Response to the European Commission's Green Paper on shadow banking[1]

1. Introduction

The HFSB welcomes the opportunity to respond to the European Commission's Green Paper on Shadow Banking.

The Hedge Fund Standards Board (HFSB) is the guardian of the Standards drawn up by international investors and hedge fund managers to create a framework of discipline for the hedge fund industry. The HFSB's mission is to promote the Standards through collaboration with managers, investors and the regulatory community.

The HFSB actively engages with the regulatory community and has responded to consultations on issues in relation to hedge fund regulation, including recent consultations from ESMA, IOSCO and others.

The HFSB is pleased to continue to inform the regulatory process and help the European Commission develop an approach to assess systemic risks arising from "shadow banking" activity.

2. General observations

Financial stability

The Hedge Fund Working Group (the predecessor of the HFSB) was put together in 2007 specifically to address general investor concerns and issues of financial stability. The final report (published in 2008) highlighted potential issues in the context of concentration of holdings and unwinding of positions during periods of market stress. It also indicated that strong risk management frameworks at individual firm level (including, liquidity risk management, stress testing and scenario analysis) were a powerful mechanism for mitigating such financial stability risk concerns. [2]

In its consultation on hedge fund redemptions in 2009[3], the HFSB addressed damaging externalities that had risen in the context of fund redemptions and the handling of situations of liquidity distress. These findings highlighted that adequate disclosure and mechanisms, which ensure fair treatment of

[1] EC Green Paper: http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf

[2] See HFWG Final Report (Section 9.5: The Global dimension/Financial Stability [p. 33]; and Appendix H: Financial Stability Dimension [p. 106])

[3] HFSB Consultation CP1/2009: Redemptions (http://www.hfsb.org/?page=11474)

investors, were a necessary ingredient to enhance overall financial stability. These findings also were considered in IOSCO's CR01/11 on Principles of Redemptions in Collective Investment Schemes.

In summary, these examples show that a solid "bottom-up" conduct framework involving strong risk management practices and adequate disclosure are necessary conditions for a stronger and more resilient financial system, and complement supervisory "top-down" efforts.

Terminology

Some of the activities covered in the "shadow banking" discussion have indeed evolved in the "shadow" of large banks and had to be consolidated into the banks' balance sheets. However, many other activities, such as asset management and ETFs have no resemblance to banks, and therefore, "shadow banking" might not be the best term here. In its introduction, the European Commission's Green Paper uses the term "non-bank credit activity" to describe "shadow banking", which we believe, reflects the nature of this activity better. An alternative term could be "market-based finance".

3. Specific comments

(numbers refer to the relevant section)

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

The HFSB acknowledges that it is difficult to come up with an all encompassing definition and that there is merit to take a broad view, which can then be narrowed down (as suggested by the FSB[4]). However, it should be pointed out that a broad definition covers every fixed income / bond investor and is not intended to label all FI investors as "shadow banks". The HFSB believes that the two stage approach proposed by the FSB provides a useful framework to reflect the evolving nature of the financial system: firstly, looking at all non-bank credit intermediation, and secondly, focusing on the subset of non-bank credit intermediation where maturity/liquidity transformation and/or flawed credit risk transfer and/or leverage create important risks.

2. 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?

It is difficult to determine a comprehensive list of entities in a fluid and fast evolving environment, and it is likely to evolve over time. In short, wherever banking is shrinking as a source of finance, it should not come as a surprise when financial innovation brings about new forms of financing.

4. 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 HFSB has repeatedly highlighted that the future is likely to bring a great deal more market-based finance (see HFSB contribution in: World Economic Forum Report: Rethinking Financial

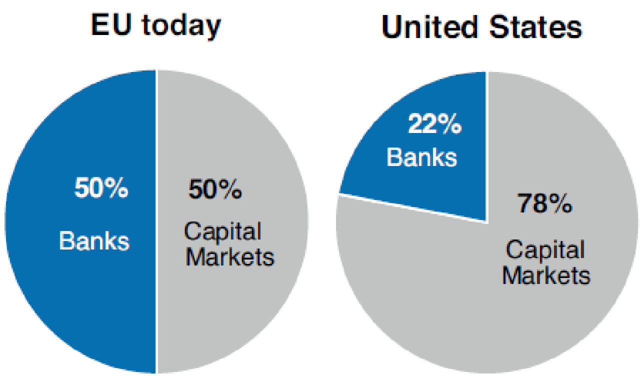
[4] FSB: Shadow Banking: Scoping the Issues: http://www.financialstabilityboard.org/publications/r_110412a.pdf (04/2011)

Innovation[5]) in light of ongoing efforts to make banking more resilient and stable, which will also make banking more expensive. More market based finance means that

a) the corporate sector has more financing options,
b) investors have more choices, and the markets allow them to manage their risks better
c) capital markets help spread risks more widely, rather than allowing risk taking being concentrated in a small number of large banks,
d) end investors can absorb losses , instead of the cost being met through the tax payer bailouts of banks,
e) capital markets provide a fertile breeding ground for financial innovation with a large number of entrepreneurial players.

While the EU is still strongly reliant on the banking sector, the US provides a fairly different picture: it relies more on capital markets. It will be important for Europe to develop and attract more non-banking forms of financing, including asset management etc to attract the required investment for economic growth. in order create jobs and prosperity in Europe.

Figure 1: Banking versus markets in the EU and the US[6]



4. 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?

(i) "Deposit like funding structures may lead to runs":

The HFSB agrees that bank like structures (or banks themselves) are exposed to risks of "runs", but believes that more detailed analysis is needed in order to evaluate these risks properly. Therefore, as a first step, it is helpful to understand bank runs and how they can be damaging to the broader system. It should also be noted that investment funds with variable pricing (as a function of underlying asset prices) and adequate mechanisms (governance, disclosure) to handle situations of liquidity distress do not give rise to such concerns.

"Bank runs and how to mitigate them"

[5] http://www.hfsb.org/files/td_article_for_wef.pdf
[6] Source: IMF Global Financial Stability Report 11/2011 (Selected indicators on the size of the capital markets, 2010), Definitions: Capital markets = stock market + Debt securities; Banking sector = Bank assets

Bank runs usually arise where there is fear of banks becoming insolvent. Given that the business model of banks is based on the confidence of depositors in banks and that under normal circumstances only a fraction of all deposits is withdrawn at a time, it is clear that banks are particularly vulnerable in “abnormal” or distress circumstances. The critical characteristics that make banks so vulnerable can be described as follows:

- Deposit taking (instant liquidity) with zero tolerance for losses
- Significant liquidity/asset transformation (illiquid loans into liquid deposits)

Banking regulations are the right mechanism to address this vulnerability with a strong bias against risk taking, liquidity requirements, and deposit insurance schemes (to reduce the likelihood of runs). Since banks operate payment systems, hold deposits and savings of retail clients, they are systemically relevant.

“Fund liquidations and runs on funds"

Fund liquidations are not unusual and happen if investors collectively decide to redeem. Such liquidations happen without any concern for systemic risk. Under normal circumstances, the price formation in the market place (and for the fund) provides a mechanism for balancing supply and demand with all investors being treated fairly and who are able to redeem at their will (in line with the redemption rules of the fund, e.g. daily, or weekly liquidity). Liquidations (and closures) of funds are not undesirable per se. On the contrary, when a manager performs badly, everyone benefits from the closure. The crucial distinction between banks and funds is that a fund does not guarantee a repayment amount: the redemption price is determined by the underlying market price of the assets in the fund, or in the event of liquidation, the liquidation value of the assets in the fund.

However, runs on funds can arise if investors fear unfair treatment or expect a loss from holding on to a fund investment. This situation can arise, for example, when parts of the underlying assets become illiquid and long term investors, who under normal circumstances would keep their investments in the fund, have an incentive to redeem for fear of being "stuck with the bottom of the barrel" (redeemers are paid by selling off the liquid portion of the portfolio, while the long term investors keep the remaining illiquid portion of the portfolio). This rational incentive for the individual investor to redeem/run on a fund can be mitigated by ensuring fair treatment of investors, i.e. ensuring that the redemption process is slowed down, or gates are enacted. The HFSB developed the Standards focussing on strong liquidity risk management practices, governance arrangements to deal with such situations, and adequate disclosure to investors or the mechanisms available to ensure fair treatment in situations of liquidity distress (see HFSB CP3).

Therefore, in line with our statement in the introduction to this response, we believe that a strong bottom up risk management approach, along with adequate tools to ensure fair treatment of investors, are crucial in mitigating concerns about runs on funds. Above all, funds do not have "deposit taking" characteristics, and therefore do not give rise to the type of systemic issues arising in banks (or bank like deposit taking investment vehicles).

<u>(ii) Build up of high hidden leverage</u>

The concept of leverage has been intensely debated in the context of the AIFM-D. One of the key lessons learnt from this discussion (including the difficulty in agreeing on a singular meaningful definition of leverage) is that leverage can have different meanings in different contexts. There are many different types of leverage, ranging from balance sheet leverage (e.g. in the context of a bank) to leverage in market based finance, which arises in the context of securities lending and the use of derivatives. The HFSB has often highlighted that leverage is usually not a standalone risk measure, but needs to be seen in the context of the respective investment strategy and portfolio. Fixed income funds can exhibit higher (and fluctuating) leverage (if classical balance sheet measures are employed) than equity funds with no relation to actual risk. Therefore, it is important to explain and categorise the types of leverage properly in order to assess the risk accordingly.

<u>(iii) Circumventing of rules and regulatory arbitrage</u>

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<u>(iv) Disorderly failures affecting the banking system</u>

The HFSB agrees that excessive risk taking in banks remains the largest source of concern from a financial stability perspective, and that it is important for systemic risk and banking supervisors to understand new sources of potentially correlated risk that banks enter, as well as overreliance on short-term funding sources.

4. 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?

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

The HFSB agrees that as a first step, supervisors need to have a good understanding of financial markets activities, how they are interrelated, and where potential concerns arise. Secondly, it is necessary to determine whether the areas of concern are addressed properly by the existing regulation, or whether further action is needed.

5. 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 HFSB agrees that regulatory authorities need to have meaningful data to make relevant supervisory judgements. Reporting systems should be designed in such a way as to ensure consistency and comparability on a global level.

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

The HFSB broadly agrees with the principles.

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

The HFSB broadly agrees with the principles.

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

Taking into account the global scale of finance and banking, IOSCO and the FSB should play a greater role, for example in the areas of ongoing assessment and analysis and facilitating a global dialogue.

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

Both banking and capital markets have seen a large spectrum of new regulations, ranging from curbing excessive risk taking in banks to more disclosure and strengthening practices in the area of alternative investments. The hedge fund industry in particular is directly affected by the AIFM-Directive, which also includes reporting to regulators, seeking to enable regulators to assess the build up of potential systemic risks.

7. 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 HFSB broadly agree with the high level analysis of the issues.

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

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

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

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