IRSG
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(by email)

14 June 2011

Dear Mr Faull,

Green Paper – Shadow Banking

The International Regulatory Strategy Group ("IRSG") is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to contribute to the shaping of the international regulatory regime, at global, regional and national levels, so that it promotes open, competitive and fair capital markets globally, supporting sustainable economic growth. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing industry views. It is an advisory body both to the City of London Corporation and to TheCityUK, which is an independent practitioner-led body set up to co-ordinate the promotion of the UK-based financial and professional services industry.

The IRSG welcomes the opportunity to respond to the European Commission Green Paper on Shadow Banking both on the specific questions raised therein as well as commenting on the key areas where the Commission is investigating.

Shadow Banking products and structures make a positive contribution to the financial system by enhancing liquidity and providing alternative sources of funding, increasing capital efficiency, distributing risk and encouraging growth. However, we do share concerns that a lack of transparency is a problem and we have addressed this in more detail in our response to the Commission's questions.

It is also clear that one of the central issues of the shadow banking debate is 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.

The IRSG would also highlight the work currently being undertaken by the FSB and IOSCO and hopes that EU regulatory developments around Shadow Banking will be in line with

those at a global level. Problems are often presented by dual regulation, whether at an EU and/or global level. Additionally, regulating different products in the same way may in itself create systemic risk.

We have provided more commentary in our responses to the Green Paper Questions as well as in our commentary on the key areas for further investigation by the Commission.

Green Paper Questions :

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

We agree that the definition encompasses the aspects of risk highlighted in the FSB paper but would question that the term itself is somewhat misleading and would suggested the alternative term "market finance".

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?**

The definition is wide enough to catch a vast range of financial structures and activities.

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?**

We feel that these products and structures contribute positively to the financial system. They serve a vital function by enhancing liquidity, increasing capital efficiency, distributing risk and encouraging growth -- so long as information on the products is properly disclosed and understood and the market is effective in transmitting pricing signals.

We believe that the fundamental principles that gave rise to these structures remain valid today. 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 who, if it were not for these structures, would not otherwise participate actively in the market). This makes borrowing more efficient, which in turn facilitates growth. Lack of transparency is a problem as this can lead to increased risk in the market. Also, the fact that structurers have some continuing responsibility for deals sold down to investors is a positive element of the recent changes. Positive steps have been taken to address

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transparency in this sector of the market.

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?

In respect of the channels identified on page 6 of the Green Paper (a) *direct borrowing from the banking system and banking contingent liabilities (credit enhancements and liquidity lines)* should not be a risk if the banking sector is properly regulated in its exposure to the shadow banking sector. It is less easy to see how (b) *massive sales of assets with repercussions on prices of financial and real assets* can be avoided, although there have recently been proposals to enforce counter-cyclical haircuts in repo and collateral arrangements but there are significant questions regarding both how relevant and how effective such a regulatory approach would be.

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?

The key point is being able to identify where those risks are, and quantify them. Once identified, risks should be disclosed properly to prospective investors. Greater transparency within the structures themselves is required, so that investors and ratings agencies can make more informed assessments.

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

We disagree partially. In light of the large global regulatory response to the financial crisis that is already in the process of being implemented (for instance, CRD II, III/Basel II, the additional core capital and liquidity requirements set out in Basel III and large exposure rules), we would be concerned that pre-emptive policy proposals in this area could create unnecessary duplication and overlap given that much of this policy has a direct or indirect impact on the activities that the Commission are concerned about. We believe that the existing regulatory efforts must be given a chance to be implemented fully and assessed.

However, 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 not stifle activity or growth to the

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extent that this monitoring is not already in place

One of the objectives of regulation should be to recognise the benefits and where possible allow for liquidity and efficiency to benefit the regulated segments of the market.

Allowing the sector to be regulated appropriately, even if the precise type of regulation is different from the retail banking sector is beneficial to the financial system. Emphasis should be given to the equivalence of outcomes of future regulation rather than the equivalence of the supervisory tools that should be deployed to reach those outcomes. A range of tools from securities markets supervision should be deployed.

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?

The existing regulatory framework, including regulations still on course to be implemented aims to provide adequate solutions to the current problems in the markets.

Current reporting requirements on banks are sufficient. Exchange of information to promote efficiency in the market should be promoted.

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

We would repeat the comment in the final bullet of question f above.

However regulation that focuses on delivering an equivalency of outcomes, which allows for diversity and is focused on enhancing liquidity within the regulated sector, could be beneficial.

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

For the reasons expressed above, regulation in this sector should focus on the appropriate regulatory tools for the securities market.

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

An internationally consistent approach to any regulation is essential. Streamlining EU

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regulation with that of the FSB and other leading international markets e.g. coordination with the SEC would be helpful.

Care should be taken to ensure that regulation does not result in the EU becoming increasingly uncompetitive.

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

Many measures that address common concerns are already in place.

We must therefore be wary of the danger that these measures may overlap/ overcompensate/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.

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

Please see Appendix below

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

Regulation must focus on improving liquidity in the market. This theme aligns well with EC/EIB's current initiatives to increase private sector funded growth through markets e.g. the 2020 Project Bond Initiative but must allow the private sector to operate effectively.

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

Current EU regulation is already posing significant time and resource costs to firms and therefore we believe that a modification of existing rules with a regard to regulation currently in the pipeline may provide a better solution.

Greater coordination and streamlining of regulation with other jurisdictions outside the EU, notably USA, would be welcome.

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

As per question f) above, monitoring would be acceptable providing it is effective and

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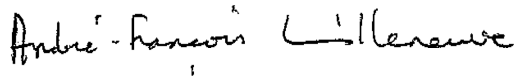
does not impede beneficial activity.

All measures should be geared towards improving transparency (which then aids accurate identification and quantification of risk).

Should you require any further information or clarification of the points raised in this letter, the IRSG would be happy to discuss this further and we may be contacted via **Elizabeth.gillam@cityoflondon.gov.uk**.

Yours sincerely



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APPENDIX

Green Paper Section 7.1: Banking Regulation

As section 6 of the Green Paper notes, there has already been substantial regulatory reform designed to capture the risks associated with banks' interaction with the shadow banking system. The depth and breadth of the reform programme, however, means that both banks and the regulatory community are still in the process of finalising implementation. Until this is complete, it is difficult to assess what additional measures may or may not be necessary. This being said, we are broadly sympathetic to the objectives set out in section 7.1 and comment on them as follows below.

Consolidation

We agree that consolidation rules must ensure that derecognition only occurs for accounting and prudential purposes as a result of genuine risk transfer. It is for this reason that we believe the accounting requirements governing consolidation should be linked to a broad notion of control and welcome the steps taken by the IASB to strengthen their regime in this area with the introduction of IFRS 10 and 11. We encourage the European Commission to endorse these standards for use by European reporting entities – this matter is now pressing given the 1 January 2013 effective date.

Notwithstanding our support for IFRS 10, 11 and 12, we remain concerned that important differences remain in this fundamental area between IFRS and US GAAP, despite the G20's request for equivalent standards. Given that a key imperative of the G20 reform agenda was to enhance regulatory comparability through the development of metrics, such as the Basel III Leverage Ratio, it is vital that we have consistency in this area. We would therefore encourage the Boards to work towards a common standard built on the IASB's notion of effective control, which in our view is superior to the overly legalistic definition under US GAAP.

Disclosure also has an important role to play in this area to enhance transparency and market discipline. We are supportive of the robust disclosure arrangements under IFRS 12 and believe they will provide a sound basis for assessing the nature, and risks associated with, an entity's interactions with other entities, including: subsidiaries, joint arrangements, associates and unconsolidated structured entities. The Basel Committee's proposals for banks to provide greater clarity on their capital structures, including disclosure of the material differences between the accounting and regulatory scope of consolidation, is also of merit and should form part of the reformed European regulatory reporting requirements for EU banks.

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Interconnectedness

We acknowledge that it is important to identify interconnectedness and to ensure that supervisors have appropriate tools available to promote stability. However, we believe that much progress has already been made in this area and that this should be assessed before new measures are developed. The CRD II amendments to the large exposures regime combined with existing powers to alter reporting and individual capital guidance enable regulators to achieve their objectives, including targeted tightening when appropriate. We observe, however, that there is scope for an assessment of the manner in which individual supervisors use these powers and for best practice to develop. By way of example, we would point to the 2009 CEBS guidance on large exposures, which introduced the look through concept. This has been implemented in different ways by national supervisors. It would be beneficial for the EBA to review implementation and pursue alignment.

Green Paper Section 7.2: Asset Management Regulation Issues

A) Exchange Traded Funds ("ETFs")

What is an ETF?

Exchange Traded Funds (ETFs) are collective investment vehicles that seek to track an index, a commodity or a basket of assets like an index fund, but trade on an exchange. In Europe, ETFs are generally regulated under the UCITS regime.

Other types of ETPs

The term ETF is often used to describe a wider range of products that are more accurately described as Exchange Traded Products (ETPs). ETPs are securities which trade intra-day on an exchange, and include ETFs, Exchange Traded Commodities (ETC), Exchange Traded Notes (ETN), and Exchange Traded Instruments (ETI).

ETNs refer to securities, commonly structured as senior, unsecured, unsubordinated debt, issued by an underwriting bank. An ETN trades on an exchange, clears and settles like an ETF but is not a fund backed by assets.

Different types of ETPs

ETPs can take a number of different forms, including:

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- **Physically-backed ETPs**, which are backed primarily by physical securities (e.g. stocks or bonds) or commodities and do not therefore use derivatives. These are commonly referred to as "plain vanilla" ETPs;
- **Synthetic ETPs**, which seek to replicate the returns of a benchmark index principally through the use of derivatives such as swaps. These are commonly referred to as "synthetic" ETPs;
- **Inverse ETPs**, which are constructed by using various derivatives for the purpose of profiting from a decline in the value of an underlying benchmark; and
- **Leveraged ETPs**, which use financial derivatives with the aim of amplifying the returns of an underlying index.

Size and nature of the market, in the EU and elsewhere

The size of the ETP market has grown significantly in recent years. The global ETF/ETP industry has more than 4,600 products (3,232 ETFs / 1,369 ETPs) managing assets of more than US$ 1,718bn (US$ 1,528bn ETF assets / US$ 189bn ETP assets). This compares with under 900 products in 2006 (713 ETFs/170 ETPs) managing assets of under US$ 600bn (US$ 566bn ETF assets / US$ 33bn ETP assets).

The European market has seen rapid growth in recent years. At the end of April 2012, the European ETF/ETP industry had 1,892 products (1,295 ETFs / 597 ETPs) managing assets of more than US$326bn (US$ 291bn ETF assets / US$ 35bn ETP assets). This compares with just over 300 products in 2006 (273 ETFs / 32 ETPs) managing US$ 92bn (US$ 90bn ETF assets / US$ 2bn ETP assets).

The asset class exposure for EU ETFs is as follows:

- Equity 64.6%
- Fixed Income 20.5%
- Commodities 11.9%
- Inverse 1.0%

Use and characteristics of ETFs (incl. types of investors / interaction with capital markets)

Investors use ETFs for a number of reasons. They have highly liquid, have other stock-like characteristics, they are tax efficient[1], and they typically have lower costs due to reduced shareholder and administrative expenses. ETFs are typically tax transparent products. High

[1] ETFs often utilise in-kind shareholder redemptions because gains with respect to distributed securities are not generally taxable to the ETF and are not distributable to the ETF's continuing shareholders, whereas index mutual funds may generate taxable gains on the sale of securities to fund shareholder redemptions

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levels of investors transparency also helps to facilitate liquidity through effective market making.

ETF shares are generated through the creation / redemption process. Creation units (large blocks of ETFs shares exchanged with baskets of underlying assets) can be bought or sold only by authorised participants, usually large institutional investors.

Shares are bought and sold on exchange through brokers in the secondary market. Units can be bought and sold throughout the day and investments are generally liquid with real-time pricing. Purchases and sales are generally transparent. There is no a minimum investment level and there are no restrictions on frequent trading of ETFs. Investors can trade in and out whenever they want, and Net Asset Values (NAVs) are calculated by the fund administrator at end of day.

Existing regulatory framework in the EU

All UCITS (including UCITS ETFs) are regulated and are subject to the same requirements and constraints. This robust product regulation is at the heart of the high level of investor protection UCITS provide. Key elements of the framework include: that the assets of the fund are held separately from the management company's balance sheet; that there is an independent depositary that oversees the activity of the manager and that safeguards the assets; and that the manager is subject to detailed requirements relating to the management of conflicts of interest.

The universe and strategies of UCITS are evolving due to investor demand for risk reduction and return enhancement. This is true for all UCITS (including UCITS ETFs) and is a global trend. In relation to UCITS, however, all strategies must fit within the detailed UCITS requirements and constraints. There are strict limits in relation to the global exposure of a UCITS; cover for investment in derivatives, and counterparty risk.

In addition, UCITS ETFs are subject to listing rules, to European-wide requirements relating to their prospectuses, and to national rules on stock lending. Furthermore, market makers in shares of UCITS ETFs are subject to European-wide rules on transaction reporting.

We therefore feel that ETFs are already adequately regulated under the UCITS framework and that ETFs should not be treated differently from other types of UCITS.

B) Money Market Funds ("MMF")

The most appropriate reform to deal with regulatory concerns is to specify substantially higher minimum liquidity requirements for MMFs under the UCITS Directive, in order to be

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able to make redemption payments without relying on secondary market liquidity. This would address concerns related to risks of run.

A second reasonable recommendation would be to require MMFs to know their client/ client types, monitor subscription/ redemption cycles, and consider risks arising from shareholder concentration. Such measures may need to be accompanied by requirements on distributing intermediaries to disclose the identity of underlying investors to MMF managers.

The Commission's Green Paper focuses on the question of fund pricing (Constant Net Asset Value "CNAV") versus Variable Net Asset Value "VNAV") - The issue may have been prejudged and further discussion is necessary.

The rationale behind a forced switch to VNAV is unclear to us. CNAV and VNAV funds are not materially different in terms of their risk/reward profile. Notably, both types of funds are still susceptible to redemptions: it is not obvious that investors in VNAV funds are less sensitive to losses than in CNAV funds. Enhanced cash funds (VNAV) suffered significant redemptions in 2007. Variability in the price of a VNAV fund would complicate cash flow planning for institutional investors, who would also be disadvantaged relative to direct investment. Finally, there would be an incremental compliance burden for investors domiciled in countries that tax income and capital gains differently.

In regards to the other areas of regulatory attention

- We do not believe changes are required to the way MMFs value their assets since asset valuation in itself neither leads to nor can help mitigate redemptions.
- The concept of a NAV buffer as proposed by IOSCO would be problematic as it would likely diminish any economic incentive to invest in the prime fund, relative to the 'risk free' option of the Treasury fund.
- MMFs are used by investors to manage credit risk through diversification, not to arbitrage bank regulation. Comparing MMFs to 'bank like' deposits is a debatable metaphor, and an insufficient foundation on which to construct MMF regulation. The UCITS Directive contains the appropriate regulatory approach, as it treats MMFs as capital markets products, whose risks and rewards are borne by their shareholders.
- We would be cautious about any move to remove reference to ratings unless and until effective alternative solutions are available.

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Green Paper Section 7.3 : Securities Lending and Repurchase Agreements

Securities lending activity plays a critical role in facilitating the movement and availability of high quality collateral in the financial system. Repo is the principal funding tool for the securities markets but can also perform an analogous role to securities lending in borrowing securities.

We are concerned however that the European Commission appears to be considering securities lending and repo together and as presenting a single set of issues. Whilst securities lending and repo are both collateralised transactions that share common features it is important to note that the markets are markedly different with different demand drivers, stakeholders and levels of post-trade complexity.

The role of securities lending and repo

Liquid collateral plays a role as a substitute for meeting money demand. The global financial system is collateral-based. Restoring stability after the crisis rests on the return of funding liquidity from private sources once confidence in counterparty credit is restored.

Securities lending and repo are essential to market liquidity, efficient price discovery and moderate price volatility, helping investors to buy and sell securities. They facilitate financial institutions and non-financial companies' capital raising and funding.

Potential risks involved

The major risks and concerns around securities lending stem from aggressive reinvestment of cash collateral and the use of cash collateral to generate leveraged funding. The major risks and concerns around repo stem from concern about the perceived procyclicality of collateralised financing. Both markets are also seen as lacking the transparency needed for users and regulators to understand the distribution of risk.

Interconnectedness in periods of stress can lead to the transmission of risk, as with any form of market intermediation. There are however also concerns about the intrinsic instability of complex networks.

Lehman's interactions with beneficial owners of collateral largely did not impair beneficial owners as most were able to liquidate their collateral and replace their lost securities. However, some struggled to liquidate their collateral and either lost money or spent a long time liquidating collateral.

Possible regulatory responses

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Although regulators regularly request securities borrow-loan records on an ad hoc basis, particularly after market failures, regulators currently do not have mandated, consistent access to securities lending transaction data

The US has rules controlling delivery periods with mandatory buy-in and a disclosure list for failures. Other countries have varying rules regarding tolerance levels for securities lending failures. While we question the approach adopted by the US, in particular the effectiveness of mandatory buy-in, some consistency of approach in other jurisdictions would have benefits to the markets and for systemic risk reduction.

Securities lending may create opacity risk when institutions involved and other market participants do not fully understand the risks to which they are exposed from these transactions. Transparency of securities lending and re-use activities could contribute significantly to reducing the risks deriving from interconnectedness.

Some policymakers have suggested limiting or banning rehypothecation. This would have a profound impact on the operation of the securities markets, reducing liquidity and raising costs. As stocklending transactions are effected under title transfer; then rehypothecation does not come into it. If the suggestion is that the transfers should be fettered in some way (by interfering with the owner's right to dispose as it wishes with the securities or the collateral) then you run recharacterisation risks on the transactions and undermine the netting analysis. If the netting is not enforceable you don't have a market any more. This market is based on a suite of netting opinions in the same way as ISDA and the GMRA/GMSLA.

It is important to stress the difference between the terms "re-use" and" re-hypothecation" as they are not synonymous. The main difference is whether a transfer of ownership occurs. Re-use occurs in repo transactions which involves the sale, including full title transfer, of the securities to the purchaser, who is then free to re-use the security in the same way as any other asset he owns (although the purchaser has an obligation to resell the securities when the date of the closing leg of the repo is reached). However, in the case of collateral which is pledged or "hypothecated", the pledgor retains legal ownership and the pledgee typically cannot use the collateral. Re-hypothecation is a special case where the pledgor gives specific permission to the pledgee to use the collateral while maintaining a security interest in the collateral

A further suggestion made in some regulatory circles is to regulate haircuts as a way of stabilising the market but there are significant questions regarding both how relevant and how effective such a regulatory approach would be.

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Green Paper Section 7.4 : Securitisation

In respect of securitization, it is important to note that this term encompasses a range of different vehicles and products – some of which may constitute shadow banking, others which obviously do not. Also, the fact that securitisation can be structured in a number of different ways would make trying to define securitisation, for the purposes of any potential shadow banking regulation, particularly difficult, as has been the case with the definition used in the CRD/Basel rules.

The risk and cost of having duplicative legislation also needs to be considered. In the context of securitisation there have been many regulatory changes recently (and others to be implemented in the coming years) which have the aim of, among other things, reducing systemic risk. It would be unhelpful to have another suite of regulations which would overlap with these and, unless they were drafted in exactly the same terms, would run a risk of creating uncertainty – it may not be possible to comply with both sets of regulation at the same time. There would also be an additional cost in institutions implementing new regulations which would run in parallel with (and have the same objective as) the new (and soon to be introduced) regulation.

Green Paper Section 7.5 : other shadow banking entities

While the paper sets out a list of "other entities" that are the focus of current analysis and commits to assess the extent to which current or impending regulation of those entities is adequate, the vital middle step of setting out clearly what risks those entities present to the financial system and in what way is currently missing for many of the entities listed.

In particular, while the paper outlines some of the risks presented by institutions which undertake liquidity and/or maturity transformation, there is no explanation of the rationale for including institutions which provide credit or credit guarantees without maturity or liquidity transformation – for example, where cash or securities on loan are match-funded with liabilities of corresponding maturity to the loan duration.

We welcome the Commission's recognition of the benefits provided to the financial system by these institutions – and also the necessity of establishing the extent to which existing legislation covers the risks presented by "shadow banking".

We believe that it is important to recognise that the potential of both entities and activities to pose a risk to the financial system as a whole will depend to a large degree on the extent to which they are governed and limited by existing sectoral regulation. Where an existing prudential regulation regime adequately covers the risks of the activities in question, no

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further data collection, requirements or scrutiny should be imposed. This is particularly important if activity-based regulation is being contemplated, which could result in dual-regulation where those activities are undertaken by entities already subject to sectoral regulation.

We welcome the recognition, both in the Green Paper itself, and from senior sources in the international regulatory community, that non-bank intermediation of credit can help to make financial system more resilient. In particular, a diversity of funding sources for businesses lowers system-wide risk – and this should be recognised and supported.

Furthermore, we also believe it important to note that some of the new tools proposed since the crisis have the potential to create new financial stability risks. For instance, mandated bail-in debt for banks could provide a new avenue for contagion to investors in that debt in the event of another crisis.

In addition, proposals such as the introduction of restrictions on changes to collateral margins are potentially problematic. In a crisis, an inability to request additional collateral against loans is likely to trigger more drastic measures by lenders with concerns over their exposure to a troubled counterparty. The obvious alternative would be to simply recall entire loans; however this could escalate systemic problems even more quickly than margin calls.

It is therefore vital that policymakers take great care when considering how to treat the shadow banking sector, to ensure that any measures adopted do not increase the vulnerability of otherwise stable business models and sectors – or create greater risks than those that they seek to address.