of the four proposed bank-like activities (maturity transformation, liquidity transformation, leverage and credit risk transfer) AND at least one of the eight activities proposed in paragraph 6 of Title I of the draft Guidelines (activities listed in annex I of CRD IV) OR these references are independent.

Indeed during the EBA's public hearing, participants asked the EBA to explain how Money Market Funds match the proposed shadow banking definition, knowing that a fund (UCITS for instance) is defined as "an undertaking with the sole object of collective investment in transferable securities or in other liquid financial assets (…)" and thus does not meet any of the eight activities of Annex I of CRD IV listed by the EBA in the draft Guidelines. The EBA's that MMFs meet the definition of shadow banking because they perform "liquidity transformation" as defined in the proposed guidelines. Our understanding is therefore that many other entities could fall in the shadow banking definition (for instance any LBO holding companies because they involve leverage).

Third country banks

Regardless of the country of incorporation, banks are always subject to authorisation and supervision by the local competent authority, hence should not be considered as shadow activities.

Insurance companies

According to the definition proposed by the EBA, it is not clear how insurance companies could fall in the definition of shadow banking activities while EU and equivalent third countries insurance are explicitly excluded. The EBA should make clear if non-equivalent third countries insurance companies fall within this definition or not. It should be underlined that a first package of third country equivalence decisions under Solvency II has been adopted by the Commission[6].

We would rather consider that regardless of the country of incorporation, insurance companies are always subject to authorisation and supervision by the local competent authority, hence should not be considered as shadow activities.

Funds

We believe that the treatment of non-UCITS (and MMF) should be consistent throughout the large exposure framework, in particular considering Commission Delegated Act 1187/2014. The latter does not distinguish between UCITS and non-UCITS funds, but funds for which the structure does not add any additional risk to those borne by the funds' assets.

In terms of challenges to the collection or provision of information to supervisory authorities, most European investment funds, be they UCITS or nationally regulated funds, already provide comprehensive information to the authorities, their investors and the wider public. The Alternative Investment Fund Manager Directive (AIFMD), in force since 2013, brings the quality of supervisory monitoring to an even higher level by imposing ambitious reporting requirements on managers of alternative investment funds:

- Supervisory reporting is mandatory for most Alternative Investment Funds (AIFs) on a quarterly basis and includes detailed information on portfolio composition, principal exposures and most significant counterparty concentrations, risk profile and liquidity management.
- The AIFMD reporting provides helpful data for assessing the interconnectedness between banks and other financial entities.
- These requirements have been developed with the specific aim of enabling supervisory authorities to effectively monitor systemic risks associated with AIF management. Specific reporting is due by AIFs that use significant leverage (commitment in excess of 3 for 1 of capital).
- The AIFMD reporting requirements are unique in the EU financial sector as regards their frequency and effectiveness.

[6] Please see 5 June press release http://europa.eu/rapid/press-release_IP-15-5126_en.htm and http://ec.europa.eu/finance/insurance/solvency/international/index_en.htm.

Should the EBA proposed guidelines remain unchanged, the distribution of AIFs, which serve the purpose of credit institutions' capital preservation and diversification, hence making them more resilient, would be massively hampered. Furthermore, we see no specific justification for singling out certain closed-ended and unleveraged AIFs, European Venture Capital Funds (EuVECAs), European Social and Entrepreneurial funds (EuSEFs) and European Long Term Investment Funds (ELTIFs). These provide useful and much needed financing to the EU businesses and economies.

As a consequence, except for those funds relying on a significant leverage, AIFs should also be excluded from the scope of shadow banking, as their regulation is now very close to that applicable to UCITS.

In addition, considering the implementation of recent European regulations applicable to Money Market Funds, we believe that these should also be excluded from the perimeter of shadow banking entities. Indeed, the European Parliament reached an agreement on MMFs in April 2015 opening the way to the implementation of a European Money Market funds regulation.

Securitization and asset financing SPV

The perimeter of securitization and SPVs to be integrated in the shadow banking scope also needs to be clarified. We believe the economic activity of the different types of vehicles needs to be the main criteria of analysis.

For example, leasing vehicles are created to detain an asset and are generally fully refinanced by a group of banks or the leaseholder client himself. The use of these SPVs in structured deals presents no regulatory arbitrage and shall not have any systemic effect. The loans granted by each bank to the SPV corresponds to the total risk exposure and the credit risk is calculated on the final client himself and not on the SPV. Therefore leasing vehicles do not belong to the shadow banking scope.

As mentioned in the introduction, the Capital Market Union encourages the development of market-based finance as an alternative to financing by banks, including activities that may be considered by the EBA as shadow banking. In addition, it is worth noting that the ECB has extended its Quantitative Easing policy to securitisation vehicles.

In its "Global shadow banking monitoring report 2014", the FSB explicitly specifies securitisation and asset financing vehicles as examples of the "securitisation-based credit intermediation and funding of financial entities" performing an economic function.

We would also like to mention a recent EBA initiative related to defining simple and transparent securitisation which should be taken into consideration when defining the scope of shadow banking activities.

Double counting with Commission Delegated Act 1187/2014

The 1187/2014 Delegated Act requires from institutions to apply a look-through approach to:

- Equity investment in funds
- Credit exposure to securitisation structures

Under the 1187/2014 Delegated Act, if a look-through approach is not possible, institutions are requested to report their aggregate exposures to such structures on one single connected client ("unknown customer"). While this Delegated Act does not cover credit exposures to funds (such as loans, derivatives, SFT …), it does cover a part of the definition of the shadow banking, particularly the securitisation and the equity investment in funds parts.

The aim of this Delegated Act is to give an incentive to banks to have a better knowledge of their exposures to such structures and identify possible link between the underlying exposures to its existing customers. Given that the aim of the shadow banking limitation is to prevent systemic risk, the look-through approach and its fall-back ("unknown customer limit") already cover this requirement by the identification or limitation of connection amongst counterparties.

Exposures to a shadow banking entity

It is not clear whether the 0, 25% threshold applies to a single exposure or to the aggregate exposure to a shadow banking entity. Could the EBA confirm that this limit is to be applied on a single exposure basis?

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.

We share EBA's view on the principle for effective processes and control mechanisms.

Moreover, Pillar 2 requirements regarding sectorial risk and concentration risk already exist and apply to banks. In fact, in the context of the overall large exposure regime under Part Four of the CRR, Article 395(2) states that the purpose of the guidelines is to set appropriate aggregate limits on large exposures or lower limits on individual exposures to shadow banking entities. However, the draft guidelines plan to set special Pillar 2 requirements which will apply exclusively to exposures to shadow banks. These additional requirements in paragraphs 1 and 2 in Title II are not necessary, in our view, since they are either already legally enshrined in the implementation of the CRD IV rules relating to Pillar 2 or are covered by the EBA's new SREP guidelines. Moreover, the use of Pillar 2 measures in such a complex context will most probably result in very heterogeneous implementation, thus endangering level playing field among banks operating cross-border.

We believe the proposed Guidelines should only apply at consolidated level –our rationale is threefold:

- Usual large exposures limits set out in the CRR already apply to exposures to all types of counterparties and therefore include any counterparty that would be considered to be a "shadow bank" under the EBA's proposed definition. These rules already apply at both solo and consolidated levels, hence a sufficient backstop already exists within the current framework. The enhanced protection against single name concentration risk that would be provided by the EBA Guidelines can still be achieved by applying it at the consolidated level.
- Applying the Guidelines at consolidated level only would make it easier for firms to manage them within the ICAAP process as individual legal entities may have only a partial view of

shadow banking activities existing within a banking group. Consequently, the risk management process aimed at increasing senior management awareness would be effective only when performed at consolidated level (group view). This is also in line with the Pillar II approach.

- The burden of infrastructure, systems and processes that firms would need to put in place to comply with the Guidelines would be less onerous if applied at the consolidated level only.

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.

We share EBA view on the principle for oversight arrangements.

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.

Any aggregate limit should be set on homogeneous group of entities and according to the EBA's mandate should not be set in addition to "tighter individual limits".

We oppose the view to use the large exposure framework to set sectorial limits, all the more considering the proposed definition of the shadow banking sector which puts together all sorts of entities (asset financing entities, unregulated entities, etc…) which may not present any financial link to one another.

Indeed, there will be no interconnectedness between a US hedge fund, a Korean leasing company and a European Money Market Fund. An aggregate limit would be totally disconnected from the effective risk borne by institutions in relation to these counterparties.

In addition, we do not see the added value of the current individual limit proposal. Such practice is already implemented in all banks, based on their respective business model and risk appetite, irrespective of whether the counterparties would be considered shadow banking entities or not. Moreover, individual exposures are already subject to the large exposure limit, including in the specific case of the "unknown client" as defined in the Commission's Delegated Act 1187/2014.

Our question concerning individual limits, is rather to understand the meaning of "tighter limits". Clarification would be needed to explain "tighter than what?"

Measurement of the exposure

The setting of internal limits for OTC derivatives implies using internal metrics (Potential Future Exposure, or other internally modelled exposure measurement), which are not equivalent to those used for the purpose of large exposures measurement (currently: the Effective Expected Positive Exposure times a multiplier, or Current Exposure Method; in the future framework: the SA CCR).

We would like the EBA to confirm that internal limits for OTC derivatives as required by the proposed guidelines under the principal approach should not be set and measured by using large exposure framework metrics but by using internal metrics, in order to avoid unduly burdensome double calculations on these transactions.

5. Do you agree with the fall back 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 fall back approach? If so, why? In particular:

a) Do you believe that Option 2 provides more incentives to gather information about exposures than Option 1?

b) Do you believe that Option 2 can be more conservative than Option 1? If so, when?

c) Do you see some practical issues in implementing one option rather than the other?

The fall-back approach, in particular in option 1, seems arbitrary, very punitive, and with no incentive to implement proper policy: one single anomaly, regardless materiality or qualitative motivation, would have a detrimental effect on the whole population.

We consider that all measures that encourage institutions to resort to look-through approaches are more relevant in terms of risk monitoring.

Our preferred approach is option 2. However, we believe that it should be clarified as it is not properly calibrated as currently drafted. Please see our comments below.

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 fall back 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?

The 25% limit seems arbitrary and, as an aggregate and sectorial limit, is not comparable to the current limit in the large exposures framework.

The large exposures framework applies to a client or a group of connected clients. As explained before, we do not believe the proposed definition of shadow banking entities would result in defining a set of shadow banking entities that are interconnected. On the contrary, most of them will be totally disconnected given the wide range of heterogeneous businesses they represent.

The figure has no rationale and is not commensurate with general activities run by banks with such different entities, in fact, we find it surprising that EBA is of the opinion that an aggregate limit of 25 % would be appropriate. As a reminder, CRD II carried an aggregate limit for all large exposures (exposures exceeding the 10%-threshold) of 800 % of own funds. On this basis, the proposed limit of 25% is far too low and obviously disconnected from the reality of actual volumes of transactions involved and business practices.

Annex: NATIONAL REGULATIONS EQUIVALENCE
On the basis of Implementation Decision 2014/908/EU

Countries	Code	OECD Countries	European Economic Area Countries	Commission implementing decision 2014/908/EU - Equivalence of the supervisory and regulatory requirements - Credit institutions	Commission implementing decision 2014/908/EU - Equivalence of the supervisory and regulatory requirements - Investment firms
EUROPEAN UNION COUNTRIES	-	Yes in majority	X	X	X
NORWAY	NO	X	X	X	X
ICELAND	IS	X	X	X	X
LICHTENSTEIN	LI		X	X	X
AUSTRALIA	AU	X		X	X
CANADA	CA	X		X	X
USA	US	X		X	X
MEXICO	MX	X		X	X
SOUTH AFRICA	ZA			X	X
SAUDI ARABIA	SA			X	X
BRAZIL	BR			X	X
CHINA	CN			X	X
SINGAPORE	SG			X	X
HONG KONG	HK			X	
JAPAN	JP	X		X	
SWITZERLAND	CH	X		X	
JERSEY	JE			X	
ISLE OF MAN	IM			X	
GUERNSEY	GG			X	
INDIA	IN			X	
MONACO	MC			X	
CHILI	CL	X			
SOUTH KOREA	KR	X			
ISRAEL	IL	X			
NEW ZEALAND	NZ	X			
TURKEY	TR	X			