European Securities and Markets Authority

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Reply of ESMA to the European Commission's Green Paper on Shadow Banking

Introductory comments

In the build-up of financial imbalances that eventually led to the financial crisis of 2007-2008, unregulated activities and leveraged entities played a significant role. The issues faced by the US shadow banking system spread quickly to Europe, as European financial institutions were highly exposed to it. Indeed, European financial institutions played a significant role in the development of the shadow banking system, for example through the issuance and purchase of Asset-Backed Securities (ABS) and Asset-Backed Commercial Paper (ABCP), while being exposed on the liability side to shadow banking entities such as US money market funds. These cross-sectoral and cross-border linkages enabled the difficulties of the US shadow banking system to spillover to Europe. In particular, regulators, supervisors and policymakers did not manage to address the risks of the shadow banking system at an early stage.

Against this background, and taking into account the recommendations in the De Larosière report, the European System of Financial Supervision (of which the European Securities and Markets Authority (ESMA) is a member) has since been created. Therefore, it is important to learn lessons from past experience in order to foster the stability of the European financial system.

ESMA's mission is to enhance the protection of investors and reinforce stable and well-functioning financial markets in the European Union (EU). As an independent institution, ESMA achieves this mission by building the single rule book for EU financial markets, and ensuring its consistent application and supervision across the EU. ESMA contributes to the supervision of financial service firms with a pan-European reach, either through direct supervision or through the active coordination of national supervisory activity. Looking forward, the development of an orderly, market-based finance system that facilitates the flow of credit to the real economy is one of the main objectives of ESMA.

ESMA welcomes the work being done on the shadow banking system at the international level by the European Systemic Risk Board (ESRB) and the European Commission and the global co-ordination role of the Financial Stability Board (FSB).

As a securities markets authority, ESMA has a strong interest in issues surrounding the shadow banking system. This derives from the fact that ESMA has a mandate[1] that is balanced between activities and entities, along the lines of the definition of the shadow banking system put forward by the FSB. Moreover, ESMA is the relevant European Supervisory Authority (ESA) for some of the entities identified by the Commission as possible components of the shadow banking system (such as money market funds and

[1] See Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority).

exchange-traded funds) and is the direct supervisor of Credit Rating Agencies (CRAs) in Europe. ESMA does not object to the publication of its reply.

Given its mandate, ESMA has already started working on issues raised by the shadow banking system, indirectly through guidelines on UCITS and through contributions to ongoing work by the European Systemic Risk Board (ESRB), but also directly through preliminary work. EU competent authorities that are members of the European System of Financial Supervision are also active in the work on shadow banking both at a national level and as members of the International Organization of Securities Commissions (IOSCO). This response elaborates on ESMA's work as well as commenting on other aspects of shadow banking, although it should be noted that it does not attempt to cover all issues relevant to that debate.

While the financial crisis has provided evidence on the risks attached to the shadow banking system, an orderly and appropriately regulated market of such activities and entities contributing to the financing of the real economy is both possible and desirable in ESMA's view.

The definition of the shadow banking system and its components

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

ESMA broadly agrees with the definition put forward by the FSB and used by the European Commission. This definition is useful in scoping the issues and providing initial guidance on the mapping of the shadow banking system. However, ESMA considers that the definition should be more focused on activities than on the entity performing the activity in order to ensure a consistent approach across sectors (and regardless of the legal framework in place). Shadow banking is characterised by activities and entities that are exposed to maturity (long term assets versus short term liabilities) and liquidity mismatch (illiquid assets versus liquid liabilities). Unlike banks, for shadow banking activities there is no access to public safety nets such as deposit guarantee schemes and central bank facilities.

In addition, it should be noted that the identification and monitoring of the shadow banking system requires an operational definition. In particular the shadow banking system is partly defined by opposition to "the regular banking system"; however, the exact scope of the latter has not been explicitly defined which may lead to confusion. While some entities and activities may have been inadequately regulated, most of the components of the shadow banking system are regulated, albeit the regulations may not take sufficiently into account the systemic risks attached to them.

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?

ESMA broadly agrees with the list of shadow banking entities and activities as a starting point. However, for monitoring purposes, it is crucial to have a flexible and evolving framework that would allow the inclusion of financial innovations as long as their features and the risks attached to them are consistent with the definition of the shadow banking system.

ESMA would also like to draw the Commission's attention to a number of entities and practices that should be considered in this context. First, ESMA is aware of an increasing trend towards use of special purpose vehicles (SPVs). The approach to consolidated accounting of such SPVs should be looked at. ESMA has also noted recent examples of investment funds being created in order to receive impaired bank assets. It will be important to ensure that there is full transparency on the risks arising from these assets, particularly liquidity risks.

Risks and benefits of the shadow banking system

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?

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?

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?

Although the financial crisis has provided evidence of the potential risks posed by the shadow banking system, the realisation of the risks does not imply that the shadow banking system is detrimental per se but rather that an effective regulatory and supervisory framework should be developed.

An analysis of the risks and benefits of the shadow banking system requires an understanding of the driving factors behind its development. From the supply side, regulatory arbitrage and risk appetite have been put forward as potential drivers. From the demand side, preference for safe assets may have played a role.

From this perspective, given the reliance of financial institutions on secured funding and new regulations linked to OTC derivatives, the demand for safe assets to be used as collateral will increase. As a result, the supply of safe assets will have to increase to cope with the demand to ensure the equilibrium. At the current juncture of a general shortage of safe assets, the shadow banking system can play a role to fill this vacuum. However, from a regulatory perspective regard should always be had to the source of the safe assets (e.g. whether the entity providing the assets is a fund, a bank etc) and the way in which the assets are provided (such as whether there is a title transfer in which ownership changes hands).

Challenges for regulatory and supervisory authorities

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

ESMA agrees with the need for stricter monitoring of the shadow banking system. Transparency and adequacy of information are key to the achievement of this objective, along with smooth data exchanges between Competent Authorities. ESMA is well placed to facilitate the transmission and disclosure of information as European securities markets regulators are represented within ESMA and work has been done and will continue to be done to ensure the efficient circulation of information. It will also be important to ensure an appropriate level of collaboration between securities, banking and insurance supervisors at national, EU and global levels with a view to avoiding regulatory arbitrage.

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 superviso-

ry practices between all EU supervisors, the Commission, the ECB and other central banks?

ESMA broadly agrees with the suggestions regarding identification and monitoring of the relevant entities and their activities. With respect to investment funds generally, and money market funds and exchange-traded funds in particular, please refer to the answer to question k) below.

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

ESMA broadly agrees with the general principles for the supervision of shadow banking. With respect to investment funds generally, and money market funds and exchange-traded funds in particular, please refer to the answer to question k) below.

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

Due to the evolving nature of the shadow banking system, a flexible approach may be used for regulation, ensuring that the legal framework can be adapted and changed, or through the use of technical standards or "soft" regulation such as guidelines or other supervisory convergence tools. However, the development of such material should ideally take place against the background of a legislative framework at EU level that would provide a clear mandate for ESMA to take regulatory action in fields such as securities lending or the repo market.

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

ESMA believes that it is extremely important to reduce the scope for regulatory arbitrage as much as possible, both within Europe and at an international level. A way to achieve this aim is to follow the FSB paper on "The Financial Crisis and Information Gaps"[2] to allow for a convergence of objectives and scope between different international regulatory authorities. The globalised nature of shadow banking requires such a multi-lateral approach to its regulation and supervision.

At the same time, regard should be had to the positive role that can be played by shadow banking entities and activities and how best to channel this activity towards the real economy. The Commission's Green Paper explicitly identifies exchange-traded funds (ETFs) as entities that fall within the scope of shadow banking. While ETFs undoubtedly raise issues that are relevant to the shadow banking debate, ESMA considers that it would be inappropriate to focus unduly on these products rather than on shadow banking activities per se (in which many other financial market participants engage). In this context, ESMA would like to highlight an aspect of the current financial services regulatory framework which it feels merits consideration on a cross-sectoral basis in the EU, namely the manufacture and management of exchange-traded products (ETPs) taking a legal form other than that of a UCITS or alternative investment fund. ESMA is of the view that increasing the regulatory requirements on ETFs while ignoring other ETPs could in fact promote the kind of regulatory arbitrage that we are keen to avoid.

A broad range of ETPs is now available on the market. These range from UCITS-compliant exchange-traded funds (ETFs), to non-fund exchange-traded notes (ETNs) structured as debt securities. As these

[2] "The Financial Crisis and Information Gaps", http://www.financialstabilityboard.org/publications/r_110715.pdf

latter instruments trade and settle in an identical fashion to ETFs, there is some evidence that they have been confused with ETFs. In particular, investors may have assumed that protections available when investing in ETFs also applied to other types of ETP. In reality, the risk of the investment exposure and the mechanism that delivers that exposure are not subject to the same requirements as UCITS.[3]

ESMA has been developing guidelines in recent months on a number of UCITS-related issues, including UCITS ETFs. This work is explained in more detail under our response to question k) below. However, one theme which emerged from the feedback to ESMA's consultations[4] was that the UCITS Directive and its implementing legislation already provided for a strong regulatory framework (on such issues as eligible investments, counterparty risk, the need to have an independent depositary and disclosure to investors) and that regard should be had to other products that compete with UCITS ETFs. Indeed, in many cases the same economic exposure can be offered to an investor through different types of ETP but the level of safeguards provided will vary significantly in each case. ESMA is of the view that adopting a more harmonised approach regarding the manufacture and management of these products would be an important step towards reducing regulatory arbitrage, strengthening investor protection and promoting financial stability.

Returning to the issues directly addressed in the Green Paper, ESMA sees scope for further clarification of the allocation of responsibility of the competent authorities and the ESAs with respect to certain entities and activities identified by the Commission. Indeed, to the extent that an activity such as securities lending is not subject to a specific piece of EU legislation, there is a greater risk of potentially conflicting approaches being taken.

What regulatory measures apply to shadow banking in the EU?

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

As noted elsewhere in this response, ESMA has carried out work in the area of investment funds that is directly relevant to shadow banking entities and activities. Further detail on these workstreams is set out in Annex I.

By means of a general introduction on this point, it is worth recalling the strict regulatory framework that is already in place with respect to UCITS in the EU, and that managers of alternative investment funds will also be brought within the scope of harmonised EU regulation as from 22 July 2013 by virtue of the Alternative Investment Fund Managers Directive (AIFMD). The UCITS Directive, complemented by the Eligible Assets Directive of 2007, the Level 2 measures introduced as part of the UCITS IV package in 2010 and an extensive set of CESR and ESMA guidelines, puts in place a comprehensive framework that helps ensure high standards on (inter alia) organisational requirements, rules of conduct, risk management, investment limits and disclosure. UCITS are also obliged to have an external, independent depositary that is responsible for safekeeping the assets of the fund. In the area of disclosure, UCITS are also obliged to prepare a Key Investor Information Document (KIID) to be provided to investors in good time before any decision to invest in a particular UCITS. The content and format of the KIID was developed specifically with the retail investor in mind and is now seen as the benchmark for the disclosures to be required under the PRIPs initiative.

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[3] The vast majority of ETFs in the EU are subject to the UCITS Directive.
[4] The two consultation papers are available via the following links: http://www.esma.europa.eu/system/files/2011_220.pdf and http://www.esma.europa.eu/system/files/2012-44_0.pdf

Turning to the AIFMD, the new Directive and its implementing measures will fill a gap in the current regulatory framework for investment funds at EU level by subjecting managers of all funds that are not UCITS (with some exceptions) to strict regulation. As is the case for UCITS, this includes rules on the internal organisation of the manager, the rules of conduct to be respected when dealing with clients and measures to help prevent and manage conflicts of interest. The overlap with UCITS extends to the rules that will be put in place on depositaries. The AIFMD also introduces specific requirements on leverage, both on how it should be calculated and the circumstances in which competent authorities or ESMA could impose limits on the leverage employed by a particular AIFM.

As can be seen, investment funds and their managers are already (or will soon be) subject to a high standard of regulation in the EU. This is not to say that they should be exempted from measures taken in the context of the shadow banking debate; indeed, as can from the text in Annex I, ESMA itself is currently working on guidelines aimed at mitigating risks arising from some activities of UCITS that are relevant to shadow banking. Rather, it is important to bear in mind that any new measures introduced should complement those already in place and, more generally, be targeted at those entities or activities for which the regulatory framework may currently be less comprehensive.

Securitisation

The Green Paper identifies securitisation as a shadow banking activity on the basis that it could represent an important source of funding for non-bank entities. Although ESMA has not worked on securitisation from the perspective of the originator of a transaction, it should be recalled that one of the aspects on which ESMA provided technical advice to the European Commission with respect to the delegated acts foreseen in the Alternative Investment Fund Managers Directive (AIFMD) related to the retention requirements to be respected by the originator when an alternative investment fund invests in a securitisation. The advice provided by ESMA sought to achieve an appropriate level of consistency with the approach already adopted in the banking and insurance sectors. By virtue of the AIFMD, the same requirements will be introduced in the UCITS Directive so as to achieve a harmonised approach across the investment fund sector.

Outstanding issues

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?

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

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

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

ESMA broadly agrees with the analysis of the issues covered by the five key areas where the Commission is further investigating options.

Regarding securities lending and repo, ESMA has recently experienced, when developing the short selling technical standards and advice to the Commission, the lack of data available to regulators on lending (and repo) transactions and positions. There is little or no regulation on these matters and it is a market segment that is to some extent opaque to supervisors. For instance, repo and securities lending transactions are not included in the MiFID transaction reporting regime as they are not perceived as necessary from a market monitoring perspective conducted on a transaction-per-transaction level. However, some less granular or more aggregated reporting regime more focussed on position information, possibly outside the MiFID regime, could be worth exploring. It could be based on position reporting per firm and security on a periodic basis.

There is also a lack of data on availability of securities, in terms of the stock of securities available for lending at a certain point in time, since there are only private providers of these types of data. A reporting regime would also bring some light to this aspect and would also have beneficial effects for other related regulatory needs, such as determining the concept of easy to borrow stocks for the purpose of the Short Selling Regulation. Lastly, this could also constitute a valuable source of information for corporate governance-related matters such as the monitoring of empty voting.

In addition, the rules determining which part of the available securities are lent or sold in repo by the main lending firms at a certain point in time is not subject to regulation. Each custodian decides what will be the buffer per security, in terms of proportion of lending transactions compared to the total availability. This ratio determines, for instance, the availability of securities for short selling, for resolving settlement failures or for other legitimate purposes. It plays a very important role in defining the supply of securities, in a similar way to the ratio between bank deposits and loans, which determines the overall supply of credit in the market. These measures are not subject to benchmarks or thresholds and they are a matter left to the discretion of each agent. It would be appropriate to make sure that the total amount of securities available for securities lending and repo is adequately measured. A possible regulatory action would be to require the existence of written policies and procedures on the methodology to define buffers and ratios to be applied, including the duty to inform the competent securities supervisor of those policies and make them available to clients on request.

Recently, a number of CCPs have experienced rising volumes going into central clearing, since the link between sovereign risk and bank risk strengthened in some EU Member States, causing many market participants to withdraw liquidity in the form of repos because of increased counterparty risk. On the one hand, clearing repos through CCPs brings the same types of benefit as for OTC derivatives in terms of prudent risk management (repos are not covered by EMIR). On the other hand, it can cause scarcity of collateral and sometimes increase pro-cyclicality. A possible regulatory option would be, in this respect, to require specific counterparty risk management procedures to manage repo exposures (central clearing would be one, but by no means the only, instrument to achieve that end).

Beyond issues of transparency for market participants and supervisors, it appears that there is no European regulation on securities lending and repurchase agreements. Some of the issues are covered through sectoral regulations (CRD, UCITS etc.) but there is a lack of a consistent framework at European level. The regulatory options to be assessed could include an analysis of the current market structure of the securities lending and repo segment. The pros and cons of bilateral transactions, tri-party-repo and CCP clearing could be assessed to formulate adequate regulatory responses. ESMA believes that the design of such a framework (including the increased transparency it would introduce) should take into account the importance of securities lending and repo activity for a significant number of market participants. The items explained above may merit the adoption of an appropriate and harmonised regulatory framework in the EU. Such framework could take the form of a standalone initiative or build on existing regulation (MiFID, CRD, UCITS) depending on the assessment of the regulatory amendments required.

Annex I – Summary of ESMA's guidelines on a Common Definition of European Money Market Funds and ETFs and other UCITS issues

Money Market Funds

Some money market funds experienced difficulties in 2007 due to their holdings of certain highly rated asset-backed securities which were downgraded by the relevant rating agencies and which showed a poor level of liquidity. In September 2008, significant levels of redemption activity were witnessed following the Lehman Brothers failure, the general unease in the money markets and the cash needs of investors. The poor level of liquidity demonstrated by a significant number of money market instruments added to the problems experienced by money market funds at that time. Moreover, deposit guarantee schemes put in place by certain governments made money market funds a less attractive alternative to bank deposits, which also resulted in increased redemptions. As a result of redemption requests, there was a significant shift of money market fund assets into overnight deposits and away from longer dated paper, which worsened the situation in the money markets themselves. The European industry requested assistance from national monetary authorities, the European Commission and the European Central Bank to increase liquidity in the money markets and help prevent a run on the funds.

In the light of the market events ESMA's predecessor, CESR, agreed in December 2008 that better coordination between its members on funds in general, and money market funds in particular, was needed, as well as a better understanding of the categorisation of money market funds given the lack of a harmonised definition. This led to the publication of CESR's guidelines on a common definition of European money market funds (Ref. CESR/10-049) in May 2010.[5] The guidelines aim to improve investor protection by setting out criteria to be applied by any fund that wishes to market itself as a money market fund. The criteria reflect the fact that investors in money market funds expect the capital value of their investment to be maintained while retaining the ability to withdraw their capital on a daily basis.

CESR's guidelines set out two categories of money market fund: Short-Term Money Market Funds and Money Market Funds. This approach recognises the distinction between short-term money market funds, which operate a very short weighted average maturity and weighted average life; and money market funds which operate with a longer weighted average maturity and weighted average life. The guidelines entered into force in line with the transposition deadline for the revised UCITS Directive (1 July 2011) and apply to both UCITS funds and non-UCITS funds.

ESMA believes that the CESR guidelines addressed some of the risks related to money market funds that were identified in the Green Paper. In particular, the detailed requirements on the maturity of the assets that may be held in each category of fund should help ensure that money market funds are less likely to suffer liquidity problems of the type seen in 2007 and 2008. The guidelines also specify that only Short-Term Money Market Funds may adopt the constant NAV model since Money Market Funds are more sensitive to interest rate changes.

ESMA has issued two Q&As in order to clarify the application of certain of the requirements in the CESR guidelines.[6]

Efficient portfolio management techniques, ETFs, collateral and securitisation

[5] http://www.esma.europa.eu/system/files/10_049.pdf
[6] http://www.esma.europa.eu/system/files/ESMA_273.pdf and http://www.esma.europa.eu/system/files/2012-113.pdf

ESMA's predecessor, CESR, began working on issues arising from exchange-traded funds (ETFs) and complex UCITS in summer 2010. The work has since expanded to encompass a range of topics which are directly relevant to the Commission's Green Paper. A discussion paper setting out ESMA's initial orientations was published in July 2011[7]; this was followed by a consultation paper in January 2012.[8] Many of the topics covered under this workstream are directly relevant to the shadow banking debate, including issues around collateral (quality, management, extent of reuse etc), the use of efficient portfolio management techniques (including securities lending) and the need for additional disclosure (including labelling of products). More generally, ESMA stresses once again that the focus should be on the activity in question rather than the entity that is performing the activity. This approach would help reduce the risk of regulatory arbitrage on the one hand while avoiding an undue focus on particular entities or products on the other.

Efficient portfolio management techniques

Pursuant to Article 51(2) of the UCITS Directive, Member States may authorise UCITS to employ techniques and instruments relating to transferable securities and money market instruments under the conditions and within the limits which they lay down provided that such techniques and instruments are used for the purpose of efficient portfolio management (EPM). Article 11 of the Eligible Assets Directive sets out further criteria on the use of these techniques and instruments. CESR's guidelines concerning eligible assets for investment by UCITS (Ref. CESR/07-044b), meanwhile, clarified that EPM techniques should not 'result in a change of the fund's declared investment objective or add substantial supplementary risks in comparison to the concerned fund's general risk policy as described in its applicable sales documents'.

These EPM techniques include sale and repurchase agreements (repo), purchase and resale agreements (reverse repo) and securities lending. ESMA considers it important to impose additional requirements on UCITS that make use of these techniques. The guidelines, which will be finalised shortly, will, inter alia:

- oblige UCITS to provide additional disclosure on the use of these techniques;
- clarify the appropriate approach to revenue-sharing arrangements;
- specify the criteria to be respected in relation to the termination of the agreements; and
- circumscribe the extent to which cash or assets received in the context of EPM techniques can be reinvested or reused.

ETFs

As noted elsewhere in this response, the majority of European ETFs are authorised as UCITS. However, it is also true that ETFs have some unique features which are not present in traditional open-ended funds. For example, investors (other than creation unit-holders) usually do not subscribe or redeem directly from the ETF but rather acquire and dispose of their shares on the secondary market. Contrary to other UCITS investors, they may not always receive the fund documentation (such as the KIID) where they acquire UCITS ETF units directly on-exchange or through dedicated websites.

[7] http://www.esma.europa.eu/system/files/2011_220.pdf
[8] http://www.esma.europa.eu/system/files/2012-44_0.pdf

ETFs are also often confused with other types of exchange-traded product such as exchange-traded notes and exchange-traded commodities (for more on this, see the answer to question j) above). They may also be confused with listed closed-ended funds.

UCITS ETFs can be established under different forms. UCITS ETFs that intend to replicate the performance of an index may do this either physically or synthetically (or via a combination of both). Some UCITS ETFs may also aim at outperforming an index and therefore are actively managed. The UCITS Directive provides that a UCITS which replicates a stock or debt securities index must include a prominent statement to this effect in the prospectus and any other promotional literature.

With respect to UCITS ETFs, ESMA's guidelines will, inter alia:

- set out a clear definition of these funds;

- clarify the information to be provided to investors where the ETF tracks the performance of an index; and

- clarify the rights of secondary market investors wishing to redeem their units.

Collateral

The use of collateral is a recurring theme in the discussions on shadow banking. In the Green Paper, it is mentioned in the context of the risk of the build-up of high, hidden leverage and, in particular, the possibility of 'churning' of collateral; in relation to ETFs engaging in securities lending and derivative transactions; and in the discussion of securities lending and repurchase agreements more generally. ESMA's guidelines will tackle issues arising from collateral in a comprehensive manner by addressing it in the context of both OTC derivative transactions and EPM techniques. ESMA believes that this global approach is appropriate as the same principles should apply to collateral as a risk mitigant regardless of the nature of the transaction or of the fund (i.e. UCITS that are not ETFs should also be covered if they receive collateral). The guidelines will impose general requirements to be satisfied by the collateral (based on those already set out in CESR's guidelines on risk measurement and calculation of global exposure and counterparty risk for UCITS of July 2010) such as on liquidity, valuation and independence of the counterparty. The guidelines will also clarify in more detail how the collateral should be diversified, what haircut policies should be in place and the appropriate reuse of cash collateral.