



EUROPEAN COMMISSION
Directorate General Internal Market and Services

Financial services policy, Relations with the Council

SUMMARY

RESPONSES RECEIVED TO THE COMMISSION'S GREEN PAPER ON SHADOW BANKING

December 2012

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This is a high level summary of key messages received to the Commission's green paper on shadow banking. All comments received will be taken into account for further considerations.

1. Executive Summary

The European Commission's consultation on shadow banking attracted high interest from stakeholders. The comments provided cover a broad range of issues and responded to all the questions raised by the European Commission Green Paper¹.

The Commission received in total 140 contributions, of which 24 from Public Authorities; 47 from registered organisations; and, 64 from individual organisations. Five organisations asked for their submissions to remain confidential.

The key messages received from stakeholders are broadly in line with the feedback received at the shadow banking conference, organised by the European Commission on 27 April 2012 in Brussels:

- ✓ There is general support for the European Commission's initiative in this area. Work should continue to improve the regulatory system in the EU and to ensure global consistency;
- ✓ There is a growing consensus that supervision and a strengthened regulatory framework is needed to harness the shadow banking system;
- ✓ It is necessary to preserve a useful channel of financial intermediation that can provide benefits to the real economy at a time when bank financing is more constrained;
- ✓ The scope of regulation should be comprehensive and flexible enough to be adaptable to future developments;
- ✓ The room for regulatory arbitrage should be reduced and regulatory divergence in the EU eliminated;
- ✓ The focus should be on activities and entities that could pose systemic risk to the financial markets;
- ✓ Potential legislative measures should take existing legislation into account and should be proportionate; and
- ✓ Transparency and data collection need to be improved in order to strengthen the basis for further policy decisions.

In addition to the key messages, more detailed comments have been provided in response to the different areas covered by the Green Paper.

Scope and definition

Respondents to the consultation acknowledged that the term "shadow banking" is widely used and broadly supported, but some stakeholders suggested that the term should be changed. They argued that the current term is very broad and provides a negative connotation. Some stakeholders suggested that the term should better reflect the characteristics of the entities or activities and suggested to replace it by "activities that are not regulated and not supervised"; "parallel banking"; or "market-based finance".

¹

http://ec.europa.eu/internal_market/consultations/2012/shadow_en.htm

Some stakeholders underlined the need for more specified definitions. For example, issues such as credit activities, credit guarantees, leasing or finance companies providing credit or credit guarantees should be used in a more consistent manner, at least at European level. On the other hand, some respondents commented that a definition for shadow banking needs to be sufficiently flexible to be adaptable to future developments in the area of shadow banking.

Other stakeholders suggested that the scope of shadow banking needs to be further specified. The Financial Stability Board (FSB) has put forward a definition which is acceptable to many stakeholders (in short: non-banks performing credit intermediation²), although some of them argue that it should either be more comprehensive or should provide a better distinction between entities and activities. Stakeholders commented that shadow banking should only include entities and credit activities which are currently not (or not sufficiently) regulated and pose a systemic risk to the financial system. According to them credit intermediation and maturity transformation are key features of shadow banking activities. More focus should be on the issue of systemically relevant activities.

Representatives of certain industries (e.g. investment funds, leasing companies, Factoring companies or credit insurance undertakings) argued that their activities should not be within the scope of shadow banking either because they don't meet the definition, or because they are already subject to regulation and double regulation should be avoided.

General principles to follow

Many stakeholders underlined that shadow banking activities largely serve the real economy. Existing channels of financing should be preserved. However, some expressed concerns about the usefulness of certain activities in view of their contribution to the overall social welfare.

Stakeholders in general expressed support for measures already taken at EU level, although some respondents suggested that non-binding measures might not be sufficient to address existing shortcomings of regulation.

The point was made that new regulation should take current developments in other areas where existing regulation is currently being revised (CRD IV, Solvency II, etc.) into account, since they may alter the structural characteristics of the EU financial system. Stakeholders reminded that bank and non-bank activities are intertwined.

Several stakeholders asked for a careful assessment of the potential consequences of any new initiatives and their cumulative impacts with other financial regulations to be implemented. Any legal measure should be proportionate and primarily targeted at entities and activities that pose significant systemic risk to the financial system.



² Financial Stability Board, Shadow Banking: Scoping the Issues, April 2011: "The system of credit intermediation that involves entities and activities outside the regular banking system".

Support was expressed for the general principles for the supervision of shadow banking, including that it should (i) be performed at the appropriate level, i.e. national and/or European; (ii) be proportionate; (iii) take into account existing supervisory capacity and expertise; and, (iv) be integrated with the macro-prudential framework.

Other respondents proposed the elimination of existing differences in EU supervision in order to reduce regulatory arbitrage, at least in Europe, but also internationally. Ideally, stakeholders would like to see any response to "shadow banking" activities to be coordinated on a global level in a coherent way and stressed that coordination is needed between existing work streams at the level of FSB, IOSCO, ECB, ESMA and the Basel Committee.

Some stakeholders expressed concerns whether traditional banking regulation per se may be appropriate to address the risks inherent in the shadow banking system. However, they underlined that activities that involve credit risk should be subject to similar solvency and liquidity requirements as credit institutions starting from a certain threshold, i.e. similar activities should be subject to similar regulations.

In addition, respondents to the consultation (called for?) improved convergence and equivalence in the area of related international standards, such as Basel requirements or International Financial Reporting Standards (IFRS), which could result in improved transparency for example regarding off-balance sheet activities.

Many stakeholders expressed support for an enhancement of the existing legal framework, (e.g. UCITs, AIFMD, EMIR, CRD, etc.), rather than the development of a separate regulatory regime focusing on shadow banking activities. They feared that this would avoid distortion of the competitiveness of the EU financial sector.

Key priorities

The Green Paper suggested five priorities for investigation, which were broadly in line with the FSB work plan:

- i. Banking regulation and interactions with shadow banking;
- ii. Asset management regulation issues with a specific focus on Money Market Funds;
- iii. Securities lending and repurchase agreements;
- iv. Securitisation practices in terms of incentives alignment and transparency; and
- v. Other shadow banking entities which may constitute a source of systemic risk.

Stakeholders expressed general support for the five proposed key areas where the Commission is further investigating options. However, a number of other suggestions have been provided.

Some stakeholders argued for an extension of the scope of the existing banking supervisory regime as far as appropriate.

Some stakeholders argued that Money Market Funds (MMFs) and Exchanged Traded Funds (ETFs) should not be subject to further regulation in view of the existing regulation on asset management and the ESMA guidelines, whereas others preferred these areas being subject to stricter regulation.

On securities lending and repurchase agreements respondents argued for a holistic regulation addressing directly the issue of increased leverage but expressed also concerns regarding haircut requirements due to the potential risk of increased pro-cyclicality. Instead, the generation of "safe assets" would be critical, as some respondents stressed.

Stakeholders did not insist on regulation on securitisation given that the EU regulatory framework has already been strengthened to deal with some of the issues.

On other financial entities (e.g. financial companies or broker-dealers), which are not explicitly targeted by the Green Paper, it was strongly recommended to wait for the final outcome of the work conducted by the FSB in order to ensure a consistent international approach.

Monitoring and transparency

There was broad agreement amongst stakeholders that transparency should be enhanced with a view to improve supervision and market discipline.

Data collection was seen by many respondents as a prerequisite for a better understanding of shadow banking activities and their implications in order to facilitate monitoring solutions, which would allow for better targeted interventions.

Indirect regulation was regarded by a number of respondents as an efficient tool to capture some of the risks posed by shadow banks. It was suggested that for example the large exposures regime should act as a backstop regime also to shadow banking activities and tackle the risk of interconnectivity by ensuring proper identification of interconnections.

Stakeholders did not object to the idea of regular monitoring and data collection in general and welcomed the work of the European Central Bank (ECB) in this area so far. In addition, they suggested that the role of the European Systemic Risk Board (ESRB) regarding monitoring macro-economic risks by collecting and bundling EU wide information should be further clarified.

Conclusion and next steps

The analysis of comments received suggests that there is support for regulatory measures in the EU subject to key principles, i.e. they have to improve financial stability, they are proportionate, they reduce regulatory arbitrage, they reflect the global characteristics of shadow banking, they improve transparency and they facilitate long-term growth.



Following the Green Paper consultation and the public conference in April 2012, the European Commission has initiated a number of discussions with stakeholders and has launched specific and targeted consultations, e.g. on UCITS and on the resolution of non-banks. The objective was to gain additional information in view of the preparation of appropriate policy reactions.

All information available will be taken into account for the development of policy proposals, which should be compatible with recommendations put forward by international organisations.

A Communication by the European Commission is planned for Q1 2013 and will provide further details regarding areas for which legal proposals might be developed and their respective timing.



2. Feedback Statement

2.1. Introduction and international developments

The 2008 global financial crisis was caused by regulatory gaps, ineffective supervision, opaque markets and overly-complex products. The European Union has shown global leadership in implementing the G20 commitments and has undertaken the biggest financial regulatory reform ever.

However, there is still an increasing area of non-bank credit activity, or shadow banking, which has not been the prime focus of prudential regulation and supervision to date. Although shadow banking performs important functions in the financial system, there is a common understanding that it can also pose potential threats to long-term financial stability.

Against this background, the Commission considers it a priority to examine in detail the issues posed by shadow banking activities and entities. The objectives are to respond actively and further contribute to the global debate; to continue to increase the resilience of the Union's financial system; and, to ensure that all financial activities contribute to economic growth.

The European Commission Green Paper described shadow banking as "the system of credit intermediation that involves entities and activities (fully or partially) outside the regular banking system." This definition is in line with the definition proposed by the Financial Stability Board (FSB).

Developments at international level

In November 2011, G20 Leaders adopted the FSB report *Shadow Banking: Strengthening Oversight and Regulation* which set out a work plan to develop policy recommendations in 2012.

On 18 November 2012 the FSB published for consultation (until 14 January 2013) an initial integrated set of policy recommendations to strengthen oversight and regulation of the shadow banking system³. The set of documents published includes the following reports:

- *An integrated Overview of Policy Recommendations;*
- *Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities;*
- *Policy recommendations to Address Shadow Banking Risks in Securities lending and Repos;*
- *Global Shadow Banking Monitoring Report 2012;*

These consultations will feed into the FSB's work to finalise a comprehensive and integrated set of policy recommendations to address shadow banking issues. These are then due to be endorsed by to the G20 leaders at the St. Petersburg Summit planned in September 2013. To finalise these policy measures, the FSB is also involving with other international standard-setters.

In 2013 the Basel Committee on Banking Supervision (BCBS) will develop policy recommendations to mitigate the spill-over effects between the regular banking system and the shadow banking system.

³ <http://www.financialstabilityboard.org/>

The International Organisation of Securities Commissions (IOSCO) has already set out final policy recommendations in its reports entitled "Policy Recommendations for Money Market Funds" and "Global Developments in Securitisation Markets"⁴.

Two specific areas are directly investigated by the FSB: i) the regulation of other shadow banking entities posing systemic risks; and ii) the regulations of securities financing transactions. On these two topics, public consultations have been launched.

Developments at the EU level

On 20 November 2012 the European Parliament adopted an own initiative report (Motion for Resolution) on shadow banking, in which it put forward the need for additional regulation of the shadow banking system⁵. It mentions that shadow banks, such as hedge funds or trading houses, benefit the real economy by lending to risky ventures that regular banks avoid. However, if their loans turn bad, they may collapse, taking regular banks with them, because they lack a capital cushion. The report argues that better prudential oversight is needed to reduce shadow banking's systemic risks, without stifling its benefits to the economy.

In response to the European Commission Green Paper the European Economic and Social Committee (EESC) adopted on 15 November 2012 a report, which concludes that measures need to be taken to address risks posed by the shadow banking system⁶.

The size of the shadow banking sector

The FSB's 2012 Global Shadow Banking Monitoring Report⁷ issued on 18 November 2012 highlights 3 key developments:

- a) The global shadow banking system grew rapidly before the crisis (in parallel to the regular banking system), rising from USD 26 trillion in 2002 to USD 62 trillion in 2007. The size of the total system declined slightly in 2008 but increased subsequently, although at a slower pace, to reach USD 67 trillion (based on 2011 figures);
- b) There is considerable diversity in the relative size, composition and growth of the shadow banking system across jurisdictions; and
- c) The granularity of available data is improving with the share of unidentified non-bank financial intermediaries within overall non-bank intermediation falling from 36% in the year 2010 to 18% in the year 2011. However, further improvements are needed to better capture the size and nature of risks in the shadow banking system on a global basis.

Stakeholders expressed concerns that the on-going reform of financial regulation of the banking (and insurance) sector may lead to a further growing market for non-regulated financial intermediaries. Therefore, measures need to be developed and have to become effective in time. Global coordination based on recommendations published by the FSB is crucial.

⁴ <http://www.iosco.org/library/index.cfm?section=pubdocs>

⁵ <http://www.europarl.europa.eu/news/en/pressroom/content/20121116IPR55709/html/Shadow-banking-balance-benefits-and-risks-say-MEPs>

⁶ <http://www.eesc.europa.eu/?i=portal.en.int-opinions.22753>

⁷ <http://www.financialstabilityboard.org/>

2.2. Responses to the Consultation

2.2.1. Summary of Responses

General Comments

Consultation respondents provided very detailed responses to the specific questions raised by the Green Paper. Many of them also provided general comments covering a broad range of areas.

Some respondents regarded the **term shadow banking** inappropriate since it seems to suggest – in particular when translated into other languages - that activities within the scope of the shadow banking definition are regarded as harmful and that there is a lack of regulation outside the banking sector in Europe.

Although a large number of respondents agreed with the **definition of shadow banking** used in the Green Paper, some stakeholders argued that the definition developed by FSB is generally too broad. As a consequence certain sectors, entities or activities should not be captured by the definition, e.g. factoring, certain insurance activities and investment funds since they are already subject to regulation. On the other hand other stakeholders argued that the definition should be broad enough to catch as many activities as possible.

Many stakeholders emphasised the need for **global coordination** in order to make sure that existing or future incentives for regulatory arbitrage are limited, in particular in view of the stricter regulation for banks and insurance entities currently under negotiation. Stakeholders stressed that an EU approach should not contradict recommendations developed by international organisations such as FSB, Basel or IOSCO.

Some stakeholders warned that the **benefits coming from the shadow banking system** should be identified and conserved and they stressed the importance of considering the negative effects posed by any new regulation on different market participants.

Other stakeholders argued that any future regulation should be **proportionate** and **focused** on entities/activities posing systemic risks to the financial system. The preference should be for enhancement of the existing legal framework instead of issuing a separate shadow banking regulation regime. Part of the policy reaction should be to look at the non-homogenous supervisory architecture in Europe and increase the level of harmonisation. Existing and future policy proposals should be coherent.

The point was made that the **interconnectedness between the banking and the non-banking sector** was regarded as substantial. Therefore more **transparency** is needed in the banking sector. It was highlighted that there is a need for better information collection processes, greater market transparency and regular monitoring to identify areas of systemic risk.

Question a

Do you agree with the proposed definition of shadow banking?

Although most consultation respondents agreed with the proposed definition and expressed general support, some concerns were raised as to whether the definition is appropriate.

Those respondents raising concerns argued that the proposed term is too broad and would therefore catch a variety of activities which should not be related to the shadow banking debate. They argued that the proposed definition would also cover certain activities already subject to regulation and which should not be treated the same way as non-regulated activities. Instead the focus should be more on systemic and potentially significant risks related to shadow banking. It should be more specifically looking at non-regulated activities.

Other respondents to the consultation expressed the view that the proposed definition is a good basis mainly because it covers entities as well as activities, which seemed to be a critical issue. Some stakeholders suggested defining entities/activities that should not be in the scope of shadow banking rather than the other way around. This would avoid that the approach becomes too broad. Others suggested that the definition should be operational, open and as broad as possible in order to be adaptable to changing market realities and entities and activities that should be included.

A number of respondents stressed the need for compliance with the FSB definition and made a strong case for using a common global definition in order to limit the potential room for arbitrage and to ensure global consistency.

Question 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 responses to the question were mixed. Although a number of consultation respondents expressed agreement, others raised strong concerns, in particular in view of the potential impacts of new regulation on certain sectors and business models.

As a general remark some respondents emphasised that shadow banking systemic risks ought to be assessed based on activities rather than a list of entities. It was highlighted that to come up with a conclusive list would not be operational since there is not a "one size fits all" solution.

Other consultation respondents agreed, but added that shadow banking should cover specific qualities of the financial system as whole, not just particular sectors of the financial industry, thus arguing for a more holistic approach. They argued that most entities and activities are already or should be subject to monitoring and regulation. Ultimately the objective should be to focus on the application of "same business, same rules".

The point was made that the focus should be on conduits and vehicles which are not consolidated in the balance sheets of banks. Securities lending and repos between regulated counterparts are mostly carried out through central counterparts. Additional entities to be scrutinised are those performing "social lending" activities (e.g. peer-to-peer credit).

Others suggested adding entities which are not only deposit-taking, e.g. treasury or risk capital funds, CCPs, securities lending and all operations involving collateral re-use, although warning that not all institutions leveraging their financial activities should be included.

The insurance industry argued that insurance and reinsurance undertakings that issue or guarantee credit products should not be classified as shadow banking.

A number of stakeholders suggested that certain activities should not be in the focus of the shadow banking debate. The argument was made, mainly by industry representatives, that activities for example in the area of securities lending and repo activities should be considered as shadow banking only with supplementary criteria (e.g. use of repo to gain leverage in excess of a certain hurdle). Others argued that the definition of MMF type funds within the sector of shadow banking is not satisfactory, as it suggests a link between risk run and deposit-like characteristics. The argument was made that the risk born by MMFs stems from the discrepancy between mark-to-market and published NAV in the specific case of MMFs measured at a constant value (C-NAVs).

Another view expressed was that shadow banking should include all credit intermediation activities that are implicitly enhanced, indirectly enhanced or unenhanced by official guarantees. These activities include debt issued or guaranteed by government-sponsored enterprises, which benefits from an implicit credit borne by the taxpayer; the off-balance sheet activities of depositary institutions, such as unfunded credit card loan commitments; and, lines of credits to conduits and bank-affiliated hedge funds.

A number of respondents stressed that ETFs do not constitute per se shadow banking entities, because excessive leverage is only used by a small number of them, which seems to be already addressed by existing legislation. The point was made that most ETFs providing credit for banking counterparties can be better addressed through banking regulation or the UCITS framework. Since ETFs in the shadow banking sector represent only a fraction of investments funds in general, they should not be distinguished from other investment funds in the treatment of shadow banking entities.

Other respondents argued for a narrower approach, comprising only entities which are unregulated or inadequately regulated.

Question 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?

The positions expressed by respondents to the consultation were mixed on this question. A number of stakeholders acknowledged that there are benefits created by the shadow banking sector, e.g. the enhancement of innovation and competition or diversification of investments. They suggested that shadow banking also contributed to the wider economy by providing credible, sound and alternative investment opportunities and vital sources of financing for businesses. Other benefits mentioned included the following:

- Shadow banking increases the number of financial firms and thus can reduce the size of market participants. In this sense it can help address the risks of 'too big to fail' financial institutions.
- Shadow banking provides additional diversity in the financial ecosystem, helping to ensure that it does not become widely or mainly dependent on the behaviour of banks.
- It is important not to create a system in which all or most of the players act like banks.
- Shadow banking can provide financial services not necessarily offered by regular banks, such as market making, thereby improving market liquidity.

- Shadow banking can help closing a funding gap and reinforce the stability of the financial system (a decentralised financial system avoids concentration of business; less transmission of systemic risk).
- The emergence of alternative funding solutions should not be deterred by heavy regulation.

Other stakeholders were more cautious in terms of the potential benefits and expressed support only if shadow banking facilitates long-term investment and thus were doubtful about benefit of financial innovation to growth.

On the other hand several stakeholders argued that there are no benefits related to shadow banking activities, since their success appears only to be linked to the fact that they rely on a lack of regulation and are based on unfair competition. It was doubted that unregulated activities could be seen as contributing to a more stable financial system and add social welfare to the society as a whole.

Some stakeholders were also concerned about access to finance for companies, in particular SMEs. They suggested that any new legislation should not work against the interest and needs of firms. As regards the possible risk diversification, some respondents expressed the view that shadow banking activities can even increase the risks for the real economy, since it is questionable whether they can provide an alternative source of funding during a period of crisis.

Overall, stakeholders expressed a clear view that, notwithstanding the benefits, the inherent risks of shadow banking justify an appropriate policy response.

Question 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?

Although there was general support for the description of the channels through which shadow banking systems are creating new risks, most respondents expressed reservations.

One respondent expressed disagreement with the implicit assumption that institutions that facilitate or support shadow banking are doing this only to avoid regulatory intervention.

Others argued that the description is only applicable to certain types of shadow banking activities, since there are many other non-bank activities which simply supply the market with additional liquidity, without using excessive leverage, e.g. asset management funds.

In the same context, a number of respondents, mainly from the financial sector, argued that, in contrast to general assumptions, certain entities or activities, such as investment funds, do not pose systemic risks. For example, MMFs create less liquidity transformation than banks; asset-liability maturity mismatch is very limited; credit quality is high; and, there are already high standards for liquidity risk management ensuring that redemption requests are met.

The argument was made that in some areas the level of regulation is already high, such as risk management and leverage, as covered by the UCITS and AIFM regime. In addition, fund managers can temporarily suspend redemptions or use "gates" to manage

redemption requests. The high degree of existing regulation and supervision prevents investment funds from being used to circumvent banking regulation. Other areas of risk (for example hidden leverage, regulatory arbitrage, disorderly failures, massive sales and runs) were regarded by some respondents as overstated or not limited to the shadow banking sector alone, and thus specific regulation aimed at shadow banking activities was not regarded as the preferred response.

A number of respondents expressed support for the risks mentioned in the Green Paper and stressed that four risk groups should in particular be addressed: (i) a more focussed monitoring system should be put in place; (ii) a tighter and better coordinated regulation focussing on stability/health of financial system is needed; (iii) convergence with other international regulatory systems, e.g. the US Dodd-Frank Act, might be useful; and (iv) enhanced transparency and quantification of the impact of shadow banking activities is necessary.

Another suggestion made was to investigate the separation between commercial banking activities and other activities of the banking group. This would be in follow-up to the report issued by the High Level Expert Group⁸ chaired by Erkki Liikanen.

Question 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?

A number of respondents to the consultation stated that additional channels should be considered.

Some respondents underlined that in addition to the general size of shadow banking, which can cause systemic risks, the reputational risk that shadow banking may entail for regular banks should be considered.

Another issue mentioned was called the “Paradox of diversification”, meaning that the more financial institutions start to behave similarly in their diversification strategy to reduce individual risks, the more the correlation of assets classes will increase resulting in higher systemic risk.

Also the risk of shadow banking institutions being used as instruments to hide illicit activities (e.g. tax fraud or money laundering strategies) was mentioned.

Many respondents confirmed that a significant amount of the risk is linked to the complexity and lack of transparency of products, structures or activities in the area of shadow banking.

It was mentioned that misalignments or even conflicts of interests may arise in securitisation-based credit intermediation, which do not exist for a traditional bank lending from its own balance sheet. This may result in a supply of poorly underwritten loans and structured securities, which could threaten the collapse of entire markets.

Complexity was mentioned by some respondents as another channel through which risks can be created, since the longer the chain of financial intermediation in shadow banking is, the more entities will be exposed to the knock-on effects of dislocation at some point further up the chain. Moreover, the complexity of the links that may form between shadow

⁸ http://ec.europa.eu/internal_market/bank/group_of_experts/index_en.htm

banks could have destabilising network effects. In addition, the lower the quality of the loan, the longer the chain that may be required to enhance the quality of the assets to the standards needed to sell to money market mutual funds and other end investors, thereby creating more risks.

Some respondents commented that complexity reduces transparency, which can be misleading for intermediaries, investors and regulators in terms of risk allocation. This may allow “risks to accumulate unnoticed and unchecked” giving rise to the possibility that, “when hidden risks suddenly become apparent, market participants effectively panic”. Opacity may also spawn “fraud, misconduct, and other opportunistic behaviour”.

Others suggested that the reliance of shadow banking on collateralised wholesale market funding may amplify economic and market cycles by facilitating leverage when asset prices are buoyant and margins and haircuts are low. This can trigger rapid and deep deleveraging when confidence is punctured by a shock, causing asset prices to fall and margins and haircuts to rise. Pro-cyclicality is made worse by the interconnectedness with the traditional banking sector, which creates negative feedback loops.

Question f

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

The majority of stakeholders agreed with the need for stricter monitoring and regulation of the shadow banking system. However, in most cases it was linked to conditions, such as:

- It should be based on the principle of "same business, same rules" and has to be coherent and based on the capacity and expertise of the system of supervision;
- Any new regulatory framework should not penalise the "good" side of shadow banking;
- Access to finance for SMEs should not be impeded;
- The opinions of FSB, ESRB, IOSCO, Basel Committee, EIOPA, ESMA, EBA should be taken into account;
- It should be based on solid analysis of the real needs and the impacts;
- Regulation needs to be targeted and proportionate;
- Regulatory action needs to be coordinated on global level; and
- The impact of on-going regulatory initiatives should be taken into account, e.g. in the area of European investment funds.

In addition to stricter regulation it was mentioned that more detailed disclosure requirements and enhanced monitoring systems could be seen as a first step for improving the understanding of the shadow banking sector. Thus, there is no need to exclusively focus on regulation.

It was suggested that a monitoring process should be put in place, including mapping, identification and detailed analysis of aspects posing systemic risk and room for regulatory arbitrage.

Many respondents stressed that the EU should not miss this opportunity to demonstrate leadership and set the global agenda for future shadow banking regulation. An EU-wide

shadowing banking data gap analysis should be commissioned to complete the work already started by the ECB and should include the input of EU practitioners, if possible.

The European Commission should create a shadow banking data management taskforce to aid in the development of potential target-operating models to meet shadow banking policy objectives, including cost-benefit analyses.

Question 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?

There was support for an EU central database building on a joint effort by public authorities and the financial services industry. The proposed EU permanent processes for the collection and exchange of information should be centralised and coordinated to limit reporting burden. It was proposed to consider an exemption for entities whose activities do not exceed certain thresholds or are not of a shadow banking nature.

The monitoring at national level and informal exchange of information between EU supervisors was regarded as sufficient by other respondents, who argued against an exchange of information at the global level.

Other comments were more critical and suggested that identification and monitoring must be carried out on the basis of the systemic risks. They considered that the proposed approach in the Green Paper generally does not achieve this; an entity/activity specific approach is necessary.

Some stakeholders proposed that the ESRB should be given a mandate to coordinate the regular monitoring of the shadow banking sector, in line with the step by step approach followed by the FSB. Furthermore, the role of the ESRB should be clarified.

For the purposes of monitoring, data and information from various sources will be needed, both aggregate and entity-specific as well as covering all financial sector.

Question h

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

There was a large degree of support for the proposed principles (Green Paper, page 6). However, concerns were raised that further details would be required for their implementation, e.g. regarding what would be deemed to be the 'appropriate level' and 'proportionate', and how supervision will be 'integrated within the macro prudential framework'. Furthermore, some respondents referred to the consolidation rules under IFRS as an important element of supervising non-bank activities.

The point was made that, in general, supervision should be carried out on European level in order to get a better understanding of existing credit intermediation chains. In contrast, some respondents preferred a more national approach.

Others commented that it is important to develop a mechanism that allows for the measurement of the level of implementation and appropriateness of the suggested principles.

Some respondents highlighted that, since the shadow banking system will continue to evolve, it is important that regulation can be adapted to new developments. Others stressed the need for regulation and principles to be deliverable and operational. In addition, new policy should only be adopted subject to EU wide consultation and cost benefit analysis.

Some respondents expressed disagreement with the principles, unless a more extensive mapping of shadow banking with an indication of the corresponding level of risk for each activity and entity is undertaken. Furthermore a clearer definition of priorities and exemptions should be developed before the principles are applied.

Question i

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

Stakeholders broadly agreed with the general principles for regulatory responses (Green Paper, page 7), but expressed some preferences and nuances to the approach:

Stakeholders suggested that 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 level of activity passes a certain threshold. However, the different stages of development in different countries should be recalled in this context. Others warned that the extension of existing banking regulation to shadow banking entities should be carefully considered, in order to determine whether the provisions suitable for the banking sector will have the same effect on the shadow banking sector. In addition there has to be clear distinction between banks and shadow banks, so that credit institutions are not subjected to double regulation.

It was suggested by some respondents that a regulatory response should be appropriately calibrated, in order to carefully consider how market activities are performed; avoid unintended consequences; preserve the benefits of shadow banking; and, ensure a level playing field between the regulated banking and non-regulated financial sectors performing similar activities. Any regulatory proposal should comply with the policy recommendations developed by FSB, IOSCO or the Basel Committee.

Stakeholders stressed that, in their view, the most effective approach would be to focus on the extension or revision of existing mechanisms. They argued that any new measures would suffer from static definitions and that indirect regulation might not sufficiently target shadow banking concerns. Aspects such as tax avoidance schemes should also be taken into account.

An approach based on economic substance and activity, rather than on fixed and narrowly-defined entities, was regarded as more effective. Instruments for addressing the links between regulated entities/activities and the shadow banking sector were regarded as necessary. It was suggested that for this purpose a number of micro-prudential instruments could be used to address macro-prudential aims, for example:

- bank capital buffers;

- sectorial capital requirements, such as specific risk weights on intra-financial system exposures;
- large exposures and activity limits;
- funding concentration limits; and
- minimum and "through the cycle" margin and haircut requirements for secured lending and financing transactions.

Some respondents were concerned that the supply of "safe assets" will have to increase in order to balance the effects of other regulatory reforms, such as the OTCD reform or the effects of the crisis, including deleveraging. With the current general shortage of safe assets, the shadow banking system can play a role to fill this vacuum. From a regulatory perspective regard should always be had to the source of safe assets and the way in which they are provided (such as whether there is a title transfer in which ownership changes hands).

Other respondents suggested that the first priority should be to establish a complete overview of the interconnectedness between all entities and activities and the banking system and to have an understanding of the unintended consequences for access to finance for the real economy. They highlighted that there is no "one-size fits all" approach, underlining the importance of flexibility and adaptability of new regulation to developments in the sector. The need for detailed impact assessments was mentioned.

Other principles mentioned included safe and efficient market structures; non-distortion of competition or interference in price-building mechanism; and financial innovation and scrutiny of unintended consequences.

Some stakeholders stressed the need for more consistent enforcement and a clarification of the powers of the ESRB, as well as the need for a close coordination between macro and micro prudential authorities and conduct-of-business regulators to avoid policy confusion.

Others raised the issue of follow up and therefore the need for periodic assessment and review of effectiveness due to the innovative nature of shadow banking.

Question j

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

This issue was regarded by almost all stakeholders as key, in order to avoid the creation of loopholes or incentives for regulatory arbitrage at the international level. Most respondents therefore argued for consistent regulatory guidelines across countries. In particular the FSB and IOSCO were mentioned as organisations which should ensure international coordination. For example the adoption of an internationally-consistent definition for shadow banking systems was regarded as a crucial element.

It was suggested that the EU should comply with the FSB's recommendations as far as possible and it should establish an integrated framework for macro and micro prudential supervision alongside global information and data exchange framework at global level. A regular exchange and sharing of information and data between authorities could be achieved by the implementation of the Global Legal Entity Identifier (LEI).

Certain respondents highlighted that the existing regulatory framework, i.e. Basel 2 and 2.5, already contain sufficient regulatory instruments that would allow for a stronger focus on international consistency. The important role of peer reviews was mentioned in this context.

Others suggested that more harmonisation through the removal of materially-unjustified differences (e.g. in accounting and consolidation rules) should be achieved. They stressed that risks related to the shadow banking sector are currently heightened to a varying extent across the EU, not only due to differences in regulation but also because of differences in interpretation and enforcement. To this end, a greater use of regulations instead of directives in EU legislation and direct supervision at EU level were mentioned as appropriate measures.

On the other hand, some stakeholders warned that full harmonisation and coordination at the international level may not be achievable due to the different structures of different markets, e.g. MMFs.

Others were more cautious and warned that global harmonisation would be unrealistic at this stage. However, they were optimistic that reliance on the FSB framework and more extensive use of peer reviews (e.g. by the IMF FSAP and FSB) could be beneficial.

Question k

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

Stakeholders summarised measures already taken at EU level, in particular legislation in the area of AIFMD, MiFID, UCITS or CRAs. These were broadly welcomed and regarded as appropriate measures for addressing key concerns.

However, some respondents expressed concerns regarding the cumulative impact of the measures and commented that the effect on particular areas of financial markets (e.g. the sustainability of securitisation market) is currently neglected. Thus, any additional regulation to address risks posed by shadow banks should not overlap with existing regulation. Furthermore, potential existing loopholes in current legislation should be identified.

It was also mentioned that indirect regulation via the banking and insurance sectors is a crucial element of a regulatory response to shadow banking. However, enlarging the scope of existing regulation should be done carefully. Others stressed the need for further evaluation of "soft rules" (Level II) developed by ESMA. One conclusion might be to make them legally binding in order to improve consistent application.

Some commentators asked for caution regarding new proposals, since they took the view that certain entities, e.g. MMFs and ETFs, are already sufficiently regulated in the EU. Concerns were also expressed regarding extending provisions of CRD IV to non-deposit taking financial companies.

Question l

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

Stakeholders broadly agreed with the five areas mentioned (Green Paper, pages 11-13), which largely reflect the five work streams set up by the FSB. Hence, most respondents stressed that the final outcome of the FSB work should be taken into account.

The following specific comments were made:

(i) Banking regulation

Most respondents believe that CRD/CRR IV will improve the regulation of shadow banks and will provide powers to set capital and liquidity guidance via a macro-prudential tool-kit. As regards the links between the banking and unregulated sectors, consolidation policy can play a role in ensuring the "same business, same rules" principle. Financial reporting requirements according to IFRS and capital guidance under CRDII/III, if applied consistently, provide a good basis for managing risks arising from banks' interaction with the shadow banking sector.

(ii) Asset management regulation issues

Most of the comments were related to MMFs and ETFs. Regarding MMFs the risks highlighted by IOSCO (runs, contagion risk, and implicit guarantee of sponsors for return of capital, constant NAV funds, rating risk) were mentioned. Views regarding valuation (constant versus variable NAV) were mixed. Some respondents suggested that MMFs are not vulnerable to massive redemptions and should not be considered shadow banking entities/activities, with the exception of C-NAV MMFs. They considered that MMFs are not a source of significant maturity transformation within Europe and represent limited risk. Others took the opposite view and argued for a substantial revision of MMF regulation.

Other comments included a proposal to exclude certain asset classes, such as raw materials, from UCITS since they would not provide added value to the society,

Regarding ETFs the ESMA guidelines were considered to establish a harmonized framework on the quality of collateral; prohibited transaction for re-use of collateral; prevention of conflicts of interest; and liquidity of the fund, although there seemed to be a preference for making those rules binding.

(iii) Securities lending and re-purchase agreements

Most stakeholders agreed with the focus in this area and suggested that the issue of increased leverage should be addressed directly, rather than indirectly, through regulation of securities markets.

Other respondents suggested introducing adequate measures to deal with liquidity mismatches, concentration and roll-over risks in collateralised funding markets. European supervisory bodies could be allowed to monitor an asset encumbrance ratio.

Some suggested exploring the issue of "who owns what" in securities financing transactions and to consider different policy options to address existing risks notably by looking at accounting rules or the introduction of quantitative limits. One respondent expressed concerns regarding the potential confusion of "re-use" and "re-hypothecation" as synonyms when in fact there is an important difference regarding the transfer of titles (which is the case for repos, but not for re-hypothecation).

A number of stakeholders was not in favour of minimum margin or haircut requirements and argued that mandatory haircuts applied to the securities lending market are likely to increase, rather than reduce, pro-cyclicality. One concern expressed was that if investment managers were not able to protect their investors by increasing haircuts (and a mandatory

minimum haircut may in effect become a maximum), they may stop lending altogether to certain counterparties.

Many commentators agreed with the idea of increased transparency and the setting up of trade repositories for repos. From a macro-economic perspective, regulatory measures should be horizontal and focus on collateral management.

(iv) Securitisation

Only a few stakeholders commented on this by stating that securitisation issues are already covered by existing regulation (CRDII/III/IV, Basel Trading Book review). A renewed assessment of a need for review should wait until the implementation is completed. Overall there was not a strong push for further regulation in this area.

(v) Other shadow banking entities

This area is still under consideration by the FSB (work stream 3). Most respondents therefore asked for further clarification and suggested waiting for the outcome of the FSB work.

Based on initial results of the FSB work, mapping of entities, risks and regulation was regarded as the right approach, with a clear focus on activities and not entities.

In addition to the five key areas, a number of respondents argued for improvements regarding the overall transparency of the shadow banking sector and in particular in the area of repos and securities lending transactions. The setting up of trade repositories was broadly supported, mainly because this could help tracking counterparty risk and potential conflicts of interest. However, this should ideally be pursued in parallel to harmonised reporting and accounting requirements.

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| Question m |
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| Are there additional issues that should be covered? If so, which ones? |
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Although most consultation respondents welcomed the scope and range of questions raised by the Green Paper, some listed a number of additional issues, including:

- the introduction of a mandatory clearing obligation (Tri Party-Repo), as well as an obligation to trade on regulated markets for standardized outside-group transactions;
- a clear focus on contingent liabilities in general, including not only those from banks, but from all potential "guarantors" and not limited to MMF-related step-in liabilities. This is because the high level of indebtedness of sovereigns and moral hazard created by government guarantees is a risk factor;
- regulators should look more into interconnections between shadow banking and the insurance sector. The core principles of Solvency II regime should be consistent with CRD IV;
- some techniques (dark pools and HFT) do not relate directly to shadow banking but they should be more in the focus, subject to monitoring and regulation if needed; and
- the Prime Collateralised Securities (PCS) initiative launched at EU level in the area of securitisation should be promoted. For example it could be assessed by EBA and recognised as eligible asset in the context of CRD IV.

Question n

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

Stakeholders provided a number of ideas regarding modifications to the current EU regulatory framework, including:

- it should be investigated if and how current rules for bank liquidity could be extended to all non-regulated bank entities, including shadow banking entities;
- more attention should be paid to naked short selling and investment in raw materials;
- the own capital requirements and future liquidity requirements, foreseen under the CRR for credit institutions engaging in securities loans transactions, should also apply in cases of chain transaction when one or more intermediaries are not credit institutions;
- there should be support for the development and use of effective macro prudential oversight to monitor risks emerging in the system as a whole and the targeted and proportionate use of macro prudential policy tools.
- instead of new regulation, the focus should be more on increased disclosure, transparency, data collection and monitoring systems; and
- existing and well-functioning regulation, e.g. UCITS, should remain unchanged.

A number of respondents argued that there are good reasons for a reform of MMFs in the area of minimum liquidity, valuation techniques, and credit ratings. Others argued in the opposite direction, maintaining that the current regulation of MMFs appropriately addresses inherent risks.

Question o

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

Stakeholders suggested a number of other measures that should be considered:

- A constant reassessment of risk mapping exercise should be conducted by relevant authorities;
- The regulatory system needs to be suitably dynamic in order to address new regulatory issues related to the inventiveness of shadow banking sector;
- Transparency of supervisory systems can be improved by the publication of core indicators, such as supervisory personnel per employee in the financial sector etc.;
- While the "single rule book" is supported, a framework should be set up allowing macro-prudential authorities some "constrained discretion" (with safeguards) in setting higher standards to deal with financial stability risks in their jurisdiction arising from SB. In addition, subject to the safeguards, it is necessary to allow for a flexible and targeted application of macro-prudential instruments to sectors, entities and activities (including a process enabling new instruments to be activated swiftly when need arises to address specific systemic risks concerns);
- More transparency is needed, e.g. a European trade repository for repos; and

- A better exchange of data and information between supervisors and the creation of EU databases without duplication of data or overburden regulated intermediaries would be beneficial in order to reduce systemic risks.

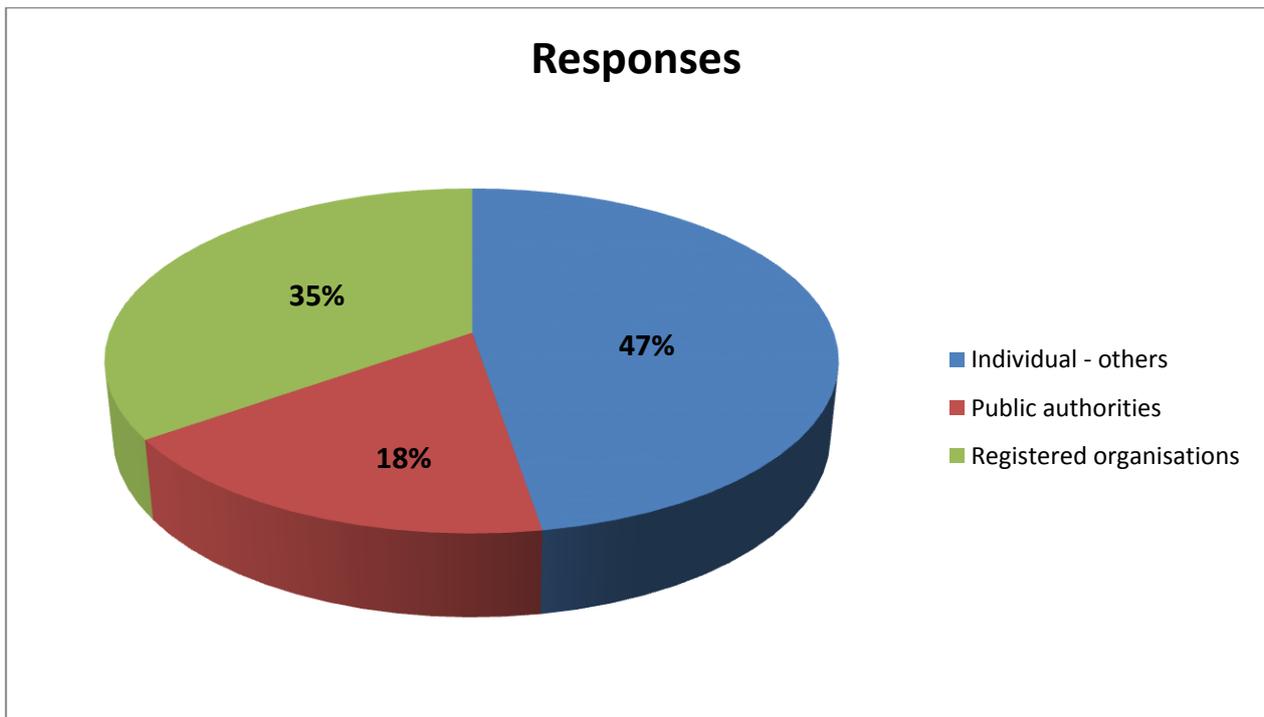
2.2.2. General Overview of the Consultation

In order to develop a deeper understanding of the issues, the European Commission launched a Green Paper and consultation from 19 March to 15 June 2012. The key objective of the Green Paper was to consult stakeholders on shadow banking issues: definition, risks and benefits, the need for stricter monitoring and regulation, outstanding issues and possible next steps.

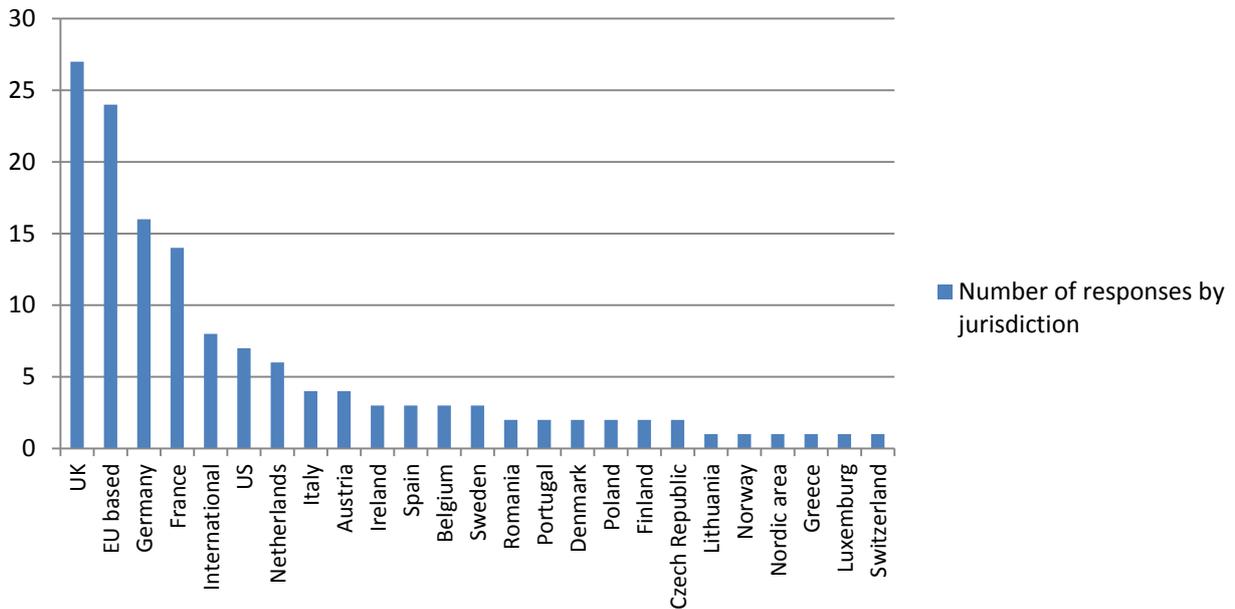
The Commission received in total 140 contributions, of which 24 from Public Authorities, 47 from registered organisations and 64 from individual organisations. Five organisations asked for their submission to remain confidential.

The largest number of responses was submitted from stakeholders in the UK, France, and Germany and from EU based firms or associations.

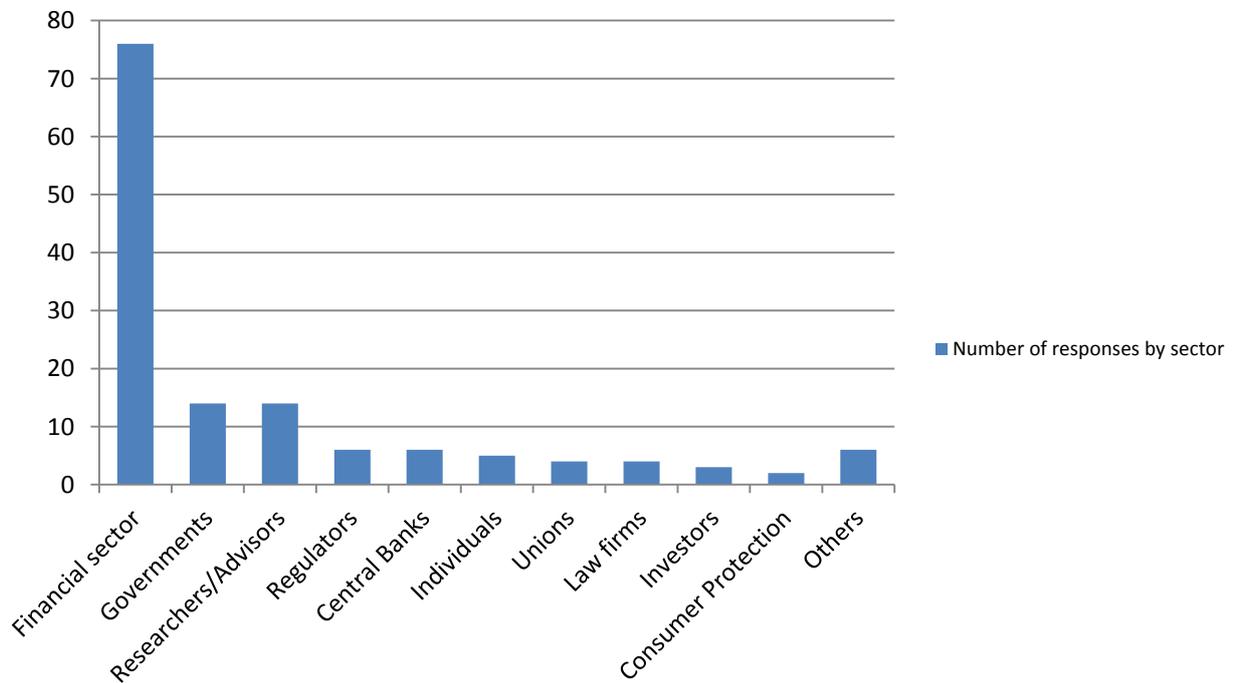
In terms of professional background, the most submissions came by far from the financial sector, including financial institutions and associations. A considerable number of submissions came from the public sector, governments, national banks and regulators.



Number of responses by jurisdiction



Number of responses by sector



2.2.3. List of participants

1. National Bank of Romania
2. AXA Investment Managers
3. ABI Associazione Bancaria Italiana
4. *Confidentiality requested*
5. Nomura International plc
6. CNMV Advisory Committee of the Spanish Securities Market Law
7. Markit Inc
8. EIOPA – European Insurance and Occupational Pensions Authority
9. HFSB – Hedge Fund Standards Board
10. MFA – Managed Funds Association
11. European Network of Credit Unions
12. VGF - Verband Geschlossene Fonds
13. EBG - European Banking Group
14. DIHK – Deutscher Industrie- und Handelskammertag e.V.
15. Rolls Royce plc
16. LeaseEurope AISBL
17. CLLS - City of London Law Society
18. IFCR - International Centre for Financial Regulation
19. *Confidentiality requested*
20. ESBG - European Savings Banks Group
21. BBA - British Bankers' Association
22. Dansk Aktionærforening
23. Eurofinas AISBL
24. Genworth Inc
25. Finance Watch AISBL
26. EBF - European Banking Federation
27. Government of Poland
28. Central Bank of Ireland
29. VÖB - Bundesverband Öffentlicher Banken Deutschlands
30. VNO-NCW and MKB Netherlands
31. ASF Association Française des Sociétés Financières
32. Tamar Joulia Paris and Casey Campbell
33. Trade Union Pro Finland
34. Clifford Chance
35. FLA - Finance and Leasing Association
36. Ministry of Finance Finland
37. VVD Group – Volkspartij voor Vrijheid en Democratie
38. TSI True Sale International GmbH
39. MBIA UK Insurance Limited
40. AFGI Association of Financial Guaranty Insurers
41. GCAE - Group Consultatif Actuariel Européen
42. ZIA - Zentraler Immobilien Ausschuss e.V.
43. Lithuanian Free Market Institute
44. Royal Ministry of Finance Norway
45. FMA – Financial Market Authority Austria
46. Groupe GTI – Gestion et Titrisation Internationales
47. BdB – Bundesverband Deutscher Banken

48. APB - Portuguese Banking Association
49. Tiberiu Tudor Salantiu
50. UniCredit Group
51. ABFA – Asset Based Finance Association
52. Mazars
53. AMUNDI Asset Management
54. BBF - Belgian Association of Factoring Companies
55. Financial Services User Group
56. CGPME
57. Jersey Financial Services Commission
58. MEDEF – Mouvement des Entreprises de France
59. Sciteb
60. Deutscher Factoring Verband e.V.
61. NFU - Nordic Financial Unions
62. BAK - Bundesarbeitskammer Austria
63. *Confidentiality requested*
64. Ministry of Finance Czech Republic
65. af2i – association française des investisseurs institutionnels
66. ICMA - ERC European Repo Council
67. ESRB – European Systemic Risk Board
68. DSGV – German Savings Banks Association
69. FAAN – Factoring and asset-based financing Association Netherlands
70. Melanie L. Fein
71. CNB – Czech National Bank
72. UNI Europa
73. Government of the Netherlands
74. IFC Forum
75. GDV – Gesamtverband der Deutschen Versicherungswirtschaft e.V.
76. RBS Group plc
77. KEPKA – Consumer Protection Centre Greece
78. IMMFA – Institutional Money Market Funds Association
79. Allianz SE
80. HSBC Global Asset Management
81. LMA - The Loan Market Association
82. Veblen Institute for Economic Reforms
83. Chris Barnard, Actuary, Germany
84. Maria Niewiadoma, Poland
85. ICISA – International Credit Insurance & Surety Association
86. Jeroen Spaargaren
87. ABI - Association of British Insurers
88. Banco de Portugal
89. CBI – Confederation of British Industry
90. ICI - Investment Company Institute
91. IIF – Institute of International Finance
92. German Authorities – Deutsche Bundesbank, Bundesministerium der Finanzen, BaFin
93. alfi – association of the luxembourg fund industry
94. AIMA – Alternative Investment Management Association
95. UBS AG

96. ISLA – International Securities Lending Association
97. IMA – Investment Management Association
98. afg – association française de la gestion financière
99. NATIXIS Asset Management
100. EACH – European Association of CCP Clearing Houses
101. EuroFinuse – EuroInvestors – The European Federation of Financial Services Users
102. Ministry of Business and Growth Denmark
103. *Confidentiality requested*
104. OFPE – Observatoire des Fonds de Près a l'Economie
105. EFAMA – European Fund and Asset Management Association
106. BARCLAYS
107. BVI – Bundesverband Investment und Asset Management e.V.
108. IntesaSanpaolo
109. EACB – European Association of Co-operative Banks
110. IRSG - International Regulatory Strategy Group
111. PricewaterhouseCoopers International Ltd
112. *Confidentiality requested*
113. FBF - Fédération Bancaire Française
114. INVERCO - Spanish Assoc. of Collective Investment Schemes and Pension Funds
115. SOMO - Centre for Research on Multinational Corporations
116. ICI Global
117. Federated Investors Inc
118. ICMA - Asset Management and Investors Council
119. BNP Paribas
120. HM Treasury United Kingdom
121. CFA Institute
122. ifia - Irish Funds Industry Association
123. State Street Corporation
124. afme - Association for Financial Markets in Europe
125. BlackRock
126. AFTE - Association Française des Trésoriers d'Entreprise
127. Italian Ministry of economy and finance and Italian supervisory Authorities
128. JWG
129. Fidelity Investments
130. Swedish Authorities
131. Insurance Europe AISBL
132. French Authorities
133. LSEG - London Stock Exchange Group
134. Government of Ireland
135. Bundesrat Germany
136. Swedish Parliament
137. EBA - European Banking Authority
138. ECB-European Central Bank - Eurosystem
139. BusinessEurope
140. ESMA- European Securities and Markets Authority