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European Banking Authority
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29 May 2015

Dear Sirs

EBA: CP/2015/06 – Limits on exposures to shadow banking entities

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

The European Banking Authority (**EBA**) published on 19 March 2015 a Consultation Paper (**CP)** pursuant to a mandate under Article 395(2) of Regulation 575/2013(**CRR**) to develop guidelines setting appropriate aggregate limits or tighter individual limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework.

In response to the EBA consultation, we set out below a number of legal issues that we have identified as significant to the implementation of the proposed guidelines (**Guidelines**).

First, however, we set out below a number of observations and contextual comments that we believe the EBA ought to consider before finalising their proposal:

1. The so-called universe of 'shadow banking' is not a term of art and neither is there international consensus on the precise definition of it nor its boundaries.

2. CRR granted the EBA a mandate which is specific as to its scope and which focuses on the guidelines setting out aggregate OR individual limits on exposures to shadow banking entities. It is clear that the EBA may impose either one or the other of these additional limits but not both.

3. The EBA appears to have interpreted the mandate as extending to enable the EBA to impose a fundamentally new prudential risk management framework that applies to exposure to shadow banking entities under the guise of the 'principal approach'. It would be helpful if the EBA reflects further on whether the Guidelines are compatible with the clearly defined mandate set out in the CRR.

4. Given the lack of helpful definitions in the CRR that set out the boundary of 'shadow banking', it is questionable whether the EBA has the mandate to determine a seminal issue such as setting the boundaries of 'shadow banking' and which will no doubt shape the future of prudential and other regulation under the CRR and other EU regulatory measures.

5. We would encourage the EBA to explore an alternative approach to the definitional issue namely to specify the exact types of entities (supplemented by exact activities and their extent/levels) that fall within the ambit of its proposal. This approach lends itself to being dynamic in line with developments in international policy making. Such approach would also allow the EBA to focus on priority risk activities and entities in the so-called shadow banking sphere.

6. The CP makes various references to equivalence of third country regimes with that applicable in the EU in the context of the definition of shadow banking entities (Excluded Undertakings). There appears to be an inconsistency in approach here.

For example, paragraph (2) of the definition which focuses on consolidated supervision refers to "prudential and supervisory requirements that are *at least* equivalent" whereas paragraph 3(h) refers to "supervisory regime of the third country concerned is deemed *equivalent*". Paragraph 3(j) refers to "prudential and supervisory requirements *comparable* to those applied…". We would appreciate a clarification whether there is an intentional objective behind these variations on the theme and also the precise source of recognition/equivalence determination that one needs to resort to in each case.

7. The EBA proposal regarding the so-called 'fallback' approach operates a presumption of connection between all 'shadow banking entity' exposures[1]. The EBA may wish to rethink this approach as it is crude and simplistic. Would perhaps a sectorial approach be more appropriate? Could a distinction be drawn by the type of risk identified i.e. liquidity transformation; maturity transformation; leverage?

The EBA approach does not appear to pay due regard to the requirements under article 395 to properly consider any material detriment on the risk profile of affected institutions.

8. Despite the clear instruction in CRR for the EBA to consider the impact of the proposal on 'the provision of credit to the real economy or on the stability and orderly functioning of financial markets' it appears from the impact assessment in section 5 of the CP that little has been done to validate any potential impact.

[1] Page 31 "The EBA sees that an aggregate limit to the shadow banking sector will result in a net benefit to the economy."

We would propose that a measure of the magnitude proposed by the EBA in the CP must be rigorously assessed using a sufficient representative sample of affected financial institutions.

We see no indication in the CP or in CRR that regulated banking and investment firms should be completely decoupled from the non-regulated or shadow banking segment of business. It is important to establish that the proposal will not crystallise this unintended outcome.

In particular, it is imperative to ensure that the proposal is compatible with the recent initiative of the European Commission regarding Capital Markets Union (**CMU**). The transformation of Europe's funding markets to rely much more on market-based finance solutions requires holistic thinking on the range of investors who would play a significant role in such transformation. Undoubtedly, the broad definition of 'shadow banking entities' would capture candidates that could be instrumental in pursuing the CMU objective of diversifying the sources of funding to complement that of banks.

9. The so-called 'fallback approach' is counter-intuitive to the policy objectives of the proposal. The proposal seeks to encourage affected institutions to establish and maintain a (new) risk framework infrastructure that is specific to 'shadow banking entities' (principal approach). Given the expected task this would create for affected institutions, it would have been appropriate and beneficial to offer an incentive that would allow affected institutions to exclude exposures meeting the rigorous information requirement from the penal aggregate limit proposals laid out in the 'fallback approach'.

Our view is that the 'all or nothing' approach proposed effectively means that the only relevant approach that is realistically achievable for a large number of the affected institutions during the foreseeable period is the 'fallback approach'. We doubt that this is the intention of the EBA.

10. The EBA should not underestimate the clarity required by affected institutions in order to implement the Guidelines. This is all the more important given the potential impact that inconsistent interpretation may lead to.

Definitions/scope

Credit intermediation activities

Has the EBA considered placing a 'de-minimis' level of in-scope credit intermediation activities below which the relevant entity would fall outside the scope of the Guidelines?

For example, should a relevant entity that engages in credit intermediation activity as an ancillary part of its core business say producing 5% of its revenue relative to other business be regarded as a 'shadow bank entity'?

Should there not be an argument that, given the policy objectives, to include such entity in scope would be disproportionate and unnecessary?

With reference to the EBA Opinion on the perimeter of credit institutions[2], it is clear that there is no uniformity across Europe in determining definitively the range of entities that should be regarded as Credit Institutions for the purposes of the CRD. Given the unsatisfactory

[2] EBA/Op/2014/12

outcome of this opinion, it is questionable whether the EBA is the correct arbiter to drawing the line between prudentially regulated and unregulated entities.

The definition of 'Credit Intermediation Activities' is set very broadly.

'bank-like activities' – the range of activities engaged in by banks vary enormously depending on which model the bank adopts. For example, universal banks engage in a very diverse range of banking, trading, corporate finance and other ancillary services. Narrower banks engage in very limited sets of activities, for example, taking deposits and granting mortgages. Some EU banks engage exclusively in securities clearing activities. Therefore, the term 'bank-like' does not appear appropriate in this context as it is far too vague to be capable of a satisfactory definition.

'maturity transformation' / 'liquidity transformation' – these terms require a much more detailed analysis. The reason is that there will be a broad range of legitimate commercial/non-financial activities that are engaged by trading companies and which could quite easily fall within these definitions. For example, is a retail chain of shops that is able to dictate suppliers' terms so that payment is deferred substantially following delivery, engaging in maturity transformation? We are confident that there is no intention by the EBA to capture non-financial commercial activity but this demonstrates the potential boundaries of a broad interpretation.
'leverage' – this term is widely used but arguably has no precise definition. For example, there is no consensus on the tipping point of liquidity facilities into 'leverage' so without further thinking in this area there is ample room for variable interpretation.

'credit risk transfer' – is the intention to cover activities that are better defined in CRR? For example, securitisation? If not, more work would be necessary to define the parameters that would assist in constructing a definition.

The definition ends with a 'catch all' phrase *'or similar activities'*. Given the lack of clarity regarding the specified activities, it would be extremely challenging to construct a process that would identify entities engaging in 'similar activities'.

Whilst the specification of example activities considered to fall within the definition is a step in the right direction, the activities in Annex 1 of the CRD have been over the years a source of confusion and inconsistent interpretation (for example, where used as a reference point under the Money Laundering Directive) and we would submit that they offer little practical help in reality.

Moreover, it is curious why the EBA has chosen to specify point 11 of Annex 1, 'portfolio management and advice'. Whilst it is well understood that some investment funds are within the contemplation of the EBA as 'shadow banks', clearly asset managers themselves are not engaged in credit intermediation activities. It is the legal vehicles constituting the investment funds that are engaging in such activities. We would suggest that the EBA reconsiders its approach in this regard.

<u>'Excluded Undertakings'</u>

Under paragraph 3(k) of the definition, the EBA is proposing that Money Market Funds should be within scope of the Guidelines (i.e. regarded as a shadow bank entity). Would it be appropriate to set a certain asset-under-management threshold below which an MMF should be out of scope?

As regards paragraph 3(l), we note that there is a large number of CCPs most notably in the US that have not (and may never be) recognised by ESMA. The scale of uncollateralised exposure to CCPs which are not so recognised by EU banks and investment banks is likely to be very sizeable. Whilst EU members of such CCPs will have done some diligence on these entities, the majority of firms would fall short of the onerous criteria set out in paragraph 4 of the Guidelines and which must be met in order for the 'principal approach' to be available. We would suggest more analysis around this particular topic.

Individual and aggregate limits

As mentioned above, the mandate granted to the EBA under Article 395(2) CRR refers specifically to 'guidelines to set appropriate aggregate limits…or tighter individual limits'. The EBA appears to have taken this mandate as an oppurtunity to develop a regime which seeks to impose both elements and which appears inconsistent with the legislative intent.

Information requirements

Paragraph 4 of the Guidelines imposes onerous information and investigation requirements regarding exposures to shadow banking entities. The EBA appears to underestimate the practical consequences of its proposed requirements considerably and in particular the willingness of counterparty ('shadow bank') entities to divulge highly sensitive and proprietary information regarding their businesses. In some cases, shadow banking entities compete with traditional banks and broker/dealers and the idea that such entities would give banks and broker/dealers access to such information is somewhat unrealistic and potentially harmful to effective competition in the financial markets.

The requirements set out in Guideline 4(e) would appear to require the bank/investment firm to conduct stress testing of the relevant entity which would of course require substantial data access. This does not appear realistic from a practical or commercial perspective.
It is not clear what the EBA seeks to capture in Guideline 4(f).

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact either Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at karen.anderson@hsf.com, or Peter Richards Carpenter by telephone on +44 (0) 20 3400 4178 or by email at peter.richards-carpenter@blplaw.com, in the first instance.

Yours sincerely

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