25 May 2012

Sent via email: MARKT-CONSULTATION-SHADOW-BANKING@ec.europa.eu

Dear Sirs

Response to European Commission (the "Commission") Green Paper: Shadow Banking (the "Consultation")

The Loan Market Association ("**LMA**") welcomes the opportunity to provide a response to the Commission in respect of the Consultation and hopes that its comments will be useful in the Commission's upcoming review.

The LMA is the trade body for the European syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 480 across EMEA and consists of banks, non-bank investors, law firms, rating agencies and service providers. The LMA has gained substantial recognition in the market and has expanded its activities to include all aspects of the primary and secondary syndicated loan markets. It sees its overall mission as acting as the authoritative voice of the European loan market vis à vis lenders, borrowers, regulators and other interested parties.

The Consultation has as its objectives, *inter alia*, to examine the issues posed by shadow banking activities and entities, with a view to increasing the resilience of the European Union's financial system and to ensuring that all financial activities contribute to economic growth. With this in mind, we would like to respond to certain of the Consultation's questions, as well as provide some general feedback relating to our views on shadow banking generally.

In responding to the Consultation, we have consulted with our members, particularly non-bank investors who are likely to be most affected by any regulation of the shadow banking industry arising out of this Consultation.

Response to Consultation Questions:

Do you agree with the proposed definition of shadow banking?

The FSB has defined the shadow banking system as "the system of credit intermediation that involves entities and activities outside the regular banking system." We believe that the key concept here is that "intermediation" entities which make loans (or otherwise give credit) are not, per se, part of the shadow banking system. Equally, the fact that an entity may obtain credit in some ways and grant it in others is not sufficient to make it a credit intermediary. In our view, credit intermediation is what occurs when an entity raises credit and uses the funds raised to directly and immediately create further credit. On this basis, the majority of the syndicated loan market falls outside the definition of the shadow banking system.

We also take the view that there is a distinction between acting as a credit intermediary and acting as an investor of savings. An institution such as a pension fund, insurance company or mutual fund is not acting as a credit intermediary when it invests the savings which it manages. This is true even where the investments made are in the form of loans. Investors such as these are not engaged in maturity transformation in the sense of transforming short-term funding into long-term assets – indeed their core business is rather the reverse. Consequently, our view is that any institution (including, for this purpose, CLOs) whose business model involves the raising of long-term funds and investment in shorter-term assets should not be regarded as part of the shadow banking sector, since such businesses, by definition, do not give rise to the issues which the shadow banking regime is intended to address.

We would also like to add that the term "shadow banking" itself has pejorative connotations and is therefore not necessarily the correct term to use. "Shadow banking" implies a deliberate lack of transparency, which is not reflective of the broad range of entities and activities which the FSB definition clearly intends to cover.

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?

We would agree that the majority of those entities listed are entities of a form which have traditionally engaged in the types of activities which fall within the proposed definition. However, we believe that shadow banking should be identified by reference to economic activity and not vehicle type. It should be noted that the same sort of "entity" for labelling purposes, can pose very different levels of risk. For example, the term "special purpose entities" is used in financial markets very broadly and potentially covers a vast number of financial vehicles, not all of which "perform liquidity and/or maturity transformation". By contrast, we note that corporates and sovereign wealth funds do not feature within the list of defined entities at all, yet we see no reason why they might not carry out activities which involve "credit intermediation… outside the regular banking system" in much the same way as an investment fund or insurance undertaking. We therefore believe that whilst it is correct to identify those vehicles/entities which are "shadow banking entities" to enable the Commission to study the role that they play within the financial system, greater investigation should be made of the actual types of activity that they carry out. Simply regulating entities by way of vehicle categorisation is potentially dangerous, and could lead to unintended consequences for low-risk investment vehicles. Furthermore, we consider that it would be very difficult to categorise shadow banking entities accurately, particularly given the rate of financial product/vehicle evolution, which could potentially render any definitions outdated within a short space of time.

In terms of the activities listed, we would urge caution about attempting to assess the types of shadow banking activity too broadly. To do so risks inadvertently capturing certain activities which pose little risk to financial stability. In fact, the dangers of doing so are already evident from the consequences of existing European legislation. For example, Article 394 of the CRD provides that a European credit institution will suffer a punitive capital charge if it invests in a "securitisation", unless the originator, sponsor or original lender holds a minimum 5% of the net economic exposure of the transaction. The underlying objective of Article 394 is to ensure appropriate origination standards in the securitisation market and ensure that interests between originator and investors in a securitisation are aligned. However, the definition of "securitisation" used in the regulation catches independently managed CLOs, despite the fact that (unlike traditional asset-backed securities) the underlying portfolios of CLOs are typically not purchased from one originator or seller but are sourced from the primary or secondary syndicated loan market by regulated investment managers who are independent of any originator or seller of the loans. In addition, the CLO investment manager is able to independently assess the quality of the portfolio and is free of the negative incentives which can arise in an "originate-to-distribute" securitisation model. Finally, CLO investment managers are already incentivised to act in the best interest of the CLO investors through the structure of their fees. The majority of management fees are performance-based and as such the CLO investment manager will only receive these fees if the CLO is performing. This compensation structure ensures that the interests of CLO asset managers are appropriately aligned with those of investors in CLOs throughout the life of a transaction.

Despite the above, Article 394 of the CRD has failed to distinguish such CLOs from traditional securitisation vehicles, and as a result, whereas prior to the financial crisis, CLOs were a significant source of non-bank investment in the syndicated loan market, this investment has now fallen away, in large measure due to the introduction of amendments to the CRD[1], which has resulted in the CLO model no longer being viable. In our view, this should act as a case study to illustrate the importance of accurately understanding how different shadow banking activities work, in order to ensure that those which have the potential to generate genuine risks to financial stability (e.g. through the introduction of leverage and maturity “arbitrage” whereby short-term funding is utilised to purchase longer-term assets) are appropriately regulated, whilst those which pose far less risk to the financial system (e.g. those entities which primarily serve an "asset management" function by investing directly in longer-term credit instruments such as bonds and syndicated loans) are suitably exempted.

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?

Yes. As a result of the financial crisis and the regulatory response to it, banks' ability to lend has been greatly reduced. In the face of new regulatory requirements and increased focus on the need to reduce risk and minimise debt, major banks are deleveraging on a global scale and as a result, are tightening the amount of credit they are willing to lend to businesses. Consequently, in order to bring about the growth necessary to fuel economic recovery, it is vital that other, non-bank, sources of credit are found to plug the gap and ensure that the funding requirements of businesses continue to be met. This is particularly pertinent given the regulatory capital treatment of European credit institutions following the implementation of CRD IV (Basel III), which will make lending to the sub-investment grade sector generally less attractive for such institutions. Whilst non-bank investors are already present in the credit markets, we believe much could still be done to broaden this valuable investor base and give it a meaningful diversity. On the other hand, if non-bank lending becomes overly constrained, it is difficult to see how the funding gap will be overcome.

In addition to the above, as a general societal trend over the last decade in Europe (and over the last four decades in the US) there has been increased disintermediation of the banking sector. It is important that the Commission recognises that this is something which does not have to be viewed as inherently negative. Whilst the LMA would support efforts to tackle genuine systemic risks in the shadow banking system, we would also urge the Commission to recognise the potential benefits that non-bank investors are able to bring to the economy, particularly at a time when access to liquidity by ordinary businesses is becoming increasingly scarce.

As you will be aware, bank disintermediation is seen to a greater degree in the US than in Europe, with lending to US middle market businesses having increased from $71bn in 2009 to $182bn in 2011[2]. This issuance is facilitated by loan mutual funds (a $70bn industry[3] which channels retail capital to corporates), CLOs and listed companies known as Business Development Companies. It is our view that in order to generate additional liquidity to the European financial markets, appropriate non-bank vehicles, with appropriately tailored regulation, should be allowed to flourish. This could be achieved by, for example, amending existing regulation to enable the CLO market in Europe to reopen. From the point of view of increasing access to syndicated lending, it could also be further achieved if loans could also become eligible assets for UCITS funds (which are already regulated investment vehicles under existing EU regulation) in line with the US model.

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?

Whilst we recognise that the description of channels highlights some of the ways in which shadow banking activities are capable of generating or transferring risk, this is only applicable to certain types of shadow banking activity. There are many other non-bank activities which simply supply the market with additional liquidity. For example, funds which serve an asset management function often invest money directly and do not use leverage. It is important to ensure that direct investment by these types of vehicle does not become constrained (whether intended or not) as a result of increased regulation.

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

As a general observation, whilst the LMA welcomes targeted and proportionate supervision of shadow banking activities, care must be taken to ensure that the cost of compliance with any reporting requirements does not become disproportionate.

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

We agree that this should be targeted, although we would also highlight the importance of taking an integrated approach. We also believe that the approach must consider economic reality and not legal form. The cumulative impact of the interaction of different regulatory measures is often overlooked, even on an intra-European level and we therefore have concerns that any regulation designed to target shadow banking entities and activities will not be adequately assessed alongside existing regulatory proposals, such as AIFMD, MiFID and Solvency II. Unless a detailed impact assessment is carried out, we believe that there is a real risk of significant unintended consequences – including the creation of perverse incentives within the regulatory system as a whole. This risk is magnified when it is recalled that the composite effect of EU regulation must in turn be assessed in the context of global legislation, including both significant national legislation of non-EU countries (Dodd-Frank and FATCA) and supranational initiatives (such as the G20 and the FSB). We would strongly urge the Commission to redirect efforts away from individual policy silos and towards the construction of a comprehensive assessment of the totality of these proposals on the EU economy and its financial services industry. Only once this assessment has been carried out, should further appropriate and targeted regulation be considered for specific shadow banking activities.

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

The LMA believes that measures must be taken to ensure a much deeper level of international convergence and co-ordination, both in the treatment of shadow banking and in the application of regulatory measures more generally. By way of an existing example, we return to and cite the problems caused by the retention rules imposed by Article 394 of the CRD and the impact that this has had on open market CLOs in the European market. According to Thompson Reuters LPC, CLO issuance in the US (which does not currently have equivalent retention rules to Article 394) had nearly topped $10bn during 2012 by the end of April. By contrast, there has been no new CLO issuances in Europe since 2011 (save for a handful of balance sheet transactions in CLO format). We do not expect to see an improvement on these figures unless amendments to Article 394 are implemented.

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

We have already voiced our concerns in relation to Article 394 of the CRD above.

In terms of the 100% liquidity requirement which has been imposed across the board for "conduits and special purpose vehicles "under CRD IV[4], it would be helpful if the Commission could clarify the extent of this definition. We believe that this percentage should not apply to, for example, loans to a property company where funds are lent directly to an SPV set up for this specific purpose. In this sort of scenario, and indeed in any similar type of scenario, we do not believe that such a facility is any different, from a liquidity perspective, from a loan facility made to a corporate directly. This is another example of the importance of applying detailed definitions to avoid unintended consequences.

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

As part of the Consultation, the Commission emphasises its desire to limit excessive exposure to shadow banking entities. Whilst we would agree that it is important to cover all relevant activities, we would urge caution in attempting to cast the net too broadly.

By way of a practical example, the LMA is currently lobbying on changes to CRD IV which relate to the drafting/interpretation of the legislation and its possible impact for the syndicated loan market. One of our concerns relates to risk weighting of exposures to financial counterparties. Under Article 148(2) of the Capital Requirements Regulation ("**CRR**"), it provides that exposures to "unregulated financial entities"[5] will carry a higher regulatory capital charge than exposures to other entities. This raises various difficulties when having to analyse which entities actually fall within this definition.

Annex I of the Capital Requirements Directive ("**CRD**") sets out a list of activities, the performance of which would result in an organisation being classified as an "unregulated financial entity". This list includes lending money, giving guarantees and trading for own account in the money markets. It is hard to see how it could be safely determined that a particular borrower had never performed any of these activities. It is our view that, at the very least, a concept of materiality should be introduced so that companies which carry out these activities as an ancillary part of their business are not caught. Without this condition, a realistic and meaningful assessment would be practically impossible.

Specific concerns have also been raised that the definition of an "unregulated financial entity" could capture both a (non financial) corporate group which happens to have finance/treasury functions; and/or lending to SPV structures expressly set up to on-lend monies to a non-financial corporate client.

We do not believe that the regulation could have been intended to capture these sorts of entities and we have suggested that specific exclusions be introduced to make this clear. In our view, this should once again act as a case study to illustrate the importance of undertaking a detailed assessment of what needs to be captured by a particular piece of regulation and the need for accurate and detailed definitions.

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

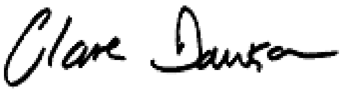
As briefly mentioned in the Consultation, we would support the creation of a global Legal Entity Identifier (LEI).

Conclusion

Whilst targeted and proportionate regulation to guard against excessive risk in the financial system is welcome, this must ultimately be balanced against the need to promote growth and ensure a healthy economic recovery. Much has been publicised in recent weeks about the need to stimulate the credit markets, and with banks continuing to shrink and delever, non-banks are likely to become a much more important source of credit in future. If their activities become unduly constrained, or the costs of compliance become excessive, these vehicles will have neither the resources nor the incentive to invest. Furthermore, too many individual pieces of regulation are likely to lead to confusion, and ultimately suffocation and disruption in the market and a reduction in the number of participants. Therefore, at the very least, we would urge the Commission to first carry out a detailed impact assessment of current regulatory proposals, and review these in the context of their cumulative impact across the entire financial system before putting additional regulations in place. When regulation is considered in isolation, the risk of negative unintended consequences becomes all the more likely.

We would be pleased to discuss any aspect of this response with you in more detail. If we can be of any further assistance, please do not hesitate to contact me via email at clare.dawson@lma.eu.com or by telephone on 020 7006 2216. Alternatively my colleague Nicholas Voisey may be contacted by email at nicholas.voisey@lma.eu.com or by telephone on 020 7006 5364.

Yours faithfully



Clare Dawson
Managing Director
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[1] Article 394 the Capital Requirements Directive (formerly Article 122a) (*Exposures to transferred credit risk*) of Directive 2006/48/EC.

[2] Thompson Reuters LPC. US middle sized issuance equates to any issuance where both deal size and company revenue are less than $500mn and includes both sponsored and non-sponsored transactions.

[3] Lipper FMI.

[4] CRD IV relates to the European Commission's proposals to replace the current Capital Requirements Directives (2006/48 and 2006/49) with a Directive and a Regulation.

[5] An "unregulated financial entity" is defined as "any other entity that is not a regulated entity but performs one or more of the activities listed in Annex I of [the CRD] or listed in Annex I of Directive 2004/39/EC [MiFID];"