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European Banking Authority Shadow Banking Guidelines – Part 2: What is a Shadow Banking Entity?

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In the second of our series of updates on the guidelines proposed by the European Banking Authority (EBA) to minimise the risks that can transmit from the shadow banking sector to the regulated banking system (the Guidelines), we examine the types of entities that fall within the scope of the EBA's definition of "shadow banking entity" for the purpose of the Guidelines. The EBA's mandate in this area is based on Article 395(2) of the Capital Requirements Regulation (Regulation (EU) No. 575/2013) (CRR). As we describe in further detail below, at this stage a great many entities are potentially shadow banks under the EBA's Guidelines.

The Definition Used by the EBA

The CRR does not provide a definition of a shadow bank. The EBA, for the purpose of the Guidelines, has accordingly defined a shadow banking entity as, in essence, one that:

- carries out "credit intermediation activities"; and
- is not subject to an alternative regime of prudential regulation under specified EU legislation.

We consider each of the above limbs in turn.

Credit Intermediation Activities

In defining what credit intermediation activities are, the EBA has adopted a similar approach to that recommended by the Financial Stability Board (FSB) in its 2011 report on shadow banking. The EBA defines credit intermediation as bank-like activities involving any of the following four features of credit intermediation identified by the FSB:

- **maturity transformation**: maturity transformation activities involve borrowing funds for short durations and lending or investing them for longer durations. This is what regulated banks typically do;
- **liquidity transformation**: liquidity transformation activities involve using liquid assets (cash) to invest in less liquid assets (loans, bonds or derivatives, for example). This is also what regulated banks typically do;
- **leverage**: this involves investing using borrowed funds (as opposed to equity). This is consistent with what regulated banks do and so this seems an appropriate characteristic to ascribe to an entity undertaking credit intermediation activities; and
- **transferring credit risk**: this involves laying-off credit risk to a third person for a fee. Again, this is something that banks often do and so is a logical characteristic to include.

The EBA's consultation paper does not provide detailed guidance on any of these activities. As indicated above, all of these activities are undertaken by regulated banks. However, many entities that are not typically considered as engaging in bank-like activities will be caught by the Guidelines. It is quite common for the treasury function of a large company to use liquid but unproductive cash in order to invest in less liquid but more productive bonds for short durations of time, in order to earn some return. This is clearly liquidity transformation. Similarly, a private equity fund investing in physical real estate assets would often, if not invariably, use leverage. Neither a corporate

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treasury department nor a real estate private equity firm would necessarily regard itself, on an intuitive basis, as engaging in bank-like activities; nor, arguably, should they be so regarded.

In addition to the approach described above, and almost to ensure that the net is being cast widely, the EBA has cross-referred to Annex 1 of the Capital Requirements Directive and indicated that entities undertaking certain specified activities listed therein shall be automatically regarded as engaging in credit intermediation activities. The specified activities are:

- taking deposits and other repayable funds;
- lending;
- financial leasing;
- issuing guarantees and commitments;
- trading in specified financial instruments (either on an own-account basis or on account of clients);
- participating in or providing services in respect of securities issues;
- money broking; and
- portfolio management and advice.

It is, to some degree at least, intuitive to regard a non-bank entity that engages in lending as an entity undertaking a bank-like activity and thus a shadow banking entity – as we indicated in Part 1 of this series, debt funds that undertake lending activities are the most ubiquitous form of shadow bank. It is perhaps less intuitive to regard a portfolio manager or advisor (who manages investments or advises on the management of investments) as falling into the same category.

It seems fair to conclude, therefore, that the EBA's definition of credit intermediation captures within its scope a number of entities that would not regard themselves as shadow banks in the ordinary sense of the term. Corporate treasury departments, private equity funds that invest in equity (as opposed to debt) and portfolio advisors are not typically considered to be shadow banks but may well be characterised as such under the Guidelines.

Prudential Regulation

Where entities are carrying out credit intermediation activities, they will be carved out from the scope of the definition of shadow banking entity (under the second limb), and therefore from the scope of the Guidelines, if they are subject to an appropriate and sufficiently robust prudential framework. Credit institutions, investment firms, insurers and entities established in third countries that are subject to prudential requirements considered to be equivalent to those applied in the EU are accordingly out of scope.

The Status of Investment Funds

In its consultation paper, the EBA has stated that:

"…As regards funds, these tend to engage in maturity and liquidity transformation and are generally regarded as outside the traditional banking sector. Therefore, prima facie, they should be in scope of the definition of shadow banking entity.…"

It is suggested that investment funds that provide debt or invest in debt products almost certainly engage in liquidity transformation. The reasoning for this is that they use cash drawn from investors to invest in less liquid debt. They potentially engage in maturity transformation by investing in debt products that have longer maturity than the maturity of the funding they deploy. Investment funds that provide debt or invest in debt products, however, are merely one type of investment fund. Investment funds that invest in equities or in physical assets such as real estate or infrastructure do not fall into the same category. Treating them in the same way is, it is suggested, not optimal.

The Responses Received by the EBA

The EBA has received numerous responses from interested parties. There are two easily discernible criticisms held by those in the investment fund industry. The first is with respect to the breadth of the definition of shadow banking entity that the EBA is proposing. It is argued that this will catch investment funds that, on the face of it, do not appear to be engaging in bank-like activities. As indicated above, we suggest that this argument has some merit. The second relates to the regulatory environment in which investment funds already operate. The EBA has excluded UCITs funds from the potential regulatory regime, but has not excluded alternative investment funds whose managers are subject to the AIFMD regime.

Conclusion

It seems to us that the approach adopted by the EBA is rational from the point of view of a regulator with responsibility for formulating regulatory principles. The responses by the participants to the consultation have equal merit. The answer may lie in the incorporation of materiality thresholds. If the predominant business of a particular entity is credit intermediation, then there is a basis for regarding that entity as a shadow bank. If the credit intermediation activity that it carries out is merely incidental to its predominant business, then there is less merit in characterising that entity as a shadow bank.

It will be interesting to see how responsive the EBA will be to the representations that have been made to it.

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.

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