Financial Services User Group's (FSUG)

reply to the

Commission's Green Paper on shadow banking

31 May 2012

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FSUG must express concern as to why the extent, the importance of and influence of the so called shadow banking activity and entities was only realised by regulators, rating agencies and world financial over sight bodies well into the financial crisis by which time irreparable damage had been inflicted on the world economic system, sovereign states' finances and the wellbeing of many millions of households and consumers. This question remains unsatisfactorily answered notwithstanding the fact that commentators had raised red flags about the increasing significance and burdening growth of this partially unregulated sector's various new investment vehicles from the final decade of the last and the first decade of the current century[1], still growing even after the 2008 global financial crisis[2]. The matter was further compounded and detriment ultimately increased by the awarding by rating agencies of extra safe ratings in respect of debts issued by these investment vehicle[3].

Shadow banking activity has attracted very significant amounts of investments derived from both institutional and private customer sources such as long term pension funds and benefited from being a significant source of funding to the regulated sector and hence played a major role in bringing about the financial crisis. This activity both as investment fund management and institutional lender poses a double threat because of the lack of access to central bank last resort lending and excessive leveraging by the borrowing entities. Dangerously high debt-to-asset ratios and ill-matched maturities have been the main causes of the financial crisis and pose significant future risks. FSUG therefore is convinced of the need to bring within the appropriate regulatory and protection environments all banking, financial investment and intermediation activities and supports the current efforts of the Financial Stability Board, the European Commission and the various other International Authorities to achieve this.

The main feature of the activities of the shadow banking system is that they are able to bypass regulatory requirements for minimum capital adequacy ratios, thereby increasing leverage and profits during boom times but also increasing losses during a crisis. Considering the high level of interconnectedness of shadow banking entities with the regular banking system, this increases the probability of systemic risks to the banking system in total. Thus, moral hazard can dramatically increase via the shadow banking system since recent experience has shown that in the recent global financial crisis losses have been socialised.

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1 Gillian Tett and Paul Davies in their *Out of the shadows: How banking's secret system broke down*, http://www.ft.com/intl/cms/s/0/42827c50-abfd-11dc-82f0-0000779fd2ac.html#axzz1qnQTgcZG.

2 According to Masters, 2011, *Shadow banking surpasses pre-crisis level*, Financial Times: "The FSB study of the 11 largest economies with significant shadow banking found the sector, which previously peaked at $50,000bn in 2007, dropped to $47,000bn in 2008 but is now back up to $51,000bn. When the rest of the Euro zone is included the sector is estimated at $60,000bn. It now constitutes more than a quarter of the entire financial system and is about half the size of traditional banks" available in http://www.ft.com/intl/cms/s/0/39c6a414-00b9-11e1-930b-00144feabdc0.html#axzz1uqbVf1EC.

3 Rating agencies still score specific shadow banking vehicles with the highest rating. In Schwarcz, 2012a, "SPEs in securitization transactions can even borrow funds at lower cost than many banks can borrow". *Compare Structured Finance Ratings Quick Check*, Moody's, 16.1.2012, http://www.moodys.com/research/Structured-Finance-Ratings-Quick-Check-Newsletter--PBS_SF161380, noting in its transition tables that over 90 % of Moody's rated asset-backed securities had AAA ratings as of 13.1.2012, with *Bank Ratings List*, Moody's, http://www.moodys.com/researchandratings/viewall-expand/financial-institutions/banks/005001000008/4294964182%204294961994%204294964487/4294964494/1/0/-/0/-/-/-/-1/-/-/-/en/global/pdf/rra, listing just eight US banks with AAA ratings out of 659 banks rated by Moody's.

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FSUG is of the opinion that shadow banking owes its very existence to the regulatory windows of avoiding supervision. As a matter of fact, Schwarcz[4] identifies two main motivators in the development of shadow banking: (a) technology and (b) regulatory arbitrage.

Shadow banking activities are, in conceptual terms, very similar (if not identical) and closely linked to the regular banking sector; these activities are exposed to similar financial risks as banks. Furthermore, the disorderly failure of shadow bank entities can carry systemic risk, both directly and through their interconnectedness with the regular banking system (according to FSB's work).

Considering all the above, FSUG suggests that there should be no 'shadows' in the banking sector in general; regulation should be shaped in a way that does not allow any chance for avoiding supervision on financial activities in general, which actually creates shadow banking. Thus, FSUG suggests that (a) all activities that currently form the shadow banking system should be regulated and supervised, and (b) measures should be taken so as to avoid any form of regulatory arbitrage in the future. We believe that it is both costly and risky to allow unsupervised situations to develop and then regulation to follow.

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

We agree with the general principle that all financial activity should be subject to consistent regulation and compliance requirements but are concerned that the proposed definition does not address the practice of 'regular' banking engaging in the practice of placing some or even much of the assets and liabilities off the banks' balance sheets. There is a danger that banks will do this even more frequently in the current and future environments because of adverse trading conditions and the insistence of regulators in requiring, even more difficult to acquire or attract, capital. We also consider it to be in the best interest of society and citizens that all financial entities which are judged by legislators and regulators to be of systemic importance to a country's financial stability and to the economy generally to be included in the definition of shadow banking – a system of credit intermediation, that involves entities and activities outside the regular banking system and raises (i) systemic risk concerns, in particular by maturity/liquidity transformation, leverage and flawed credit risk transfer, and/or (ii) regulatory arbitrage concerns

Schwarcz (2012a) adopts a broad definition that refers to the provision of any financial products and services covering all non-banks that provide financial products and services. This definition is flexible enough to encompass the inevitable evolution of financial products and services over time. We are in favour of adopting this broad definition, following the rationale stated in the introduction, namely that all possible uncovered activities should be covered by regulation and supervision.

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?

We are in agreement with the list of shadow banking entities and activities mentioned but are not sure if such activity as Credit Default Swaps and instruments issued by first and second lien lenders are specifically included.

[4] Schwarcz, Steven L., *Regulating Shadow Banking*, 1.3.2012, available at SSRN: http://ssrn.com/abstract=1993185 or http://dx.doi.org/10.2139/ssrn.1993185.

We also raise the issue of the more than one trillion euro market of with-profit insurance policies in France ('fonds en euros'), which can often be used like sight deposits by policy holders. One could argue that insurers are de facto 'performing maturity and liquidity transformation' of these deposits. As insurers provide a capital guarantee on these products, they could become endangered by 'run' of policy holders' funds. That would force those insurers to sell assets (a large part of which being Euro Sovereign Bonds) at a bad time, and would increase the systemic risk on these financial assets (Euro Sovereign bonds, corporate bonds, equities).

Regarding activities, Pozsar et al.[5] classify (and describe) activities to direct vs. indirect and to explicit vs. implicit and suggest that shadow banking should include all credit intermediation activities that are implicitly enhanced, indirectly enhanced or unenhanced by official guarantees. Specifically, these activities are:

- Activities with direct and implicit official enhancement include debt issued or guaranteed by the government sponsored enterprises, which benefit from an implicit credit put to the taxpayer.

- Activities with indirect official enhancement generally include for example the off-balance sheet activities of depository institutions like unfunded credit card loan commitments and lines of credit to conduits.

- Activities with indirect and implicit official enhancement include asset management activities such as bank-affiliated hedge funds and money market mutual funds, and securities lending activities of custodian banks. While financial intermediary liabilities with an explicit enhancement benefit from official sector puts, liabilities enhanced with an implicit credit put option might not benefit from such enhancements ex post.

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?*

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 concept of 'positive contribution' can be vague. Shadow banking has the potential to increase economic efficiency but also to increase risk; in the financial literature, risk and return are positively correlated. For example, Schwarcz (2012a) describes that through the mechanism of disintermediation, companies can borrow cheaper via the shadow banking system without paying the traditional banking mark-up. On the other hand, he mentions that to the extent it is relatively harder to control shadow banking's market failures or there are more such failures in shadow banking, that itself could increase systemic risk because uncorrected market failures not only can lead to inefficiencies in the allocation of capital within the financial system but also can contribute to systemic failures. Furthermore, there is an issue of how this positive contribution is being allocated to the economy and to the society in general. If we consider that profits were privatised while losses were socialised in some cases of the recent global financial crisis, perhaps the risks for the economy and the society as a total are higher than the positive contributions.

[5] Pozsar Z., Adrian T., Ashcraft A. and Boesky H., 2010, *Shadow Banking*, Federal Reserve Bank of New York Staff Reports, No. 458.

While we are not enamoured with the term 'shadow banking' although it is in common usage for many years – it could imply or have the connotation of illegal/ fraudulent activity – which is most frequently not the case. Mr Jean-Pierre Jouyet, Autorité des Marches Financiers Chairman, mentioned at the European Commission conference on shadow banking, 27.4.2012 in Brussels, (pages 6-7 of his speech) that "I would like to stress that we need a shadow banking system as much as we need banks. Properly monitored or regulated, a healthy shadow banking system is probably one of the conditions for more growth in Europe tomorrow. And to highlight this role of shadow banking, maybe the entities of the shadow banking system should be rebranded with a more appreciative word, like alternative financing mechanisms, once they are properly regulated."

In fact, shadow banking provides useful services as it can expand and enlarge the opportunities for investors and because of its particularly well focused activity often can be more effective in its spheres of activity offering risk off set opportunities for regular banking institutions.

FSUG agrees that shadow banking can and does contribute positively to the overall financial system but recognise that the four risk groupings mentioned in the Green Paper must be addressed. This is why we support a more focused monitoring , tighter and better coordinated regulation of this activity to ensure that regulatory practices focus on the health and stability of the financial system as a whole. We also believe that provisions in the USA Dodd-Frank Act, in so far as this Act is relevant, might be a useful template to follow by the EU. Although the Dodd-Frank Act puts great stock in the idea of improving disclosure, its efficacy may be limited as some parts of the shadow-banking network are so complex that they are viewed as incomprehensible (Schwarcz 2012a). It is particularly important to ensure the greatest transparency and to enhance the ability to quantify and measure the impacts that all activity and trades have therefore we would suggest that they should take place via exchanges and clearing systems.

The High-Level Expert Group on reforming the structure of the EU banking sector set up by the European Commission[6], could also help by recommending a separation between commercial banking activities and other activities of banking groups. This would, among other benefits including ending conflicts of interests between different businesses in the same banking group, clarify the distinction and the relationships between commercial banking activities, regulated as such, and other financing activities or activities impacting the financing of the real economy.

Shadow banking activity does not exist in isolation of the regular banking system with the latter often dependant on the former for sources of funding from which to provide credit to businesses and the real economy. Much of this funding arises from short term volatile high cost related resources. However, they often take on additional risks, at a higher cost and potential profit and because of the interrelationship with the regular banking system this can contribute to the increase in systemic risk. The unregulated shadow banking entities do not have available to them central bank support or guarantees. We agree with the description of the channels through which shadow banking activity is creating new risks and transferring them to other parts of the financial system.

6 http://ec.europa.eu/commission_2010-2014/barnier/headlines/articles-interviews/2012/01/20120126_en.htm

However, it would be interesting to assess the inter-relationship among the four channels of new risks so as to identify the key factor. Specifically, it is the circumvention of rules and regulatory arbitrage (risk iii) that allows building up of high, hidden leverage (risk ii), that increases the probability of disorderly failures (risk iv) that (via interconnectedness) may affect the banking system; also note that under the assumption of the existence of a situation of high, hidden leverage, the negative consequences from 'runs' on the financial system as a whole are increased exponentially. That is why we believe that the key factor that creates most of the risks is regulatory arbitrage.

In responding jointly to questions (c) and (d) we concur with the four groupings of risks as set out in the Paper. While shadow banking activity may be exposed to risks that are similar to the regulated banking system these risks can and were amplified in their magnitude and impact as for example resulting in the Lehman debacle. The most severe risk, that Special Investment Vehicles face, results from the nature of their financial activity, whereby they borrow short and then invest in long-term illiquid assets, such as mortgage-backed securities. The inability to obtain further funding or realise assets results in failure of the institution.

Ballooning in the supply of credit into the regulated banking system/credit markets was further acerbated by the leveraging effect of the supply of funding from shadow banking institutions. Regulators and governments were blind to this effect or chose not to intervene and exert control while governments welcomed the revenue bonanza.

It is normal for institutions, as might individuals, to seek out the route to least intrusive regulation. This may include seeking to minimise allocations to capital reserves in order to optimise profits, dividends and bonuses or placing large tracts of financial activity off balance sheet out of sight of auditors and regulators. All of this activity can and has amounted to deception of shareholders and the wider stakeholder community, has contaminated the regulated system, caused recession, unemployment and increased sovereign debt and placed a huge intergenerational financial burden on the current and future generations of tax payers.

FSUG is in favour of all necessary policy enactments and follow up actions to eliminate the risks of the shadow banking system subverting orthodox, regulated banking activity. Regulators must also be proactively alert in identifying the emergence of future detrimental trends.

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?

We have mentioned the case of insurance products in response to question (b) above. However, we note that Awrey[7] examines the complexity of financial innovation under the scope of regulatory challenges and implies shadow banking creates market fragmentation, interconnectedness and opacity, making it difficult for market participants to effectively process information. We are of the view that regulators must be constantly vigilant and on the lookout for the emergence of new risks particularly in times of volatile market conditions.

[7] Awrey, Dan, 2011, *Complexity, Innovation and the Regulation of Modern Financial Markets*, Harvard Business Law Review, Forthcoming, Oxford Legal Studies Research Paper No. 49/2011. Available at SSRN: http://ssrn.com/abstract=1916649 or http://dx.doi.org/10.2139/ssrn.1916649.

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

Yes we do. It is necessary that all EU regulatory authorities become fully aware and are up to date on the nature and extent of and who are the current and emerging players in all aspects of shadow banking activity and that they share information and data on a formal, coordinated and regular basis. Especially, the interconnections to the 'traditional banking activities' require stricter monitoring and regulation, e.g. with regard to liquidity, risk transformation and leverage effects whenever there is a risk of boosting leverage within the system as a whole and creating mis-matches in the maturity of liabilities.

FSUG believes that the financial sector as a whole should be regulated and supervised. Having said that, in principle it is not a question of agreeing with the need for stricter monitoring and regulation for a distinct part of the financial sector, namely the shadow banking system, which has used the vehicle of technology to by-pass regulation. It is more of a question of not allowing regulatory arbitrage in the future.

Furthermore, regulatory authorities will have to cope with challenges that are inherently difficult to evaluate. For example, Schwarcz[8] argues that there are four types of market failures: (a) information failure, (b) rationality failure, (c) principal-agent failure and (d) incentive failure. These are inherent in the financial system overall but can be exacerbated by shadow banking's complexity.

In another paper (Schwarcz 2012a) he mentions that, regarding information failure, some parts of the shadow banking network are so complex that they are viewed as incomprehensible, concluding that some amount of information failure will be inevitable. Regarding rationality failure, human's bounded rationality that leads him/her to believe what he wants to believe, have led them to believe that the investment-grade rated securities issued in highly complex second-generation securitisation transactions, offering much higher returns than other similarly rated securities, represented good investments even though they were at least partly backed by subprime mortgages. Furthermore, the complexity of shadow banking exacerbates the principal-agent failure. Regarding incentive failure, in a financial market context, where too many owners (e.g. investors) have rights in a scarce resource (a class of securities), no single investor will have a sufficient amount at risk to individually motivate monitoring.

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?

FSUG underlines the necessity of identifying and monitoring the shadow banking system overall and the level of interconnectedness with the traditional banking system. We are aware that there is a very high level of complexity in the system[9].

We agree with the general principles set out for the identification and ongoing monitoring of shadow banking entities, current and emerging, and the constituent activities. It should be accepted that these banking activities are now an important part of the entire banking system and will grow and adapt themselves to emerging business and economic circumstances. Therefore there is a clear need for the EU to establish new or extend existing systems and

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8 Schwarcz, Steven L., 2.3.2012, *Controlling Financial Chaos: The Power and Limits of Law*, Wisconsin Law Review, No. 3, 2012. Available at SSRN: http://ssrn.com/abstract=2016434.

9 For an interesting work in graphically depicting the shadow banking system see Pozsar et al., footnote 5.

processes on the exchange of information and supervision practices among all supervisors, central banks, other relevant authorities and the EC. An EU central database as a joint effort by public authorities and the financial services industry in Europe as proposed by Mr Victor Constancio, Vice president of the ECB, would in our opinion constitute a permanent process for the collection and exchange of information on the identification and oversight processes between all relevant European authorities.

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

While the general principles for supervision are comprehensive it will be very important for supervisory authorities to understand and be aware of the existence of all credit intermediation chains which have had and could continue to have such an impact for both benefit and detriment.

Similarly an ongoing deep knowledge and understanding of the connections, relationships and impacts that the shadow banking system exerts on the overall financial system will be paramount to identify and mitigate risks.

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

FSUG supports the opinion of the Commission that authorities should take into account the high- level principles of supervision proposed in the FSB report and supports the Commission view that a specific approach to each entity/activity is also appropriate. While it is likely that new regulation specifically directed at shadow banking entities/activity will be required, a useful supplementary approach can be the extension of existing regulations to them and also ensuring that the links, relationships and connections between regular banking and its activities with shadow banking are also regulated.

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

The regular exchange and sharing of information and data between authorities would help as would the implementation of the proposed Legal Entity Identifier (LEI).

As mentioned earlier (b), we also believe that provisions in the USA Dodd-Frank Act might be a useful template to follow by the EU and would help avoid regulatory arbitrage, at least between the EU and the USA.

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

Some aspects of all three regulatory approaches – indirect, enlarging and direct – to dealing with shadow banking activities and entities are already being implemented and there are also further legislative proposals being negotiated.

We are pleased that under CRD III banks are required to hold significantly more capital to cover their risks when investing in complex re-securitisations and that Member State regulators are to take into account reputational risks arising from complex securitisation structures and products when carrying out risk assessments.

The extension of the scope of the MiFID framework will increase transparency of non-equity instruments which will contribute towards identifying risks from shadow banking, while increased proactive intervention powers for Member State regulators will help them identify and mitigate emerging shadow banking risks.

With regard to the ESMA 'Guidelines' which came into force on 1.7.2011, we feel that they should have a stronger force requiring compliance. We also support the recent advice of the Securities & Markets Stakeholder Group of ESMA on ETFs[10]. This paper requires in particular:

- consistent regulatory environment between ETFs (which are UCITS and therefore subject to UCITS directives provisions and the other 'ETPs' (Exchange Traded Products)

- much more transparency and disclosures on total return swaps between funds (not only ETFs) and banks, and on securities lending by funds (not only ETFs again)

- banning of total return swaps between funds (not only ETFs) and the parent bank of the fund manager.

It is disappointing that ESMA did not follow most of these recommendations in its public consultation subsequently launched on ETFs.

We are pleased to note that insurance regulation, Solvency II, addresses shadow banking issues, specifically requiring the total balance sheet approach where all entities and exposures are subject to group supervision.

The approaches outlined so far in this Green Paper will need to be strengthened particularly to address the various new shadow banking activities that will seek to exploit and circumvent existing regulation and supervisory oversight.

Regulating the shadow banking system should also include the mechanisms of recovery and resolution (perhaps similar to the EU framework for bank recovery and resolution).

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

FSUG supports the work of the Commission, in coordination with the other relevant EU regulatory bodies, in examining existing measures and working towards an early proposal for a comprehensive supervisory regime and regulatory framework of the shadow banking system.

FSUG agrees with the analysis of the five key areas where the Commission is investigating options.

FSUG also believes there should be much more transparency and disclosures on securities lending: Who are the counterparties? For how much? For what percentage of the fund's assets? For how long on average? Who are the lending agents, what is the remuneration of the lending agent and of the fund manager? Why is the profit not returned to the fund (to the investors)?, etc.

Furthermore, we fully support the European Commission's intention to extend certain provisions of CRD IV to non-deposit taking finance companies, aiming at limiting the scope for future regulatory arbitrage for providers of credit; as already mentioned in our response, we believe that the starting point of this effort in general should be to avoid future regulatory arbitrage.

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10 http://www.esma.europa.eu/system/files/2011_SMSG_18.pdf

Last we would like to underline the issue of the lack of powers by national supervisors to collect data on shadow banking entities. We believe that it is of utmost importance to ensure that supervisors have the necessary powers to collect and share data on a global basis.

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

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

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

Shadow banking is a global activity and it is not sufficient for the EU alone to tackle the risks that arise and to implement the risk mitigation efforts required. FSUG would draw attention to the possibility of regulatory fragmentation effect which can occur if there is not sufficient coordination among the various national and supra national authorities. As mentioned earlier shadow banking is a global activity with global impacts requiring oversight and compliance of a similar dimension. There needs to be cooperation at the world wide level for regulation to be fully effective. This indicates the need to be able to identify all entities that are engaged in shadow banking activities which requires a globally accepted definition. Also required is a properly functioning monitoring and reporting system freely sharing information and data and the identification of loopholes and regulatory gaps.

With regard to a regulatory framework and further measures to address risks and issues concerning shadow banking FSUG is happy to endorse the following recommendations as they relate to shadow banking made by Mr Paul Tucker, at the Shadow Banking European conference in Brussels on 27.4.2012[11]:

- Shadow banking vehicles or funds that are sponsored or operated by banks should be consolidated on to bank balance sheets.

- The draw-down rate assumed in the Basel 3 Liquidity Coverage Ratio should be higher for committed lines to financial companies than for lines to non-financial companies. That is, banks should hold more liquid assets against such exposures.

- Bank supervisors to limit the extent to which banks could fund themselves short-term from US money funds and from other fragile/flighty sources, including CNAV money funds domiciled elsewhere.

- If shadow banks are financed materially by short-term debt, they should be subject to bank-type regulation and supervision of the resilience of their balance sheets.

- Only banks should be able to use client moneys and unencumbered assets to finance their own business to a material extent; and that should be a clear principal relationship. Legal form should come into line with economic substance.

- For non-banks, any client moneys and unencumbered assets should be segregated and should not be used to finance the business to a material extent. It should, however, remain permissible for non-banks to lend to such clients on a collateralised basis to finance their holdings of securities ('margin lending').

[11] http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech566.pdf

- There should be greater market transparency, perhaps ideally via a Trade Repository with open access to aggregate data, so that the world can see what is happening in these very important but opaque financing markets. (That would be helpful for market participants themselves.)

- Financial firms and funds should not be able to lend against securities that they are not permitted or proficient enough to hold outright.

- Non-bank financial firms should be regulated in how they employ cash collateral.

- The authorities should be able to step in and set minimum haircut or margin levels for the collateralised financing markets (or segments of them). (That would need to be pursued at international level. It might be linked to central bank haircuts.)

FSUG fully appreciates that these and any other such recommendations should be rigorously analysed for their practical usefulness and evaluated for their financial impacts before advanced as part of a regulatory framework.