11 January 2013

Sent via email: fsb@bis.org

Dear Sirs

Response to Financial Stability Board (the "Board") Consultative Document: Strengthening Oversight and Regulation of Shadow Banking (the "Consultation")

The Loan Market Association ("**LMA**") welcomes the opportunity to provide a response to the Board in respect of the Consultation and hopes that its comments will be useful in the formation of policy.

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 set out a policy framework to address shadow banking risks posed by non-bank financial entities other than money market funds, with a view to increasing the resilience of the financial system and to ensuring that all financial activities contribute to economic growth. We welcome the observation in the Consultation that credit intermediation by non-bank financial entities can 'often generate benefits for the financial system and real economy, for example by providing alternative financing/funding to the economy and by creating competition in financial markets that may lead to innovation, efficient credit allocation and cost reduction'.

With this in consideration, we would like to provide some general feedback relating to our views on shadow banking generally.

We agree that shadow banking should be identified by reference to economic function 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". 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.

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[i], 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 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.

Concerning the appropriateness of the policy tool kit, we would suggest that this is not too onerously applied without a full impact assessment of all current regulatory proposals on the wider economy. 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 requirement for credit institutions under 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 Board 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 Board to remember the potential benefits that non-bank investors are able to bring to the economy as noted in our introductory remarks, particularly at a time when access to liquidity by ordinary businesses is becoming increasingly scarce. This is particularly important in the low systemic risk syndicated loan market.

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[ii]. This issuance is facilitated by loan mutual funds (a $70bn industry[iii] 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.

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.

We would highlight the importance of taking an integrated and globally consistent approach to ensure alignment with other regulatory proposals. 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, Dodd-Frank, FATCA 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 the composite effects of national, and supranational regulation is recognised. We would strongly urge the Board to direct efforts away from individual policy silos and towards the construction of a comprehensive assessment of the totality of these proposals on the financial services industry. Only once this assessment has been carried out, should further appropriate and targeted regulation be considered for specific shadow banking activities.

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) is expected to top $50bn during 2012. By contrast, there has been no new CLO issuance in Europe since 2011 (save for a handful of balance sheet transactions in CLO format).

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 we would urge the Board to carry out a detailed impact assessment of all 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

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

[ii] 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.

[iii] Lipper FMI.