Financing through shadow banking – what to look out for

02 May 2018 | Contributed by Patrikios Pavlou & Associates LLC

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Introduction

In recent years Cyprus companies have sought, albeit not often, to generate financing outside the regular banking system through unconventional non-bank credit activities (ie, so-called 'shadow banking', which are backed by quasi-security arrangements). Shadow banking takes the form of, among other things:

- securities lending transactions;
- repurchase transactions; and
- derivatives transactions.

This has created a large sector parallel to the banking system, resulting in a call for strengthened regulations to mitigate risks and support financial stability.

EU Securities Financing Transactions Regulation

The EU Securities Financing Transactions Regulation (2015/2365) and the EU Over-the-Counter Derivatives, Central Counterparties and Trade Repositories Regulation (648/2012) (EMIR), which apply to Cyprus as an EU member state, must be considered as regards shadow banking.

The EU Securities Financing Transactions Regulation responds to the need to enhance the transparency of securities financing markets – and thus of the financial system – with the aim of reducing the risks associated with the use of securities financing transactions (SFTs) in shadow banking systems. It covers SFTs in the form of:

- a repurchase transaction, which is a transaction governed by an agreement by which a counterparty transfers securities, commodities or guaranteed rights relating to title to securities or commodities. Further, the guarantee is issued by a recognised exchange which holds the rights to the securities or commodities and the agreement does not allow a counterparty to transfer or pledge a particular security or commodity to more than one counterparty at a time, subject to a commitment to repurchase them or substituted securities or commodities of the same description at a specified price on a future date specified, or to be specified, by the transferor (ie, a repurchase agreement for the counterparty selling the securities or commodities and a reverse repurchase agreement for the counterparty buying them);
- securities or commodities lending and securities or commodities borrowing, which is a transaction by which a counterparty transfers securities or commodities subject to a commitment that the borrower will return

equivalent securities or commodities on a future date or when requested to do so by the transferor. The transaction is considered to be:
    - securities or commodities lending for the counterparty transferring the securities or commodities; or
    - securities or commodities borrowing for the counterparty to which they are transferred;
- a buy-sell back transaction or sell-buy back transaction; and
- a margin-lending transaction.

The EU Securities Financing Transactions Regulation creates, among other things, a framework under which details of SFTs can be efficiently reported to trade repositories. It addresses the need to:

- introduce provisions on the exchange of information between competent authorities; and
- strengthen the duties of assistance and cooperation that authorities owe each other.

The EU Securities Financing Transactions Regulation also establishes strict rules for counterparties concerning re-use. It applies to:

- a counterparty to an SFT that is established in:
    - the European Union, including all its branches, irrespective of where they are located; or
    - a third country if the SFT is concluded in the course of the operation of a branch in the country of that counterparty; and
- a counterparty engaging in re-use that is established:
    - in the European Union, including all its branches irrespective of where they are located; or
    - in a third country, where the re-use is effected in the course of the operations of a branch in the country of that counterparty or concerns financial instruments provided under a collateral arrangement by a counterparty established in the European Union or a branch in the European Union of a counterparty established in a third country.

Cyprus companies that enter into such SFTs must observe:

- the impending reporting obligations under the EU Securities Financing Transactions Regulation and the deadlines within which they must be made; and
- the provisions on the re-use of financial instruments received as collateral.

Certain EU Securities Financing Transactions Regulation provisions already apply. The transaction reporting obligation is expected to come into effect in the second quarter of 2019, so Cyprus companies entering into such transactions must keep this in mind. The Cyprus Securities and Exchange Commission (CySEC) is the competent authority for the implementation of the regulation.

Failure to comply with the regulation will result in the imposition of administrative and criminal penalties.

EMIR

In parallel to the EU Securities Financing Transactions Regulation, the EMIR has also introduced reporting, clearing and operational risk management obligations, which may apply to non-financial counterparties (ie, a mere limited liability company). The EMIR also directly applies in Cyprus. As specified by CySEC, it aims to identify the risks associated with over-the-counter (OTC) derivatives, which generally lack transparency, as they are privately negotiated contracts and any information concerning them is usually available only to the contracting parties, as they create a complex web of interdependence which can make it difficult to identify the nature and level of risk involved.

Cyprus companies entering into OTC derivative transactions must carefully consider their requirements under the EMIR, as they not only apply to financial counterparties, but also to non-financial counterparties (NFCs) – for example, liability companies which constitute none of the following:

- an investment firm authorised in accordance with EU Markets in Financial Instruments Directive (2004/39/EC);
- a credit institution authorised in accordance with EU Directive 2006/48/EC;
- an insurance undertaking authorised in accordance with EU Directive 73/239/EEC;
- an assurance undertaking authorised in accordance with EU Life Assurance Directive (2002/83/EC);

- a reinsurance undertaking authorised in accordance with EU Reinsurance Directive (2005/68/EC);
- an undertaking for collective investment in transferable securities (UCITS) – and where relevant its management company – authorised in accordance with the EU UCITS IV Directive (2009/65/EC);
- an institution for occupational retirement provision within the meaning of Article 6(a) of the EU Pension Funds Directive (2003/41/EC); and
- an alternative investment fund managed by alternative investment fund managers (AIFMs) authorised or registered in accordance with EU AIFM Directive (2011/61/EU).

The EMIR introduces:

- reporting obligations whereby a derivative (both exchange-traded and OTC derivatives whether cleared or not, including intra-group transactions) and any modification or termination thereof must be reported to a registered or recognised trade repository within the prescribed timeframe. Regulatory technical standards specify the details of what must be reported and the format and frequency of such reports. A list of registered trade repositories can be found here. Care must be taken to ensure that the trade repository chosen accepts the type of contract to be reported.
- clearing obligations that apply if the position of the counterparties under the derivative transaction is above the relevant 'clearing threshold' (ie, a predefined amount dependent on the position held by the counterparty in relation to the asset class of the derivative transaction). The following clearing thresholds apply:
  - €1 billion (gross notional value) for credit derivative contracts;
  - €1 billion (gross notional value) for equity derivatives contracts;
  - €3 billion (gross notional value) for interest rate derivative contracts;
  - €3 billion (gross notional value) for foreign exchange derivative contracts; and
  - €3 billion (gross notional value) for commodity derivative contracts and others.
- operational risk management requirements under which if the clearing threshold is exceeded, subject to certain exceptions, the Cyprus entity:
  - must immediately notify the European Securities and Markets Authority and CySEC by completing the relevant form;
  - will become subject to the clearing obligation for future contracts if the rolling average position over 30 working days exceeds the threshold; and
  - must centrally clear all relevant future contracts through a central clearing counterparty within four months of becoming subject to the clearing obligation.

All NFCs (irrelevant of the clearing threshold) must have appropriate procedures in place to ensure that they can confirm the details of their non-cleared derivatives contracts with counterparties. An NFC must ensure that it exercises due diligence and appropriate procedures and that arrangements are in place to:

- measure, monitor and mitigate operational risk and counterparty credit risk, including timely confirmation of the terms of the derivative transaction in order to reconcile portfolios;
- manage the associated risk and identify disputes between parties early and resolve them; and
- monitor the value of outstanding contracts.

Fines

Unlike the reporting obligations under the EU Securities Financing Transactions Regulation, obligations under the EMIR are already in force and must be complied with or fines will apply. As the competent regulatory authority, CySEC may impose an administrative fine not exceeding €350,000. In case of repeated violation, an administrative fine not exceeding €700,000, depending on the seriousness of the violation, may be imposed. If it is proven that the party responsible for the violation received illicit gain exceeding the amount of the administrative fine, CySEC may impose an additional fine of up to double the amount of the gain. The fine will be for each party that fails to comply with the requirements.

Comment

As Cyprus is a popular jurisdiction for establishing special purpose vehicles with an increased involvement in shadow banking, it is important to highlight the significance of the newly introduced regulations analysed above, which now bring non-financial counterparties, such as limited liability companies, into the ambit of transparency reporting.

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