

## Green Paper on Shadow Banking

Consultation of the European Commission

### Reply of the European Federation of Financial Services Users (EuroFinuse)

12 June 2012

*The European Federation of Financial Services Users (“EuroFinuse”) (formerly European Federation of Investors, in short EuroInvestors) counts more than fifty national and international member and sub-member organizations. In turn those count about four million individual members. EuroFinuse acts as an independent financial expertise center to the direct benefit of the European financial services users (shareholders, other investors, savers, pension fund participants, life insurance policy holders, borrowers, etc.) and other stakeholders of the European financial services who are independent from the financial industry.*

*EuroFinuse has experts participating in the Securities & Markets, the Banking and the Pensions Stakeholder Groups of the European Supervisory Authorities, and the EC Financial Services User Group. Its national members also participate in the national financial regulators and supervisors bodies when allowed. For further details please see our website: [www.eurofinuse.org](http://www.eurofinuse.org).*

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**The European Federation of Financial Services Users**

76, rue du Lombard, 1000 Bruxelles - Belgium  
Tel. (32) 2 514 37 77 - Fax. (32) 2 514 36 66  
e-mail: [info@eurofinuse.org](mailto:info@eurofinuse.org) - <http://www.eurofinuse.org>

## Executive Summary

The European Federation of Financial Services Users (EuroFinuse) supports the Financial Services User Group (FSUG) response to the consultation to this consultation, and part of our response is derived from it.

We also express concern as to why the extent, the importance of and influence of the so called shadow banking activities and entities was only realized by regulators, rating agencies and world financial oversight 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.

Moreover<sup>1</sup>, shadow banking activities are mainly performed by banks and for their benefit: special purpose vehicles enabling banks to securitize and take assets off balance sheet with the blessing of rating agencies (especially on subprime mortgage loans and the like), money market funds (sold by banks and invested in bank certificates of deposit), the multi-trillion and opaque business of securities lending<sup>2</sup>, total return swaps between banks and their asset management affiliate, etc.; these two latter activities not being by far limited to Exchange-traded funds.

The very first action that regulators and supervisors should take is to demand much more transparency from banks on these above-mentioned “shadow” and off-balance sheet activities, so that they acquire a thorough understanding of the amounts involved, the reasons, purposes and cost to end users such as fund investors of these activities. There should be no more significant “banking shadows”.

We are indeed concerned when we see € one trillion of almost “free” money granted to European banks by the ECB through the two recent “LTROs”<sup>3</sup> without the ECB and the Euro governments having any clear report of where and how this huge subsidy to European banks is used for. Obviously not to fund the real economy, as all evidence shows the reduced levels of bank lending to SMEs and to households compared to pre-crisis levels and the increase in the cost (spreads) of such lending: at an historical high.

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<sup>1</sup> As recalled by Paul Tucker at the 27 April 2012 EC Conference on Shadow Banking – see our last comments in this paper.

<sup>2</sup> See for example IMF working paper: Manmohan Singh and Peter Stella, Money and Collateral, April 2012.

<sup>3</sup> We refer to our response to the consultation by the High Level Working Group on reforming EU banking structures, note 5

*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.

*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.

We also raise the issue of the more than € one trillion 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). 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, 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, to the extent it is relatively harder to control shadow banking’s market failures or there are more such failures in shadow banking, that it 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 privatized while losses were socialized 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.

While we are not enamored 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, Autorite des Marches Financiers Chairman mentioned at the EC Conference on shadow banking, April 27<sup>th</sup> 2012, 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.

EuroFinuse agrees that shadow banking can and does contribute positively to the overall financial system but recognize 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 US 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. 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 EC<sup>4</sup> 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.

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.

It is normal for institutions, as might individuals, to seek out the route to least intrusive regulation. This may include seeking to minimize allocations to capital reserves in order to optimize 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. EuroFinuse 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 trend.

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<sup>4</sup> [http://ec.europa.eu/commission\\_2010-2014/barnier/headlines/articles-interviews/2012/01/20120126\\_en.htm](http://ec.europa.eu/commission_2010-2014/barnier/headlines/articles-interviews/2012/01/20120126_en.htm)

*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. 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.

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

Yes we do.

The very first action that regulators and supervisors should take is to demand much more transparency from banks on these above-mentioned “shadow” and off-balance sheet activities, so that they acquire a thorough understanding of the amounts involved, the reasons, purposes and cost to end users such as fund investors of these activities. There should be no more significant “banking shadows”.

We are indeed concerned when we see € one trillion of almost “free” money granted to European banks by the ECB through the two recent “LTROs”<sup>5</sup> without the ECB and the Euro governments having any clear report of where and how this huge subsidy to European banks is used for. Obviously not to fund the real economy, as all evidence shows the reduced levels of bank lending to SMEs and to households compared to pre-crisis levels and the increase in the cost (spreads) of such lending: at an historical high.

EuroFinuse believes that the financial sector as a whole should be regulated and supervised. We believe it is more a question of not allowing regulatory arbitrage in the future than 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.

*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?*

EuroFinuse underlines the necessity of identifying and monitoring the shadow banking system overall and the level of interconnectedness with the traditional banking system.

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<sup>5</sup> We refer to our response to the consultation by the High Level Working Group on reforming EU banking structures, note 5

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 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?*

EuroFinuse 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 possible 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 to 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 MS 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 should contribute towards identifying risks from shadow banking, while increased proactive intervention powers for MS regulators will help them identify and mitigate emerging shadow banking risks.

With regard to the ESMA “Guidelines” which came into force on 1 July’11 we feel that they should have a stronger force requiring compliance. We also strongly support the recent advice of the Securities & Markets Stakeholder Group of ESMA on ETFs<sup>6</sup>.

EuroFinuse asks in particular for:

- 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 the huge amounts of securities lending by funds (not only ETFs again):
  - o Who are the counterparties of investment funds swaps and securities lending (we suspect it is mostly banks)?
  - o What are banks using the cash and collateral for?
  - o Who are the “securities lending agents? Are they tied to the asset management companies? How? What is their cost and take of the securities lending income?
  - o Why are several asset managers keeping a share of securities lending net income instead of returning all of it to the funds investors who fund all this activity and bear all the risks?

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<sup>6</sup> [http://www.esma.europa.eu/system/files/2011\\_SMSG\\_18.pdf](http://www.esma.europa.eu/system/files/2011_SMSG_18.pdf)



- The collateral provided or the securities provided by the counterparty in total return swaps have often nothing to do with the funds investment objectives. How do the supervisors ensure that these securities have similar volatility and risk profile as to the investment objectives of the funds?
- 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.

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?*

EuroFinuse 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.

As mentioned above (k), EuroFinuse 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.

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. There is a 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.

EuroFinuse endorses the following recommendations as they relate to shadow banking made by Mr. Paul Tucker, Deputy Governor of the Bank of England, and member of the G20 Financial Stability Board's Steering at the European Conference, Brussels 27 April 2012:

- 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 they 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
- 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.<sup>3</sup> it might be linked to central bank haircuts.).