Submission

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CREATING LASTING VALUE

19 June 2015

On behalf of the Public Affairs Executive (PAE) of the *EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY*

Response to the EBA consultation paper "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"

The general approach proposed by the EBA is to exclude from the scope of the definition of 'shadow banking entities' entities that are subject to an appropriate prudential framework either as a result of prudential consolidation or, where entities are not within the scope of consolidation, certain sector-specific prudential frameworks which are deemed to cover for the risks posed by the bank-like activities of the entity. With regard to funds nevertheless, non-MMFs UCITS established in the EU (and those established in third countries where equivalent supervisory requirements apply) would be excluded. Said differently, all funds would be considered as falling in the scope of the definition of shadow banking entities except if they are non-MMF UCITS (and third country firms subject to equivalent requirements). All MMFs (being UCITS or AIFs), all AIFs and all unregulated funds would fall in the scope.

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).*

I. Introduction

The EBA's consultation paper defines shadow banking entities as entities that:

a) are carrying out credit intermediation activities, defined as bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities; and

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b) are not within the scope of prudential consolidation nor subject to solo prudential requirements under specified EU legislation (or equivalent third country legal frameworks). Entities referred to in Article 2(5) and Article 9(2) of Directive 2013/36/EU (CRD) are also not to be regarded as shadow banking entities.

The consultation paper explains that as such the Guidelines focus on institutions' exposures to entities that pose the greatest risk both in terms of direct exposures those institutions face and on the risk of credit intermediation being carried out outside the regulated framework.

The EBA specifies further that as regards *funds*, these tend to engage in maturity and liquidity transformation and are generally regarded as outside of the traditional banking sector. Therefore, it is argued that, *prima facie*, they should be in the scope of the definition of a "shadow banking entity". As a consequence, in the EBA's opinion all Money Market Funds (MMFs), all Alternative Investment Funds (AIFs) and other unregulated funds should fall in the scope of the EBA's guidelines.

By contrast, the EBA states that some funds are regulated pursuant to prudential frameworks similar to those applied to credit institutions and investment firms (for example, referring to the UCITS Directive[1]). The UCITS Directive sets out requirements for asset managers and management of undertakings for collective investment in transferable securities. The EBA concludes that such UCITS funds do not pose the same level of risk as unregulated funds and should not therefore be regarded as shadow banking entities. The Guidelines should, the EBA suggests, focus on those entities that pose the greatest risk to [credit] institutions. However, our view is that the EBA's conclusion that <u>all</u> AIFs should be caught by the definition of shadow banking entities is inconsistent with this approach.

The approach on which the EBA is consulting in particular does not take into account the fact that the regulatory framework set out in the Alternative Investment Fund Managers Directive[2] (AIFMD) is equivalent to the UCITS framework and very similar to the prudential framework applied to credit institutions and investment firms.

The definition of an AIF set out in the AIFMD covers a very broad range of AIFs that have different structures, business models and risk profiles and is inappropriate for use in an undifferentiated way to identify 'shadow banks'. The AIF definition encompasses funds with very diverse structures and investment strategies, and captures everything from a highly leveraged hedge fund taking short positions in listed equities, through to funds investing in tangible real estate assets, or infrastructure, credit funds as well as private equity and venture capital funds providing equity for the long term to businesses, many of which are small and medium-sized enterprises (SMEs). Indeed as Article 4(1)(a) of the AIFMD makes clear, often the only characteristic that AIFs share is that they are <u>*not* UCITS funds.</u>

[1] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities.
[2] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

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Private equity funds[3], given their specific structure, business model and investment characteristics do not operate in the "shadow"; they are not outside the EU regulatory framework; and they do not carry out banking activities. As a consequence they should not be caught by the EBA's suggested definition of "shadow banking entities":

- PE funds invest in businesses and typically make long-term, equity backed investments;
- PE funds do not offer redemption rights for investors;
- PE funds typically do not use leverage at a fund level, i.e. they do not borrow at a fund level;
- PE funds follow an active ownership model, working directly with the management and employees to develop the company;
- PE fund managers are regulated under the AIFMD, in addition to other relevant rules applicable at national level; and
- PE fund managers predominantly invest in unlisted securities, i.e. their investments are not directly affected by market movements.

II. General presentation of private equity

The specific characteristics of the private equity industry must be taken into account fully when assessing which type of non-bank entities are involved in shadow banking and while developing the definition of "shadow banking entities".

Private equity is a long-term investment approach, which takes time to mature. Fund structures in private equity have been specifically designed to reflect this long-term characteristic. Investors participate by making a legally binding commitment to invest a specified amount of capital in the fund, entitling them to a proportional share of fund interests.

Funds are usually structured as closed-end vehicles with a minimum life-span of 10 years, to ensure that the underlying companies in which investments are made have the time and potential to grow and develop further. They are not designed to be traded like a liquid asset, or for investors to be able to redeem their investment during the life of the fund, indeed this is typically expressly excluded by the legal agreement, which governs the management of the fund. Although a secondary market can exist, the terms under which an investor can sell their position on the secondary market to another investor are limited and strictly governed by the terms of the fund's legal agreement. The EVCA risk measurement guidelines cover this topic in more detail (https://www.evca.eu/media/10083/EVCA-Risk-Measurement-Guidelines-January-2013.pdf).

The fund manager draws down from this capital pool of commitments to fund the equity investment (often a controlling investment) in a diverse range of portfolio companies over the course of the fund's investment period (typically 5-6 years of the fund's life). As the fund realizes its investment in each portfolio company the proceeds are promptly distributed to the investors.

[3] The term "private equity" is used in this response to refer to all segments of the industry, including venture capital. The term "venture capital" is used in specific contexts where there are issues that relate particularly to this segment.

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The fund manager seeks to increase the value of the portfolio companies through long-term active ownership. Active ownership in the context of a private equity fund's investment typically means being active members of the board of the company and working with the management team, outside the formal board meeting cycle, on a variety of operational aspects of the business as decided by the board. This includes contributing to the development and implementation of the business strategy, recruitment of key members of the management team and helping management build a sustainable business beyond the period in which the private equity fund is invested.

An investor's average net invested capital (or capital at risk) is measured by the paid-in amount minus distributed capital. As funds typically start making distributions to investors before having drawn down and invested the entire commitment, the capital at risk is invariably much lower, on average, than the investor's overall legal commitment to the fund. In addition, proceeds from realizations can be used to fund that part of the investor's commitment still to be drawn down.

Private equity funds typically do not employ leverage at the level of the fund[4] and are legally structured to prevent exposure for the fund itself. Borrowing is typically contractually restricted at the fund level. A private equity fund is, however, generally permitted to borrow on a short term basis for the very specific purpose of efficient cash flow management, i.e. to bridge the period from when an investment is made by the fund to when money is received from investors following the issue of a draw down notice, requiring investors to pay over a portion of their capital committed to the fund. Amounts borrowed at the fund level for these purposes are typically capped and secured for their duration against the undrawn (but legally binding) commitments of investors, and therefore do not increase the aggregate amount available for investments at fund level.

The private equity model also protects against systemic risk by ensuring that no portfolio company bears any risk as a result of the debt of other portfolio companies that have been backed by the same fund and/or manager. Moreover, private equity funds do not face the risks of "runs" because their investments are fully backed by equity commitments from their investors, which are predominantly institutional such as pension funds and insurance companies, and are structured as closed-end funds to which investors are committed throughout the life of the fund, with no discretionary right of redemption.

III. Level 1 mandate sets out clear conditions that should be taken into account when developing Guidelines on banks' exposures to shadow banking entities

Article 395(2) of the Capital Requirements Regulation (CRR) mandates the EBA to issue guidelines to set out limits on banks' exposures to shadow banking entities. Article 395(2) reads as follows:

[4] There are, though, some private equity funds that deploy a limited amount of leverage, even if in other respects they are virtually identical to their unleveraged equivalents. In some cases such funds may be regarded as "leveraged" simply because occasionally they will enter into certain transactions - necessary to facilitate their day-to-day business - that may technically be considered as leverage. However, this leverage is not substantial and in any event far less than most financial institutions, whether banks or hedge funds.

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"EBA shall, in accordance with Article 16 of Regulation (EU) No 1093/2010, taking into account the effect of the credit risk mitigation in accordance with Articles 399 to 403 as well as the outcomes of developments in the area of shadow banking and large exposures at the Union and international levels, issue guidelines by 31 December 2014 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.

In developing those guidelines, 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 mandate suggests that when developing its guidelines the EBA, among other things, should:

- focus on those shadow banking entities that carry out banking activities outside a regulatory framework;
- take into account the outcomes of developments in the area of shadow banking at the Union and international levels; and
- assess the potential negative impact of the proposed guidelines on the real economy or on financial stability.

A) Private equity funds do not carry out banking activities and they do not operate outside a regulatory framework

a) Private equity funds do not operate in the shadow, outside a regulatory framework.

Private equity managers and/or funds are not outside a regulatory framework. They will fall under a EU, Member State or third country regulatory regime.

Private equity is subject to stringent EU regulation set out in the AIFMD, which was adopted in 2011 and fully entered into force in July 2014. Its aim was to create a harmonised set of rules for fund marketing and the management of private equity, venture capital and other alternative investment funds in Europe, including a threshold below which managers of smaller funds - given their low importance from a systemic risk perspective - are exempted from most requirements. This Directive regulates the management and marketing of AIFs, and the funds themselves are also subject (via their managers) to a number of requirements (as explained in further detail in the table in Appendix). Moreover, AIFs and their respective structures are also subject to additional regulation and supervision at national level.

The AIFMD sets out various requirements similar to those found under the regulatory framework applicable to credit institutions and investment firms, regarding matters ranging from disclosure and transparency towards investors and national competent authorities, capital adequacy, liquidity requirements, and governance-related provisions. It also includes specific provisions which either do

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not exist in the banking regulatory framework or which go even further, notably regarding the monitoring of leverage, where this is relevant to the particular fund (and as noted above in Section II this will rarely be relevant to private equity funds). For example, Articles 22, 23 and 24 provide for disclosure rules to investors and competent authorities, including specific obligations on those funds employing leverage.

The private equity industry is appropriately supervised and operates in an EU-regulated environment, both in terms of formal regulation and in terms of the governance structure under which private equity funds operate. The private equity industry meets high standards of transparency as the AIFMD sets out disclosure and reporting obligations *vis-à-vis* investors and competent authorities.

The regulatory framework under which the private equity industry operates is of high quality and is fully comparable to the UCITS Directive – a regime that the EBA considers as an appropriate prudential framework and one that helps to justify such funds' exclusion from the list of shadow banking entities. Paragraph 13 of the EBA's consultation paper correctly notes that the UCITS Directive prescribes a robust set of requirements under which UCITS funds and their managers operate, including requirements on the asset manager (e.g. initial capital; own funds; internal controls) and the funds (e.g. limits to leverage and concentration). But it does not say anything about AIFMs and AIFs being subject to similar requirements under AIFMD, and instead states that all AIFs should fall in scope of the definition of "shadow banking entities".

It needs to be understood and accepted that both the UCITS and AIFM directives require funds and fund managers to meet similar prudential, reporting, transparency and governance requirements (see UCITS/AIFMD comparison table in the Appendix). Both UCITS and AIF managers must obtain prior authorisation, hold sufficient initial capital, ensure the sound and prudent management of the management company, as well as disclose information to investors and supervisory authorities. They also need to ensure that an appropriate risk management system is in place. Similar requirements are also imposed at a fund level (i.e. disclosure requirements and risk management process for all AIFs, as well as liquidity management system for leveraged and open-ended AIFs). This clearly demonstrates that AIFMD provides an appropriate and sufficiently robust EU-level prudential framework.

This is a view that is shared by ESMA, which has expressed publicly its view that the UCITS and AIFM directives have similar characteristics and both have various requirements that are designed to mitigate risks[5]. The Joint Forum[6], in its recent paper *"Developments in credit risk management across sectors: current practices and recommendations"*, echoed this noting in particular that *"significant improvements in the asset management area with regard to risk management – both in the UCITS Directive and in the AIFMD – can be observed"*. It underlined that in some cases the provisions in the

[5] Steven Maijoor's speech for the IBA Conference on the Globalisation of Investment Funds, 1 June 2015, Paris
[6] The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors

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AIFMD are even more demanding than under the UCITS directive (for instance regarding risk management).

This makes the marked difference in the EBA's proposed treatment of UCITS funds and all AIFs difficult to understand. The consultation paper does not explain why in the EBA's view the AIFMD regime is so inferior to UCITS that *all* AIFs should be treated as shadow banks regardless of their risk profile, business model and strategy. Nor does it explain why other – Member State or third country – regimes do not provide an appropriate and sufficiently robust prudential frameworks.

b) Private equity funds do not undertake banking activities.

The EU regulatory framework therefore provides a solid justification for taking a much more differentiated approach to AIFs than the EBA has proposed. The actual nature of private equity and the activities such funds undertake provide a second clear justification for the EBA to take a different approach.

Private equity funds are not engaged in credit intermediation activities and do not give rise to any maturity mismatch or systemic risks. The EBA's consultation paper itself (paragraph 12) acknowledges that funds only *"tend"* to engage in credit intermediation activities and that they are only *"prima facie"* within the scope of the shadow banking definition. This statement implies a recognition that not all funds should be automatically caught and that certain funds and strategies may not actually be seen as activities that pose the greatest risk. Distinctions and differences between AIFs need to be considered much more carefully in the development of these Guidelines so that only those AIFs that are of genuine risk are identified as shadow banking entities.

(i) Private equity firms are not part of the credit intermediation chain

The EBA describes the four key characteristics of credit intermediation as: (a) maturity transformation (borrowing short and lending/investing on longer timescales); (b) liquidity transformation (using cash-like liabilities to buy less liquid assets); (c) leverage; and (d) credit risk transfer. As explained below, none of these activities are undertaken by private equity funds.

Private equity firms do not rely on short-term credit for their operations and neither do they lend to financial system participants. Private equity funds' investments generally concern illiquid, unlisted securities. While some acquisitions by private equity funds may, like any other corporate acquisition, involve borrowing (which, it should be noted, is subject to credit review by the lending bank), the resulting debt is typically borne by the target's holding company and *not* by the private equity fund. Thus, private equity funds are not involved in credit intermediation activities.

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The EBA itself reached this conclusion in its recent Opinion on matters relating to the perimeter of credit institutions, where the examples it provided of entities carrying on credit intermediation did not include private equity funds.[7]

(ii) Private equity activities do not give rise to systemic risk or maturity mismatch

Private equity funds have a long life, are closed-ended and investors cannot withdraw their commitments from the fund at will, nor even on notice. Given the absence of redemption rights at a fund level, there is no potential maturity mismatch.

Private equity funds' investments are diversified both geographically and among industries. Each portfolio company group has its own specific holding company. Each portfolio company group is managed independently, and private equity funds report their returns on a portfolio company-by-portfolio company basis. A portfolio company group backed by a private equity fund is not in any way responsible for or exposed – directly or indirectly – to the borrowings of any other portfolio company of the same fund or manager. Therefore, since private equity activities are diversified and private equity structures are not cross-collateralized (they are silo-ed for each portfolio company), they do not give rise to systemic risks.

There is no deep interconnectedness between private equity firms and banks or other non-bank financial companies. In particular, there is no ownership linkage and funds do not benefit from implicit credit commitments. The portfolio companies in which private equity funds invest do business with different banks as well as non-bank financial companies across the industry sectors and geographies they cover within the ordinary course of their business. The mere fact that a portfolio company's shareholders include private equity funds does not make a private equity fund a credit intermediary.

<u>B) Consistency with EU and international developments</u>

The EBA's mandate expressly requires that "*international level*" developments on shadow banking should be taken into account in the development of these Guidelines. There has been significant international progress in this regard, particularly from the Financial Stability Board (FSB) that needs to be reflected fully in the Guidelines.

Although the FSB, initially identified certain types of entities, including some fund structures, as being potentially involved in shadow banking, its detailed assessment of these entities, led it to conclude that there is "*a high degree of heterogeneity and diversity in business models and risk profiles not only across the various sectors in the non-bank financial space, but also within the same sector or entity-type*".

[7] The entities listed by the EBA in its Opinion were money market funds, special purpose vehicles engaged in securitisation transactions, securities and derivatives dealers and companies engaged in factoring, leasing or hire purchase.

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Therefore, in its August 2013 Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities, the FSB recognised that there is no merit in seeking to badge particular *types* of fund as 'shadow banks', given the variety in structure and activity undertaken even amongst funds bearing the same broad descriptor.

Instead, when defining "shadow banking" the FSB adopted the economic function-based perspective, which allows the extent of non-bank financial entities' involvement in shadow banking to be judged by looking through to their underlying economic functions, rather than focussing on their legal names or forms.

The FSB has identified 5 economic activities that might constitute shadow banking:

- management of collective investment vehicles with features that make them susceptible to runs;
- loan provision that is dependent on short-term funding;
- intermediation of market activities that is dependent on short-term funding or on secured funding of client assets;
- facilitation of credit creation; and
- securitisation-based credit intermediation and funding of financial entities.

Importantly, the FSB recognises that even if a particular fund does potentially perform one of these economic functions, it does not necessarily imply that its existing regulation and supervision is inadequate.

The EBA's consultation paper suggests that its work follows the approach prescribed by the FSB and indeed makes reference to the FSB's Global Shadow Banking Monitoring Report for 2014. Unfortunately, that reference is itself not entirely clear, since the EBA does not refer to a particular section of the FSB report. Moreover the definition that the EBA suggests is concentrated on the regulatory classification of entities rather than on their economic functions or activities they perform, which seems to be a significant departure from the FSB's conclusions.

The EBA's work to define "shadow banking entities" should better reflect the FSB work and its latest developments in that regard, including its approach based on the 5 economic functions above. Consistency with such an approach would clarify that closed-ended AIFs employing little or no leverage at a fund level, and which are not involved in any of the 5 economic functions the FSB identified, should not be captured by any definition of shadow banking entities. The final version of the text should avoid the risk that entities are caught by the EBA's guidelines only because of their regulatory classification, without looking through to their business model or risk profile.

C) Impact on the real economy and on financial stability

Article 395(2) of the CRR also requires the EBA to take account of the potential impact of the proposed guidelines on the provision of credit to the real economy.

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Although private equity funds do not carry out banking activities (and as such do not provide credit to the real economy), they are an important way to channel investment from institutional investors to companies and they play an important role in delivering smart, sustainable and inclusive growth that creates jobs and enhances the long-term competitiveness of the European Union.

This role partly depends on the relationship that the private equity industry and private equity backed companies have with banks. The EBA should not ignore the benefits this relationship can bring and should ensure that that banks can continue to support private equity and venture capital funds and the companies those funds back, both as potential equity investors in such funds and through the provision of lending and other banking services.

Over the four years between 2009 and 2013, banks accounted for almost 9% of all funds raised by the European private equity industry and through this asset class, have invested €28bn in European companies. More than 87% of private equity backed companies are SMEs, which constitute the backbone of the European economy.

While private equity funds are important for supporting European growth and innovation, as confirmed by the European Commission in its Green Paper on Capital Markets Union, private equity funds are small relative to European gross domestic product and relative to banks' overall exposures. As such it is very difficult to argue that they pose a systemic risk.

Furthermore, we think it is unfortunate that the consultation paper does not provide an analysis of whether the introduction of the additional limits would have a material detrimental impact on the provision of credit to the real economy; an element that is required explicitly by the EBA's mandate.

We believe a proper impact assessment should be carried out to evaluate the potential consequences of the proposed approaches and their implications for the supply of capital to the real economy (including SMEs). The EBA, as required under Article 395(2) of the CRR, should consider that assessment while developing its Guidelines.

IV. <u>Coherence with the treatment of private equity funds in EU law (Solvency II, Banking Structural Reform proposal, Capital Markets Union)</u>

The European Commission, in its September 2013 Communication on Shadow Banking, which sets out the Commission's latest thinking on shadow banking takes a broadly similar approach to the FSB. In particular it recognises that many entities which could be part of the shadow banking sector, are already appropriately regulated and supervised for the risks they pose.

The Commission has also, critically, recognised that AIFs are not identical or homogeneous. They have acknowledged that there are certain types of AIFs that play a positive role in financing the real economy and that professional investors (like banks, pensions funds or insurers) should be able to continue to invest in these types of funds. As a consequence, certain types of private equity and venture capital funds have, for example, been granted a more appropriate treatment than other AIFs

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(commensurate to their risk and characteristics) and can thus benefit from a lower risk weighting under the Solvency II framework.

The Commission also proposed to exempt those (private equity) funds that meet specific criteria from the proprietary trading ban that constitutes one of the key elements of its proposal on structural measures improving the resilience of EU credit institutions[8].

The Green Paper on the Capital Markets Union further underlines that private equity plays an important role in the European economy and explicitly names private equity and venture capital as an important source of direct financing and clearly suggests that this industry should be promoted and further developed.

The EBA's approach to shadow banking should not contradict the EU's objective of encouraging long term investments, such as private equity nor run counter to the objective of Capital Markets Union to promote access to new sources of finance, particularly for SMEs.

The EBA's Guidelines need to be coherent with existing (and forthcoming) EU law, and particularly the Commission's (which was accepted by the Council and the European Parliament), acknowledgment that the AIFs universe is not homogeneous. On this basis the Guidelines should exclude private equity funds, meeting certain requirements, from the definition of shadow banking entities. In particular those funds that are closed-ended and do not employ or employ little leverage at fund level.

As explained above, typically, private equity funds are unleveraged. However in some specific cases private equity may deploy a limited amount of leverage, even if in other respects they are virtually identical to their unleveraged equivalents.

We think therefore that a binary distinction between "leveraged" and "non-leveraged" funds would not be appropriate as the mere use of some leverage should not itself be the trigger for a fund being designated a shadow bank. The exemption for private equity funds should rather be built on the distinction between AIFs that are substantially leveraged and AIFs that are not substantially leveraged. The concept of "substantial leverage" is already defined in the AIMFD framework[9] and provides supervisors with appropriate tools to intervene if fund leverage threatens financial stability, including in the banking sector.

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[8] Proposal for a regulation of the European Parliament and the Council on structural measures improving the resilience of EU credit institutions, COM(2014) 43 final

[9] The concept of "substantial leverage" is defined in Article 111 of Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision. The AIMF directive also provides tools for monitoring and addressing any potential systemic risk that could arise from fund leverage. Where the stability and integrity of the financial system may be threatened, the competent authorities have the power to impose limits on the level of leverage.

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V. The EBA opinion on the perimeter of credit institutions and on the different approaches across EU Member States on the interpretation of the definition of "credit institution" in the CRR - follow – up to the Commission Green Paper on shadow banking

On 27 November 2014 the EBA published its Opinion on the perimeter of credit institutions and on the different approaches across EU Member States on the interpretation of the definition of "credit institution" in the CRR.[10] This opinion is a follow-up to the Commission's September 2013 Communication on shadow banking, which among other things suggests that a precise assessment of the way in which the definition of credit institutions is applied and the way in which credit institutions are identified in the 28 Member States is necessary.

In October 2013 the EBA was invited by the Commission to carry out a comprehensive study of various legal and quantitative aspects regarding "credit institutions" and other entities carrying out bank-like activities in the EU. As a consequence the EBA conducted surveys of the competent authorities, intended to identify those entities that are genuinely "operating in the shadows" in the sense of being entirely outside the scope of existing solo prudential requirements under EU measures. On the basis of those surveys and contributions received from national competent authorities the EBA prepared its opinion.

The current consultation paper on banks' exposures to shadow banking entities suggests that the EBA's approach to the definition of "shadow banking entities" follows the above mentioned EBA Opinion and Report. However, in this Opinion, the EBA seems to have adopted a more granular approach, for instance in the way in which it refers to credit intermediation.[11] However, positively (and in fact contrary to the draft Guidelines on limits on exposures to shadow banking entities) the Report did not identify AIFs and AIFMs as a source of problems and consequently the EBA has not formulated any specific recommendations with regard to AIFs and the AIFM Directive from this work.

VI. Breadth of the definition of "shadow banking entities" and "credit intermediation activities"

As a more general comment, we are concerned that the proposed definition of the term "shadow banking entities" in the Guidelines is extremely broad and may catch a wider range of entities than was intended. The definition of "credit intermediation activities", which forms the main part of the test for determining whether any particular entity is a shadow banking entity, is extremely broad. This results in part from the use of vague concepts such as "maturity transformation", "leverage" or "credit risk transfer" which are not clearly defined and therefore will be difficult to apply consistently across the EU. We also consider that the phrase "or similar activities" is too unclear to form part of

[10] Opinion of the European Banking Authority on matters relating to the perimeter of credit institutions, EBA/Op/2014/12.

[11] According to the EBA, "*The four key features of credit intermediation considered are: (a) maturity transformation (borrowing short and lending/investing on longer timescales); (b) liquidity transformation (using cash-like liabilities to buy less liquid assets); (c) leverage; (d) credit risk transfer (transferring the risk of credit default to another person for a fee). Examples of entities carrying on credit intermediation include: money market funds, special purpose vehicles engaged in securitisation transactions, securities and derivatives dealers and companies engaged in factoring, leasing or hire purchase.*"

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the basic definition of credit intermediation activities and is likely to result in divergent subjective judgements being applied by different EU Member States.

In addition, the cross-reference to the activities in Annex 1 of the CRD is also extremely wide because it does not incorporate any threshold whereby those activities must form a substantial part of the activities of an entity before it can be classified as a shadow banking entity. For example, the list of Annex 1 activities includes a reference to the activity of lending (point 2 of Annex 1). Without any materiality threshold, any entity which engages in the activity of lending even once and which is not an "excluded undertaking" would appear to constitute a shadow banking entity. For example, an ordinary commercial company which makes a loan or extends credit to an employee or counterparty could be said to be engaged in the activity of lending and would therefore appear to constitute a shadow banking entity on the basis of the proposed definition. We assume that this outcome was not intended by the EBA and would therefore ask the EBA to modify the definition of "shadow banking entities" so that it is clear that those activities must form a significant part of the entity's activities. We think that the definition could be sensibly aligned with the definition of a financial institution in the CRR, so that entities that undertake credit intermediation activities (including Annex 1 activities) as only minor or ancillary activities are excluded.

VII. Conclusion

We regret that the EBA's approach to defining shadow banking entities does not fully take into account the comprehensive FSB work undertaken on the subject. We think that the FSB has taken a pragmatic and appropriately granular approach that aims to ensure that shadow banking entities are identified on the basis of the activities they carry on and their economic functions, rather on the basis of their name or their regulatory classification.

We encourage the EBA to reconsider its approach and recognise that AIFs are not identical and they do not pose the same risk, and in particular to recognise that AIFs that are private equity funds have neither the characteristics nor the level of risks to credit institutions that would justify their identification as shadow banks.

Consequently, we strongly recommend that certain type of AIFs that meet relevant criteria, should be exempted from the definition of "shadow banking entities", in particular those that are closed–ended and not significantly leveraged. Private equity i) does not undertake banking activities; ii) does not create systemic risk as a result of liquidity/maturity transformation, or leverage; and iii) is subject to comprehensive sectoral legislation, including the AIFMD in the EU, the Member States' national regimes (particularly the case for those smaller entities that the co-legislators decided should not have to apply the full AIFMD regime) and other regimes in other jurisdictions.

Such an approach would be coherent with the treatment of private equity funds under EU law, notably in Solvency II, the Commission's recent Banking Structural Reform proposal, and the objectives pursued by the EU with the establishment of a Capital Markets Union.

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We would be keen to engage with the EBA in order to further explain the view of the private equity industry and provide necessary information on our asset class to assist in ensuring that the EBA's definition of shadow banking entities does not have any potential adverse consequences for the private equity industry.

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Appendix A: Practical implications of certain elements of the EBA' approach

While we strongly believe that private equity funds are not shadow banking entities and should not be caught by the EBA' definition and the EBA' Guidelines, we nonetheless encourage the EBA to consider the practical difficulties of certain elements of the approach suggested in the consultation paper.

I. Inclusion of a "no fire-sale" provision

We note that in the EBA's discussion of the principal and fallback approaches in the Guidelines, the EBA states that the "portfolio [of the relevant institution] must be adjusted" if the exposure limits that must be applied by the institution are lower than its current exposures. This implies that institutions may need to sell or transfer assets, or otherwise abruptly adjust their exposures, in order to comply with the relevant limits with the Guidelines enter into effect.

We are concerned that this could lead to "fire-sales" of assets and/or sudden reductions in exposures to clients or counterparties which could cause significant market disruption. We would suggest that the EBA should include a "no fire-sale" provision in the Guidelines which is based on a similar provision included in Recital 69 and Article 54 the Alternative Fund Managers Directive Level 2 Regulation (Commission Delegated Regulation (EU) No. 231/2013) in connection with securitisation retention requirements. Our suggested drafting for such a provision is as follows:

"*Where the exposures of an institution exceed any applicable limit on exposures to shadow banking entities that result from the application of either the principal or fallback approaches, the institution shall take such corrective action as may be in its best interests. This corrective action should not involve any direct obligation to reduce the exposure immediately after the breach of the limit has become apparent, thereby avoiding a "fire-sale" of an asset or significant disruption to the relevant client or counterparty. The institution should take the breach into account when considering whether to incur any future exposure."*

II. Requirements for disclosure of information by shadow banking entities

The Guidelines impose a number of obligations on institutions which are likely to require them to obtain very detailed information from shadow banking entities to whom they have exposures. These include:

- The identification of all potential risks resulting from individual exposures to shadow banking entities;
- The application of the institution's internal risk management framework, with analyses of the business of the shadow banking entity performed by risk officers;
- The identification of the risks arising from exposures to shadow banking entities in the institution's ICAAP and capital planning;

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- The identification of interconnectedness between shadow banking entities themselves and between shadow banking entities and the institution, using a "robust process"; and
- The need to use a wide range of information about the shadow banking entity in order to qualify for the more flexible principal approach.

We are concerned that it is likely to be impractical to require the disclosure by the shadow banking entity of information at this level detail. Much of this information may be proprietary in nature and there is a possibility that the institution and the relevant shadow banking entity may be competitors in other contexts, meaning that disclosure may be harmful to the business of the shadow banking entity. Even if there is no direct risk of competition, many shadow banking entities would still have legitimate concerns about sharing highly sensitive and confidential information with counterparties or investors who are institutions subject to the Guidelines and in certain cases, there may be legal restrictions on doing so.

To the extent that the Guidelines require institutions to use information relating to shadow banking entities as part of the risk analysis or the application of the principal or fallback approaches, such a requirement must be applied in a proportionate manner, taking into account the practical, legal and commercial limitations on the nature of information that can be shared between entities.

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Appendix B: UCITS / AIFMD Overview Table

Directive 2009/65	Requirements applicable at fund level	Directive 2011/61
Articles 5 and 27	Prior authorisation of the UCITS is required. / Prior authorisation of the AIF internally managed required.	Article 5
Article 14 b para. 3	Remuneration policy principles apply at fund level.	Article 13
Article 15	Investment companies must have appropriate procedures in place to deal properly with investor complaints.	(professional investors - not retail, Article 43)
Article 22	Appointment of a single depositary by the fund is mandatory.	Article 21
Article 25 para 2	In carrying out their functions, the fund and the depositary must act fairly and solely in the interest of the UCITS.	Article 21
Article 29 para 1	A UCITS without management company must hold higher initial capital, and respect additional rules (disclosure of information, rules on conflict of interest). / An internally managed AIF must hold higher initial capital.	Article 9
Article 30	Requirements applicable to the managing companies will apply to the UCITS if it has not designated a managing company. UCITS may only manage assets of their own portfolio.	-
-	In cases of failure of an AIFM to ensure compliance with the applicable requirements of an AIF, the competent authorities can require the AIFM to resign as manager of that AIF.	Recital 11 and Article 5(3)
Article 51 para 1	Risk management processes must be in place, including risk limits for AIFs.	Article 15
Articles 52 et s.	Requirements on diversification of assets, concentration of exposure, and limits on acquisition of voting rights apply.	-
-	Liquidity management systems must be in place.	Article 16
-	Securitisation requirements apply.	Article 17
Articles 68 et s.	Disclosure requirements apply.	Articles 22 and 23
Article 76	Regular reports must be published regarding the issue, sale, repurchase or redemption price of the UCITS' units. / Valuation requirements apply for each AIF managed by an AIFM.	Article 19
Article 83	Prohibition of borrowing. There may be temporary exceptions to that principle. / Limits on leverage used by the AIFM are supervised by the competent authority.	Article 25
Article 84	UCITS are open-ended: they must repurchase or redeem its units at the request of any unit-holder. / AIFs may be open-ended or closed-ended.	Article 2 (2) (a)
Article 88	UCITS shall not grant loans or act as a guarantor on behalf of third parties.	-

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Directive 2009/65	Requirements applicable at manager level	Directive 2011/61
Article 6 para 1	MCs/AIFMs must obtain prior authorisation from national authorities to acquire their "passport".	Articles 6(1) and 7
Article 6 para 2	MCs/AIFMs may engage in investment management, administration and marketing activities. Exceptionally, they may undertake discretionary portfolio management service.	Article 6(2) to (4)
Article 7 para 1	MCs/AIFMs must have initial capital, and additional own funds depending on portfolio value.	Article 9
Articles 7 and 12, para 1	MCs/AIFMs must respect rules regarding conflict of interests.	Articles 12 (1) (d) and 14
Article 8 (1) and 12 para 1	MCs/AIFMs must insure the sound and prudent management of the management company.	Articles 8 (1) and 12
Article 13	Delegation of functions by the MCs/AIFMs is possible, provided it does not become a letter-box entity.	Article 20
Article 14	MCs/AIFMs must act in the best interests of the fund it manages, avoid conflicts of interests.	Article 12
Articles 14a and 14b	MCs/AIFMs must implement remuneration policies that are consistent with sound and effective risk management.	Article 13
Article 15	MCs must establish appropriate procedures and arrangements to deal properly with investor complaints.	(professional investors - not retail, Article 43)
Article 18 para 1 and 4	Any MC undertaking activities under the freedom to provide services must inform its (home) authority.	Article 33
Article 19 para 4	The MC must comply with the fund rules, the instruments of incorporation, and the prospectus.	Article 18
Article 20 para 1 and 4	A MC which applies to manage a UCITS established in another Member State must provide the competent authorities of the UCITS home Member State with documentation regarding the depositary and delegation arrangements.	Article 33
Article 22	A MC must ensure that a single depositary is appointed.	Article 21 para 1
Article 25 para 2	In carrying out their [respective] functions, the MC/AIFM [and the depositary] must act fairly and in the interest of the fund and its investors.	Article 21 para 10
Article 51 para 1	Risk management processes/systems must be in place.	Article 15
Article 56 para 1	A MC must not acquire any shares carrying voting rights which would enable it to exercise significant influence over the management of an issuing body. / Additional obligations apply in case of acquisition of control by an AIF managed by an AIFM.	Articles 26 to 30
Article 68 para 1 and 2, 69 para 1,2,3,4; 70 para 1 and 2,3,71,72	A MC/AIFM must disclose information to investors.	Articles 22 and 23
Article 83 para 1	The MC is prohibited from borrowing or granting loans. / Limits on leverage used by the AIFM are supervised by the competent authority.	Article 15(4) and Article 25

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About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About EVCA

The EVCA is the voice of European private equity.

Our membership covers all private equity activity, from early-stage venture capital through to large private equity firms and funds investing in infrastructure. Our members also include institutional investors, such as pension funds and insurance companies, who are a key source of long-term financing in Europe and who invest in private equity, venture capital and infrastructure funds. We represent 650 member firms and 500 affiliate members.

The EVCA shapes the future direction of the industry, while promoting it to stakeholders such as entrepreneurs, business owners and employee representatives.

We explain private equity to the public and help shape public policy, so that our members can conduct their business effectively.

The EVCA is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members and spreading best practice through our training courses.

We have the facts when it comes to European private equity, thanks to our trusted and authoritative research and analysis.

The EVCA has 25 dedicated staff working in Brussels to make sure that our industry is understood and heard.