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European Banking Authority Shadow Banking Guidelines – Part 4: The Impact of the Guidelines

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In the fourth and last of our updates in the current series on the European Banking Authority's (EBA) draft Guidelines on limits on exposures of EU regulated banks to shadow banking (the Guidelines), we examine how the proposed requirements might impact the behavior of both shadow banks and regulated banks. This update develops the themes outlined in our earlier updates.

To recap, shadow banks undertake the same types of activities (described as credit intermediation activities) as regulated banks, but do so outside a system of prudential regulation. Certain credit intermediation activities are inherently risky and if shadow banks carry out these activities, then exposures to them will be inherently risky from both a macro-prudential and micro-prudential perspective. Exposures to shadow banks also potentially provide the opportunity for regulated banks to undertake regulatory arbitrage, using shadow banks as intermediaries when it comes to taking risks that the former are unable to take in an efficient manner. These concerns have provided the motivation, from a policy standpoint, to control the exposure of the regulated banking sector to the shadow banking sector. As we describe below, the Guidelines propose that this should be achieved by regulated financial institutions setting limits to their individual exposures to shadow banks and to the shadow banking sector as a whole.

What is an Exposure?

In the definitions section of the Guidelines, the phrase *"Exposures to shadow banking entities"* is defined as *"exposures to shadow banking entities pursuant to Part Four of the CRR with an exposure value equal to or in excess of 0.25% of an institution eligible capital"*. Exposures, in and for the purposes of Part Four of Regulation (EU) No. 575 2013 (CRR), which deals with large exposures, means any asset or off-balance sheet item referred to in Part Three, Title II, Chapter Two of the CRR. While this lists a series of different types of exposure and the associated risk weights for capital adequacy purposes, it does not provide a definition. However, from a practical standpoint, an exposure would include any situation where a regulated bank is or may be owed money by a shadow bank or may owe money to a shadow bank. An example of the former is where a regulated bank lends money to a shadow bank and expects to receive payments of interest and repayments of principal. An example of the latter is where a regulated bank sells credit protection to a shadow bank through a credit default swap or similar arrangement and may be required to make credit protection payments.

It is noteworthy that "small" exposures are excluded from what will amount to an exposure for the purposes of the Guidelines, though of course a large number of small exposures could result in there being a material exposure overall.

Collecting Information

Firstly, under the Guidelines, regulated banks will be required to collect detailed information about the exposures that they have to shadow banks and to identify:

- their individual exposures to shadow banking entities;
- all potential risks arising from such exposures; and

- the potential impact of those risks.

These requirements present a potentially significant burden to regulated banks. As drafted, once an entity has been categorised by a regulated bank as a shadow bank (a matter that requires definitional certainty), each exposure to that shadow bank that exceeds the 0.25% capital threshold referred to above would have to be identified and comprehensively analysed from a risk perspective. In some cases, this should be relatively straightforward, for example, where a regulated bank has provided a loan directly to a shadow bank or has provided credit protection to a shadow bank. In other cases, the process might be more difficult, for example, where the asset management division of a regulated bank has invested in the equity of an investment fund that then may invest in private equity funds, some of which may have debt strategies, resulting in them being regarded as shadow banks. Therefore for EU regulated banks, the collection and processing of information about their dealings with shadow banks will be yet another regulatory burden. On the other hand, while preparing and sharing the relevant information with regulated banks is equally burdensome for shadow banks, this, along with adopting a diversified approach to accessing the facilities that they require from regulated banks, may also be in their interests.

Controlling Risks

Secondly, having identified and analysed its individual exposures to shadow banks, the regulated bank will be required to adopt a framework to manage, control and mitigate the risks that it has identified. This requires, as a preliminary matter, that the risks are appropriately understood by a regulated bank. In addition to focusing on the individual risks arising from its exposure to individual shadow banking entities, a regulated bank will also be expected to focus on the “interconnectedness” between different shadow banking entities, and between itself and the shadow banking entities. The EBA recognises the practical difficulty with doing this, and so the Guidelines require a regulated bank to set out “appropriate mitigation techniques” in order to address the situation where interconnectedness cannot be analysed with certainty. While it is clearly possible to envisage situations of interconnectedness when dealing with shadow banks, it is more difficult, it is suggested, to identify concrete information or prepare concrete analyses in relation to the impact of such interconnectedness. Assume, for example, that a regulated bank has provided a facility to a shadow bank that uses this facility to refinance loans that it has made to three other shadow banks who all lend to SMEs in the UK. On the face of it, the regulated bank has exposure to three shadow banks (the clients of its client) as well as its own client. All of these entities could be adversely affected by factors that impact upon the SME sector, such as the increases in the minimum wage. Determining interconnectedness in this situation seems straightforward; however, analysing the quantitative effects of interconnectedness will not be so easy. From a practical perspective, the development by regulated banks of appropriate mitigation techniques that involve limiting the ultimate sectorial exposure may be advisable.

Management Oversight

Thirdly, the Guidelines propose that once the exposures and associated risks have been identified, the steps proposed to manage, control and mitigate those risks should be regularly subject to scrutiny by the management body of regulated banks. This is an important governance matter because it requires senior management of a regulated bank to both inform itself of, and assess its exposure to, shadow banks.

Setting Limits

The Guidelines’ fourth requirement, perhaps the most significant, requires regulated banks to set their exposure limits. The exposure limits, as we have indicated in our earlier updates, operate at two levels. Firstly, regulated banks are required to set aggregate limits to the shadow banking sector as a whole, relative to their eligible capital. Secondly, the regulated banks are required to set limits to individual exposures to shadow banks.

The setting of aggregate limits is by reference to the characteristics of the regulated bank, where individual regulated banks are required to take into account:

- its business model, risk management framework and risk appetite;

- the size of its exposure to shadow banking entities relative to regulated financial services sector entities; and
- factors relating to interconnectedness.

The setting of individual limits, on the other hand, is largely by reference to the characteristics of the shadow banks that the regulated bank has exposure to, including:

- the regulatory status of the shadow banking entity, in particular whether it is subject to any form of prudential regulation (it should be borne in mind that an entity will not be regarded as a shadow bank at all if it is subject to a suitably robust system of prudential regulation);
- the financial situation of the shadow banking entity;
- the shadow bank's portfolio (in particular non-performing assets);
- the credit process used by the shadow bank (although the Guidelines recognise that there may be a limited amount of information available to a regulated bank on this);
- whether the shadow bank will be vulnerable to asset price or credit quality volatility;
- whether the volume of credit intermediation activities represent a significant amount relative to other activities of the shadow bank (although as discussed in Part 2 of our series of updates on the Guidelines, it is arguable that if the credit intermediation activity carried out by an entity is merely incidental to its predominant business, it should not be classified as a shadow bank);
- interconnectedness; and
- any other factors that the regulated bank regards as relevant.

While the Guidelines outline that individual exposure limits will be set on an analytical basis, if this is not possible, an aggregate exposure limit of 25% of a regulated bank's eligible capital will be used (the "fallback approach"). This provides a regulated bank with a practical, albeit blunt, means of achieving compliance with the Guidelines. It does not, of course, do away with the need for definitional certainty with respect to the terms "shadow bank" and "exposure", nor with the need for regulated banks to undertake an assessment of the risks stemming from such exposures.

Conclusion

Shadow banks are a feature of the post-financial crisis world, and they come in many different forms – from the lending platforms of the world's largest private equity and hedge fund managers, to P2P lenders, and to entities engaged in various forms of consumer lending using crowd-funding techniques. Given that these entities will be clients of, and work with, regulated banks (not just competitors), the formulation of the Guidelines to regulate the interaction between the shadow banking sector and the regulated banking sector is highly important for the ongoing development of the capital markets.

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.