

## Feature

### KEY POINTS

- Adoption of the International Monetary Fund's wider definition of "shadow banking" as compared to the European Banking Authority (EBA)'s narrower definition of a "shadow banking entity" would lead to better regulation of systemic risk.
- Traditional banks will face high costs and be subjected to further regulatory burden if the EBA sets limits on exposures to the shadow banking sector.
- The better method may be to place the regulatory burden on the market as a whole.

Authors Shehram Khattak, Jonathan Lawrence and Dr Ronnie Yearwood

# The European Banking Authority Shadow Banking Guidelines: unintended consequences

This article considers the recent European Banking Authority (EBA) Shadow Banking Guidelines (Guidelines), seeks a definition of shadow banking and discusses some of the potential consequences of the Guidelines for traditional banks and the shadow banking sector. It also reviews some of the other tools that may be employed to provide regulatory oversight to shadow banks and to provide consumers with proper risk information.

## INTRODUCTION

Shadow banking often complements traditional banking by engaging in credit intermediation activities, thereby deepening market liquidity and broadening access to funding. This can enhance efficiency and not only contributes to the growth of the financial sector but to overall growth in the "real" economy, for example by providing increased funding resources to small and medium-sized enterprises (SMEs) and individuals.

However, the shadow banking sector often comes under criticism due to the perceived risks associated with its activities including interconnectedness with and "contamination" of traditional banking and lack of regulation. The nature of shadow banking transactions tends to separate obligations from their risk of non-performance and trade on that risk, thereby creating complex intermediation chains. These increase the opacity of transactions and mean that assessing the quality of assets and monitoring risks becomes increasingly difficult. It also may eliminate incentives to ensure quality valuations and underwriting. During good economic conditions, when market confidence is high, such issues are not perceived as problematic. However, difficult economic circumstances have demonstrated that when the market loses

confidence, investors in the shadow bank sector withdraw and withhold funds. In such circumstances, shadow banks may be forced to offload assets quickly through "fire sales", which can trigger because of the interconnectedness, "runs" on traditional banks. Traditional banks can become contaminated by volatility in shadow banking through guarantees, swaps or other regulatory arbitrage techniques which expose them to shadow banking. That shadow banks do not have access to liquidity facilities from central banks and cannot provide deposit guarantees means investors (including traditional banks) may panic without any perceived protective mechanism to alleviate market concern.

The EBA published its Guidelines under its mandate 'to set appropriate aggregate limits to such exposures or tighter individual limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework'.<sup>1</sup> In setting exposure limits, the EBA seeks to maximise the ability of an institution to bear the burden of an economic downturn and to minimise the contagion effect.

The EBA's aim to minimise risk posed to institutions through their exposures to shadow banking entities is laudable. However, the EBA's mandate limits the regulatory tools at its disposal and

arguably drove the EBA to articulate the Guidelines in their current form. Ironically, the EBA in being restricted to setting exposure limits may not have been able to properly address the European Union's concern as set out in the second limb of its mandate '[the] EBA shall consider whether the introduction of additional limits would have a material detrimental impact on the risk profile of institutions established in the Union, on the provision of credit to the real economy or on the stability and orderly functioning of financial markets'.

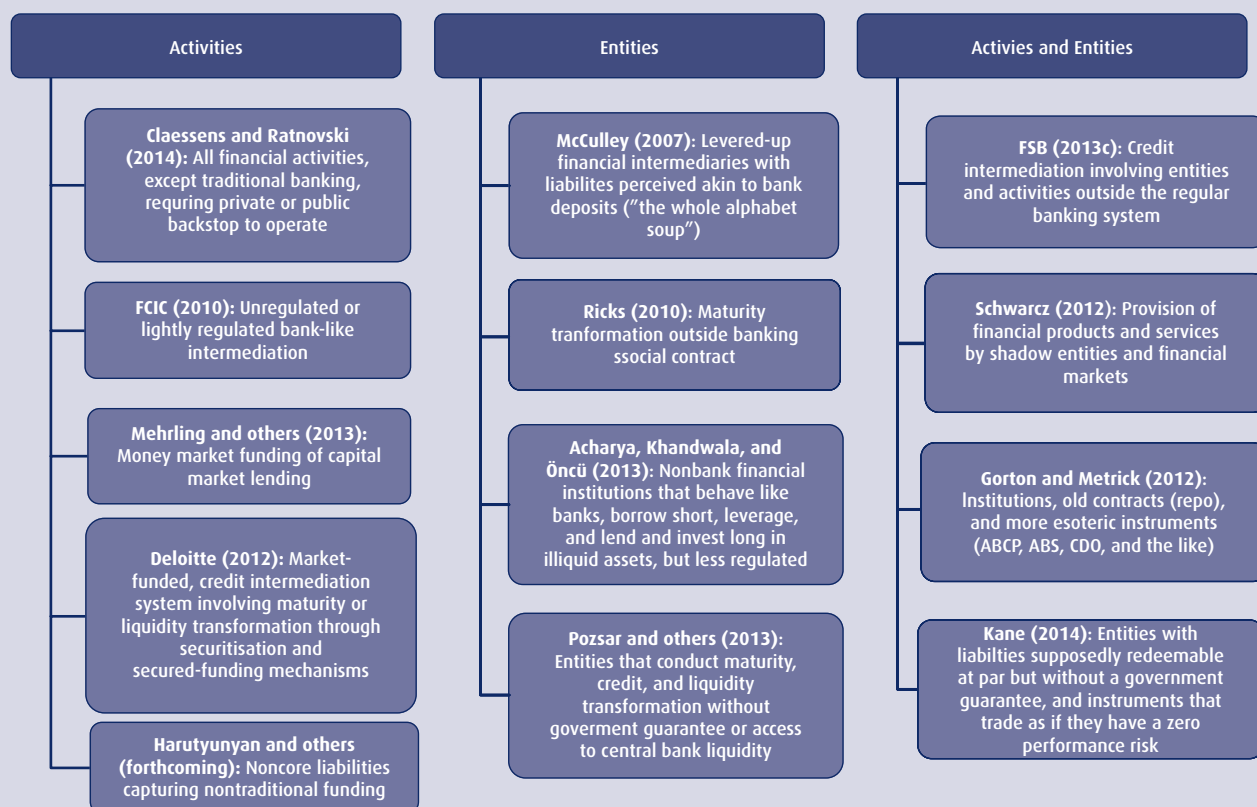
This article is divided into three parts. Part 1 considers the parameters of shadow banking and the limitations of the EBA definition. Part 2 discusses the Guidelines and some potential consequences of focusing on exposure limits, arguably leaving consumer and systemic risk largely untouched. Part 3 highlights other regulatory tools that may be employed to provide market oversight and enhanced consumer safety.

## PART 1: DEFINING SHADOW BANKING

"Shadow banking" is a term that is highly resistant to definition. The term is related to a broad spectrum of activities and entities that are usually posited as falling outside traditional "banking". However, the two sectors overlap in many areas. Such a myriad of considerations are well illustrated in Table 1 opposite.

In its Guidelines, the EBA defined a shadow banking entity as an entity that carries out 'credit intermediation activities'. Credit intermediation activities are defined as 'bank-like activities involving maturity transformation, liquidity transformation,

TABLE 1: DIFFERENT DEFINITIONS OF SHADOW BANKING<sup>2</sup>



leverage, credit risk transfer or similar activities, and are neither within the scope of prudential consolidation nor subject to solo prudential requirements under specified EU regulation.

The Guidelines do not provide much detailed guidance and so it is difficult to be precise about what the EBA intends with its definition. However, market commentators have already noted that such a definition may capture, for example, the treasury department of a corporate engaging in liquidity transformation by investing cash in bonds. Real estate funds may also be caught by the definition in relation to which it has been noted that ‘a cornerstone of shadow banking regulation should be that it can only apply to entities that carry on bank-like activities. Real estate funds investing in buildings do nothing of the sort.’<sup>3</sup>

Commentators from the International Monetary Fund (IMF), speaking in their personal capacities, criticised previous

attempts at defining shadow banking in the ‘IMF Working Paper: Shedding Light on Shadow Banking’ stating that the definitions ‘miss significant non-traditional banking activities carried out by banks themselves, thus leading to an incomplete picture of the [shadow banking system] and of the potential vulnerabilities associated with it.’<sup>4</sup>

Accordingly, the observers focused on the sources of funding and whether or not they are “non-core liabilities”. Core liabilities include ‘bank deposits mainly from nonfinancial corporations and household’, whereas non-core liabilities include ‘all the remaining funding sources, particularly market funding.’<sup>5</sup> Non-core liabilities are based on ‘the types of financial institutions that are issuers of non-core liabilities’, the holders of non-core liabilities (counterparties), and the ‘financial instruments that are the components of non-core liabilities.’<sup>6</sup> Core liabilities are issued only by banks and non-core liabilities can be issued

by banks, money market funds and other financial intermediaries.

The advantage of such a definition is that it captures the entire shadow banking market, leaving little room to take advantage of unforeseen loopholes or for arbitrage. It would seem that the broader definition from the IMF critics can provide a basis for better regulation of systemic risk.

## PART 2: THE GUIDELINES AND POTENTIAL CONSEQUENCES

The Guidelines require banks to:

- General principle: develop a risk framework, forcing banking institutions to look more closely at their relationships and commitments in order to develop an ‘internal framework for identification, management, control and mitigation of risk’ and ‘implement a robust process for determining interconnectedness between shadow banking entities and between

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shadow banking entities and the institution.

- **Exposure limits:** set aggregate and individual exposure limits to the shadow banking sector. According to the Guidelines, institutions should limit their exposure to individual shadow banking entities with an 'exposure value, after credit risk mitigation and exemptions, equal to or in excess of 0.25% of the institution's eligible capital'. If an institution is unable to apply the aggregate and individual limits, their aggregate exposures to shadow banking entities should be subject to limits on large exposures, which the EBA termed the "fallback approach".

### This may have the effect of forcing shadow banks further into the "shadows" and mean that traditional banks reduce their contact with shadow banks ...

#### The cost and regulatory burden is high and the Guidelines may be ineffective

Developing and implementing a risk framework and setting exposure limits will necessarily incur costs associated with new processes in relation to risk management, due diligence, disclosure, training and end-to-end monitoring (for example, monitoring compliance at the point of investment and then ongoing investment and counterparty monitoring).<sup>7</sup> Further, management liability is increased with the requirements to inform itself of and assess the frameworks, limits and processes being implemented.

The shadow banking sector contains sophisticated and specialist participants with high risk appetites. It is likely that much of the regulatory burden will either be shifted contractually or will be circumvented by novel techniques. In seeking to shift the regulatory burden, market participants will look to synergies with other applicable regulations where compliance procedures have already been implemented (for example, in relation to MiFID, Basel III, or in relation to other risks such as data protection or anti money laundering). There may also be a migration of business to other parts of the

market creating further "shadowy" pockets and having a negative impact on the regulated sector through decreased competition.

In a sector as amorphous as shadow banking, costs can quickly spiral due to the complexity and opacity of the market and its participants. Accordingly, in order to give any effect to the Guidelines, a working definition of a shadow bank and the activities that fall within its scope, as discussed in Part 1, will be required. Unfortunately, as noted above, the EBA definition may fall short of providing an exact and robust definition, which makes putting the general principles into action somewhat difficult. Given that even simply determining that there is an exposure may not be straightforward, it is possible to appreciate

how difficult analysing the quantitative effects of an exposure may become. Consider, for example, the analysis that will need to be conducted at various points along the intermediation chain in a synthetic securitisation.

#### Interconnectedness

"Interconnectedness" is a major concern behind the development of the Guidelines – between different shadow banking entities, and between traditional institutions and the shadow banking sector. The Guidelines contemplate scenarios where it may not be possible to analyse interconnectedness with certainty and require a regulated bank to set out "appropriate mitigation techniques" in order to address such situations. For example, consider the complexity of the intermediation chain where a regulated bank provides a loan to a shadow bank which then uses the funds to invest into a synthetic securitisation, based on a primary collateralised loan obligation where the underlying loan assets originate from SMEs. In such an instance, determining that there is interconnectedness is straightforward; however, quantifying the level of exposure can quickly become complicated. It is difficult to craft "appropriate mitigation techniques"

if quantifying exposure is challenging. It is therefore advisable to consider the overall exposure to entire shadow banking market as opposed to a particular entity.

### PART 3: CONSIDERING OTHER TOOLS

#### Regulatory transference to the market

The compliance and cost burden of the Guidelines primarily falls on regulated entities. It is likely that traditional institutions will demand information and assistance with their compliance requirements if shadow banks want to access the facilities that they require from regulated banks. This may have the effect of forcing shadow banks further into the "shadows" and mean that traditional banks reduce their contact with shadow banks or spin-off their more risky arms.

Therefore, the interaction that could force shadow banks to raise regulatory standards from their end could be reduced while at the same time increasing the regulatory burden on conventional banks. The overall effect may be a reduction in the interaction between banks and shadow banks and a lack of transference of regulatory insights and culture from the traditional to the shadow sectors.

Instead, the better method may be to place the regulatory burden on the market. Participants could not then contractually offload obligations and this may encourage the market to raise compliance standards as a whole, ultimately stabilising the risk profiles of financial institutions.

#### Clear disclosure with a market focus

Markets may be more efficient where *caveat emptor* prevails. It would be interesting to see how the market would react should regulators focus on systemic and holistic regulation instead of the application of a patchwork of rules such as bail-in regulations, capital adequacy and quality, leverage ratios and risk weighting. Increasingly complex regulations obfuscate the rights available to market participants; increasingly complex products are developed to navigate regulatory exposure. This may

**Biog box**

Shehram Khattak and Dr Ronnie Yearwood are associates and Jonathan Lawrence is a partner in the Finance Practice Area of K&L Gates in London. Email: [shehram.khattak@klgates.com](mailto:shehram.khattak@klgates.com), [ronnie.yearwood@klgates.com](mailto:ronnie.yearwood@klgates.com) and [jonathan.lawrence@klgates.com](mailto:jonathan.lawrence@klgates.com)

even trigger a migration to the less regulated sectors. The unfortunate effect is increased risk and lack of clarity, compounding any fragility within the market.

Regulations still encourage regulatory arbitrage and complex intermediation chains as market participants seek to develop transactions that attract the least amount of regulatory oversight. Guarantees are an example of such techniques. Most guarantees have historically been permitted to remain off balance sheet (for example, under Basel rules) which has meant exposures remain concealed. It may not be long before other techniques are developed through insurance companies, asset managers, and even hedge and private equity funds for instance.

One possible way to address these matters is to shift from identifying and regulating particular entities that issue the liabilities and instead focus on funding sources and designating entire intermediation markets for oversight. Such a focus may limit the leverage available through collateralised lending generally, no matter which entity is involved.<sup>8</sup> It would also enable regulators to evaluate trends and market bubbles, thereby

mitigating some risks by market-wide communication.

**CONCLUSION**

Most legal practitioners tend not to worry about philosophy or theory. Generally their aim is to fix things using the rules at their disposal. However, there is something instructive in G.W.F. Hegel's statement that the 'owl of Minerva [wisdom or knowledge] takes its flight only when the shades of night are gathering'. We tend to understand facts after the event and so new guidelines can, paradoxically, suffer from the "benefit" of hindsight. It seems as though the EBA has constructed a set of Guidelines designed to prevent a crisis that has already occurred. Therefore, although the Guidelines attempt to tackle the issues posed, they need to be viewed as the starting point, not the destination. ■

**1** Article 395 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

**2** IMF Global Financial Stability Report, "Risk Taking, Liquidity, and Shadow Banking: Curbing Excess while Promoting Growth", October 2014, 91.

**3** See for example various commentators in the British Property Federation press release: 'European real estate urges EBA to reconsider shadow banking rules', 26 June 2015 (<http://www.bpf.org.uk/media/press-releases/european-real-estate-urges-eba-reconsider-shadow-banking-rules>).

**4** Artak Harutyunyan, Alexander Massara, Giovanni Ugazio, Goran Amidzic, and Richard Walton, 'IMF Working Paper: Shedding Light on Shadow Banking', WP/15/1, January 2015 (hereinafter, 'IMF Working Paper: Shedding Light on Shadow Banking') 4.

**5** *Ibid.*, 5.

**6** *Ibid.*, 7.

**7** See the Guidelines, 38 for the views of the Banking Stakeholder Group.

**8** See for example, Marcus Stanley, 'The Paradox of Shadow Banking', 14, published by the Roosevelt Institute on 12 November 2013.