

ASSET MANAGEMENT AND INVESTORS COUNCIL

Financial Stability Board

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

May 16, 2011

Sent by email

To whom it may concern,

Shadow Banking – Scoping the Issues

The ICMA Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concern to its broad membership, rather than having a specific product focus.

The AMIC welcomes the opportunity to respond to the FSB background note entitled 'Shadow Banking: Scoping the Issues'. The FSB has rightly recognised in its paper the economic benefits that the shadow banking system gives market participants and corporates by providing alternative sources of funding and liquidity. However the financial crisis has also shown the shortcomings of the system.

The Council has been particularly interested in the shadow banking topic in light of the Basel III reforms and their direct impact on traditional banking structures, and indirectly on the asset management industry. As the title of the FSB Note suggests, the AMIC believes that a key step in the 'shadow banking' discussion is to clarify the type of activities understood under the term 'shadow banking'. Moreover the AMIC would like to ensure that recommendations of regulatory reforms take into account the current regulatory developments and its impact on the asset management industry; and avoid regulatory overlaps. The Council also recommends a global approach in the definition and identification of shadow banking issues.

DEFINING AND SCOPING SHADOW BANKING

1. The AMIC would like to highlight the fact that the asset management industry is primarily the management of clients' money. The AMIC is concerned that the FSB may cast the net too wide and associate the whole asset management industry with shadow banking. The Council understands that whereas traditional banking relies on deposits through bank branches for funding, the shadow banking system had relied on the issuance of money market instruments (such as commercial paper, ABCP and repo) to money market investors (such as money market funds) for funding, as well as the issuance of longer-term medium-term notes (MTNs) and public bonds to medium- to longer-term debt investors such as securities lenders, pension funds and insurance companies. And therefore institutional investors, have through the credit intermediation chain, an interest in the shadow banking activities and future regulatory proposals. Shadow banking can be considered as assets being managed off the banking sector balance sheet and therefore the demarcation hinges on who owns or controls these assets.
2. The AMIC does recognise some activities of the asset management industry that might be considered as shadow banking. The Council agrees that 'shadow banking' is related to maturity transformation – an area that could pose systemic risks to the financial system. 'Shadow banking' activities from this point of view share a common feature: they obtain financing at short duration through the money markets, and they invest these funds in longer-term financial assets. Different funds show very different levels of maturity transformation. Whereas bank products typically exhibit maturity transformation numbered in years, under CESR short term money market transformation the maximum average maturity of a fund is 60 days.
3. Other activities should be considered to ensure stability in the financial system and the effective management of risk, for instance enhanced MMFs and synthetic ETFs. These areas would benefit from greater transparency. The latest pronouncements by regulators on the ETF market show regulatory intent to analyse, understand and ultimately consider these products in the shadow banking system."

POSSIBLE KNOCK-ON EFFECTS OF CURRENT REGULATORY DEVELOPMENTS

4. Basel I and II intended to eliminate regulatory arbitrage between different regulated banking systems but in effect contracted the boundaries of banking; the Basel reforms created a new incentive for regulatory arbitrage between the more regulated bank-based credit system and the less regulated capital market-based credit system. High costs and restrictions imposed by regulators on banks, and growing competition from specialist non-banks put increasing pressure on banks' profit margins. The reality of significant increases in traditional banks' capital and liquidity requirements could make the 'parallel' banking system even more prominent and competitive going forward.
5. The surge in banking regulation has altered banking. Going back to first principles it is clear that banks should set aside capital to buffer themselves against both poor lending decisions and adverse market movements so that in the worst case

they can repay their creditors, not default and cause systemic contagion through the financial system.

6. Setting a single amount of capital at the institution or bank level is inevitable but regulators need to be mindful that by doing so they may encourage banks to transfer risk off their balance sheets to other non-bank institutions that are less able to estimate risk, because of information asymmetry, or absorb losses should they occur. While risk transfer to those who are best able to manage it is desirable – annuity funds buying corporate bonds for their long term stable cash flows – there are cases where this risk transfer is done solely to avoid regulatory capital charges and may leave the losses to fall back onto the banking system as the risk transfer may have only been notional (perhaps to an off-shore non bank subsidiary or hedge fund with whom the bank has a prime broker agreement).

ENHANCED TRANSPARENCY

7. An important element of the shadow banking system is securitisation. In light of the crisis event it is evident that investors should be able to gain access to the underlying loan data so they can examine and evaluate the risks for themselves rather than rely on complex hedging structures or credit grades from rating agencies. The ratings of structured products have been widely criticised during the recent crisis. With the correct level of regulatory oversight and a separation between banks and non-banks to ensure risk is fully transparent and transferred: setting new regulatory capital requirements at the banking institution level is desirable but regulators should be mindful of arbitrage opportunities of risk transfer.
8. The AMIC has also noted the de-leveraging of the banking sector, in preparation for the implementation of the Basel III framework. The shrinkage of proprietary trading means that risk is being shifted to the asset management industry - without the necessary information about the quality of the assets. The Council believes that enhanced transparency would enable the industry to assess and price potential risks in the market.

The AMIC would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Robert Parker', with a long horizontal flourish extending to the right.

Robert Parker
AMIC Chairman