

# Bank of England PRA

## Appendix 6: Draft supervisory statement – Identifying, monitoring, and managing exposures to shadow banking entities

### Supervisory statement

December 2023

Draft for consultation



# Identifying, monitoring, and managing exposures to shadow banking entities

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# 1: Introduction

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[NOTE: This draft supervisory statement (SS) contains material from the European Banking Authority (EBA) Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395(2) of Regulation (EU) No 575/2013 (EBA/GL/2015/20). To assist readers, the PRA has included a note where the guidelines were amended to refer to UK legislation. This note does not form part of the PRA's proposals and the PRA does not propose to include this note in the final SS.]

1.1 This SS is relevant to all Capital Requirements Regulation (CRR) firms and CRR consolidation entities.

1.2 This SS outlines the Prudential Regulation Authority's (PRA) expectations in relation to the methodology that firms should use, as part of their internal processes and policies, for addressing and managing concentration risk arising from exposures to shadow banking entities (SBEs). It covers:

- a. limits to exposures to SBEs
- b. the principal approach for setting limits to exposures to SBEs
- c. the fall-back approach

1.3 This SS should be read in conjunction with the specified CRR articles, the requirements of the PRA Rulebook, and the high-level expectations outlined in the PRA's approach to banking supervision, as well as any additional sources and legislation listed in the document.

## Definitions

1.4 Unless otherwise specified, terms used in this SS have the same meaning as in the CRR and the relevant Part of the PRA Rulebook.

1.5 The expectations set out in this SS shall only apply to a firm's exposure to an individual SBE where that exposure value, after taking into account the effect of the credit risk mitigation in accordance with Article 399 to 400 of the Large Exposures (CRR) Part of the PRA Rulebook, is equal to or in excess of 0.25% of the firm's tier 1 capital.

1.6 For the purposes of 1.2 (the definition of 'shadow banking entity') and 1(3)(o) of Annex 1 of the Large Exposures (CRR) Part of the PRA Rulebook and of paragraph 3.3(f) of this SS, 'credit intermediation activities' mean bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities. These activities include at least those listed in the following points of Annex I of UK Capital Requirements Directive (2013/36/EU) (CRD): Point 1 to 3, 6 to 8, and 10. [Updated to refer to UK CRD].

## 2: Limits to exposures to shadow banking entities

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### Effective processes and control mechanisms

2.1 Firms are expected to comply with the general principles referred to within this chapter, as well as set limits as referred to under Chapter 3, as applicable.

2.2 Firms are expected to:

- a. Identify their individual exposures to SBEs and perform investigations that are proportionate to the size of these exposures to find potential risks to the firm and their impact;
- b. Set out an internal framework for the identification, management, control, and mitigation of the risks outlined in point (a). This framework should include clearly defined analyses to be performed by risk officers regarding the business of a SBE to which an exposure arises, the potential risks to the firm and the likelihood of contagion stemming from these risks to the entity. Those analyses should be performed under the supervision of the [firm's] credit risk committee, which should be duly informed of the results;
- c. Ensure that risks outlined in point (a) are adequately taken into account within the firm's Internal Capital Adequacy Assessment Process and capital planning;
- d. Based on the assessment conducted under letter (a), set the firm's risk appetite for exposures to SBEs;
- e. Implement a robust process for determining interconnectedness between SBEs, and between SBEs and the firm. 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;
- f. Have effective procedures and reporting processes to the management body regarding exposures to SBEs within the firm's overall risk management framework; and
- g. Implement appropriate action plans in the event of a breach of the limits set by the firm in accordance with Chapter 3 or Chapter 4, if applicable.

## Oversight by the management body

2.3 When overseeing the application of the principles in paragraph 2.2 as well as the application of limits set out in accordance with the principal approach in Chapter 3, the firm's management body should, on a regular predetermined basis:

- a. Review and approve the firm's risk appetite to exposures to SBEs and the aggregate and individual limits set in line with Chapter 3;
- b. Review and approve the risk management process to manage exposures to SBEs, including analysis of risks arising from those exposures, risk mitigation techniques and potential impact on the firm under stressed scenarios;
- c. Review the firm's exposures to SBEs (on an aggregate and individual basis) as a percentage of total exposures and expected and incurred losses; and
- d. Ensure the setting of the limits referred to in this SS is documented, including any changes to them.

2.4 The firm's management body may delegate the reviews set out in paragraph 2.3 (a) to (d) to senior management.

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## 3: Principal approach for setting limits to exposures to shadow banking entities

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### Setting aggregate limits on exposures to SBEs

3.1 Unless the fallback approach in Chapter 4 applies, the PRA expects firms to set an aggregate limit to their exposures to SBEs relative to their tier 1 capital.

3.2 When setting an aggregate limit to exposures to SBEs, each firm should take into account:

- a. Its business model, risk management framework as outlined in paragraph 2.2(b), and risk appetite as outlined in paragraph 2.2(d);
- b. The size of its current exposures to SBEs relative to its total exposures and relative to its total exposure to regulated financial institutions;
- c. Interconnectedness as outlined in paragraph 2.2(e).

### Setting individual limits on exposures to SBEs

3.3 Unless the fallback approach in Chapter 4 applies, and independently of the aggregate limit outlined in paragraphs 3.1 and 3.2, firms are expected to set limits on their individual exposures to SBEs. When setting those limits, as part of their internal assessment process, firms should take into account:

- a. The regulatory status of the SBE, in particular whether it is subject to any type of prudential or supervisory requirements;
- b. The financial situation of the SBE including, but not limited to, its capital position, leverage, and liquidity position;
- c. Information available about the portfolio of the SBE, in particular non-performing loans;
- d. Available evidence about the adequacy of the credit analysis performed by the SBE on its portfolio, if applicable;
- e. Whether the SBE will be vulnerable to asset price or credit quality volatility;
- f. Concentration of credit intermediation activities relative to other business activities of the SBE;

- g. Interconnectedness as outlined in paragraph 2.2(e); and
- h. Any other relevant factors identified by the firm under paragraph 2.2(a).

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## 4: Fallback approach

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4.1 If it is not practical or is disproportionate for firms to apply the principal approach as set out in Chapter 3, then the following expectations apply.

4.2 Firms' aggregate exposures to SBEs should be subject to the limits on large exposures in accordance with Article 395 in section 4 of the Large Exposures (CRR) Part of the PRA Rulebook.

4.3 Firms should apply the fallback approach in the following way:

- a. If firms cannot meet the requirements regarding effective processes and control mechanisms or oversight by their management body as set out in Chapter 2, they should apply the fallback approach to all their exposures to SBEs (ie the sum of all their exposures to SBEs).
- b. If firms can meet the requirements regarding effective processes and control mechanisms or oversight by their management body as set out in Chapter 2 but cannot gather sufficient information to enable them to set out appropriate limits as set out in Chapter 3, they should only apply the fallback approach to the exposures to SBEs for which the firms are not able to gather sufficient information. The principal approach as set out in Chapter 3 should be applied to the remaining exposures to SBEs.