International
Capital
Market
Association

ICMA

ASSET MANAGEMENT AND INVESTORS COUNCIL

Jonathan Faull
European Commission
DG Internal Market and Services
Rue de Spa/Spastraat, 2
B-1000 Bruxelles, Brussel
Belgium

June 15, 2012

<u>*Sent by email*</u>

Dear Mr Faull,

Green Paper – Shadow Banking

The ICMA Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concerned to its broad membership, rather than having a specific product focus.

The AMIC welcomes the opportunity to respond to the European Commission Green Paper on shadow banking. The shadow banking system also offers economic benefit, and provides market participants and corporates alternative sources of funding and liquidity. Having non-retail banking entities participating in the market creates a mechanism to mitigate risk for retail depositors, as risk is diversified from the banking sector into a greater number of other sectors (e.g. insurance companies and pension funds which, but for these structures, would not otherwise participate actively in the market). This makes borrowing more efficient, which in turn facilitates growth. Moreover some of these activities have been around since the 1980s such as repos and secured lending, or the 1970s with the launch with money market funds. Money market funds provide a source of liquidity, diversification and market-based yields for a wide array of investors including consumers, small businesses and other enterprises. For many investors, MMFs provide greater liquidity and credit diversification that can be achieved through investing in instruments directly.

However the financial crisis has also shown the shortcomings of the system. We share concerns that lack of transparency is a problem as this can hide risks to market participants. The overall level of risks should remain appropriate and adequately disclosed to prospective investors. Greater transparency within the structures themselves is required so that investors can make more informed decisions. We believe positive regulatory steps have been taken to address transparency.

However ‘shadow banking’ contains pejorative connotations. In fact, shadow banking is an alternative term for market finance. It is market-based because it decomposes the process of credit intermediation into an articulated sequence or chain of discrete operations typically performed by separate specialist non-bank entities which interact across the wholesale financial market. Shadow banking also relies on active secondary markets in order to be able to price assets and relies on the wholesale financial market for funding. The use of the ‘shadow banking term’ reflects the fact that debate has been so far viewed through the lens of banking supervision and the prudential regulatory tool-kit. It also ignores the fact that many ‘shadow banking’ entities and activities are already highly regulated under securities legislation. The AMIC urges the European Commission to use an alternative label – for instance ‘market finance’.

The Council has been particularly interested in the shadow banking topic in light of the Basel III reforms and their direct impact on traditional banking structures, and indirectly on the asset management industry. The AMIC believes that a key step in the ‘shadow banking’ discussion is to clarify the type of activities understood under this term. Regulating different products in the same way in itself create systemic risk. Moreover the AMIC would like to ensure that recommendations of regulatory reforms take into account the current regulatory developments and its impact on the asset management industry; and avoid regulatory overlaps considering the work also conducting by the FSB and IOSCO. Problems may result from dual regulation, whether at an EU and/or global level. The Council in fact recommends a global approach in the definition and identification of shadow banking issues rather than an EU led project. Regulation should not result in the EU becoming uncompetitive. Measures may overlap or conflict with any new regulations, thereby hindering the ability of the EU to respond to the critical need for growth and the ability of financial institutions to rebuild financial stability.

DEFINING AND SCOPING SHADOW BANKING

1. The AMIC would like to highlight the fact that the asset management industry is primarily the management of clients’ money. The AMIC is concerned that the European Commission may cast the net too wide and associate in the future the whole asset management industry with shadow banking. The central issue of the current shadow banking debate is in fact one of definition, and in the first place the definition of what exactly constitutes ‘shadow banking’. In order to be effective, policy development will need to define clearly the entities and activities in scope.

2. Any new policy recommendations should be mindful of the function of some market finance activities in protecting the end investor. In fulfilling their fiduciary duty towards their clients, investment managers carefully manage their counterparty exposure to banks. This may entail for example increasing collateral haircuts in times of stress. Any limitation on the ability to do so would force end investor to be exposed to greater risk in times of market stress. Alternatively, investment managers could stop dealing with certain counterparties which would increase pro-cyclicality.

3. Moreover some of the activities mentioned in the Green Paper are either already regulated, or in the process of being regulated. The Council understands that whereas traditional banking relies on deposits through bank branches for funding, the shadow banking system had relied on the issuance of money market instruments (such as commercial paper, ABCP and repo) to money market investors (such as money market funds) for funding, as well as the issuance of longer-term medium-term notes (MTNs) and public bonds to medium- to longer-term debt investors such as securities lenders, pension funds and insurance companies. And therefore institutional investors, have through the credit intermediation chain, an interest in the shadow banking activities and future regulatory proposals. Shadow banking can be considered as assets being managed off the banking sector balance sheet and therefore the demarcation hinges on who owns or controls these assets.

4. In addition various EU Member States may consider the same activity differently, for instance corporate lending is almost completely unregulated in the UK when it is subject to quite tight regulation in other member states. There is even divergence on points as basic as what a bank is. Whereas in the UK a bank is a deposit-taking institution in France it is an institution that takes deposits and lends. Until national regimes can be harmonised on what being a bank really means, it is difficult to define shadow banking. In addition as some regulators discussed, the Council believes that shadow banking probably involves a combination of identifying the activities that create risks and deciding which entities should be subject to new requirements in relation to those activities.

5. However investment management is an agency based model where capital controls de facto restrict the performance an investment manager can return to his client· Reduced performance on an on–going basis leads to the erosion of savings and retirement income in the long–term, which is contrary to wider public policy goals of encouraging savings and stimulating consumption and growth. Fund management activities are governed by extensive sets of rules requiring appropriate authorisation and prudential supervision of the fund manager and in most instances, also authorisation and marketing notification of each single investment fund· It is also worth noting that the European fund industry already observes the highest regulatory standards at both manager and product level· Any further regulatory action at EU level pertaining to investment funds should clearly aim at enhancing the existing frameworks of UCITS Directive and AIFMD by bringing in greater consistency between member states.

6. The AMIC does recognise some activities of the asset management industry that might be considered as shadow banking. The Council agrees that ‘shadow

banking' is related to maturity transformation – an area that could pose systemic risks to the financial system. 'Shadow banking' activities from this point of view share a common feature: they obtain financing at short duration through the money markets, and they invest these funds in longer-term financial assets. Different funds show very different levels of maturity transformation. Whereas bank products typically exhibit maturity transformation numbered in years, under CESR short term money market transformation the maximum average maturity of a fund is 60 days.

7. Other activities should be considered to ensure stability in the financial system and the effective management of risk, for instance enhanced MMFs and synthetic ETFs. These areas would benefit from greater transparency. The latest pronouncements by regulators on the ETF market show regulatory intent to analyse, understand and ultimately consider these products in the shadow banking system. The Council believes that already a lot of work is on-going on these two topics at European level, and conclusions should be drawn from these consultations before adding a new, separate, layer of regulation.

POSSIBLE KNOCK-ON EFFECTS OF CURRENT REGULATORY DEVELOPMENTS

8. Basel I and II intended to eliminate regulatory arbitrage between different regulated banking systems but in effect contracted the boundaries of banking; the Basel reforms created a new incentive for regulatory arbitrage between the more regulated bank-based credit system and the less regulated capital market-based credit system. High costs and restrictions imposed by regulators on banks, and growing competition from specialist non-banks put increasing pressure on banks' profit margins. The reality of significant increases in traditional banks' capital and liquidity requirements could make the 'parallel' banking system even more prominent and competitive going forward.

9. The surge in banking regulation has altered banking. Going back to first principles it is clear that banks should set aside capital to buffer themselves against both poor lending decisions and adverse market movements so that in the worst case they can repay their creditors, not default and cause systemic contagion through the financial system.

10. Setting a single amount of capital at the institution or bank level is inevitable but regulators need to be mindful that by doing so they may encourage banks to transfer risk off their balance sheets to other non-bank institutions. While risk transfer to those who are best able to manage is desirable – annuity funds buying corporate bonds for their long term stable cash flows – there are cases where this risk transfer is done solely to avoid regulatory capital charges and may leave the losses to fall back onto the banking system as the risk transfer may have only been notional (perhaps to an off-shore non bank subsidiary or hedge fund with whom the bank has a prime broker agreement).

11. Banks need also to constrain the build up of excessive on and off-balance sheet leverage to avoid destabilising their deleveraging processes. Accordingly banks will be expected to reinforce their risk-base capital requirements with a backstop

measure on gross exposure to be incorporated into Pillar 1. Although the implications of this measure are still unclear, some signs are visible: reduction of lending and assets are expected to be transferred from bank balance sheets to investors and asset managers.

12. There is a need to see existing regulatory efforts being implemented fully and also tested before adding a new layer of regulation. The key issues that gave rise to the financial crisis have been identified and addressed through the existing European and global regulatory efforts. Further regulation runs the very risk of stifling liquidity and hampering growth. Market participants should be given the time to finalise implementation of current regulatory measures proposed. Any new requirements should be realised by targeted and specific amendments to existing legislation, such as UCITS and AIFMD frameworks.

ENHANCED TRANSPARENCY

13. An important element of the shadow banking system is securitisation. In light of the crisis event it is evident that investors should be able to gain access to the underlying loan data so they can examine and evaluate the risks for themselves rather than rely on complex hedging structures or credit grades from rating agencies. The ratings of structured products have been widely criticised during the recent crisis. With the correct level of regulatory oversight and a separation between banks and non-banks to ensure risk is fully transparent and transferred: setting new regulatory capital requirements at the banking institution level is desirable but regulators should be mindful of arbitrage opportunities of risk transfer.

14. The AMIC called for better transparency and definition in the money market fund sector[1] and the ETF one[2]. Some of the regulatory responses or proposals are already addressing some of these issues in the European context. Transparency is vital to the proper function of the sector and, accordingly, we would support efforts aimed at better monitoring of transparency so long as it is not overly intrusive, does not impair liquidity and does stifle activity or growth.

15. The AMIC has also noted the de-leveraging of the banking sector, in preparation for the implementation of the Basel III framework. The shrinkage of proprietary trading means that risk is being shifted to the asset management industry - without the necessary information about the quality of the assets. The Council believes that enhanced transparency would enable the industry to assess and price potential risks in the market.

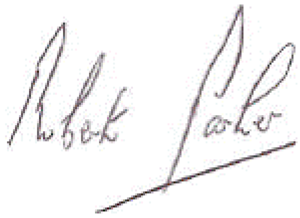
---

[1] ICMA Asset Management and Investors Council – Money Market Funds reports, published in December 2008 and March 2009.

[2] ICMA Asset Management and Investors Council – ETF Working Group report, published on 26 September 2011

The AMIC would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours sincerely,



Robert Parker
AMIC Chairman