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European Banking Authority Shadow Banking Guidelines – Part 3: The Rationale and Context Behind the Guidelines

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In the third of our series of updates on the European Banking Authority (EBA) consultation paper on the draft EBA Guidelines on limits to the exposures that EU regulated banks should have to shadow banks (the Guidelines), we examine the rationale for this undertaking by the EBA. This update will provide the context for the requirements laid down by the Guidelines that apply to the regulated banking sector.

Attorneys
[Partha Pal](#)
[Chris McGarry](#)
[Richard Hanson](#)
[Paola Bahari](#)

In its consultation paper, the EBA has identified both micro-prudential and macro-prudential risks stemming from exposures to shadow banks. We look at these in turn.

Micro-prudential Risks

The consultation paper issued by the EBA has recognised that credit intermediation activities, such as maturity transformation and liquidity transformation, which are typically undertaken by both regulated banks and shadow banks, are “inherently risky”. Regulated Banks are typically subject to a regime of prudential regulation, and their ability to access liquidity assistance from central banks offers a degree of protection against these risks. Shadow banks, however, are generally not subject to a prudential regulatory regime and do not have access to central bank liquidity. If a regulated bank were to have significant exposure to a shadow bank in financial distress (with a material level of default in respect of its investments, for example), there could be knock-on effects if the shadow bank then defaulted on its obligations to the regulated bank, potentially requiring the shadow banks assets to be sold at fire sale prices and exposing the regulated bank to losses.

Recognition of the contagion effects between shadow banks and the regulated banking sector has prompted the attempt to limit the exposure that individual regulated banks established in the European Union have to shadow banks, both on an aggregated basis (i.e., a ceiling of exposure to all shadow banks) and to individual shadow banks.

Macro-prudential Risks

The exposure of regulated banks to shadow banks also creates various macro-prudential risks. The Guidelines seek to address, in particular, the systemic risk to the financial system that stems from the provision by regulated banks of funding lines to shadow banks carrying out bank-like activities. This funding into shadow banks is often characterised by sharp changes in fund flows and volatility. During cyclical upswings, for example, there might be a considerable amount of overlending by regulated banks, increasing the ability of shadow banks to engage in highly leveraged financial activities and expanding the amount of credit availability for the real economy. In a downturn, regulated banks can overreact by significantly reducing their lending to shadow banks, thus causing shadow banks to contract their own lending activities. This can lead to volatility in the onward flows of funds into the real economy. The exposures of regulated banks to shadow banks potentially accentuate the normal fluctuations of the credit cycles of the economy and could have repercussions on financial stability and the macro-economic environment by magnifying the impact of credit expansion and contraction. The EBA hopes to reduce the factors that amplify the credit cycle by limiting the overall risk exposure that regulated banks have to shadow banks on an aggregated basis and hence reduce the volatility of the onward flow of funds.

Regulatory Arbitrage

In its consultation paper, the EBA has also identified the risk that regulated banks might seek to increase their exposure to shadow banks as a means of engaging in regulatory arbitrage. This is considered to be more than a theoretical possibility, particularly in light of increased regulatory restrictions on banks and the latter's consequent desire to obtain exposure to higher yielding, riskier assets using different approaches.

Again, exposure limits may help to reduce this risk.

Are Exposure Limits the Answer?

It is suggested that limits to the exposure of regulated banks to shadow banks, both at an individual and an aggregate level, may indeed be the most effective way of managing the micro-prudential risks arising from their interaction. The approach proposed in the Guidelines will help regulated banks mitigate the risk of loss.

From the perspective of macro-prudential risks, the imposition of exposure limits may not be as effective since shadow banks could obtain leverage from sources other than regulated banks, such as insurance companies, pension funds or indeed other shadow banks. Limiting the macro-prudential risks can be better achieved through leverage limits imposed on shadow banks directly rather than or, possibly in addition to, exposure limits imposed on regulated banks.

Similarly, while exposure limits may have some positive effect in limiting regulatory arbitrage, it seems more logical to disincentivise regulatory arbitrage by limiting the benefits to regulated banks of doing indirectly that which they cannot do directly.

The Consequences of Exposure Limits

The EBA has, of course, recognised that some shadow banks play a “*valuable role in providing alternative sources of funding to the real economy*”. Indeed, one of the key lessons learned from the global financial crisis, from both a micro-economic and macro-economic perspective, was that over-reliance on a specific source of financing creates systemic risks for the real economy. There is therefore a sound policy reason for not inhibiting the development of the shadow banking sector, which the EBA recognises. However, the demand for alternative sources of financing, as well as the need to ensure that the costs of the financing are minimised, could well be a catalyst for excessive leverage within the shadow banking sector. The management of exposure limits to the shadow banking sector might therefore play a role in helping to control credit expansion in order to achieve financial stability.

In our next update on the shadow banking sector, we will focus on the implementation of exposure limits contemplated in the Guidelines. We will examine the compliance process in relation to regulated banks and the ways in which a compliance function could be effectively organised.

Ropes & Gray will continue to monitor developments in this area. If you would like to learn more about the issues in this alert, please contact any of the attorneys listed above or your usual Ropes & Gray advisor.