EU COMMISSION GREEN PAPER ON SHADOW BANKING

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The level at which the organisation operates (national / EU / international) and the Member State or other country (in case of a national organisation) : **BNP Paribas Group (www.bnpparibas.com) is a European leader in banking and financial services, with a significant and growing presence in the United States and leading positions in Asia.**

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High level observations

We are not convinced that elaborating specific rules based on the "shadow banking" label is an efficient way forward. The concept is not an easy one to grasp; it is also a perverse one as it seems to indicate that banking can be developed outside regulation and subsequently that the regulatory scope of the function has not been properly set. Conversely, it would also be unfair to presume that non banks' activities are harmful. On the contrary, they are a very important component of the financial system, in terms of funding, maturity transformation and also diversification of risks.

It is nevertheless true that there is no worldwide definition of banking and that the European one is rather restricted, excluding both institutions that originate loans or other financing instruments but do not take deposits, and actors of the delivery and payment systems. In addition, the coming CRD IV/CRR, totally based on the size of the banks' balance sheet, will clearly encourage disintermediation while the European financial system is not prepared for this move. In point of fact, the Authorities appear to be the primary promoters of the "shadow banking" that they now profess to desire to keep under strict control.

Beyond this paradoxical situation, we believe that the Commission should wait for the outcome of the five FSB work streams to start setting a global framework, if any is needed, and initiating additional regulations on top of the ones that have already been recently or are being strengthened.

In that respect, the work of the FSB, and thereafter of the Commission should be focused on those non-bank financial activities rather than on legal entities that can potentially contribute to systemic risk, and should combine this analysis with that of the necessary features of a stable financial system that cannot be contained within national borders.

This approach might lead the Authorities to reconsider their definition of banking. As far as we are concerned, we believe it consists of delivering one or both of the two following services:

1. Collecting deposits and making payments; banks are at the heart of payment systems.
2. Financing the economy and helping it to hedge its financial risk; to this end, banks practice maturity transformation and take credit and market risks.

The correct performance of such functions implies strong supervision and access to Central Bank funding. We are concerned that breaking these functions into separate pieces will not make the financial system safer, on the contrary. It will be harder to supervise; it will contain risks disseminated among multiple actors with diverse objectives and understanding of their social responsibilities. The Commission should not accept for example the development of payment services with its ancillary businesses outside of the banking system.

Systemic risk is simply the expression of global economic and financial imbalances: budget deficits, trade deficits, demographic and generation gaps and finally the prevalence of short termism largely due to fair value accounting. Systemic risk will not disappear just because it will have been scattered all over the financial marketplace. There are only two ways to tackle the issue. The most efficient one would be to reduce these imbalances. The second best one would be to make sure that banks and investors are capable of absorbing knowingly the risks they take.

All in all, we are not convinced that specific "shadow banking" regulation should be developed. Banks are professional risk takers and managers. They are regulated and supervised to do so. We can probably assume that they are the safest harbours to perform this function for the economy despite current ways of thinking. The activities of non banks should certainly be monitored and they actually are, even though more effective macro supervision might be needed, it being understood that effectiveness means having the courage to impose action rather than expanding capacities for analysis. Investors should be aware of their risk, which certainly means consumer protection but also strong educational efforts. Markets cannot provide all the answers; they are highly volatile and therefore destabilizing; they are nonetheless useful for the economy and supplementary to the banking function.

Lastly, the accumulation of reforms while most of them are not yet enforced or their effects assessed calls for an observation period before entering into uncharted waters.

Christian Lajoie, Head of Group Prudential Affairs

As Commissioner Barnier[1] pointed it out, this consultation on shadow banking is intended to answer three major questions:

- Is regulation established in the banking sector propelling a migration toward shadow banking?

- Do we have the right regulation to identify and assess the risk of shadow banking?

- What role does shadow banking play in financing the economy and how can it play a more effective role?

He thus posed the shadow banking issue in terms of regulatory consistency, financial stability and economic growth.

We understand that the objective pursued by the Commission is not to set up new regulation that would apply to shadow banking players on top of the sectorial regulations that already exist. It is rather to rely on the existing or proposed regulations specific to each of the players in the financial system and complete them as needed within the perspective drawn by Commissioner Barnier.

Currently, regulations (both existing and proposed) are essentially designed to protect investors/consumers of financial products and depositors. This dimension is important but should be supplemented by a broader vision of the finance channels of the European economy and the risks that threaten the financial system as a whole. From this perspective, the analysis should focus on:

- first, making sure that regulations are consistent and based on the general principle that same functions or same activities must call for equivalent regulations whatever the nature of the performer of the activities in order to address the same objectives and have the same effects and consequences;

- Secondly, keeping the control of the systemic risks that may be generated by shadow banking entities, or between these entities and banks while making sure that we do not smother the economic growth on behalf of financial stability.

Our comments are divided in five sections which refer to the scope of the shadow banking and the four questions raised by Commissioner Barnier.

[1] - High level Conference: “Towards better regulation of the shadow banking system”
Brussels, 27 April 2012

1 - What scope for shadow banking systemic analysis?

Shadow banking and non-banks

1.1 We think the expression "shadow banking" is inappropriate because it carries two false ideas:

- that there is a homogeneous set of non banking financial players, more or less regulated, which exposes the financial system to poorly controlled risks;

- that there are banking activities outside the regulated banking system.

1.2 Financing the economy, or bringing lenders and borrowers together, can be done using three channels:

- In a "non-intermediated" way, by creating a direct relationship via the capital markets or via private placements. The financing instrument goes through an institution, but this institution doesn't manage it; it only structures it and or sells it to the market.

- In an "intermediated" way, where the financing instrument passes through an institution which funds and manages it. Depending on the case, this could be:

- a banking institution, or
- a non-banking institution.

1.3 Non-banking financial intermediaries (or "non-banks") are characterized by the fact that they contribute to the systemic risk of the financial system, without having access to:

- Central Bank refinancing;

- Deposit Guarantee Schemes.[2]

As a result, there is a continuum between institutional investors (family offices, foundations, pension funds, insurance companies, mutual funds) and hedge funds, MMFs and securitization institutions (ABCP, conduits, SIV, etc.).

It is all these non-banks and their relations that we believe can be related to the expression "shadow banking".

This approach leads to two considerations:

1.4 We noted that non-banks do not form a homogeneous population (either in terms of business, or in terms of risk profile, or in terms of regulations). Non-banks include long-term investors (like family offices, pension funds, sovereign funds, insurance companies, etc.), more short-term investors (like MMFs, ETFs, hedge funds, etc.) and other entities that offer payment services or which make loans without taking deposits. The heterogeneity of this population reinforces the point discussed in the introduction, which is the inadequacy of a new regulatory project which would pretend to cover this entire scope by adding regulation to the sectorial regulations that already exist or are being planned.

1.5 While banking regulations deal with solvency risk and deposit guarantee, non–banks regulations deal with protection of consumers and risk of contagion between the non-bank financial system and the banking system in a context of crisis.

These two problems (protection of deposits and protection of investments, at the same time as the risk of contagion between these two populations) cannot be separated. They should

[2] - In Europe, only banking institutions ("credit institutions") can collect deposits.

be considered to be two pillars of financial stability and, as such be regulated in a complementary and completely consistent way.

The main functions of banks

1.6 Defining negatively the scope of the analysis as being that of non-banks implies that we first define what banks are.

For the purpose of our analysis, we distinguish two major functions for banks:

1.7 <u>First function of banks</u>: Collecting deposits and making payments. Banks constitute the payment system core. The correct running of these systems implies liquidity capacity, and this is why banks have access to Central Banks. They assume the liquidity management of the economy and this why theyare regulated.

As non-banking financial intermediaries have no direct access to Central Banks, banks are their "lenders of last resort".

1.8 <u>Second function of banks</u>: In order to finance the economy, banks do maturity transformation and take risks. They primarily take credit risk and, because of the risk related to the transformation made on their balance sheet, they take liquidity and interest rate risks (in addition, of course, to all the other risks generated by their operation, primarily market risks and operational risks). They are regulated in this respect. These regulations are not, however, separate from the previous regulations because assets of banks protect deposits. This is the reason of the stringent level demanded to banks in terms of credit quality at origination, in terms of risk management and lastly in terms of liquidity and own funds.

Banks are therefore specialists of lending and managing risks. We think it is fundamental to leave this activity to banks; it is their expertise and they are regulated accordingly. In the interest of the financial system stability, if a non-banking entity wants to originate loans, it must be governed by regulations equivalent to banking ones.

1.9 We believe it is important to note in this respect that the source of the 2007 crisis was in the United States, where many loans were originated outside of banks, banks intervening later in the process, to package loans before selling them. Furthermore, it is precisely because the number of intermediaries between borrowers and banks increased while they were not required to retain a portion of the risks that they were transferring that the credit risk quality deteriorated. Whatever the regulation established, it is therefore necessary to prevent the origination of loans and the subsequent monitoring of credit risk from being completely removed from banking activities.

The role of non-banks (in connection with banks)

1.10 The non-banks' regulatory environment is not the one of banks: it is often much less stringent (hence the increased risk and the possibility of regulatory arbitrages).

By competing for the collection of funds, non-banks offer investment vehicles, mainly short term ones. They recycle them in the other financing circuits by focusing on the rotation of assets.

1.11 The non-bank world derives from a functional approach rather than a defined perimeter of legal entities

A corporate giving its clients credit, whether or not it transforms maturity on its balance sheet could be considered as belonging to the non-bank world. It can also be the case of commodities traders. Just like a number of players that currently appear in the segments of payment services. They collect "quasi-deposits" and they are authorized to give consumer loans with a maturity not exceeding one year.

2 - Is banking regulation propelling a migration toward shadow banking?

2.1 The non-bank financial system is due to the need expressed by economic agents to have an alternative investment channel to bank deposits. The existence of this channel is not an issue in itself. Its recent evolution is more problematic.

2.2 We can distinguish two phases in the recent evolution of the non-bank financial system:

Before 2007:

The main driver of growth in the non-bank financial system comes from the asset securitisation as banks were short of funding or wanted to increase their risk turnover in order to bolster their origination fees. During this phase, traditional European securitisation activities financed the real economy through retail (prime RMBS, credit cards, auto loans) as well as corporate (corporate and SME CLO). Separately, some banks were engaged in aggressive arbitrage activities with off balance sheet vehicle (such as SIV) to which they provided liquidity lines. In turn SIV were large investors in ABS tranches.

In the same time, European MMFs were investing in AAA securitisation tranches with a variety of maturities (ranging from short to medium-term).

After 2007:

The US sub-prime debacle led to a drastic reduction in the amount of new financing based on securitisations worldwide, as market slump affected all areas of securitisation, including the European traditional one. Overall, global non-bank activities were also sharply reduced and, in Europe, SIV vehicles were consolidated back.

The strengthening of bank regulation in Europe (CRD 2, CRD 3 then CRD 4), viewed as a response to the crisis generated by the financial system formed by the US non-banks, together with sharp review of rating methodology which led to downgrades of ABS tranches, led to significant increases of banks' capital requirements (in a context in which they couldn't raise capital) and of liquidity constraints that put massive pressure on banks to reduce their balance sheet. The sovereign issue combined with the real estate bubble in some countries triggered a confidence crisis that made European bank funding even more difficult particularly in non Euro currencies.

2.3 Two facts:

1st fact: Securitisation is just a risk transfer tool which passes on the exposure to the underlying portfolio to tranche holders: according to S&P review of European and US securitisation of Prime RMBS from 2007 to Q1 2011, US RMBS suffered 137 times higher losses (9.62%) than European RMBS (0.02%), whilst both activities relied on similar securitisation tools. The key differentiating factor was the quality of the underlying pool of securitised assets, and hence origination was the prime driving performance factor. Extensive banking regulation in Europe normally ensured high assessment of risk at origination and subsequent good monitoring. Where regulators want to encourage the growth of the non-bank sector, it would be necessary to make sure that non-banking financial institutions are governed by the same objectives/regulatory constraints as banks in order to maintain the risk quality at origination, or that this risk management is assumed by banks.

Credit risk management remains the expertise of banks. The "skin in the game" rule, which is intended to align incentives so that banks have no interest in subsequent changes in the risks, expresses this capacity and responsibility.

2nd fact: In Europe, in contrast to the pre-2007 period, when the main flows in sub-prime area were originated by non-banks and then sold to banks, the post-2007 period reverse the flow, shifting activities from banks to non-banks as banks were forced to deleverage their balance sheet whilst the economy needs finding alternative source of funding. The dynamics of the financial system formed by non-banks in Europe is, therefore now, much more complex than five years ago.

3 - Do we have good regulations to identify/evaluate the risks of shadow banking in Europe?

General considerations

3.1 Regulating non-banks and banks in identical way for competitive motives cannot be an end in itself, even though an alignment of certain regulations could reduce the risk of regulatory arbitrage. The main issue is to control systemic risk to ensure financial stability. That control presupposes identifying activities at risk and then regulating them or the entities providing them. The flexibility of the non-bank financial system (which is greater than that of the banking system) must be preserved.

3.2 Financial stability objectives should be reached in a dynamic rather than static approach:

- Building regulation takes time. Before implementing it, it is necessary to define the concepts, assess the impacts and follow the decisional and legislative processes. The development of new regulation must be evidence-based. Indeed, it cannot be done without going through the stage of cost/benefit analysis. However, that analysis calls for extensive information, which is not the case. While building a regulatory mechanism takes time, so does implementing it in consideration of the macro-economic environment.

- If the objective is indeed to address the question of the systemic risks of the financial system formed by non-banks, it is a mistake to consider that systemic risk had become “usual” risk. This type of approach leads to building regulations on extreme situations, as is the case of CRD/CRR 4, that might prove to be too stringent for the current economic situation. Regulation should, on the contrary, be based on more frequent situations, with the regulator reserving the right to act by exception (and in a proportional manner) when the situation so requires.

- It would be a mistake to pretend to regulate the financial system formed by non-banks under the pretext that it conducts bank-type activities while it is not regulated as a bank. We should start by assessing precisely the reality of the risk created (is there a systemic risk and of what nature?) then, if necessary, by identifying the nature of the activities or the entities that contribute to it, and finally only by questioning the adequacy of the existing regulations. It seems to us that such an approach would lead to favouring indirect regulation per entity, supplemented by supervision of the activity through reporting to a European entity (like the ESRB), which also makes it possible to supervise the threshold effects within the financial system formed by non-banks.

3.3 In terms of financial stability, transparency is critical. This transparency may include trade repositories for repos and securities lending/borrowing on one hand and the registration of securitisation and risk transfer vehicles on the other hand. In order to avoid being simply a collection of data, but rather information, reporting should be well targeted, using practices and requirements of the management universe. This centralization of information should be placed under the aegis of the ECB and the ESRB[3], to the benefit of the financial system players. In effect, these institutions could use this information to reduce the emergence of the systemic risk, primarily by feeding it back down to national supervisors.

[3] - The responsibility of the BCE is limited to the euro zone, which is not the case for the ESRB.

The Trade Repositories should be based on the underlying assets and organized by geographic zone (ideally three geographic zones: Europe, USA and Rest of the World). When creating new requests for reporting, to avoid duplicating already existing mechanisms it would be advisable to make maximum use of infrastructures that already exist or are in the planning stage.

It would also be convenient to start with how to address the question of the repos, activity in which banks are very active then to address the issue of the securities lendings/borrowings that concern a wider range of actors mainly non-banks. The reporting (in particular to supervisors) on securities lending/borrowing is different from the one on repos. Thus, it would be necessary that supervisors agree on a common reporting structure before going further ahead.

Direct regulation of entities

3.4 Non-bank activities are generally regulated (notably CRD 3 and UCIT 4 for the current regulations and CRD/CRR 4, Solvency 2, UCIT 5 et AIFM pour future ones) however with a different objective (depositors and consumers protection perspective) than the systemic risk one. Therefore, the question is not the regulations themselves but the way regulations address the systemic risk issue. For example, do these regulations give the entities we are concerned with the ability to resist to a systemic crisis? In this perspective, some additional developments could certainly be undertaken in the case of non-bank activities but they should not be labelled "shadow banking".

3.5 The UCIT 4 regulation, set up in 2011, even if it didn't take into account all the issues raised by the crisis, correctly addresses the systemic risk of MMFs (calculation of VaR, linear valuation limited to a time frame of a few months, limit on the maturity of assets, etc). The forthcoming UCIT 5 (and the probable UCIT 6) will complete the framework.

As regard to AIFM, it is not yet implemented and we still have to wait to assess its implementation.

Indirect regulation of activities

3.6 Certain banks' business lines are *de facto* part of the non-bank financial system (desks of repos or securities lending/borrowing, prime brokerage, etc.) and requested to comply with the banking regulation. Moreover, non-banks are partially regulated because of their interrelation with banks.

Direct regulation of activities

3.7 In its consultation, the Commission opens the door to the regulation of certain activities referred to as "shadow banking" ones (securitisations, repo, securities lending/borrowing). On this point, we believe that much has already been done through the indirect regulation (see above).

3.8 After CRD 3 and CRD/CRR 4 (added to CRA 2 and CRA 3), the question of the securitisations risk has already been addressed in Europe. The current challenge is how to re-launch European securitisation markets.

3.9 Non-banks are the main players in the securities lending/borrowing market, with the CIBs of banks acting as intermediaries. Those transactions are essential ingredients of the financial markets. They contribute to the liquidity of securities, thereby provide a source of liquidity to non-banks. They are also necessary to banks for their derivatives activities and particularly for their market-making activities (they indeed provide liquidity and security turnover indispensable to market-making activities). Therefore, it seems dangerous to seek to strongly regulate this activity outside of an objective data analysis and ongoing transaction monitoring (see above, on Trade Repositories).

- Leverage

3.10 As regard to the classification of a transaction and of its principal risk we note that it ultimately depends on the nature of the two contracting counterparties. Classifying a "repo" (for example) as shadow banking activity is possible only as long as this repo is not contracted between two banks. Moreover, the principal risk of a repo contracted between banks and an investment funds is the counterparty risk for the fund and the liquidity risk for the bank.[4]. Moreover, the range of these risks largely depends on the direction of the transactions, and in particular on the existence or not of "Wrong Way Risk" as defined by CRR. It thus appears to us more judicious to impose a total transparency for on the repo markets or the benefit of regulators and to privilege, when needed, a regulation by entity.

Nor should we aim at the wrong target. If the question is the leverage nature for some non-banks (since certain transactions can be considered as financing activity), the right answer is not to regulate the activity but rather to regulate the players (asking non-banks to quantify their risk like banks). Such regulation would also make it possible to harness the leverage effects built by other means (e.g., derivatives). As noted previously, UCITS already regulates the matter for MMFs (for AIFM funds, we still have to wait).

- Pro-cyclicality

3.11 The second source of systemic risk identified by the FSB in securities lending is due to their nature as financial transaction: a pro-cyclical effect attached to the use of collateral valued at market value, which can cause poor system running due to valuation or liquidity issues.

Although we cannot deny the pro-cyclic nature of the financing provided by these transactions, yet before launching a regulation project, we would need to evaluate the degree of systemic risk with which these transactions burden the financial system: in many cases, the financing need of the activities financed by repo is contra-cyclical.

From the perspective of liquidity, the European financial system can be viewed as a three-tiered system: ECB/banks/non-banks. Although the ECB plays the role of lender of last resort for banks (by substituting immediate liquidity for the receivables placed under repurchase agreements by the banks), in fact banks act as lenders of last resort for non-banks. Indeed, the assurance of liquidity offered to non-banks by the securities markets (which results from the option that they have to be able to sell, or lend them, before their maturity) is limited. Only banks, by buying paper from non-banks, or by placing it under repurchase agreement, can substitute immediate liquidity for a receivable that may lost value and become illiquid in the market.

Besides covered bonds, ECB now accepts a broader spectrum of securitisations and loans. But that poses operational issues: dependence of ABS on their ratings (only "AAA" ABS are accepted, which is pro-cyclical) and loans' covenants management (the transfer of the loans to the ECB supposes a transfer of property which prevents the bank from exercising the covenants).

It could be useful to work with the ECB on developing vehicles and list of criteria (LTV, diversification, etc.) that would make certain types of securitizations of loans to small and

[4] - Repos are mainly done to fund balance sheet on securities (not derivatives): banks and all other players must reverse repo their short bonds positions, and optimise funding by repoing out their long bonds positions. This is purely funding management.

medium enterprises (SME), or consumer loans, ECB eligible collateral and which would be seen as alternative to covered bonds.

The industry through EFR and AFME/ ESF has just launched officially the PCS initiative (Prime Collateral Securities) to boost the contribution of the securitisation to the financing of the real economy with an industry label based on standardisation, transparency and simple structure: it is expected these initiative will gather official support, including potentially eligibility to the ECB refinancing operations and qualification as highly liquid assets for liquidity ratio purposes

- Contagion

3.12 The third systemic source of risk identified by the FSB is the risk of contagion from the intervention of chains of intermediaries (to which the banks contribute); a default of a counterparty (considered to be systemic?) can then spread across the system.

CCP type institutions can help to limit this risk by interposing themselves in the chains of transactions. The intervention of this type of institution poses difficulties for certain transactions or certain underlying securities (particularly for underlying equity securities). Beyond that, the fundamental question is to know whether the CCPs effectively resolve the question of propagation of the default risk or whether we are merely moving the risk, by concentrating it and repositioning it ultimately on a state support (over-capitalization of CCPs raises the question of the viability of their economic model). In any event, since non-banks cannot have direct access to a CCP in Europe[5], banks will be required to preserve bilateral relations with non-banks, without necessarily being able to control their mutual exposures to the same non-bank counterparty.

Actually, the use of CCPs is much more an issue for securities lending/borrowing than for repos transactions. Indeed, the market of the repos (of which the banks are very important actors) is a market of assets but also, and mainly, a financing market. Counterparty risk management thus takes a particular importance (even if repos are callable with a 24h notice, their effective duration is much longer). Securities lending/borrowing are much shorter than repos and fund managers are led to frequently substitute securities for those which were lent or borrowed (because of the rules of dispersion of the credit risks in the funds.

We don’t think that it would be a good idea to force all transactions to go through CCPs, notably securities lending and borrowing.

Before making clearing mandatory, an important step for Regulators would be to make trade reporting mandatory. In fact, trade repositories are much more important for Regulators than CCPs, they give them total transparency on markets (this is acknowledged by the Bank of Canada for instance).

Enforcing trade repositories on repos would be less complex, less costly for everyone, and more efficient and all-encompassing than clearing (which would damage access to repos for some entities which have no cash to pay the Initial Margins required by CCPs).

In fact, trade repositories already exist on repos: ACP/FSA require transactions reporting and the ICSDs and custodians have all the information available (Euroclear, Clearstream in Europe, BoNY and JP Morgan in the USA). Regulators could easily require that those entities provide the appropriate data.

[5] - For repos, the clearing member acts as principal in the transaction, vis-a-vis its counterpart (a non-bank, for example) and the same on the other side, vis-a-vis the CCP (which is at risk on him). Thus, in Europe only well capitalized banks can be clearing members. It is difficult to see which benefit hedge funds, SIVs… would find in becoming clearing members.

4 - How could the effectiveness of shadow banking be improved?

4.1 The non-bank financial system is a complement to the banking system. It offers alternative investment channels to banking deposits and ensures the liquidity of financial assets, particularly to the benefit of banks' market-making activities. Therefore, it seems necessary to improve the effectiveness of this financial sub-system while limiting its risk. We believe that this includes, first, the application of a few fundamental principles applied to the world of funds managers and investors as set forth below.

4.2 Investors should be rightly informed and conscious of the risks they take. That entails target disclosure from funds, particularly on their risk profile, and which reminds investors that the amounts invested are not deposits but equity capital (as explained below, invested amounts are not guaranteed). The KIID (Key Information Investor Document), set up within Asset Management through UCITS 4 and potentially extended to pension funds and insurance companies by European project PRIPS, contributes to the reinforcement of this transparency and education of the end-investor.

4.3 Investors should understand that, if there is a decrease in the NAV of the fund, there will be no ″bail out″:

- the guarantee on deposits applies only to banks…and for deposits;

- the difference between the return on deposits in banks and the return on market assets partially reflects the opportunity cost the depositors agree to bear in order to benefit from guaranteed[6] liquidity;

- if no guarantee is explicitly given to funds by banks or insurance companies, it is the amounts invested, and therefore the investors themselves, that have to absorb the financial shocks. In effect, in this case, there is no absorption mechanism as equity does for banks. Investment vehicles are "pass through".

4.4 It is in the interest of investors that fund managers deliver transparency about their investment horizon and about the resources they have set up to manage their risks, particularly credit risk.

It is also in the interest of financial stability that risks are not simply moved (from a regulated sector to a less regulated one), but are treated as such wherever they are.

In the context of the credit risk of banking-type assets, such as loans, funds managers should have an obligation to set up a mechanism (process and tools) for the management of credit risks analogous to those which are established in the banks, and which are subject to the control of the supervision authorities. If fund managers do not want to set up this mechanism, then they should delegate it to banks equipped and supervised to that end.

4.5 It is in the interest of the economy that risks are rightly understood, accepted and fairly rewarded. On the one hand, there are no more non risky assets and, on the other hand, without any capacity to assess risk it is not possible to fix risk appetite and ask for sound reward of the latter.

The current search for yield by the fund managers can be the occasion to relaunch securitisation (particularly in the form of simple and transparent products). To mitigate the lack of long term resources, banks should be able to rely on non-banks or securitising the loans they have originated. However, this process can work only if there are investors interested in taking SME risk, which is *per se* neither liquid nor AAA rated.

4.6 A (well educated) investor works on two scales, that of credit risks and that of liquidity. The recent situation of the AAA collateral market is characterized by the fact that investors,

[6] - This also includes the cost to the bank of managing payment instruments.

as a whole have sought to position themselves at the same time on both ends of the two scales (minimum credit risk and maximum liquidity). Yet investors who invest within its time horizon do not need very liquid assets. Likewise, if risk is correctly rewarded, investors may not necessarily find it beneficial to position themselves on AAA assets.

This question of risk pricing also refers to the role of banks in relation to the scale of the credit risk. Indeed, banks originate and package risk and, by evaluating it and managing it, are in the best position to communicate about its level, a requirement for good hierarchical structuring of remuneration in the market. This is particularly true in the case of credit granted to SMEs.

In this process, banks are simultaneously judges and litigants. A simple way to avoid this conflict of interests is to require banks:

- to systematically hold (without covering the risk thereof) a fraction of the assets that they originate in partnership with the investors;

- to be transparent about the quality of their risks

At the international level, investors should disclose the investments they made in securitised assets in order to locate risks so that supervisors can be informed about the risk propagation.

We note that things are moving in this area thanks to market-led initiatives (at the European level, see for example PCS, as well as the French banks' initiative supported by Banque de France). At the same time, ECB templates for mortgages and auto loans (which will provide information on a loan-by-loan basis) are close to completion.

5 - Shadow banking and financial stability in Europe

5.1 As said in the forewords, the objective of Commissioner Barnier is to enhance the stability of the European financial system while ensuring that the financing of the economy is adequate. We consequently wish to replace the debate on the "shadow banking" within the broader framework of the channels of financing of the European economy and its model of growth.

5.2 As it has just been underlined many times, banking regulations have been reinforced considerably. These regulations will constrain (and it is one of the goals pursued by the public authorities) the use of banks' balance sheet and liquidity, and thus will limit the share of the banking intermediation in the European economy. However, in continental Europe (i.e. the euro zone), more than 80% of the financing of the non-financial corporates are born by banks, and 20% by the markets. In the United States, the share of the debt of the companies financed by the markets is 70%, as opposed to 30% by banks.

Lack of long term investors in Europe and excess of short term

5.3 It would be an error to think that capital markets will be a ready substitute to banks to finance the European growth. Indeed, saving capacity is important in Europe but with a preference for liquid investments. Another characteristic of the European saving capacity is the lack of long term investors due to the low development of pension funds in the euro zone (with the exception of the Nederlands). On the borrowers' side, the economic tissue, mostly made of middle and small firms, suffers from a double handicap: low name recognition and low capitalisation that make direct access to capital markets difficult. In France, investors prefer to invest in the largest firms listed on the CAC 40. In the current crisis context, this situation creates an excess of short term funding in the European financial system. This not only penalises long term investment but also put the system at risk. In fact, funds investing largely in long term assets, supposedly liquid, create a huge synthetic transformation and liquidity risk.

5.4 To conclude, main risks are:

- either European firms financing will not be sufficient and well suited, exposing the whole system to an ALM risk;

- or European firms will be financed by non European entities, via direct financing but more probably via non-banks channels.

The reduction of excessive short termism

5.5 To control the non-bank financial system maturity transformation, a priority should be to encourage investors to better match the time horizon of their investments with their true funding capacities and maturity expectations. That means encouraging the short-term players to reduce their positive maturity transformation and encouraging institutional investors that hold long liabilities to reduce their negative maturity transformation[7].

In this context, where banks reduce their balance sheet and their capacity to hold all the risks they originated, to encourage long-term investors to bear long-term risks would avoid causing the financial system as a whole to bear an ALM risk related to the maturity mismatch (which can cause liquidity problems or losses in value on assets). By selling long-term assets to long-term investors, banks reduce their balance sheets but do not transfer that liquidity risk or that “maturity mismatch” to investors, the time horizon of whom is short.

In the same way, short-term investors (MMF type) carry the short-term risk and the transformation position within the short-term (between the overnight and the 3-month horizon).

Finally, banks carry the resulting structural transformation position of the economy. They are regulated accordingly.

5.6 The reduction in excess short term in the system can occur through measures that:

a - Encourage investors and funds managers to invest in assets corresponding to their time horizon (to reduce their transformation risk and dependency on asset liquidity).

In the case of insurers, that may involve an incentive to carry project bonds (following the example of the asset class of covered bonds for project bonds that have EIB-type credit-raising mechanisms or mechanisms similar to the techniques used in covered bonds) while their liability maturity should be lengthened through various incentives and regulations.

On the assets side, Solvency 2 imposes huge capital charges on ABS held by insurance companies in their balance sheet. For example, the capital charge of a 5 years / AAA asset is:

- 3,5% for a covered bond,

- 4,5% for a corporate bond,

- 35% for a securitisation.

This disproportionate and punitive capital charge bears little resemblance to actual credit losses (it is equivalent to the equity capital charge). It hampers the recovery of the European securitisation market, adding pressure on bank funding.

[7] - The IMF cites the excess of short term flow from institutional investors seeking to invest in short-term liquid assets (“reverse maturity transformation”), investments they do in the non-banks financial system.

b - Encourage the large corporate clients to go directly to the markets, banks providing liquidity lines in case of markets drying up.

c - Facilitate the securitisation of SMEs and mid-size companies financing for which bank credit is the primary source of financing.

In France, the economic stakes are fundamental since those companies account for two thirds of employment and 50% of value added. The real issue is that of reviving securitizations in this area.

In the Basel 3 framework, these commitments are penalized (capital and liquidity ratios).

In this perspective, the recent market-led initiative (PCS) should be strongly supported by the European Authorities. PCS (Prime Collateralised Securities) has been developed to apply a label to securitisation issuances which meet specific eligibility criteria. The PCS label will be awarded only to securitisations that are backed by granular asset classes that have performed well through the financial crisis and that are of direct relevance to the real economy (auto loans, leases, residential mortgage loans, loans to small and medium enterprises, consumer loans, credit card receivables).

It is interesting to note that PCS eligibility criteria have been developed to include existing market standards where these are considered by PCS to be current best practices (ECB, Bank of England and HFC reporting standards).

PCS label will bring added quality, transparency and standardisation to the market. This will deepen the securitisation investor base in Europe and, in turn, improve overall liquidity. By increasing the securitisation of real economy asset classes, it will support the recovery and future growth of the European economy.

In this perspective, CRR 4 should contribute to the revival of the European securitisation markets by considering PCS securitisation issues as liquid and including them in the future liquidity buffers. Consequently, the ECB should also enlarge the scope of its eligible securitisation issues.