

Mr. Martin Merlin
Head of Unit 02
Financial Services Policy, Relations with the Council
European Commission

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Re: European Commission Green Paper on Shadow Banking

Dear Mr. Merlin,

CFA Institute appreciates the opportunity to comment on the European Commission's "Green Paper on Shadow Banking."

We are a global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal is to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including more than 101,000 Chartered Financial Analyst® charterholders, and 136 member societies. For more information, visit www.cfainstitute.org.

CFA Institute fully supports macroprudential regulation and systemic risk monitoring as essential tools to strengthen financial markets, and improve their stability and transparency. In the aftermath of the banking crisis, regulatory activity has focused on banking reform, extension of regulation to all unregulated activities, and macroprudential supervision. Much has already been achieved or is in progress in the European Union through detailed sectoral legislation.

The Financial Stability Board (FSB) workstream on "shadow banking" is meant to cover all entities and activities providing credit intermediation outside the regular banking system that can be a source of systemic risk. We consider it is appropriate to also include such entities and activities in the monitoring activities of systemic risk supervisors, and a policy review would be helpful in identifying areas where reforms or new regulation may be required.

However, analysing all "shadow banking" entities and activities as a single large category from the perspective of banking supervision would not be the correct approach. Financial entities play different roles in the financial markets, and it would be inappropriate to regulate all of them as banking institutions. Firstly, many of these entities, such as the different types

of investment funds and/or fund managers, are already highly regulated. Secondly, these entities perform different intermediation functions and thus provide diversification for investors, securities issuers and for markets in general; and thirdly, they are tailored to different client characteristics, needs, and risk appetite profiles. Consequently, they should be subject to separate, tailored regulatory regimes. The FSB has defined systemic importance (in the context of systemically important financial institutions) according to the size, interconnectedness and substitutability of firms. Consideration of separate, tailored regimes for shadow banking entities should have due regard to these three dimensions of systemic risk, as well as to the extent of regulation already applied to these entities.

In sum, a more careful and detailed approach is required, after a clear identification of the risks that need to be addressed. In some cases a review of existing sectoral regulation would be a suitable response, while in other areas (for example collateral issues related to repos and securities lending) a more horizontal, cross-sectoral approach is required because the activities are common throughout financial markets and are performed by a variety of entities.

WHAT IS SHADOW BANKING?

a) Do you agree with the proposed definition of 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?

CFA Institute agrees with the FSB definition of shadow banking¹ and with the list of entities and activities to be reviewed and monitored proposed by the Commission.

However, the term “shadow banking” has a negative connotation and in our opinion should be replaced with a neutral one. It implies that such entities are just like banks, but are either unregulated or insufficiently regulated, whilst ignoring the fact that some entities in question are already highly regulated in the European Union (for example investment funds and investment managers under the UCITS Directive, MiFID the AIFMD, as well as insurance undertakings) and in other jurisdictions.

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?

CFA Institute agrees that “shadow banking” positively contributes to the financial system by providing alternative funding channels to the “real economy.” This contribution is particularly important nowadays, when banks are deleveraging. Such entities and activities provide diversification of funding sources and investment options, and most investment funds

¹ As per the Consultation, the FSB definition of shadow banking is “the system of credit intermediation that involves entities and activities outside the regular banking system.” This includes such entities engaging in “accepting funding with deposit-like characteristics; performing maturity and/or liquidity transformation; undergoing credit risk transfer; and using direct or indirect financial leverage.”

continued to function throughout the financial crisis without government support, with only isolated problems in Europe. For example, IOSCO points to the importance of Money Market Funds as providers of short-term funding for financial institutions, businesses and governments, as well as to their importance for investors, particularly for large institutional investors².

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?

Yes, we agree that risks may be created or transferred through “runs” on deposit-like structures, the build-up of high, hidden leverage, circumvention of rules and regulatory arbitrage, and through disorderly failures of closely linked entities affecting the banking system. These kinds of activities create significant risks, regardless of the structure of the financial institution.

However, the general dependencies and inter-linkages existing in capital markets cannot be reduced to the negative impact of “shadow banking” entities on the banking system. To prevent any systemic effects to the banks, it is incumbent upon the banks and banking regulators to reduce their reliance upon such short-term financing.

The risk of “runs” on funds is very different from the risk of runs on bank deposits, and fund regulation or fund rules already provide tools to manage them (i.e. redemption charges or restrictions). For Money Market Funds, Guidelines adopted by CESR in 2010³ already provide significant enhancements to their structure and liquidity.

In general, funds are investment vehicles in which investors bear the investment risk with no guarantee of capital reimbursement (except where a specific capital guarantee is provided by third parties). Regulation should not attempt to eliminate investment risk, but should provide investor protection, transparency and proportionate measures to enhance market stability.

Further, the risk of “runs” on funds offering daily liquidity (such as UCITS) is not limited to “deposit-like structures” such as Money Market Funds, but can occur for all UCITS during periods of market stress. Management of heavy redemptions is an important tool for investor protection and to reduce contagion effects, but daily redemptions are a fundamental right of UCITS investors and can only be restricted under specific circumstances.

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 Interim Report of the FSB Workstream on Securities Lending and Repos “Securities Lending and Repos: Market Overview and Financial Stability Issues” published in April 2012

² IOSCO Consultation Report on “Money Market Fund Systemic Risk Analysis and Reform Options” (CR07/12 dated 27 April 2012)

³ Guidelines on a Common definition of European money market funds (CESR/10-049)

also discusses the role of other entities in activities that may pose risks to the financial system. The Commission correctly identifies securities lending and repos as activities that require special attention. However, it does not mention the potential transmission risk arising from CCPs, CCP clearing members, and derivative brokers due to rehypothecation/margin reuse.

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?

CFA Institute agrees that stricter monitoring and improved transparency would be helpful, but the need for further regulation needs to be carefully assessed. In particular, extending banking prudential regulation to entities such as investment funds may not be appropriate. As we have noted above, the need for further regulation must take full account of the extent to which these entities are already regulated.

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?

We agree that authorities must identify and monitor relevant entities and their activities, and fill data gaps regarding the interconnectedness between banks and non-banks. Information exchanges must involve national supervisors and the three European Supervisory Authorities, and the ESRB should play a key coordination role. Consistent and permanent processes should be established for the collection of information, and supervisors at all levels should be given the necessary powers to carry out their duties.

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

CFA Institute fully agrees that supervision of shadow banking should be performed at the appropriate level, i.e. national and/or European. It should be proportionate, take into account existing supervisory capacity and expertise, and be integrated with the macro-prudential framework.

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

We agree with the FSB's principles (supported by the Commission), which state that regulatory measures should be targeted, proportionate, forward-looking and adaptable, effective, and should be subject to assessment and review. We also strongly support the Commission's statement that "a specific approach to each kind of entity and/or activity must be adopted."

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

Global consistency is desirable at a principle level, and should be pursued by all international bodies involved in the ongoing discussion on shadow banking. However, achieving such consistency will be very difficult to achieve at a detailed level. In the case of investment funds, very detailed regulation already exists around the world and there is no global passport for fund distribution, so it seems appropriate to leave the implementation details to EU level.

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?

We consider that the EU has taken many steps to regulate “shadow banking” entities and activities, and some of them (UCITS funds, for example) are already subject to very strict regulation.

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?

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?

We agree with the Commission’s analysis of banking and asset management regulation, securities lending and repurchase agreements, securitisation, and other shadow banking entities.

At the EU level it is critical to improve data gathering and information sharing to assist monitoring by systemic risk authorities. Additionally, targeted measures should be considered where appropriate, taking into account the existing high level of regulation.

In particular, with regard to ETFs we agree that collateral issues are not confined to ETFs, and should therefore be viewed within the UCITS framework as a whole. Other issues should be regulated through ESMA’s upcoming guidelines on ETFs.

Regarding Money Market Funds (MMFs), CESR’s “Guidelines on a Common definition of European money market funds” have already done much to reduce credit and credit spread risk, as well as sensitivity to interest rates, while the quality of investable assets has been

improved. Measures to deal with the risk of “runs” should be carefully considered, as such risk cannot be entirely eliminated in times of market stress and is common to all instruments and deposits with daily redemption rights.

For repurchase agreements and securities lending we suggest improved monitoring and transparency for all market players. Modifications to existing sectoral regulation would not be appropriate in this case, as they would create regulatory gaps and arbitrage. Within the UCITS Directive, rules for collateral from securities lending equivalent to those for OTC derivatives should also be introduced. Equivalent rules should apply to funds under the AIFMD.

CFA Institute supports measures aiming at improving data collection (for example, a global Legal Entity Identifier) and data exchanges among regulators, as they would enhance safe and transparent capital markets.

Please do not hesitate to contact us should you wish to discuss any of the points raised:

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Kind regards,



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