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RESPONSE OF THE FRENCH BANKING FEDERATION (FBF) TO THE EUROPEAN COMMISSION'S CONSULTATION IN RESPECT OF THE GREEN PAPER ON SHADOW BANKING

The Fédération Bancaire Française (the French Banking Federation, hereinafter FBF) is the professional organisation that represents the interests of the banking sector in France. It comprises all of the credit establishments registered as banks and doing business in France, i.e. more than 450 commercial and cooperative banks. FBF member banks have 40,000 permanent branches in France, 400,000 employees and 60 million customers

French banks welcome this consultation and thank the European Commission for organising it with a view to establishing comprehensive supervision of the shadow banking system.

I - CONTEXT

In March 2012, the Internal Market and Services Commissioner, Michel Barnier, launched a review of how to identify and mitigate the "major threat" that shadow banking could pose in terms of financial stability.

The European Commission hopes to contribute to the work being carried out by the G20 on entities that "provide alternatives to non-guaranteed deposits, constitute alternative funding for the real economy and constitute a possible source of risk diversification".

This method of financing can produce systemic risks. Shadow banking entities are unregulated and some of them are exposed to the risk of sudden and potentially significant redemptions by investors (runs). Leveraged entities are not always subject to appropriate limits designed to mitigate the risks generated by their activities.

The FBF understands the Commission's legitimate concerns regarding potential contagion from shadow banking and the need to achieve a fair balance in terms of regulating this sector following the crisis. The FBF is very much in favour of this consultation, which it believes requires a series of impact studies. These impact studies are a necessary pre-condition to defining effective and appropriate regulations. The FBF thanks the European Commission for organising this consultation and hereby submits its members' initial conclusions.

In this respect, it makes the following comments in response to the Commission's questions.

II - KEY MESSAGES

- So-called shadow banking is complex and continually evolving in response to new regulations. **It needs to be considered as a system of activities, markets and contracts that are connected by institutions. In this respect, it complements the banking system by providing an alternative to bank financing and by offering an alternative method of financing that encourages risk diversification owing to its greater degree of specialisation. It plays a useful role in financing the real economy provided it does not present systemic risk or generate distortions in terms of regulatory controls between entities engaging in the same activity.**

  In this respect, the **FBF considers that a detailed analysis of how these credit intermediation channels functions is needed before these activities are called into question. This will require a global vision of all the issues at stake. The curtailing or elimination of shadow banking activities by applying an inappropriate regulatory framework would have a negative impact on the financing of the real economy.**

- **To achieve this, shadow banking needs to be considered alongside the banking system.**

  Banks are highly regulated because of the risks attached to their specific activities: deposits/loans, payment systems that generate maturity and liquidity transformation risk and their use of financial leverage.

  Currently these activities are often provided partly and/or alongside other activities by non-banking entities or infrastructures that can present systemic risk in the same way as banks. It is therefore essential to identify those activities that perform maturity and liquidity transformation and which transfer risk, with or without financial leverage, regardless of whether they are carried out by regulated entities (banks) or non-regulated entities (shadow banking entities).

- The links between shadow banking entities and activities must therefore first be identified in respect of this type of banking risk to ensure that the real economy will not be negatively impacted by a weakened financing system. **In this approach it is important to determine the characteristics of the risks that arise from these activities and the consequences of their interconnectedness rather than merely describing the different types of activity in order to produce an academic definition. At this stage it is also appropriate to ensure that the process does not over-regulate banks and other regulated entities (insurers, UCITS and AIFM, financial companies).**

- The first priority is therefore for the regulatory authorities to identify the entities and activities concerned. A thorough approach is needed when mapping this information. **It must be targeted and forward-looking so the competent supervisory authorities can compare information using a standard model. The exercise**

must involve the financial professionals the best placed to report the necessary information to the regulator.

- In our opinion, **shadow banking entities and activities that incur credit risk (even those that do not collect customer deposits) should be subject to similar solvency and liquidity requirements as credit institutions once their activity reaches a certain level.**

- **As shadow banking entities have no access to ECB refinancing and are unable to fund their commitments, they could suddenly be forced to cease providing financing or to sell off their assets on the market in order to preserve their activity – these actions are likely to undermine financial stability.**

  More generally, shadow banking entities should be subject to **regulations that are adapted to and consistent with their situation, designed to maintain financial stability and safeguard against systemic risk.**

- **Lastly, Europe must be able to contribute to the work undertaken by the FSB and use information collected at an international level to propose solutions that take into account the fact that shadow banking is at various stages of development in different countries even within Europe or the euro zone. This is due to the history of the financial system and the role played by the financial markets in financing the economy as well as the different ways in which the Banking Directive has been transposed into Member States' national law[1]. Shadow banking is, incidentally, less developed in Europe.**

[1] '*Shadow Banking in the euro area (ECB): overview occasional paper no. 133 april 2012*'

III - ANSWERS TO QUESTIONS

GREEN PAPER – SHADOW BANKING

3. WHAT IS SHADOW BANKING?

Questions:

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

To define the potential threats in terms of systemic risk arising from shadow banking, it would be appropriate to **use the rules applied to manage banking risk** as a starting point. Banking risk is essentially characterised by the role of banks in performing **maturity and liquidity** transformation, in managing deposits/loans and by their use of **financial leverage**.

In response to these practices, regulators have developed **prudential regulations** adapted to the different risks incurred in terms of **solvency, liquidity, leverage and operational risk**. As a result, banking activities are highly regulated and are subject to **considerable transparency vis-à-vis the regulators**. In this respect, the implementation of a dual regulatory framework seems unwarranted.

The Financial Stability Board (FSB) has defined shadow banking as the **system of credit intermediation that involves entities and activities outside the regular banking system**, operating by accepting **funding with deposit-like characteristics**, **performing maturity and/or liquidity transformation**, undergoing **credit risk transfer** and using direct or indirect **financial leverage**.

This definition seems to adequately cover the banking functions defined above. In this case, if these activities are carried out by non-banking entities that use deposits or bonds and other debt securities, they must be **subject to the same prudential rules as banks** when they reach a certain volume of activity and for an equivalent risk exposure. This same logic should be applied when identifying the different entities and activities concerned.

This approach will provide a level playing field by type of risk and will also **prevent any distortion in competition arising from the status of the entity carrying out the banking or non-banking activity**. To calculate the requirements, it is, however, necessary to exclude activities under a certain amount.

In this respect, in Europe, securitisation vehicles, money market funds, ETFs and finance companies are **already covered by appropriate regulations in terms of investor protection and/or prudential banking rules** for their activities that incur transformation, leverage and/or liquidity risk.

However, other channels can present **macro-prudential risks**. This applies to credit **guarantees or sureties provided by entities without bank status**. These guarantee activities must be governed by prudential requirements, regardless of the status of the non-banking entity.

Payment institutions could also, in the future, engage in credit, leverage or transformation activities in the form of deferred payments.

In terms of systemic risk, it is only fair that **certain non-banking entities that provide *de***

facto **payment services be subject to prudential rules covering operational risk and also solvency risk** if they offer credit services.

Similarly, **direct loan platforms and inter-company loans** over long periods and involving large sums should also be subject to prudential supervision.

An activity that presents the same risks once it exceeds a certain amount should be **subject to the same controls and prudential requirements** regardless of whether it is a **banking or non-banking activity, carried out directly or by a consolidated undertaking**.

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?

Some authorities will prefer an institutional approach to regulation, while others will maintain that the response must be broken down by activity. In view of the financial instruments, entities and activities listed, the Green Paper seems to have opted for an entity- and activity-based solution.

For the FBF, the approach cannot be limited to a list of entities and activities, but should instead be based on a matrix showing the interconnections between the two. The matrix could cross-reference entities with those areas/aspects in which regulations are incomplete or nonexistent.

To improve the analysis, it is necessary to take into account prudential aspects at both the consolidated level and for individual entities, the leverage effect and the risk of 'runs'.

While it is often said that these activities and entities must be better supervised, **it is not enough to limit the supervision to a list**. **The definition of appropriate measures must be based on crisis scenarios** that can confirm that the regulation is proportionate to the real risk incurred.

- **Securitisation**

Asset securitisation must be allowed to develop in order to underpin financing for the real economy. It should be considered as a significant and stable source of liquidity that participates in providing alternative funding for banks. Regulatory measures have already been introduced to improve securitisation procedures and enhance transparency regarding these markets and vehicles. In Europe, the industry has introduced a quality label in order to promote simple securitisation solutions.

In detail, the FBF recalls that the EU has not yet delivered harmonised legislation on securitisation deals and seems to have "unjustified misconceptions" about this activity.

Several measures have, however, been taken to improve securitisation, which is a useful mechanism for transferring risk. These measures include:

- Contractual structures and the operational application of standardised transactions across the European Union;

- And securitisation transactions carried out by institutions that are already at least partially regulated by the Capital Requirements Directive (Directive 2009/111/EC of

the European Parliament and Council dated 16 September 2009, modifying Directives 2006/48/EC, 2006/49/EC and 2007/64/EC).

This directive clearly lays out the prudential treatment of loans assigned to securitisation deals, including how they can be removed from credit institutions' balance sheets for the purposes of calculating total assets and revenue.

As a result, any initiative from the EU regarding legislation for securitisation transactions should only be envisaged after all regulatory requirements have taken effect and been assessed for their effectiveness and impact.

- **Repos and guaranteed loans**

Repo activities are of crucial importance for credit institutions and other market participants in terms of ensuring liquidity.

This function will gain importance in the future owing to new regulatory requirements, in particular new capital requirements and the new regulatory framework for derivatives: this will raise demand for high-quality liquid assets in particular, to meet collateralisation requirements. At the same time, access to high-quality assets is becoming increasingly difficult.

Therefore, regulatory requirements concerning securities lending and repos must be fair, otherwise the consequences could unintentionally impact the financial markets.

The repo market is also facing challenges due to the fragmentation of existing systems across Europe. This fragmentation was identified by the International Capital Market Association (ICMA) in its White Paper on the Operation of the European repo market, which cites short-selling and settlement failures as barriers to efficiency in the cross-border transfer of securities, because each system operates under a separate legal and regulatory framework.

As a result, official initiatives to harmonise the systems and commercial practices of central securities depositories for national and international securities and to increase their interconnectivity would probably enhance the efficiency of cross-border security transfers and would thereby reduce delivery failures on the repo market.

Regarding the proposed implementation of a common trade repository, its main purpose should be limited to gathering market statistics, after an in-depth cost/benefit analysis enables progress to be made on this matter. This includes assessing information already published.

At this stage, it is therefore important to prevent developments from giving rise to over-regulation for banks and other regulated entities (European UCITS and AIFM directives); regulations owing to their status as regulated entities and regulations governing their activities with shadow banking entities.
In this respect, asset managers, AIFMs and ETFs should not be on the Commission's list.

In the FBF's opinion, the list to be considered should only include constant net asset value money market funds, certain securitisation activities (after assessing the impact of existing regulations), guarantees and sureties provided by non-banking institutions, payment institutions when they play a role in transformation or disrupt payment

systems, repo activities, specialised lending in general and the commodities market, which comprises non-banking entities outside the scope of the MiFID.

4. WHAT ARE THE RISKS AND BENEFITS RELATED TO SHADOW BANKING?

Questions:

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?

Shadow banking plays a useful role alongside the financial system by providing an alternative to bank deposits for investors and alternative financing solutions that can complement the traditional banking system due to its greater degree of specialisation, while diversifying risks.

Therefore, the FBF considers it particularly important not to cast doubt on these activities. Their curtailment or elimination owing to excessive regulations would have a negative impact on the financing of the real economy.

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 this approach it is essential to determine the characteristics of the risks that arise from these activities and the consequences of their interconnectedness rather than merely describing the different types of activity in order to produce an academic definition.

All risk management provisions (prudential ratios for regulated entities, market clearing, shoring up the shadow banking sector) increase the need for collateral, which can also cause systemic risk.

While the FBF agrees with the Commission's description of the different existing channels, it disputes the statement that they create new risks or transfer them elsewhere. It is therefore questionable at this stage to assume that the activities and entities mentioned are harmful to the financial system. However, supervision does seem essential.

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 credit activities carried out by non-banking entities must be understood by regulators (inter-company loans, loans made by platforms).

5. WHAT ARE THE CHALLENGES FOR SUPERVISORY AND REGULATORY AUTHORITIES?

Questions:

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

Before introducing new measures to supervise shadow banking, the authorities need to identify and define an appropriate approach for the entities concerned and their activities, so as to accurately assess their systemic importance and provide a proportionate regulatory response that takes account of the risks incurred.

In this respect, the work carried out by the FSB and other international bodies needs to be finalised so their conclusions can be adequately reflected in any new measures.

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 outcome of this approach will be different according to the country and the scope of banking laws and regulations applied. As the jurisdictional scope has not yet been standardised in Europe, the degree of adaptation may need to be adjusted to each country. Certain activities require banking status in some Member States but not in others. The importance of shadow banking can therefore vary considerably from one country to another.

The mapping of entities and activities should be targeted, forward-looking, adaptable and standardised so that the competent supervisors can compare information using a harmonised trade repository and confirm the need for greater transparency.

This exercise must involve the industry professionals the best placed to report information to the regulator, in this case, custodians.

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

The general principles for the supervision of shadow banking comply with the announced objective, provided they are proportionate to the issues at stake. This is particularly true if the chosen approach considers entities rather than activities. An approach based on adequate supervision could be more beneficial than an overly zealous regulation.

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

The general principles concerning the regulatory responses to shadow banking fit the regulatory objective, provided they are proportionate to the issues at stake.

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

To prevent regulatory arbitrage at an international level, it would be appropriate to refer to the

work carried out by the FSB, in particular confirming the notions of "reciprocity" and "mutual recognition" between states. An international consensus will guarantee extensive and effective supervision.

6. 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?

The measures taken, in discussion or under consideration in the European Union are moving in the right direction and already partly respond to concerns about shadow banking. They must be coordinated with the recommendations made at an international level by the FSB.

From our viewpoint, and by way of example, shadow banking entities that incur credit risk (even those that do not collect customer deposits) should be subject to comparable supervision and rules so as not to create competitive distortions with credit institutions, which operate in a regulated framework.

"Comparable rules" should therefore include the implementation of risk management processes, ratings and other tools (with all their inherent constraints, such as back-testing, etc.) and, evidently, solvency and liquidity ratio monitoring requirements where appropriate. These entities have no access to the ECB and are unable to fund their commitments, which means they could suddenly be forced to cease providing financing or to sell off their assets on the market in order to preserve their activity – these actions are likely to undermine financial stability.

More generally, shadow banking entities should be subject to a level of regulation that is adapted to and consistent with their situation, designed to maintain financial stability and safeguard against systemic risk.

Activities/entities	**Solvency**	**Liquidity**	**Governance Risk management**	**Business continuity**	**Crisis manage ment**	***Resolution***	***Other***
Credit risk							
Credit intermediation	X	X	X	X	X		
Credit guarantees	X	X	X	X	X		
Repos and securities lending	X	X					
Securitisation							
Quasi-deposits							
CNAV MMF	X	X		X			
Payments					X		

The "Other" column concerns other banking regulations that could apply *mutatis mutandis* to certain activities/entities, such as rules governing anti-money laundering/anti-terrorist financing provisions, large exposures, transparency and financial information, the leverage ratio, etc.

The idea is not to submit shadow banking entities or activities to banking regulations, but to

complement their sector regulations where applicable in order to reduce systemic risk and maintain financial stability while submitting them to appropriate prudential rules if they engage in the same activities as banks.

These activities are not regulated directly (i.e. as such) but they are monitored indirectly via the entities that undertake them (e.g. for securitisation, at present, the investors are regulated, and rightly so). An entity of any nature that performs credit transformation should be regulated in respect of this activity.

Similarly, a bank that engages in repos or securities lending/borrowing will see these transactions regulated in respect of its counterparty risk and their impact on liquidity.

As a result, the columns refer to regulatory issues that should appear in the sector regulations of the entities concerned. Repos, for example, require regulations on the solvency and liquidity of the entity carrying out these transactions. It being understood that a solvency regulation is not synonymous with a capital ratio.

Indeed, it is difficult to imagine how a solvency requirement expressed as a capital ratio could be imposed on a fund (a money market fund, for instance), which by nature uses no financial leverage (they are 100% funded in capital). However, funds could be required to calculate VaR and SVaR. (N.B. UCITS already calculate their VaR). Nothing is yet planned for AIFM funds, the regulatory framework of which has not yet been finalised.

7. 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?

The FBF agrees with the main points of the Commission's analysis. It insists on the need to coordinate European work on this issue with that carried out by the Financial Stability Board, which is already well advanced as the first recommendations are due to be published in July 2012.

It also emphasises the need for consistency between existing sector regulations (CRD V, Solvency II, UCITS, AIFM, CRA, etc.) and new regulations in order to safeguard financial stability and avoid systemic crises.

- While the FBF agrees with the analysis of the five key areas, regarding **asset management**, we consider it inappropriate to incriminate potential problems concerning the mismatch between liquidity offered to ETF investors and less-liquid UCITS, which incidentally must adhere to strict rules and limits concerning their investment policies.

  Like UCITS, ETFs are also regulated and their relationships with the banks that act as their sponsors are very transparent.

  With easy access to liquid and diversified markets, ETFs provide the opportunity for innovative commercial strategies that encourage a diversified risk profile. As a result, these products, which are generally available to a relatively limited number of investors seeking above-average returns, do not encourage the formation of systemic

risk. Adequate investor information, as required by the MiFID, is the most suitable solution.

The same conclusion can be drawn regarding derivatives, insofar as UCITS are subject to limits in terms of the amount and type of derivatives in which they can invest.

Regarding the risk of runs, this risk is already limited in respect of UCITS and AIFM funds by the regulations already in place.

- For **repos and securities lending**, the FBF emphasises that collateralisation activities were encouraged by the ECB during the financial crisis owing to their stabilising effect. Given the central role played by banks in these markets, they are already covered by existing regulations. However, the FBF is in favour of increasing the monitoring of potential risk concentration.

- Furthermore, the growing importance of central counterparties and their obligation to provide highly liquid guarantees implies that liquidity is needed to underpin risk management activities. In this respect, the **securitisation** of illiquid assets and the use of asset pools arising from guaranteed lending/borrowing will be essential to ensure that this does not reduce liquidity in other sectors of the economy.

The FBF agrees with the European Commission on the need to better supervise shadow banking. Also, with a view to improving efficiency and harmonisation, it seems appropriate, initially, to take into account the work already carried out by the FSB in order to ensure consistency in the analysis.

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

The FBF has no particular comments to add at this stage.

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

It seems premature to decide on the changes to be made without first carrying out an impact study. **We emphasise that any changes need to be coordinated at a European level with the recommendations currently being prepared by the Financial Stability Board.**

Moreover, **this involves moving from sector-based regulations to industry-wide regulations covering the aspects of financial stability and systemic risk.**

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

To ensure efficient monitoring of the shadow banking system as identified by the Commission, it is essential that existing information (by country / by product type / by type of investor) be mapped in order to identify what aspects are already covered by this information.

This exercise will enable an assessment of whether there is real reason to consider that certain areas of the shadow banking system are currently opaque, and identify what

information would be rapidly available for transmission to the supervisory authorities.

This approach would also be more cost-efficient for all stakeholders.

It is also essential that the market participants likely to be involved in collecting and reporting this information be systematically involved in the work carried out on this issue by the international authorities and the European Commission. Their understanding of the transactions and the corresponding channels together with their knowledge of the controls already in place and intended to meet the need for disclosure to end clients, regulators and databases (often transmitted daily), will provide significant added value in determining the type of reporting the best able to enhance shadow banking transparency.

Similarly, it is important to take into account the market practices currently recommended by professional associations and the initiatives being taken by the industry (for example, prime collateralised securities for securitisation), all of which are intended to provide a framework for correct transaction execution and transparency and ensure compliance with codes of conduct for the related processes.

The FBF agrees that better overall supervision must be considered. Its success will be closely linked to the capacity of supervisory bodies and Member States to agree on global procedures while remaining focused on achieving regular and effective exchanges of information.