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## Shadow Banking

**14 September 2012**

### **AFME Comments on ECON Draft Report**

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The Association for Financial Markets in Europe (AFME) welcomes the own-initiative report on Shadow Banking undertaken by the European Parliament Economic and Monetary Affairs Committee. 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.

In the spirit of constructive engagement, we would like to take the opportunity to provide some broad thoughts and perspectives on a number of important aspects included in the draft report being considered by MEPs. We provide below a high-level summary of our views on the current European and global regulatory debate on shadow banking, as well comments on specific aspects of the draft ECON report.

#### **1 Executive Summary/ 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. The European corporate and consumer sectors have traditionally relied heavily on the banking sector for their funding requirements, unlike for example in the US, where the capital markets are more developed and the real economy is less reliant on deposit funding. This significant lack of diversity in funding sources is one of the key constraints that limit the competitiveness of the financial system in the EU and increases systemic risks in the European financial sector, as AFME has highlighted in a response to the Liikanen group. Shadow banking can play an important role in easing the pressures in the European economy that these developments generate and should be encouraged and facilitated. The liquidity, funding, diversity and competition benefits shadow banking can provide are significant.

As noted in the ECON draft report, since the crisis some of the practices associated with shadow banking have disappeared. It is important to also note that many of the risks associated with bank-shadow bank interconnectedness (such as SPV funding, liquidity lines, large exposure limits) are being addressed through various regulatory initiatives, such as the CRD IV package, as well as institutions' own actions. We strongly support the harmonisation of regulations across the region and,

in our view, if the regulatory landscape in Europe is harmonised and that systemically important firms are captured by relevant prudential regulations, credit that such firms extend is capitalised and therefore any additional risk taking by such firms should be seen as a business decision.

While we recognise the very real role played in the financial crisis by certain products such as US subprime and CDO squared, we would like to draw the Parliament's attention to the differences in the European and US standards and market practices even before the crisis. European securitisations have always been subject to a higher level of regulation, which is why the credit performance of European securitisations has been very good throughout the crisis. For example, since the onset of the crisis, defaults on European prime RMBS (all tranches, not only the AAA tranches) have totalled just 7 basis points, whilst in the US the figure is over 1100 basis points. From a secondary market pricing standpoint, European RMBS have outperformed most sovereign debt, bank and many covered bonds.

It is important that MEPs and policy makers take into account the strong credit and price performance of European securitisation since the crisis and more recently the significant steps already taken by the industry, the European Parliament itself and other policymakers and regulators to encourage best practices in securitisation origination as well as investment. For example, mandatory risk retention requirements required by the Capital Requirements Directive and other legislation force a more transparent alignment of interests.

From the industry standpoint, AFME would like to specifically draw attention to the Prime Collateralised Securities (PCS) initiative, which is aimed at ensuring best practices through a label which identifies securitisations which demonstrate a high level of quality, simplicity and transparency. PCS initiative has already received words of support from the European Commission, European Banking Authority, EIOPA, and ESMA. It is an important means of providing additional cash to the real economy. AFME recommends that policymakers take the time to review details of how the industry has already changed, instead of burdening it with new regulations at a time when alternatives to bank financing are increasingly important. A brief summary of PCS is included in the Annex.

With regards to prudential and accounting consolidations, we would like to note in this context that the Basel Committee on Banking Supervision is undertaking an important task in reviewing the issues between non banking entities and the banking entities that sponsor them. The outcome from this review, and the way it is implemented in Europe, will improve the consistency of the regulatory consolidation across jurisdictions and mitigate the risks that arise from systemically important shadow banking entities.

This is not to say that shadow banking will not, like all financial sector activity, generate certain future risks. However, before specific policy options are considered, we would recommend that policy makers 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. In this respect, our views echo those of the ECB (response to the

Commission's Green Paper) that any shadow bank regulation needs to be thoroughly analysed in terms of costs and benefits and focus only on systemically important institutions and activities.

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. We note that the ECON draft report supports the approach proposed by the Commission on indirect regulation of shadow banking. 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 it is critical to ensure that existing initiatives are properly implemented and calibrated before imposing any further requirements.

A global approach to addressing issues is required. We believe EU policy makers should wait for the approach for shadow banking to be settled globally before proceeding with regulatory proposals.

## **2 Comments on specific issues**

### **Contribution of Shadow Banking to the Economy**

AFME strongly believes 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:

- 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).
- Reduced reliance on bank deposits, guaranteed by deposit guarantee schemes, to fund lending to the real economy

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

### **Definition of Shadow Banking**

The ECON draft report welcome's the FSB's definition of shadow banking as "a system of intermediaries, instruments, entities or financial contracts generating a combination of bank-like functions but outside the regulatory perimeter or under a regulatory regime which is either light or addresses issues other than systemic risks, and without access to central bank liquidity facility or public sector credit guarantees".

AFME believes that 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:

- non-bank credit intermediation (lending or investment) activities;
- activities that are unregulated or regulated in a materially different manner than similar banking activities, and
- activities that could be a source of systemic risk and/or regulatory arbitrage (including asset and liability mismatching/maturity transformation)

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.

### **A Fragmented Regulatory Landscape**

The ECON draft report correctly notes that some shadow banking activities are regulated or unregulated according to the jurisdiction in question. The regulatory framework and oversight of shadow banking is indeed fragmented in Europe, causing regulatory arbitrage that is due to the different regulatory scopes and enforcement processes across the single market. We welcome any proposals that help establish uniform regulatory requirements throughout the EU. This is also proposed by the ECB in their response to the Commission's Green Paper on Shadow Banking.

We also note the ongoing work of the High-Level Expert Group on Reforming the Structure of the EU Banking Sector (the "Liikanen Group"), which has a mandate to look at the structure of financial institutions in Europe. Any proposals on shadow banking should take into account the recommendations of the Liikanen Group as they may well impact on the interrelations between bank and non-bank entities. This should be carefully considered in the own-initiative paper that proposes separation of investment and retail banking activities. AFME is opposed to separation of investment and retail banks and we have explained the reasons in our extensive response to the Liikanen High-Level Expert Group (1.6.2012).

## Securitisation

AFME and its members are very concerned by draft report's remarks regarding securitisation. We believe the evidence does not support a negative view of securitisation or the risks it poses to the financial system. It is important that MEPs and policy makers take into account the strong credit and price performance of European securitisation since the crisis and more recently the significant steps already taken by the industry, the European Parliament itself and other policymakers and regulators.

Securitisation "incentives" and the retention of risk (otherwise known as "skin in the game"), which have always been features of European securitisations, have now been enshrined in legislation by Article 122a of the CRD. This has been in effect since January 2011. In addition, transparency has been significantly enhanced already by Article 122a of the CRD ("CRD 2"), and by new disclosure requirements of loan and other data by the ECB and some national central banks. Nearly all European securitisation is undertaken by regulated banks and mortgage lending is itself regulated in most EU Member States.

The industry agrees with regulatory requirements which discourage investment by regulated institutions in complex re-securitisation transactions ("CDO squared"), and new capital requirements for them under, for example, Solvency II will anyway prevent such a market re-emerging. Further regulation will have unintended consequences for certain structures which do not carry the risks of products such as US subprime or CDO squared but which, for sensible reasons, involve more than one stage in the securitisation process. Such transactions, such as asset-backed commercial paper conduits, finance real economy assets for leading European companies, such as trade or auto receivables.

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 (please see Annex at the end of this document), are aimed at ensuring that securitisations which come to benefit from the PCS label demonstrate a high level of quality, simplicity and transparency. AFME and the European Financial Services Round Table (EFR) have set up an independent PCS initiative, and the working group includes the ECB, EIB, European Commission and Bank of England as observers. ECB President Draghi publicly supports the development of PCS, and other policymakers such as the European Commission, European Banking Authority, EIOPA, and ESMA have in public speeches or in writing supported the development of PCS, since it can provide needed funding to the European real economy. Notably, PCS will only include high quality assets such as SMEs, auto loans, leases, and residential mortgages which meet high quality origination criteria, and consumer loans. Re-securitisations will not be eligible.

In considering regulatory needs in the securitisation field, AFME believes policy makers should take into account the substantive steps taken by the markets, as well as regulators to ensure that European securitisations conform to standards of quality, simplicity/standardisation, and transparency, which are attributes which lead to improved secondary market liquidity. While the bank sector remains under stress, it is essential to encourage capital markets funding of the real economy. Securitisation,

sensibly deployed and prudently regulated, can play an important part in providing finance for good quality assets such as residential mortgages and auto and consumer loans.

We would also like to draw attention to the fact that European structured finance has performed well: since the onset of the crisis, defaults on European prime RMBS have totalled just 7 basis points (all tranches, not just the AAA tranches), well within expectations. During the period of market turbulence in 2011, the market price performance of European RMBS has been superior to most EU sovereign debt and senior bank debt, as well as many covered bonds.

In today's difficult financial environment, AFME acknowledges the need to strengthen systemic stability, but we are very concerned about sentiment and regulation that makes access to capital markets and funding more difficult, without discernable benefits to participants and without allowing existing regulation time to prove itself. We believe further regulation in this area carries the risk of undermining the already fragile provision of finance to the EU economy and may increase the already high dependency on bank financing.

## **Annex - Overview of PCS Prime Collateralised Securitisation Initiative**

- PCS is a market-led initiative developed to apply a label to securitisation issues which meet specific eligibility criteria with the aim of increasing the funding of real economy assets through securitisation thereby supporting the recovery and future growth of the European economy.
- The PCS label is intended to be a simple way of communicating and identifying securitisations that meet predefined best practice standards with regard to quality, transparency and simplicity/standardisation. The aim of setting these standards is to increase the depth of the securitisation investor base so as to allow for an increase in primary issuance and improve secondary market liquidity.
- PCS is not intended to replace investor due diligence or credit ratings or to act as an alternative form of credit analysis. PCS eligibility is, however, limited to the most senior tranches in a securitisation capital structure.
- An independent, not-for-profit, organisation has been set up to develop, launch, promote and administer the PCS label. The PCS organisation will comprise the PCS Association which will own the label and the PCS Secretariat which will be responsible for day to day operations including label issuance and monitoring.
- PCS will be governed by an independent Board made up of a mix of senior non-industry professionals and senior financial services industry professionals. The PCS organisation will be a self-financing entity after an initial period of pre-funded operation.
- The PCS label will only be awarded to securitisations that are backed by asset classes that have performed well through the financial crisis and also that are of direct relevance to the real economy. These include European auto loans and leases, residential mortgage loans, loans to small and medium enterprises, consumer loans and credit card receivables.
- PCS has intentionally excluded certain asset classes from its eligibility criteria. These excluded asset classes currently include CMBS, CDOs, synthetic securitisations, resecuritisations and residential mortgages which do not meet defined quality criteria.