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European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA
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Re: EBA/CP/2015/06

Draft EBA Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 para.2 Regulation (EU) No.575/2013

CFA Institute responded to the European Banking Authority (EBA) consultation paper on Guidelines on limits on exposures to shadow banking entities on 19th June 2015 via the EBA online consultation response form.

The responses provided are presented below.

Q1. Do you agree with the approach the EBA has proposed for the purposes of defining shadow banking entities? In particular:

- *Do you consider that this approach is workable in practice? If not, please explain why and present possible alternatives.*
- *Do you agree with the proposed approach to the exclusion of certain undertakings, including the approach to the treatment of funds? In particular, do you see any risks stemming from the exclusion of non-MMF UCITS given the size of the industry? If you do not agree with the proposed approach, please explain why not and present the rationale for the alternative approach(es) (e.g. on the basis of specific prudential requirements, redemption limits, maximum liquidity mismatch and leverage etc).*

For the purposes of defining shadow banking entities, the EBA proposes to exclude entities that are subject to an appropriate prudential framework from the scope of the definition, such as insurers, credit institutions and investment firms. With regard to investment funds, all non-MMF UCITS would also be excluded. Consequently, the scope of the definition of shadow banking entities in the context of investment funds would comprise all money market funds (whether authorised as UCITS or alternative investment funds), all alternative investment funds and all unregulated funds.

CFA Institute broadly agrees with the scope of the definition. With regard to money market funds, these entities perform bank-like credit intermediation to the extent that they transform the maturity and liquidity of their liabilities (shareholders' funds) via the assets invested in. By investing in short-duration, held-to-maturity debt, such as government securities and commercial paper (i.e., loans to issuers), MMFs create a maturity mismatch between the money "borrowed" (shareholders' funds) and the money "lent" or invested.

Moreover, MMFs are a source of interconnection between the banking and nonbank financial sectors because these entities are large holders of bank-issued commercial paper. For example, according to

the European Commission's impact assessment accompanying the proposal for a regulation on money market funds in 2013, MMFs allocated approximately 85% of their assets to securities issued by banks, which accounted for approximately 38% of the short-term debt issued by banks.

For these reasons, we agree it is appropriate to include all MMFs within the scope of the definition of shadow banking entities.

However, with regard to the establishment of specific limits to MMFs, it should be recognised that MMFs are a key funding source for banks and other corporates and thus they ultimately support the provision of credit to the real economy – a point recognised within the Capital Requirements Regulation (Art. 395(2) Regulation (EU) No.575/2013) as a relevant factor when considering whether to establish additional exposure limits. Secondly, and moreover, it should also be recognised that MMFs will be subject to a separate EU regulatory framework. The draft EU regulation on MMFs addresses maturity transformation via portfolio maturity limits and liquid assets requirements, for example. Additionally, the draft MMF regulation addresses the risk of runs (noted in the consultation paper among the concerns regarding shadow banks) via limited redemption facilities and proposals to limit the type of funds that can maintain CNAV pricing (in effect, most funds will have to adopt variable net asset value (VNAV) pricing). Accordingly, the establishment of exposure limits should take account of product-specific regulation and the extent to which shadow banking risks are already addressed at the fund level.

CFA Institute also considers that it is appropriate to exclude non-MMF UCITS from the scope of the definition of shadow banking entities. The UCITS directive provides for the mitigation of risks applicable to shadow banking via, for example, restrictions on leverage, liquidity risk management policies, and detailed rules on portfolio composition and asset concentration limits. Moreover, non-MMF UCITS funds do not provide for the possibility of CNAV pricing and their shares are exposed to a greater degree of market price risk than MMF shares (given the differences in portfolio composition between MMFs and non-MMFs). As such, the liabilities of non-MMF UCITS do not share the same bank-like deposit-based funding characteristics of MMFs. Further, non-MMF UCITS typically do not allocate investments to bank commercial paper to the same extent as MMFs (i.e. they are less of a short-term funding source for banks), which further justifies their exclusion from the scope of the definition of shadow banking entities.

With regard to the inclusion of all alternative investment funds (AIFs) and unregulated funds, one drawback is the possible inclusion of non-leveraged equity AIFs within the scope of the definition of shadow banking entities. Equity investment funds that do not employ leverage (such as via derivatives or securities financing) essentially do not intermediate credit; equity investments do not have a maturity as such, and may be highly liquid. Consequently, it may be possible for certain investment funds to be captured within the definition that in essence do not entail maturity transformation, liquidity transformation, credit risk transfer, or leverage. For practical purposes, it may be acceptable to include all AIFs and unregulated funds within the definition, but to allow firms to assign a relatively high threshold for exposure to non-leveraged equity funds, or to exclude such funds from the aggregate exposure limit.

Q2. Do you agree with the approach the EBA has proposed for the purposes of establishing effective processes and control mechanisms? If not, please explain why and present possible alternatives.

The proposed list of principles for establishing effective processes and control mechanisms appears reasonable and CFA Institute has no further comments.

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Q3. Do you agree with the approach the EBA has proposed for the purposes of establishing appropriate oversight arrangements? If not, please explain why and present possible alternatives.

The proposed list of principles for establishing appropriate oversight arrangements appears reasonable and CFA Institute has no further comments.

Q4. Do you agree with the approaches the EBA has proposed for the purposes of establishing aggregate and individual limits? If not, please explain why and present possible alternatives.

In determining the aggregate exposure limit, the EBA proposes that each firm takes account of (a) its business model and risk management framework, (b) the size of its current exposures to shadow banking entities relative to its total exposures and relative to its total exposure to regulated financial sector entities, and (c) interconnectedness.

We broadly agree with this approach. With regard to point (b), however, reference to “the total exposure to regulated financial sector entities” is somewhat misleading as it implies that these regulated financial sector entities are distinct from shadow banking entities – the corollary being that shadow banking entities are unregulated. However, MMFs and AIFs (registered under the EU Alternative Investment Fund Managers Directive) are subject to product-level regulation, as noted elsewhere. Therefore, it may be more appropriate to refer to “the size of current exposures to shadow banking entities relative to its total exposures and relative to other entities within the scope of the CRR” in place of “regulated financial sector entities.”

Taking account of interconnectedness within the process for setting aggregate exposure limits (as well as for setting individual limits) is appropriate but may be difficult to quantify in practice depending on the availability of data. We acknowledge that this situation is accounted for under para. 1.e of the principles (“implement a robust process for determining interconnectedness between shadow banking entities, and between shadow banking entities and the institution. This process should in particular address situations where interconnectedness cannot be determined, and set out appropriate mitigation techniques to address potential risks stemming from this uncertainty.”) It may be helpful to provide more detailed guidance to firms regarding the measurement of interconnectedness and how to apply the guidance where interconnectedness cannot be reasonably quantified.

The criteria listed for the determination of individual exposure limits appear reasonable.We also broadly support the EBA’s proposed approach of requiring firms to use the principal approach (i.e. the application of the criteria listed in the guidance) to determine exposure limits, and to only use the fallback approach (applying an aggregate exposure limit of 25% of eligible capital to shadow banking entities) where it is not possible to apply the principal approach due to either insufficient information on shadow banking entities or a lack of effective processes to use that information.

Q5. Do you agree with the fallback approach the EBA has proposed, including the cases in which it should apply? If not, please explain why and present possible alternatives. Do you think that Option 2 is preferable to Option 1 for the fallback approach? If so, why? In particular:

- Do you believe that Option 2 provides more incentives to gather information about exposures than Option 1?
- Do you believe that Option 2 can be more conservative than Option 1? If so, when?
- Do you see some practical issues in implementing one option rather than the other?

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CFA Institute believes that option 2 (applying the fallback approach only to those shadow banking exposures to which the principal approach cannot be applied) is preferable to option 1 (applying the fallback approach (aggregate 25% exposure limit) to all exposures when the institution cannot apply all of the criteria of the principal approach to all exposures).

We acknowledge the EBA's stated preference for option 1 on the basis that it is simpler to apply and is more conservative. However, in our view, option 2 makes better use of available information on shadow banking entities and activities and thus provides for the possibility of more appropriate and realistic exposure limits than option 1. We agree with the EBA that both options provide incentives to firms to gain sufficient information about shadow banking exposures under the principal approach (to avoid being subject to a potentially more conservative limit of 25% of eligible capital under the fallback approach); however, to a certain extent, this incentive may be stronger under option 2 by rewarding the collection and use of pertinent data with appropriate exposure limits.

Q6. Taking into account, in particular, the fact that the 25% limit is consistent with the current limit in the large exposures framework, do you agree it is an adequate limit for the fallback approach? If not, why? What would the impact of such a limit be in the case of Option 1? And in the case of Option 2?

CFA Institute agrees that the 25% limit is an adequate limit for the fallback approach having regard to the large exposures framework. We have no further comments.