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Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.

EBF Response to European Commission Green Paper on Shadow Banking

Key Points:

- **Impact of "Shadow Banking" on funding banks and real economy must be understood**

The shadow banking entities and activities identified by the FSB and Commission are often (key) customers and sources of funding for banks. The final policy recommendations need to take account of the global impact on the ability of banks to provide finance to their customers and the real economy. Given the current financial and economic fragility it is imperative that the current level and diversity of funding is increased or at least maintained and that interlinkages are properly understood.

- **Securitisation needs to be reinstated to support funding of the real economy**

Securitisation of high-quality assets should be seen as an important and stable source of alternative funding for banks. Regulatory steps have already been taken to enhance securitisation transactions and to increase the transparency of the market. Regulatory change is being supported by market initiatives such as the Prime Collateralised Securities (PCS) that reduce the need for further regulation.

- **A better description and definition of Shadow Banking is required**

The term "shadow banking' fails to describe the very diverse entities and activities covered in the green paper and has pejorative connotations. It does not duly reflect the important functions these entities provide to the financial sector and the economy as a whole. So-called "shadow banking" activities should therefore be assessed and dealt with individually as the risk and funding implications for each category will be unique to each other.

- **A stocktaking of regulatory initiatives needs to be taken first**

After having done so much already, an assessment of existing and forthcoming regulation is needed at a global, European and at national level to identify potential gaps and overlaps as well as any residual risk and opportunity for arbitrage. No one knows yet where the present regulatory initiatives will end up in Europe. Excessive, incompatible regulation or duplication of policy measures should be avoided in an effort to reduce regulatory uncertainty and the opportunity for regulatory arbitrage.

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- **Use macro-prudential supervision to monitor risks**

The structures established to perform macro-prudential supervision, such as the European Systemic Risk Board, should be used to monitor the evolution of the financial system and shadow banking activities to identify systemic risks and propose steps to mitigate them.

- **Europe should contribute to the FSB work and wait for this to be finalised before starting its own projects**

Given their global nature, the issues considered in the Green Paper are best addressed via the Financial Stability Board. We strongly support the Commission' decision to consult on how it should engage on this topic at the FSB but urge that any measures taken at EU level are consistent with those agreed by the FSB in terms of both content and timing.

- **The need to avoid unintended consequences**

Any potential indirect regulation should be construed so that future credit crunches are avoided and procyclicality not be reinforced. Furthermore, efforts to address risks posed by the shadow banking sector should not paradoxically incentivise regulatory arbitrage.

- **The need for a level playing field**

With regard to the potential approaches for addressing shadow bank concerns, the EBF considers that all entities that perform credit intermediation should be made subject to the same rules. The non application (or light application) of prudential regulatory standards and supervisory oversight to entities that are engaged in activities similar to those of banks distorts the level playing field. We would also add, that internationally consistent regulation will both minimise the prospect of regulatory arbitrage and enhance competition.

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Related documents: European Commission on Green paper on Shadow Banking
http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf

Response to Consultation Questions:

WHAT IS SHADOW BANKING?

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

Our Members generally agree with the proposed definition, but consider that it is a somewhat vague, pejorative and arbitrary term to describe a variety of market finance activities. It would be more helpful if the definition(s) addressed specific potential risks and concerns of shadow banking. For instance, we note that the paper does not reference one of the FSB criteria of lack of access to Central Bank liquidity lines and hence no guarantee of liquidity support.

It is meanwhile rather common to define shadow banking as an interaction between entities and activities. This approach tries to grasp the complexity of the issues involved and the fact that the individual entities and activities generally associated with shadow banking – as such - cannot serve as indicators for shadow banking. But it should be used with care. Due to continuous financial innovation shadow banking will be a moving target. Some EBF Members would further consider that it is easier to define activities rather than entities as regulated or un-regulated and note that this would reduce the prospect for arbitrage.

It should be kept in mind that the systemic risk connected with shadow banking activities depends not only on the scale of these activities but even more on the context within which they take place and the entities which undertake them. This is especially true in respect to ETFs, MMFs and repurchase (repo) transactions.

Therefore this approach will only work if the two-dimensional nature of the issue is always recognised, especially in connection with the development of regulatory requirements: The focus of any regulation can therefore not be any entity or activity as such but only situations where the relevant activities interact and the manner in which they interact.

In addition, some EBF Members are concerned, that the definition proposed includes as one of its elements "*accepting funding with deposit-like characteristics*". Accepting funding with deposit-like characteristics is a structural element of banking activity and this particular case would most likely correspond, not to a problem of lack of regulation, but to a situation of unlawful provision of banking services, which, according to each member state's national law, can only be provided by specific types of authorised entities or institutions (same game, same rules). As such, the definition of shadow banking should not include as one if its elements the acceptance of funding with deposit-like characteristics. Or at least 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 is not classified shadow banking.

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?

Simply looking at a list of activities or entities might be misleading, when the objective is to reduce systemic risk or regulatory arbitrage. Activities may only give rise to systemic risk in

combination with other activities or depending on the scale of the activity. The same financial instruments are used for a variety of purposes in connection with different business partners and are therefore connected with different levels of risk. Reducing systemic risk or regulatory arbitrage in the shadow banking sector will require the analysis of every single activity and the assessment of whether separately, in combination and in which context they will pose potential systemic risk.

The EBF would thus agree with the preliminary list in the sense that these activities need to be the subject of further analysis and monitoring. We note however that investment funds and securitisation transactions are already addressed by regulation as outlined below. At the very least, existing securities and prudential regulations should be taken into consideration when investigating the risk and final policy recommendations.

Investment Funds

Due to, their activity funds, generally shall not be considered under the umbrella of shadow banking. Indeed European investment funds or the managers must either comply with Directive 2009/65/EC (Recast of Directive 85/611/EEC) (hereinafter referred to as "**UCITS Directive**") or with Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (hereinafter referred to as "**AIFM Directive**") and accompanying level 2 and 3 regulations. UCITS regulation will very soon be under review to align its depositary regime on the AIFM, leading to the same systemic risks protection.").

The Green Paper also mentions "*Money Market Funds (MMFs) and other types of investment funds or products with deposit-like characteristics, which make them vulnerable to massive redemptions ("runs")*". However, in the particular case of investment funds, current European Union legislation foresees specific mechanisms that mitigate the risk of possible redemption "*runs*". One may consider that some funds may fall outside of an EU regime, but given the broad nature of the AIFM scope combined with the UCITS framework few, if not none, of these funds will be regulated at Member State level only.

A last word on funds will be on closed end investment funds (fixed number of units or shares), for which the problem of "runs" will not exist, due to the fact that, in these cases, redemption is only possible when the duration of the fund expires.

Securitisation Transactions

The EU has not issued harmonised legislation regarding securitisation transactions, but even still, it is our Members' opinion that the Green Paper has certain underlying unjustified prejudices in respect of this activity. Numerous steps have been taken to enhance the securitisation market, which has the potential to be a robust risk transfer mechanism, including:

- Contractual structures and operational details of these transactions are highly standardised across the EU;
- Situations of non-compliance did not reach the same level as in the United States of America; and
- Securitisation transactions carried out by credit institutions (which are the more relevant in terms of systemic risk) are already partially regulated in the Capital Requirements Directive (Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC).

The referred to Directive determines the prudential treatment of credits assigned for securitisation transactions, namely the terms under which they can be removed from the balance sheet of credit institutions, for the purpose of determining their total assets, as well as their income.

In addition, Commission Regulation (EC) Nº 809/2004 of 29 April 2004 also establishes the information to be contained in prospectuses for asset backed securities transactions (including securitisation transactions).

As such, any EU legislative initiative, regarding securitisation transactions, should only be considered after all the regulatory requirements have taken effect and been assessed for their effectiveness and impact. If further measures are considered necessary then these should use the contractual standards and structures used in the market (which incorporate solid guarantees for creditors) as well as the rules included in the Capital Requirements Directive as a starting point.

Repos and Secured Lending

Securities lending transactions and repurchase (repo) transactions are of fundamental importance for credit institutions and other market participants to ensure their liquidity. This function will become even more important in the future as a consequence of new regulatory requirements, in particular the new capital requirements regime and the new regulatory framework for derivatives: The new regulatory framework will significantly raise demand for highly liquid / high quality assets, in particular, in order to satisfy collateralisation requirements (e.g. for CCP-clearing or for bilateral OTC-derivative transactions). At the same time, the access to high quality assets is becoming more difficult.

Securities lending as well as securities repurchase (repo) transactions are instruments widely used in the financial markets. They are essential for securing funding and liquidity. Consequently, any regulatory requirements regarding securities lending and repurchase (repo) transactions directed at shadow banking should be balanced. Otherwise it can have unintended and potentially far reaching adverse consequences for the financial market as a whole.

The repo market is faced with a challenge due to the fragmentation in the existing European settlement systems. This fragmentation has been pointed out by ICMA in its white paper on the operation of the European repo market, the role of short-selling, the problem of settlement failures and the need for reform on the market infrastructure of July 13, 2010[1] as one of the main obstructions in the efficiency of cross-border transfers of securities, since each settlement system operates under different legal and regulatory frameworks. This lack of harmonisation contributes to delivery failures in repo transactions.

Therefore, official initiatives to harmonise the systems and business practices of national central securities depositories (CSDs) and to increase the interconnectivity between CSDs and International CSDs would probably improve the efficiency of cross-border transfers of securities and, therefore, could reduce delivery failures in the repo-market.

[1] http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/ICMA%20ERC%20European%20repo%20market%20white%20paper%20July%202010%20(2).pdf

With regard for making the case for a repo trade repository it seems to be based mainly on the need to collect market statistics. A thorough cost-benefit analysis of the case for a repo trade repository is clearly required before advancing such a proposal. This includes the assessment of the availability of already existing data.

Finally, we note the work of the International Capital Markets Association (ICMA) in its paper on Shadow Banking and Repo[2] which addresses the risks, i.e. excessive leverage, pro-cyclicality, encumbrance and transparency, and possible policy recommendations. The EBF broadly supports this analysis.

WHAT ARE THE RISKS AND BENEFITS RELATED TO 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?

Yes. The EBF generally agrees with the advantages indicated in the Green Paper. It can increase efficiency, provide diversification and spur competition and innovation. Properly structured it can make the financial sector more robust. The examples are well known and widely accepted. As to the importance of securities lending and repurchase (repo) transactions as instruments to safeguard liquidity/access to collateral, as well as to the importance of securitisations, see our response to Question b)

However, in order to safeguard the financial system it would be preferable to identify shadow banking activities first in a global context and, once the specific needs are determined, globally, regionally and nationally, the EU should prepare appropriate measures. In this regard we look forward to the policy recommendations due from the Financial Stability Board before the end of the year.

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?

The EBF agrees with the description of channels. The channels described are those observed during the recent financial crisis. This should, however, not lead to the conclusion that shadow banking activities will generally follow these channels. With reference to the paper of the European Repo Council from March 2012 it can for example be documented that there is no general risk of a run for repos. The same comes true for MMFs. Although the mentioned transfer channels have been observed in the past with special activities it is not permissible to consider them as general channels of risk transfer for shadow banking activities.

The channels alone do not yet give a description of the real systemic risk to be addressed by future regulations. As mentioned above, a debate on regulatory reform requires further stocktaking efforts such as market sizing, spill over risks, etc. Otherwise, it will be difficult to make regulatory intensity proportional to looming systemic risks. We should also consider the following:

[2] http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Shadow%20banking%20and%20repo%2020%20March%202012.pdf

(i) Deposit-like funding structures may lead to "runs":

As indicated above, "*run*" risks in respect of open ended investment funds are mitigated, because both the UCITS Directive and the AIFM Directive grant powers to supervisory entities that allow them to suspend the redemption of investment units or shares.

In regard to close ended investment funds, the risk will not exist, because normally redemption is only possible when the duration of the fund expires.

In case of securitisation transactions, the risk of runs does not exist as payment periodicity is predetermined in each transaction's terms and conditions. Anticipated payment is only possible when specific circumstances, which are not controlled by the holders of the securitisation notes, occur.

(ii) Build-up of high, hidden leverage:

On this matter the Green Paper is vague and does not indicate the types of collateral funding being churned.

This risk is not applicable to UCITS, considering that there are specific provisions that determine that leverage is only possible up to a certain percentage of the fund's net asset value.

Lastly, the AIFM Directive established specific reporting mechanisms regarding leveraging of AIFM Funds. It is now possible for the fund's respective supervisory entity to impose limits, in order to reduce the use of leverage and, therefore, prevent systemic risks.

As such, once again, the EBF believes that there is no reason to include UCITS or AIFM Funds within the scope of the discussion on the shadow banking system.

(iii) Circumvention of rules and regulatory arbitrage:

Regulators should be aware that besides arbitrage between entities and activities there also exists arbitrage between jurisdictions. It would be wrong to get more equality between entities and activities through giving up equality between jurisdictions. Regulatory steps must therefore be closely in line with the FSB standards and progress in other jurisdictions. Future proposals of new EU provisions need to be explicitly calibrated against these developments.

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?

Considering the generic analysis included in the Green Paper, it is not possible at this stage to indicate other channels through which shadow banking activities are creating new risks or transferring them to other parts of the financial system.

WHAT ARE THE CHALLENGES FOR SUPERVISORY AND REGULATORY AUTHORITIES?

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

Yes. Once the activities that should be included in shadow banking are identified and their respective risks are ascertained either (i) the relevant existing supervision structure and regulation should be utilised or, at the very least, (ii) they should be included in one of the

three traditional financial sectors and, consequently, their relevant supervisory entity and applicable regulation should be determined.

We believe that equipped with a suitable mandate, existing bodies and agencies are perfectly placed to contribute in establishing a more informative picture of risk transfer mechanisms employed today and set to develop in the future. Increased ongoing monitoring should help to establish facts. Where these are found to lead to undue systematic risk, corrective actions should be introduced. For this purpose some existing regulatory frameworks may have to be expanded. Hence we see the solution in the enhanced applicability of existing rules, rather than in completely new set of rules.

We fully support the objectives of the initiative, in particular the goal to ensure a comprehensive and consistent regulation of all markets and market participants (similar regulation for similar risks).

As a lesson learned from the recent financial crisis we do agree that there is a strong need for the industry and the supervisory community to thoroughly understand the interconnections, amounts and distribution of risks within the existing financial system.

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?

Yes. But, considering the information presented in the Green Paper, it is not possible at this stage to identify the activities that should be included in shadow banking, as well as the risks entailed by such activities. As such, it is not possible to determine the specific needs for regulation and supervision.

Once the referred to risks are identified, it might be necessary to implement continuing procedures of data processing and exchange of information between institutions at EU level and supervisory institutions at member state level.

Considering the current supervisory structure at EU level, the ESRB, if provided with the necessary staff and technical means, should be the most adequate institution to process the compiled data, considering it has a global perspective of all three traditional financial sectors.

We would like to point out that currently the EU is undertaking a significant reform of supervisory reporting requirements for banks. The interconnection with the banking sector is taken into account by the introduction of new reporting definitions. From these new figures a lot of information can be derived.

In addition, the proposed global trade repositories alone will result in hundreds of millions of information points every year, providing an unprecedented transparency to OTC markets - mostly, by bringing data already available together at one point. Existing information should be fully utilised and analysed, before new reporting requirements are added. We would like to remark, that we see the need of an intense and good exchange of information between the different European regulatory institutions. However, we would opt for a coordinated approach of all institutions towards the issue. In the past we have experienced that in the end each national or multinational institution defines their own information needs leaving banks with different reporting streams to implement. Here we note the ongoing work of the European Banking Authority in drafting Implementing Technical Standards (ITS) on

supervisory reporting requirements for institutions which will set out numerous reporting requests (Consultation papers CP 50 published on 20 December 2011 and CP 51 published on 13 February 2012).

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

Yes, however, EBF members would like to underline the importance of the general principle that same financial activities should be subject to the same regulation and supervision globally (if the risk is currently not addressed otherwise), in order to limit regulatory arbitrage to the largest extent. Notwithstanding that approach, global authorities should have enough room to manoeuvre as to accommodate both similar regulation and supervision practices to the specific nature of the different players in the market.

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

Yes. These activities require swift and flexible reactions.

As such, for shadow banking activities in which scope of action is limited to one member state, the first body to intervene should be the national supervisory entities, which should determine, amongst themselves, the sector where the activity should be included (banking, capital markets and insurance).

Once the national supervisory entity has been established, it should determine the course of action to be taken in respect of that specific shadow banking situation and inform its corresponding parent supervisory entity (EBA, ESMA or EIOPA). The latter should disclose their information to the ESRB, which in turn should make an analysis in order to determine the eventual need for regulation at EU level.

In what regards situations that involve several jurisdictions, clearly the ESRB seems to be the right entity to recommend the course of action to be taken.

The Green Paper proposes three types of approaches, which may be adequate, depending on the circumstances.

Indirect regulation has advantages whenever the activities in question are not similar to already regulated activities, but, at the very least, are generically susceptible of being included in one of the three traditional financial sectors. However, indirect regulation also risks regulatory arbitrage.

Appropriate extension or revision of existing regulation will be the most logical solution for activities which are equivalent or structurally similar to other activities which are already regulated.

Lastly, new regulation shall be the best option for situations where the shadow banking activity is neither similar to activities which are already regulated or, at the very least, when it is not possible or too burdensome to simple assign such activity to one of the three typical financial sectors.

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

International consistency will be enhanced if national regulatory measures and timetables are coordinated by the FSB. Beyond the agreement of the steps to be taken, we see an important role for the FSB to monitor the implementation of agreed recommendations and to draw attention to inconsistencies which could rise to regulatory arbitrage.

As such, we encourage the European Commission to be an active participant in the discussion at the FSB and then to follow through and implement any recommendations in parallel with other key jurisdictions.

WHAT REGULATORY MEASURES APPLY TO SHADOW BANKING IN THE EU?

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

The EU has made great strides in enhancing the European regulatory and supervisory regime. However, we see a case for a greater degree of coordination and assessment of costs and benefits to avoid excessive regulation, as we believe that the interaction and the overall impact of all regulatory measures mentioned as well as others not mentioned (e.g. Regulation on OTC-derivatives, central counterparties and trade repositories) has not yet been taken into account.

OUTSTANDING ISSUES

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

The EBF agrees with the analysis of the issues currently covered by the five key areas. However, in what regards "Asset management regulation issues" (Point 7.2), it makes no sense to claim that there is a possible mismatch between liquidity offered to ETF investors and less-liquid underlying assets in what regards UCITS, because the latter must comply with strict rules and limits regarding investment policies.

ETFs are fully regulated as UCITSs. Their relationships with banks, where these act as sponsors, are very transparent. ETFs have been a very successful investment format due to their low cost basis. Considering average long term returns of around 5% p.a. in most asset classes, lowering costs to investors by 1-2% p.a. significantly increases the final wealth available to investors and enables them to follow a more conservative, less risky investment strategy to achieve their long term investment objectives.

Beside efficient access to broad and diversified markets, ETFs are also used to enable very specific trading strategies with a different risk profile. These products are usually only accessed by a relatively small number of investors seeking above average returns, and are thus very unlikely to result in systematic risks. The adequate information of investors, as prescribed in MiFID is key.

The same should be said in respect of derivative transactions, because UCITS are subjected to limits regarding the amounts they can invest in derivatives, as well as the types of derivatives they can invest in.

In what regards the risk of "runs", it should be noted that it is mitigated in respect of UCITS, as well as in respect of AIFM Funds, for the reasons indicated in our answer to question b).

With regard to securities lending and repurchase (repo) transactions the EBF points out that collateralisation of otherwise unsecured claims has been strongly supported during the financial crisis by the ECB and other bodies for their stabilising effects. The securities lending and repo businesses are the logical consequences, as well as the necessary precondition to this development. Given the central role of banks in these markets they are currently already well in the scope of existing regulation. Nevertheless, we welcome an objective monitoring of potentially evolving risk concentrations. Existing central counter party clearing of repo transactions, which already accounts for a large part of the market, provides not only stability, but also an excellent source for data which should be available to regulators to establish facts. However, it should be noted that there are limitations over the degree to which CCPs can play a broader role in the market and that the reasons for this are explored in detail in a recent Basel Committee on Payment and Settlement Systems working paper on the topic (www.bis.org/publ/cpss91.pdf).

Furthermore, the increasing importance of central counterparties, and their requirement for highly liquid collateral, implies a permanently increased need for liquidity to support risk management activities. Here, the securitisation of illiquid assets as well as the use of the resulting asset pools for secured lending and borrowing will be an essential instrument in ensuring that this does not result in a liquidity crunch in other parts of the economy.

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

Considering the current stage of the discussion on shadow banking, where it is not yet possible to identify the specific risks, it is not possible to anticipate what additional issues should be covered. Additional issues will most likely be duly identified as the discussion regarding shadow banking develops over time.

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

Determining the necessary modifications to the current EU regulatory framework will only be possible after the risks, entities and activities that should be included within the scope of shadow banking are clearly identified.

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

Determining other measures will only be possible after the risks and activities that should be included within the scope of shadow banking are clearly identified.