ANNEX 2

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

INTRODUCTION

1. Annex 2 to BR/09 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 (the 'Annex') specifies the methodology that credit institutions shall use, as part of their internal processes and policies, for addressing and managing concentration risk arising from exposures to shadow banking entities.

SCOPE AND APPLICATION

2. The scope of this Annex is to implement the Guidelines on the Limits on Exposures to Shadow Banking Entities (EBA/GL/2015/20), issued by the European Banking Authority ('EBA') on the 14 December 2015 (hereinafter referred to for the purposes of this Annex as 'the EBA Guidelines'), which set appropriate aggregate limits or tighter individual limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework. From a microprudential perspective, shadow banking entities are generally not subject to the same standards of prudential regulation, do not provide protection to investors' investment from these entities' failures and do not have access to central banks' liquidity facilities. To the extent that shadow banking entities carry out bank-like activities, exposures to such entities may therefore be inherently risky - and thus specific limits for individual and aggregate exposures are warranted.

   In order to minimise the risks posed to credit institutions arising from their exposures to shadow banking entities, this Annex lays down requirements for credit institutions to set limits, as part of their internal processes, on their individual exposures to shadow banking entities and on their aggregate exposure to shadow banking entities.

3. In accordance with articles 17B and 17C of the Act, credit institutions are required to have sound, effective and comprehensive strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed, as well as effective processes to identify, manage, monitor and report such risks and adequate internal control mechanisms.

4. Furthermore, in accordance with Regulation 3 of the Supervisory Consolidation Regulations (S.L. 371.15) and Regulation 8 of the Banking Act (Supervisory Review) Regulations (S.L. 371.16), the Authority will review the arrangements, strategies, processes and mechanisms implemented by credit institutions and will evaluate the risks to which the credit institutions are or might be exposed. Furthermore, the Authority may apply the supervisory review and evaluation process (SREP) to credit institutions which are or might be exposed to similar risks or pose similar risks to the financial system.

5. This Annex applies to those credit institutions to which Part Four of the CRR (large exposures) applies, in accordance with the level of application set out in Part I, Title II, of the CRR.

6. Credit institutions that fall within the scope of this Annex shall comply with the general principles laid down hereunder as well as set limits where applicable.

DEFINITIONS

7. For the purposes of this Annex, unless the context otherwise requires, the following definitions shall apply:

"*Credit intermediation activities*" shall refer to bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities.

These activities include at least those listed in points 1, 4 to 6, and 8 of the Schedule to the Act.

"*Excluded undertakings*" shall refer to:

(i) Undertakings included in consolidated supervision on the basis of the consolidated situation of an institution as defined in Article 4(1)(47) of the CRR;

(ii) Undertakings which are supervised on a consolidated basis by a third country competent authority pursuant to the law of a third country which applies prudential and supervisory requirements that are at least equivalent to those applied in the Union;

(iii) Undertakings which are not within the scope of points (1) and (2) but which are:
   a) credit institutions;
   b) investment firms;
   c) third country credit institutions if the third country applies prudential and supervisory requirements to that institution that are at least equivalent to those applied in the Union;

d) recognised third country investment firms;
e) entities which are financial institutions authorised and supervised by the competent authorities or third country competent authorities and subject to prudential requirements comparable to those applied to institutions in terms of robustness where the institution's exposure or exposures to the entity concerned is treated as an exposure to an institution pursuant to Article 119(5) of the CRR;
f) entities referred to in Appendix III of BR/01;
g) entities referred to in the first proviso to Article 2A of the Act;
h) insurance holding companies, insurance undertakings, reinsurance undertakings and third country insurance undertakings and third country reinsurance undertakings where the supervisory regime of the third country concerned is deemed equivalent;
i) undertakings excluded from the scope of S.L. 403.22 on Insurance Business (Exemptions) Regulations in accordance with Regulation 3 of those Regulations;
j) institutions for occupational retirement provision within the meaning of point (a) of Article 2(1) of the Retirement Pensions (European Passport Rights for Institutions for Occupational Retirement Provision) Regulations (S.L. 514.05) or subject to prudential and supervisory requirements comparable to those applied to institutions within the meaning of Article 2(1) of S.L. 514.05 in terms of robustness;
k) undertakings for collective investment:
    I. within the meaning of Article 2(1) of the Investment Services Act (Marketing of UCITS) Regulations (S.L. 370.18);
    II. established in third countries where they are authorised under laws which provide that they are subject to supervision considered to be equivalent to that laid down in S.L. 370.18 on Investment Services Act (Marketing of UCITS) Regulations;
    III. within the meaning of Article 2(1) of the Investment Services Act (Marketing of Alternative Investment Funds) Regulations (S.L. 370.21) with the exception of: (i) undertakings employing leverage on a substantial basis according to Article 111(1) of Commission Delegated Regulation (EU) 231/2013 and/or (ii) undertakings which are allowed to originate loans or purchase third party lending exposures onto their balance-sheet pursuant to the relevant fund rules or instruments of incorporation;
    IV. which are authorised as 'European long-term investment funds' in accordance with the Investment Services Act (European Long-Term Investment Funds) Regulations (S.L. 370.31);
    V. within the meaning of Article 2(1) of the Investment Services Act (European Venture Capital Funds) Regulations, which refers to 'qualifying social entrepreneurship funds';

VI. within the meaning of Article 2(1) of the Investment Services Act (European Venture Capital Funds) Regulations (S.L. 370.26, which refers to 'qualifying venture capital fund';

Except for undertakings that invest in financial assets with a residual maturity not exceeding two years, also known as short-term assets, and have as distinct or cumulative objectives offering returns in line with money market rates or preserving the value of the investment, also known as money market funds;

l) central counterparties (CCPs) as defined in Article 2(1) of the Financial Markets Act (OTC Derivatives, Central Counterparties and Trade Repositories) Regulations (S.L. 345.17) established in the EU and third country CCPs recognised by ESMA pursuant to Article 25 of Regulation (EU) No 648/2012;
m) electronic money issuers as defined in point 8 of the Financial Institutions Rule on the taking up, pursuit of and prudential supervision of the business of financial institutions authorised to issue electronic money (FIR/03/2011);
n) payment institutions as defined in Article 2(1) of the Financial Institutions Act (Cap. 376);
o) entities the principal activity of which is to carry out credit intermediation activities for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings;
p) resolution authorities, asset management vehicles and bridge institutions as defined in Article 2(1) of the Recovery and Resolution Regulations (L.N. 301 of 2015) and entities wholly or partially owned by one or more public authorities established prior to the 1 January 2016 for the purpose of receiving and holding some or all of the assets, rights and liabilities of one or more institutions in order to preserve or restore the viability, liquidity or solvency of an institution or to stabilise the financial market.

"*Exposures to shadow banking entities*" shall have the meaning of exposures to individual shadow banking entities pursuant to Part Four of the CRR with an exposure value, after taking into account the effect of the credit risk mitigation in accordance with Articles 399 to 403 and exemptions in accordance with Articles 400 and 493(3) of that Regulation, equal to or in excess of 0.25% of the institution's eligible capital as defined in Article 4(1)(71) of the CRR.

"*Shadow banking entities*" shall refer to undertakings that carry out one or more credit intermediation activities and that are not excluded undertakings.

EFFECTIVE PROCESSES AND CONTROL MECHANISMS

8. Credit Institutions shall:

a. Identify their individual exposures to shadow banking entities, and consider all potential risks to the institution, including the potential impact of those risks, arising from those exposures to shadow banking entities;

b. Set out an internal framework for the identification, management, control and mitigation of the risks arising from exposures to shadow banking entities. Such framework shall include clear definitions of the analyses to be performed by risk officers in relation to the business of the shadow banking entity from which the exposure arises, where the potential risks to the credit institution and the likelihood of contagion are stemming from the risks imposed by such entity. The analyses found in the framework for the identification, management, control and mitigation of risks arising from exposures to shadow banking, shall be performed under the supervision of the credit risk committee, who shall also be duly informed of the results;

c. Ensure that the risks stemming from the individual exposures to shadow banking entities are adequately taken into account within the institution's Internal Capital Adequacy Assessment (ICAAP) and capital planning;

d. Based on the assessment conducted when identifying individual exposures to shadow banking entities, the credit institution shall ascertain its risk tolerance or risk appetite with regards to the exposures to shadow banking entities;

e. Implement a robust process for determining the interconnectedness between shadow banking entities, and between the shadow banking entities and the institution itself. The process in question shall, in particular, address situations where interconnectedness cannot be determined, and shall also set out the appropriate mitigation techniques to address the potential risk stemming from this uncertainty;

f. Produce effective procedures and reporting processes to the management body, with regards to exposures to shadow banking entities, within the institution's overall framework;

g. Implement appropriate action plans in the event of a breach of the limits set by the institution.

OVERSIGHT BY THE BOARD OF DIRECTORS

9. When overseeing the application of the principles referred to in the paragraphs above, as well as the application of limits set out by the institution itself, the credit institution's Board of Directors shall, on a regular and predetermined basis:

a) review and approve the credit institution's risk appetite to exposures to shadow banking entities and the aggregate and individual limits set by the credit institution itself;

b) review and approve the risk management process to manage exposures to shadow banking entities, including the analysis of risks arising from those exposures, risk mitigation techniques and potential impact on the institution under stressed scenarios;

c) review the institution's exposures to shadow banking entities, on an aggregate and individual basis, as a percentage of total exposures and expected and incurred losses; ensure the setting of the limits referred to in this Act is documented, included any changes made to them.

The Board of Directors within the credit institution shall delegate the reviews set out in this point to the senior management.

SETTING AN AGGREGATE LIMIT ON EXPOSURES TO SHADOW BANKING ENTITIES

10. Credit institutions shall set an aggregate limit to their exposures to shadow banking entities, relative to their eligible capital.

11. In the process of setting an aggregate limit to exposures to shadow banking entities, each credit institution shall take into account:

a) its business model, risk management framework, and risk appetite, both as outlined in paragraph 8(b) and (d) above;
b) the size of its current exposures to regulated financial sector entities;
c) the interconnectedness as outlined in paragraph 8 above.

SETTING INDIVIDUAL LIMITS ON EXPOSURES TO SHADOW BANKING ENTITIES

12. Credit institutions, independently of the aggregate limit, and in addition to it, shall set tighter limits on their individual exposures to shadow banking entities. The credit institutions, when setting such limits as part of their internal assessment process, shall take into account:

a) the regulatory status of the shadow banking entity, in particular whether it is subject to any type of prudential or supervisory requirements;
b) the financial situation of the shadow banking entity, including, but not limited to, its capital position, leverage, and liquidity position;

c) the information available about the portfolio of the shadow banking entity, in particular non-performing loans;

d) the available evidence , if applicable about the adequacy of the credit analysis performed by the shadow baking entity on its portfolio;

e) the potential risk of the shadow banking entity being vulnerable to asset price or credit quality volatility;

f) the concentration of credit intermediation activities relative to other business activities of the shadow banking entity;

g) the interconnectedness as outlined in paragraph 8;

h) and any other relevant factors identified by the institution.

FALL-BACK APPROACH

13. In the instance where a credit institution is not able to apply the principal approach set out in paragraphs 12 to 14 of this Annex, which is addressing and managing the concentration risk arising from exposures to individual shadow banking entities, their aggregate exposures to shadow banking entities, shall be subject to the limits on large exposures in accordance with Article 395 of the CRR, including the use of Article 395(5) of the same Regulation, which is also known as the fall-back approach.

14. Credit institutions shall apply the fall-back approach in the following ways:

a) in instances where the credit institution cannot meet the requirements with regard to effective processes and control mechanisms or oversight by their Board of Directors, as set out in paragraphs 8 and 9 of this Annex, they shall apply the fall-back approach to all their exposures to shadow banking entities (i.e. the sum of all their exposures to shadow banking entities);

b) in instances where the credit institution can meet the requirements regarding effective processes and control mechanisms or oversight by the Board of Directors as set out in paragraphs 8 and 9 of this Annex, but cannot gather sufficient information to enable them to set out appropriate limits as set out in points 10 to 12 of this Annex, they shall apply the fall-back approach to the exposures to shadow banking entities for which the institution is not capable of gathering sufficient information.