
Consultation Response

14 June 2012

European Commission Green Paper on Shadow Banking

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Commission's Green Paper on Shadow Banking. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We provide below our high-level response to the consultation, which is followed by answers to the individual questions asked by the Commission.

1 High-Level Response

AFME believes that shadow banking contributes positively to the financial system by providing significant funding to capital markets and thus the economy, and by diversifying risk in the financial system. As prudential requirements on banks increase and as the deleveraging of the banking sector continues the importance of the non-bank and capital markets funding sources will grow. Shadow banking can play a role in easing the pressures in the economy that these developments generate and should be encouraged and facilitated.

AFME acknowledges the policy maker concerns with shadow banking and looks forward to working with policy makers at the global level and in the EU – in particular, the Commission – to develop policy on shadow banking. However, AFME would be concerned by any presumption by policy-makers that shadow banking is inherently bad for financial stability and therefore to be discouraged. The liquidity, funding, diversity and competition benefits shadow banking can provide are significant.

This is not to say that shadow banking does not, like all financial sector activity, generate certain risks. However, before specific policy options are considered policy-makers should clearly define the problem being addressed and develop a focused solution. If the concern of policy-makers is systemic risk outside of the regulated banking sector then they should address these specific concerns directly. Policy discourse should not be limited to a defined sector, especially when the definition is not settled and is perhaps delinked from the systemic risk present.

Where, after a comprehensive analysis of the risks (including an impact assessment, if appropriate) a regulatory solution is determined to be necessary, AFME members strongly believe that targeted, direct regulatory interventions are likely to be most effective and efficient. AFME cautions against too

much focus on indirect regulation, which could in fact increase the regulatory arbitrage that policy-makers are seeking to address. Increasing prudential requirements on banks as a means of indirectly regulating of shadow banking is likely to encourage more activity to move outside of the banking sector. Indirect regulation also raises the potential for layering new regulation onto already-regulated firms. Given the fluidity of current regulatory change initiatives, we believe that is critical to ensure that existing initiatives are properly implemented and calibrated before imposing any further requirements. Financial groups subject to consolidated prudential regulation are facing significant additional regulation as a result of changes agreed globally, at the EU level and in individual jurisdictions, and supervisors already have a wide range of existing tools and powers to ensure that risks are appropriately managed and mitigated.

A global approach to addressing issues is required. While AFME notes the high-level nature of the consultation in the context of ongoing FSB work streams, we believe the Commission should wait for the approach for shadow banking to be settled globally before proceeding with regulatory proposals. In the context of this global work project, AFME considers it premature to comment in detail on possible actions in respect of 'shadow banking'.

2 Responses to Consultation Questions

a) Do you agree with the proposed definition of shadow banking?

AFME believes that activities should be the initial focus of the discussion on shadow banking, not least to provide a means of ensuring equivalence and parity of treatment. Unless there are sound reasons not to do so, financial market products and services should receive equivalent regulatory treatment regardless of the legal entity carrying them out. Entities will need to be discussed, not as part of the definition but when considering the appropriate ways of addressing the potential issues identified.

The Commission's definition of the term 'shadow banking' is a confusing hybrid that covers both activities and entities, but then defines the entities by the activities they undertake. We understand this to mean that an entity that undertakes any one of the activities listed would be defined in its entirety as a shadow bank. Depending on the policy responses proposed, this may not be appropriate or proportionate and reinforces the appeal of focusing the definition on activities.

AFME believes policy-makers should be focussed on identifying and addressing all risks outside of the regulated sector. However, not all financial services activities outside of the regulated banking sector should necessarily be considered shadow banking. A tailored and targeted approach is necessary to appropriately capture any systemic risks present. We recommend that policymakers focus on:

- i. non-bank credit intermediation (lending or investment) activities,
- ii. activities that are unregulated or regulated in a materially different manner than similar banking activities (including investment activities), and
- iii. activities that could be a source of systemic risk and/or regulatory arbitrage

We do not believe that “undergoing credit risk transfer” is necessarily a source of systemic risk or arbitrage. For example, the sale by a bank or non-bank of a loan or asset is a credit risk transfer, but this transfer is not necessarily systemically relevant.

The definition should be clear that where one of the listed activities is performed by a prudentially regulated entity or an entity within a prudentially regulated consolidated group it should not be the subject of additional regulation under the heading of ‘shadow banking’. For example, a collateral upgrade transaction carried out by an insurer or securities lending or repo activities carried out by a bank should not be subject to different and additional rules derived from their categorisation as shadow banking, since these activities are already regulated. Financial groups subject to consolidated prudential regulation are already subject to significant regulation and their supervisors have a wide range of tools and powers to ensure that risks are appropriately managed and mitigated.

Finally, AFME notes that the definitions used for shadow banking are not always consistent. For example, in some instances shadow banking is defined as being *outside* of the traditional banking sector, and in others it is defined as being *partially outside* the traditional banking sector. This lack of consistency may lead to sub-optimal regulatory outcomes.

b) Do you agree with the preliminary list of shadow banking entities and activities? Should more entities and/or activities be analysed? If so, which ones?

In general AFME agrees with the list of entities and activities that might be analysed and assessed for potential systemic risk and regulatory arbitrage, subject to the comments immediately above and noting the difficulty of creating a specific list when the definition of shadow banking is not fully settled. We also agree that any list should be kept under review as shadow banking will likely evolve over time.

In addition, AFME would like to underline the fact that it considers the list to be a list of entities and activities which, subject to our earlier comments, are proper subjects of *inquiry* in the context of systemic risk. This does not imply that AFME considers new regulatory action to be needed in respect of such entities and activities. The decision regarding any such new measures should only be made after a comprehensive analysis of any actual risks posed by these entities or activities.

Other activities that could be considered include:

- Corporate paper issuance by non-financial firms could be considered shadow banking, including aspects of maturity transformation, leverage, and credit intermediation
- Asset management companies formed to assist troubled financial institutions (often known as “bad banks”) if not set up in the legal form of banks. These entities could be considered part of the shadow banking sector
- Peer-to-peer lending or crowd funding is a relatively small but growing example of non-bank credit intermediation. There are firms in the retail sector, facilitating such lending; while in the corporate sector, peer-to-peer lending between non-financial firms also takes place (e.g. a larger corporate providing loans to its suppliers). These practices exhibit the characteristics of shadow banking and should be added to the Commission’s list

- Commodity trading carried out by non-bank firms could exhibit characteristics meeting the definition of shadow banking

In focusing on these particular activities we simply intend to draw attention to the fact that they are examples of other aspects of the financial market that could, for completeness, be considered within the proposed definition of shadow banking.

c) Do you agree that shadow banking can contribute positively to the financial system? Are there other beneficial aspects from these activities that should be retained and promoted in the future?

AFME strongly agrees that shadow banking contributes positively to the financial system by providing a significant source of funding for the economy in addition to that provided by regulated banks, as well as facilitating efficient capital allocation and diversifying risk. For example:

- Issuance of corporate bonds technically meets the FSB definition of shadow banking (credit intermediation outside of the regular banking system). Yet, it is an established activity in capital markets and an invaluable part of the economy that should be promoted as an alternative means of financing the economy
- Additional liquidity in financial markets assists in the process of price discovery, while also narrowing spreads which ultimately decreases the cost of financial services to end users
- Competition from the shadow sector enhances the functioning of financial markets and benefits users of the financial system
- A properly constituted securitisation market can play a beneficial role in the intermediation of funds and the financing of the real economy (see, for example, the comments of FSA Chairman Lord Turner in his 2012 Rostov Lecture at John Hopkins University)

It is important that the beneficial aspects of shadow banking are not unduly diminished through new regulation.

d) Do you agree with the description of channels through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?

AFME generally agrees with the description of the channels through which shadow banking activities can transfer risks to other parts of the financial system. While we note that the focus of the question is on the channels, we caution against the presumption implicit in the question that shadow banking activities are creating and transferring risks – as noted elsewhere in our response, the level of risk present should be determined in a targeted and refined manner. We also note that risk distribution can be a beneficial process, so long as it is properly understood and managed.

We note that call deposit-like funding structures may lead to ‘runs’ when there is a loss of confidence in their viability. Regulation here should promote financial stability, including ensuring that investors are not artificially insulated from the risks associated with their investment decisions.

AFME agrees that circumvention of rules and regulatory arbitrage is a concern. The description given in the paper of 'regulatory fragmentation' to avoid regulation or supervision may be accurate in some instances, but AFME would caution against any assumption that all disintermediated activities are carried out for the purposes of, or have the effect of, avoiding regulation. Wholesale capital markets are characterised by many actors specialising in various aspects of the financial system. Such a seemingly fragmented system should not be equated with or be seen as evidence of a regulatory 'race to the bottom'.

AFME agrees that disorderly failures could affect the banking system directly through exposures (lending or contingent liabilities) or indirectly through sales of assets affecting asset prices. We note that such risks will not only arise from the shadow banking sector but will arise from other parts of the economy also. For example, lending by banks to sovereigns has affected the European banking sector directly. This reinforces the point made elsewhere that the focus of policy-makers should not be on shadow banking alone but on also on wider risks in the economy, whether they meet the definition of 'shadow banking' or not.

e) Should other channels be considered through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?

AFME has no other channels to suggest.

f) Do you agree with the need for stricter monitoring and regulation of shadow banking entities and activities?

AFME agrees that more monitoring should be considered to ensure supervisors and macroeconomic authorities have the appropriate information to support financial stability.

AFME also agrees that stricter regulation of shadow banking activities may be necessary to address issues of regulatory arbitrage and systemic risk. However, it should not be presumed that non-bank regulation is no regulation at all. Any new regulation should be proportionate and targeted depending on the particular risks identified. Additionally, any new regulation should be the result of a detailed assessment of the risks present and the options available to address those risks, along with a consultative impact assessment and cost benefit analysis. In short, any new regulatory proposals should follow the approach of "better regulation".

g) Do you agree with the suggestions regarding identification and monitoring of the relevant entities and their activities? Do you think that the EU needs permanent processes for the collection and exchange of information on identification and supervisory practices between all EU supervisors, the Commission, the ECB and other central banks?

AFME agrees that processes should be put in place to ensure supervisors and macroeconomic authorities have the appropriate information to support financial stability. However, it is not necessarily clear that the Commission itself needs to be involved in any detailed information sharing process. Supervisors and macroeconomic authorities should monitor and analyse the information

received under such processes and make recommendations to the Commission and others relating to identified issues.

We recommend that strong and regular information sharing be put in place between national, European, and global regulatory entities to avoid costly and unnecessary duplicative reporting. Any new information should be channelled to the greatest extent possible through existing reporting processes to ensure the information is provided efficiently and accurately for both market participants and public authorities.

h) Do you agree with the general principles for the supervision of shadow banking set out above?

AFME notes the assumption in this section of the paper that shadow banking entities will be regulated. In the first place, AFME prefers the approach of viewing shadow banking by its activities rather than entities, as outlined above. Secondly, any regulation should involve quantitative analysis of the activity and its impact on the wider economy. It may be the case for some aspects of shadow banking that continued or enhanced monitoring is an appropriate solution.

We ask for clarity about the meaning of 'tak[ing] into account existing supervisory capacity' when determining the approach to supervising shadow banking. AFME would be concerned if it means that identified risks are not addressed where a supervisor does not have sufficient resources. Supervisors should use a risk-based approach to target their focus on areas of greatest concern. If their resources are insufficient to address an extended scope of supervision there is a case for either their existing resources to be deployed in a different manner or for new resources to be added

i) Do you agree with the general principles for regulatory responses set out above?

AFME agrees with the general principles set out in this section of the Paper. In particular we agree that a specific approach to each kind of activity (rather than entity) should be adopted.

Though the appropriate approach will vary by activity AFME cautions against too much reliance on indirect regulation (regulating the links between the banking system and shadow banking entities). In many cases indirect regulation could be an ineffective and inefficient way of addressing identified risks, and could in fact increase the regulatory arbitrage that policy-makers are seeking to address. More indirect regulation that increases prudential requirements on banks will encourage more activity outside of the banking sector. In any event, connections between banks and shadow banking entities are already captured through both capital (capital requirements associated with risk exposures) and liquidity (liquidity lines included in calculation of liquidity ratios) regulation.

We query what 'alternative or complementary non-regulatory measures' might be considered, as referred to in the final sentence of this section. It is not clear what measures are being alluded to.

j) What measures could be envisaged to ensure international consistency in the treatment of shadow banking and avoid global regulatory arbitrage?

AFME strongly supports a global approach to shadow banking to ensure international consistency. In this regard the Commission should await the outcome of the FSB workstreams before it advances an approach to shadow banking in Europe. In this regard AFME cautions against including any provisions relating to shadow banking in CRD IV.

k) What are your views on the current measures already taken at the EU level to deal with shadow banking issues?

AFME notes the extensive reform programme already underway that will affect both banking and shadow banking activities. We believe that the impact of the existing reforms should be carefully assessed before engaging in a new set of regulatory changes

l) Do you agree with the analysis of the issues currently covered by the five key areas where the Commission is further investigating options?

As a general point, although AFME broadly agrees with the approach of the Commission, we recommend that the Commission waits for all the FSB workstreams to be settled before proceeding with specific initiatives. This is most likely to ensure a coordinated and global approach to the issues. While most of the issues covered are broadly sensible, only when detailed proposals are made can a meaningful dialogue take place. Given the high-level nature of the proposals set out in the Paper it is difficult to provide detailed comments, though comments on selected aspects are set out below.

In respect of bank regulation, AFME queries whether applying a large exposure regime 'individually as well as globally' means the Commission is considering sectoral exposure limits. The large exposures regime is designed and calibrated for addressing particular risks associated with significant exposure to connected entities. The extension of this to a sectoral level is very different in concept. A full assessment of the impact of a sectoral large exposures regime should be carried out as part of the consideration of any change. Such a regulation could have significant impacts on business models and significant knock-on consequences for the provision of credit to certain parts of the economy. In addition there could be practical issues in implementing such a regime.

Repos and securities lending are forms of traditional secured lending. A large part of this activity takes place between regulated entities and is, therefore, properly dealt with by existing regulation rather than any new shadow banking rules. To the extent that repos and securities lending from and between regulated institutions generate regulatory concerns, these would need to be addressed in existing and future regulation. Should they be addressed additionally in separate shadow banking rules, there would be a risk of regulatory 'doubling-up' – or regulation on regulation. There is also a concern that repos and securities lending create an unhealthy level of leverage in the system. We would recommend a thorough empirical analysis of whether (and under what circumstances) repos and securities lending create dangerous leverage so as to ensure that regulatory actions are targeted

and effective. AFME draws attention to the positive benefits that can result from greater disclosure, such as the introduction of the publication of average haircuts in the United States.

With regard to securitisations, AFME believes it is very important to clarify what is and isn't a securitisation that partakes of shadow banking.

Most 'traditional' term securitisations, for example, are structured in the form of a fund, where a pool of assets is credit-tranched and sold to institutional investors. Traditional securitisations include 'pass-throughs', where the investors' rights to repayment is dependent on the securitised assets producing cash and the timing of that event. As such they involve no maturity transformation and do not involve any leverage issues.

Also, when looking at possible regulatory approaches to securitisation, AFME would like to draw attention to existing industry measures being taken in Europe. These measures, undertaken under the Prime Collateralised Securities (PCS) initiative, are aimed at ensuring that securitisations which come to benefit from the PCS label demonstrate a high level of quality, simplicity and transparency. AFME would therefore urge the Commission, when looking at whether there are any regulatory needs in the securitisation field, to not simply look back but also to look forward and take into account the substantive steps taken by the markets, as well as regulators.

In the case of ABCP Conduits, maturity transformation clearly can be undertaken. There may be a maturity mismatch between conduit assets and liabilities. However, this mismatch is absorbed through the existence of liquidity lines provided by banks in almost all cases. In these types of structures, there is no maturity transformation and creation of systemic risk *at the level of the ABCP conduits*. AFME recognises that, upon the liquidity lines being drawn, the maturity transformation originally created at the level of the ABCP conduit is thereby transferred to the liquidity providing bank. Therefore, this is a risk that is a proper subject of regulatory interest. However, this issue is most appropriately dealt with, at the outset, at the level of banking regulation. In other words, the maturity transformation risks that appear within ABCP conduits are not 'shadow banking' risks. As such, they are being extensively covered by changes in banking regulations such as CRD IV and Basel III.

Other types of structured vehicles, such as Structured Investment Vehicles (SIVs), are not strictly speaking securitisations since SIV liabilities were not directly backed by SIV assets. Their nature is more that of leveraged funds. However, SIVs definitely did engage in highly leveraged forms of maturity transformation. Certain forms of complex Collateralised Debt Obligations (CDOs), which are securitisations, also contained high levels of embedded leverage. However, we would like to point out that this is not the case for traditional real economy asset securitisations and, for the reasons outlined above, for Asset Backed Commercial Paper Conduits (ABCP Conduits). Accordingly, AFME does not agree that all forms of securitisation by definition, generate 'shadow banking' concerns. AFME would urge the Commission – as set out above – to focus its actions on shadow banking on "activities" that generate risk rather than entities or asset classes.

AFME is strongly supportive of the concept of legal entity identifiers. AFME believes that such identifiers should be broadly applied to all entities transacting in financial products and to all jurisdictions globally, thus improving the ability to track risks in the system.

m) Are there additional issues that should be covered? If so, which ones?

AFME has no other issues to suggest.

n) What modifications to the current EU regulatory framework, if any, would be necessary properly to address the risks and issues outlined above?

It is too early to consider changes to the regulatory framework. The risks and issues need to be explored and elaborated in much greater detail first. This will enable global policymakers to reflect on the most appropriate responses, ensuring that any regulatory changes can be designed so as to be targeted and proportionate.

As a general point, introduction of prudential requirements will not be appropriate in all instances. Increased disclosure and transparency coupled with an efficient use of data already collected by regulators or available in the public domain, an oversight by macroprudential supervisors, and well coordinated microprudential and macroprudential supervisors may often be an appropriate solution.

In respect of securitisation, AFME notes the changes that have already been introduced (or are in the process of being introduced) in CRD IV, CRA I and CRA III. Together with any additional disclosure and transparency that the Commission deems appropriate and taking into account our earlier response that traditional securitisations do not generate shadow banking concerns, AFME believes it is necessary to assess carefully the nature and extent of any remaining shadow banking issues following the extensive regulatory changes already effected.

o) What other measures, such as increased monitoring or non-binding measures should be considered?

AFME agrees that increased monitoring should be considered. AFME also recommends that strong and regular information sharing be put in place between national, European, and global regulatory entities to avoid costly and unnecessary duplicative reporting.