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European Banking Authority Shadow Banking Guidelines – Part 1: An Overview

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Shadow banking has been a subject of great interest to financial regulators and policy makers since the global financial crisis. A topic of particular focus has been the interconnectedness between the world of unregulated shadow banks and that of regulated banks, and how distress in the former could cause instability in the latter. The interconnectedness could arise, for example, by financial institutions having credit exposure to shadow banks by providing them with leverage.

In the first of our series of updates on the guidelines proposed by the European Banking Authority (EBA) on limits on exposures of EU regulated banks to shadow banks (the Guidelines), we provide an overview of the key areas considered under the Guidelines. This update also considers how the Guidelines could have an impact on the operation of debt funds (perhaps the most ubiquitous form of shadow bank and an increasing force in the credit markets) operating in Europe.

The EBA's Mandate

The mandate of the EBA to issue the Guidelines comes from paragraph 2 of Article 395 of Regulation (EU) No. 575/2013 (Capital Requirements Regulation or CRR). In formulating the Guidelines, Article 395(2) of the CRR requires the EBA to be mindful of any material detrimental impact on the risk profile of European regulated financial institutions, on the provision of credit to the real economy by shadow banks, and on the stability and orderly functioning of the financial markets.

Formulating the Exposure Guidelines

In order to develop the Guidelines in accordance with its mandate, the EBA ran a consultation until 19 June 2015, to which anyone could contribute. The consultation invited respondents to comment on certain key questions, which are set out in Part 5 of the consultation paper issued by the EBA on 19 March 2015. In essence, the aim of the questions was to examine and establish the following:

- who should be treated as a shadow banking entity;
- how regulated banks should identify the individual exposures that they have to shadow banking entities;
- how regulated banks should create, implement and supervise a framework to identify, manage, control, mitigate and otherwise deal in a prudent manner with the risks they undertake by having such exposures; and
- how regulated banks should limit such exposures, both on an aggregated basis and on the basis of individual shadow banking entities.

We will briefly consider each of these areas in turn.

What is a Shadow Banking Entity?

The approach proposed by the EBA in its consultation paper is to define a shadow banking entity as an entity that undertakes "credit intermediation activities" and that is not "an excluded entity". Credit intermediation activities are the kinds of activities that banks typically undertake. From a practical standpoint, debt funds undertake some of the activities that banks undertake – they make loans to their clients. The conclusion may be less easily reached with respect to other shadow banking entities engaging in more sophisticated activities. Entities that undertake credit intermediation activities but that are subject to a system of prudential regulation are considered to be excluded entities for the purpose of the Guidelines.

Identifying Exposures to Shadow Banking Entities

This seems a logical step in the process. However, without definitional certainty with respect to the terms "shadow banking entities" and "credit intermediation", it will be difficult from a practical perspective to identify the exposures. We examine these matters in more detail in subsequent updates.

Creating a Risk Identification and Management Framework

This is the most burdensome part of the EBA's proposal. It shifts the responsibility of implementing a framework to manage the risk of exposure to shadow banking onto the regulated banks. To quote from the EBA consultation paper:

"…This framework should include clearly defined analyses to be performed by risk officers regarding the business of a shadow banking entity to which an exposure arises, the potential risks to the institution, and the likelihood of contagion stemming from these risks to the entity. Those analyses should be performed under the supervision of the credit risk committee…"

The process of risk identification and management is potentially intensive. Creating the framework is likely to be a rigorous process for a regulated bank, particularly because the EBA proposes that the results of the analysis have to be presented to the management body of the institution. That management body will, among other things, have to review and approve the regulated bank's appetite for taking risk on shadow banking entities. Further, a regulated bank with exposure to shadow banking entities will be required to have an action plan ready for implementation if and when exposure limits are breached.

Exposure Limits

The EBA contemplates that regulated banks established in the European Union will need to set exposure limits to shadow banking entities. There are two dimensions to those exposure limits. The first is the requirement to set aggregate limits and the second is to set limits to individual shadow banking entities. The requirement to set aggregate exposure limits involves a regulated bank looking at, among other things, its own capital position, and its overall risk appetite for exposures as well as its current exposure to shadow banking entities. The requirement to set individual exposure limits involves more of a focus on the status, financial situation and activities of the individual shadow banking entity in question. The EBA's consultation paper also proposes a fallback approach to setting exposure limits. If these limits cannot be set because of a lack of information or want of process, the limit should be 25% of the eligible capital of the financial institution.

Some Initial Considerations for Debt Funds

It should be borne in mind that the EBA's consultation paper is only that. Nonetheless it may be interesting to consider the position of a debt fund that is seeking to leverage its investments by entering into a repurchase agreement with a regulated bank (a repo), a relatively common form of debt fund leverage. It can be taken as a given that the debt fund is a shadow banking entity. It can also be taken as a given that the exposure under the repo of the regulated bank is the notional maximum amount of loans that can be sold under its terms. However, creating a risk identification and management framework is, we suggest, considerably harder because it will involve assessing both the risk of the shadow banking entity (which is a function of its financial strength, management and investment strategy) and the risk of the loans that are the subject of the repo. These could be homogenous consumer loans or heterogeneous commercial real estate loans. The construction of a rigorous framework will require the regulated bank to undertake significant due diligence on both the debt fund and the loans that it is proposing to finance through the repo (both existing and arising in the future). It will also necessitate willingness by the debt fund to provide the information for such due diligence. The risk position will need to be monitored on an ongoing basis. There may be resistance on the part of the debt fund to provide the relevant information. The repo might also need to be structurally enhanced in order to enable the regulated bank to manage the loans if the debt fund defaults, through the engagement of a third-party servicer.

Conclusion

In subsequent updates on European shadow banking regulation, we propose to look in more detail at each of the elements proposed by the EBA, as well as at the feedback that the EBA received from interested parties. We will be doing so both from the perspective of shadow banking entities and from that of the regulated banks with the exposures. We will also examine in greater detail the policy rationale behind the Guidelines and the process that the EBA is engaging in.

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.