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1 June 2012

By E-Mail to markt-consultation-shadow-banking@ec.europa.eu

Dear Sirs

Re: CLLS Regulatory Law Committee Response to the European Commission's Green Paper on Shadow Banking (the "Green Paper")

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues. The CLLS is registered on the European Commission's Transparency Register, and its registration number is 24418535037-82.

This paper has been prepared by The City of London Law Society Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms across Europe who operate in or use the services provided by the financial markets and in particular advise a wide range of credit intermediaries, investment managers, custodians, private equity, debt and other specialist fund managers.

We welcome the opportunity to provide input at this early stage to the European Commission's development of a regulatory response to the potential systemic risks identified in relation to non-bank credit intermediation activities.

Key comments

Our headline observation is that while the Green Paper outlines in high level terms the Commission's initial thinking in this area, the Commission has not yet articulated a clear scope or objective for any more detailed regulatory policy proposals which may follow. Before seeking to develop any such more detailed proposals for further regulation, therefore, we strongly support the idea that a clear regulatory policy objective or set of objectives should first be explained.

The first, and in many ways most difficult, hurdle the Commission is faced with is how to define shadow banking; but this is of course a critical step. Without a sound and coherent definition of what is to be controlled, successful regulation will not be possible. Regulating on a sectoral basis is particularly difficult if the concerns which are sought to be addressed by regulation do not reside exclusively in a single coherent sector.

The FSB's definition as more specifically expanded upon by the Commission in this Green Paper provides a good starting place for the debate. But while that definition may suffice in broad debates about the important ways in which the activities concerned may affect or contribute to systemic risk, it is not sufficiently clear or certain – and in our view it is manifestly unsuitable – for framing good legislative proposals.

Framing any legislative proposal around such a broad and generic definition would give rise to significant legal uncertainty for sections of both the financial and the non-financial economy, would potentially be inconsistent with, or overlap with, existing or soon-to-be-enacted financial regulatory measures, and would therefore almost certainly have damaging unintended consequences not only for the European financial sector but quite possibly also broader sections of the non-financial economy.

We therefore urge the Commission to refrain from publishing legislative proposals in this area unless and until either (i) a more specific and finite definition of shadow banking has been identified or, at the very least, (ii) clear statements can be made as to categories of already-regulated activity and of unregulated commercial activity which are definitely not intended to be captured within any definition of shadow banking.

We recognise the Commission's desire to limit so-called regulatory arbitrage between the banking and non-banking sectors, but sound and reasonable limits to the perimeter of European financial regulation must be defined if proposals such as this are not to cause widespread legal uncertainty as well as disruption to socially-useful economic activity.

Comments on the policy objective for shadow banking

Although not articulated in the Green Paper, we infer that the central reasoning behind the Commission's desire to regulate shadow banking activity is, on the one hand, to reduce systemic liquidity risk arising out of non-bank leverage and maturity mismatch/transformation activities and, on the other, to provide additional protection to persons who provide unsecured funding to non-bank credit intermediaries (i.e. persons equivalent to those whom regulation seeks to protect in relation to traditional bank funding models).

The Commission has observed that high leverage is inherently risky, and maturity mismatch heightens the risk of runs, increases the fragility of the financial sector and augments the potential spill-over effects of any failures.

Yet the Commission has equally acknowledged that maturity transformation taking place outside the traditional banking sector can be useful when it provides a source of non-bank credit to the 'real economy' (i.e. households and companies), transferring capital from those who wish to invest to those who wish to borrow. The shadow banking sector clearly can make a positive contribution to the economy. Consequently, we believe the key challenge for the Commission is in trying to achieve the optimal balance between benefit and risk, to avoid a European financial system which is safe yet sterile.

We do not disagree with the general proposition that protection for the providers of funding to credit intermediaries, not just bank depositors, ought to improve confidence and therefore stability in the financial sector as a whole. This objective might suggest, however, that any

future regulation of shadow banking should most sensibly focus on the sources of funding for credit intermediation activities, rather than the types of credit activity performed by shadow-banking organisations.

Certainty needed in relation to the scope of any new regulatory measure

It seems to us that the Commission has a range of options for formulating legislative proposals to capture within the regulatory net the assortment of non-bank firms and activities which perform bank-like functions but which do not yet fall within the scope of existing financial regulation. We comment further on these options below.

While each option will have its challenges, and may risk unintended economic and political consequences, we believe there are at least three principal points which will pervade all of these options:

1. **A balance must be struck:** The Commission must consider carefully how any proposals that it makes might affect access to credit for the so-called 'real economy'. We suggest that the Commission should lead efforts to achieve this understanding in the EU before legislative measures are put on a track from which it may become much harder to deviate. Key questions that should first be addressed would include: to what extent do shadow banking activities contribute to economic growth and well-being in the EU? What is the correct balance to be struck when attempting to manage systemic risk on the one hand and the consequences of discouraging, for example, lending by non-bank organisations (at a time when other regulatory reforms are already leading traditional banks to contract their loan books)? What further work might be done to reach a better understanding of the effects that various proposals might have, taking into account the multitude of other regulatory initiatives that are already being pursued by the EU?

2. **Adequate international co-ordination is essential:** Much unintended economic damage could be done if the EU carries forward legislative proposals in this area without a greater level of effective international co-ordination than has been experienced in relation to other recent legislative initiatives in the financial services sector. We believe it will have been a significant concern to the very many financial institutions which are active in both European and other major financial markets that the Green Paper does not, for example, discuss in any detail co-ordination of legislative proposals with the United States or any other countries outside the EU; and

3. **'Third country' issues:** So-called 'third country' provisions, which address the terms on which firms established and regulated outside the EU may carry on business within or into the EU, feature in much EU legislation. We would reiterate the increasingly common refrain that careful thought must be given to the treatment of third country issues under any new legislative proposals in this area; this will be necessary to ensure both that European economies retain access to much-needed funding and investment sources, and that equally European capital providers retain much-needed abilities to deploy resources in an appropriately diversified manner.

It is not the place of this Committee to suggest an exhaustive definition of firms or activities which should be regarded either as falling within the "shadow banking sector" (and indeed we doubt that such a coherent sector exists) or as being deserving of additional regulatory oversight.

In broad terms, though, the Commission could approach the question of the scope of any shadow banking measure either from the bottom up – defining, as the Green Paper has tentatively started to do, a series of specific activities; or from the top down – starting with a broad definition such as that formulated by the FSB and then proceeding to exclude from it a range of general and specific types of firm or activity.

The bottom up approach may not provide a single universal solution, and we recognise that questions would inevitably arise as to how such activities should be defined and reviewed from time to time, but in our opinion this approach would have the significant benefit of greater certainty, both as regards legislative intent and practical outcome. It also lends itself to the more satisfactory outcome of a collection of more specific regulatory frameworks rather than needing to attempt a 'one size fits all' framework.

We do not consider that we are an appropriate body to suggest to the Commission a list of specific activities which should be regarded as shadow banking activities. We do, however, consider it appropriate to identify a number of areas of financial and commercial activity that are either:

- apparently harmless and do not appear to contribute significantly, or at all, to systemic risk but which could potentially be captured by use of the blunt and legally uncertain definition of shadow banking used by the FSB; or

- as the Commission has acknowledged in the Green Paper, subject to prudential regulation which already, or will in due course, provides an adequate prudential framework within which to capture, manage and mitigate the risks about which the Commission is concerned.

If the top down approach were to be favoured, in the interests of both legal and practical certainty we would urge the Commission to consider express exclusions of these (and potentially other yet-to-be-identified) activities from any general broad definition of shadow banking.

Those areas of activity are:

(A) **Insurance activities**: Many insurance and reinsurance companies carry on activities referred to in the definition, but yet they are already subject to detailed prudential regulation in EU member states, and will be subject to the Solvency II regime which, as the Commission acknowledges, will provide for *"comprehensive regulation centred on a risk-based and economic approach, along with strong risk management requirements"*;

(B) **Asset management activities**: UCITS funds are already subject to a detailed regulatory regime in the EU. Non-UCITS funds will largely be subject to the

regime to be introduced under the Alternative Investment Fund Managers Directive. Both regimes make provision for the treatment of credit and liquidity risks arising in funds to which they relate;

(C) **Investment activities**: Investment firms are regulated in the EU under national regimes implementing the Markets in Financial Instruments Directive. They are also subject to substantially the same regulatory capital regime as banks in the EU;

(D) **Consumer credit activities**: Consumer credit activities are subject to detailed regulation in the EU, both under EU legislation and additional, national, rules;

(E) **Corporate lending activities**: By this we mean the activity of providing funding for general corporate activities;

(F) **Corporate borrowing activities**: It cannot be intended that any business that uses borrowings to fund the acquisition or creation of new assets is potentially captured by both the FSB's definition and the more detailed elaboration of that definition set out in the Commission's Green Paper, as this would lead to the majority of large corporations being treated as shadow banks.

(G) **Payment services and e-money activities**: The fast-growing areas of payment services and e-money issuance are already regulated pursuant to detailed EU legislation;

(H) **Trade finance**: Activities related to trade finance, such as the issuance and acceptance of letters of credit and other financing instruments such as bills of exchange;

(I) **The provision of credit in connection with sale of goods and services**: Many manufacturing and service companies carry on activities that appear to fall within the FSB's definition of shadow banking, including the sale and financing of manufactured goods on credit, and hire purchase and finance leasing activities; and

(J) **Group corporate treasury activities**: The Commission must contemplate exemptive arrangements that would enable corporate treasury activities to continue effectively.

It can be seen that in crafting any definition of the scope of shadow banking, much careful work will be required to ensure that these systemically and economically beneficial activities are not unnecessarily curtailed and that unintended disruption of socially useful financial activity is minimised.

An alternative approach to the regulation of shadow banking

One possible means of minimising the risk of unnecessary and unintended disruption to which the Commission makes reference, and which we would urge the Commission to consider as an

alternative to the creation of further disruption and uncertainty for regulators and firms already struggling to support growth in European economies, would be to create a framework of enhanced monitoring falling short of prudential supervision, supported by reporting obligations and, perhaps, limited and clearly defined powers of intervention.

Enhanced monitoring supported by reporting obligations would allow relevant regulatory authorities to track the growth of credit, liquidity and related risks, while powers of intervention in carefully prescribed circumstances could then provide tools to enable regulators to take targeted action where necessary. Shadow banking activities that were subject to such arrangements would not then need to be regulated as such, but regulators could nevertheless be empowered to intervene in targeted ways, for example to limit the existence or growth of credit bubbles.

If the Commission would find it helpful to discuss any of these comments then we would be happy to do so. Please contact Margaret Chamberlain in the first instance by telephone on +44 (0) 20 7295 3233 or by email at margaret.chamberlain@traverssmith.com.

Yours faithfully,

M. Chamberl.

Margaret Chamberlain

Chair, Regulatory Law Committee

CLLS

THE CITY OF LONDON LAW SOCIETY

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