Amundi
ASSET MANAGEMENT

Answer to F S B's
Consultative Document on Shadow Banking

A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities

(January 2013)

Amundi is a leading asset manager, ranking second in Europe and among the top ten in the world with assets under management above 700 billions euros. It is active in many different countries and serves a diversified clientele of retail, corporate and institutional investors through a large range of products and investment solutions.
Amundi welcomes the opportunity offered by FSB to openly present comments, views and feelings about the issue of so called "shadow banking" or "market finance" entities.
Before addressing more specifically those questions where an asset manager may express views based on its experience and reflexion, Amundi wants to draw attention to the following points:

- Asset management is **a highly regulated and closely supervised industry** which does not create systemic risk; more specifically MMFs which are not in the scope of the present document are regulated in terms of maturity, liquidity, credit risk, absence of equity or FX risks…
- Contrary to the banking industry, there is no leveraging of balance sheets in the fund industry: **asset managers run the money clients have entrusted them with**; leverage higher than 3 is exceptional and refers mostly to hedge funds;
- **Hedge funds mapping** should be achieved (and not limited to credit hedge funds) as they may participate to different functions analysed in the report in a manner that multiplies risk;
- Private equity funds, mentioned in the introduction, present a perfect example of total congruency between liquidity to the holder and investments and divestments of the fund; only **mezzanine funds** contributing to leverage without capital risk are concerned with potential risk;
- **Maturity mismatch** of ETF or credit funds should not be overestimated: it simply disappears for synthetic ETFs and it is an essential part of the fund manager duties to monitor the transformation risk and avoid illiquid assets;
- Eligible collateral has to be analysed in the context of the coming regulation on derivatives (EMIR and DFA) in a flexible approach that might not create market disruptions; a solution consists in allowing a **large list of eligible collateral together with appropriate haircut**; furthermore it should be authorized for counterparties to agree on **re-use of collateral**;
- Funding through **wholesale Repo** ought to be further analysed as it appears as a spot where systemic risk may appear;
- Transparent **pass-through securitisation** of a portfolio of loans should be encouraged, but structured securitisation relying on a SPV that refinances itself autonomously should be regulated as bank intermediation is.

Questions (Please provide any evidence supportive of your response, including studies or other documentation as necessary)
Q1. Do you agree that the high-level policy framework effectively addresses shadow banking risks (maturity/liquidity transformation, leverage and/or imperfect credit risk transfer) posed by non-bank financial entities other than MMFs? Does the framework address the risk of regulatory arbitrage?

As described in the framework, the approach of WS 3 seems consistent with FSB's general view on Shadow Banking (SB): not a question of absence of regulation, but of credit and duration transformation.
The economic 5 functions that have been identified provide a better framework for analysis than the list of entities mentioned in the introduction which includes many activities not inclined to represent any systemic risk.
The tool list, as explained, has to be implemented in a manner proportionate to risk incurred and to preliminary costs/benefits assessment in order to avoid unnecessary or inefficient regulation, together with a specific attention to existing local regulation in order to avoid market disruptions.
"Information sharing" looks as a flexible and efficient enough tool to track regulatory arbitrage and spot grey areas resulting either from regulatory loopholes or constant innovation.

Q2. Do the five economic functions set out in Section 2 capture all non-bank financial activities that may pose shadow banking risks in the non-bank financial space? Are there additional economic function(s) that authorities should consider? If so, please provide details, including the kinds of shadow banking entities/activities that would be covered by the additional economic function(s).

The global feeling when reading section 2 is that many examples **do not evidence specific risk of SB but refer much more to market risks in general**. It does not mean that the analysis is uninteresting, but suggests that regulation might be possible to introduce as it is for banks. Insurance companies or collective investment schemes are already largely regulated and are probably up to expected standards, with sometimes a regulation more demanding than for banks.
It appears that excess of some techniques have led, or may lead, to systemic risk. Typically **excessive leverage** is hazardous and should be controlled in funds (2.1), in securitizations (2.5), in the balance sheet of insurance providers (2.4) or of brokers (2.3) relying on short term refinancing. **Maturity mismatch** also may be problematic but is not in all circumstances: in the fund industry it is part of the asset manager's job to follow both liabilities and assets and to adapt the profile of investments to the expectations of investors.
In case of **extremely adverse market conditions** (as mentioned, for credit, in the third and last bullet point of §2.1) it is common sense to fear unexpected comportments and "runs". It is not the manifestation of an intrinsic failure of a SB activity, but relates to the essence of markets and human behaviour. The same risk exists for banks that are not in a position to offer immediate liquidity to all their cash depositors.
Some examples presented in the report evidence that **fraud** is to be fought against. It is a general truth that is not limited to SB. The last bullet point of §2.2 refers to by-passing (a mild world for violating) existing regulation.

Similarly erroneous appreciation of risk leading to mispricing looks more like a traditional **operational risk** than a risk specific to SB. All §2.4 argument against credit enhancement relies on the mispricing of credit insurance by monoline companies or mortgage insurers. The role of Credit Rating Agencies in this process should not be overlooked: their mis-appreciation of risk led to mis-rating and logical mispricing, with the help of a regulation too heavily dependent on ratings. It is not a matter of regulation (except for the deletion of references to ratings) or control but of professional skills.
In other cases, the **local legislation** has in some countries like France, already decided to limit to banks (or financial institutions regulated similarly to banks) the possibility to receive deposits (cf. first bullet point in §2.2) or extend loans.
At the end, the most specific area of risk stemming from SB is **wholesale financing mainly through Repo**. Few counterparties understand that they may participate to excessive leverage when they refinance assets through Repo or authorize their custodian to re-hypothecate their holdings. They simply use efficient techniques to secure cash available.
These comments are designed to evidence that regulators have already developed tools to address most of these issues that are common to banks and non-banks. However, the diversified activities of **hedge funds**, which are probably among the most active SB actors, should be specifically analysed and mapped as they may touch on several economic functions in a way that is not additive but multiplicative in terms of risks.

Q3. Are the suggested information items listed in the Annex for assessing the extent of shadow banking risks appropriate in capturing the shadow banking risk factors? Are there additional items authorities could consider? Would collecting or providing any of the information items listed in the Annex present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

Below are expressed some questions and suggestions about Annex 1.
<u>Maturity transformation</u>: why compare original maturity of asset/liabilities to outstanding maturity by buckets? Is not the comparison of weighted–average remaining and original maturities enough to appreciate the portfolio? Is the reference to original maturity relevant at all?
For the facilitation of credit creation, the expected data on maturity transformation may not be pertinent for insurance companies.
For securitization, early redemptions profile is of interest to estimate the expected maturity.
<u>Liquidity transformation:</u>
The definition of “liquid” assets should not rely on a legal differentiation of the market on which they trade: OTC markets are very liquid in many instances. The criterion might be relevant for equities, but for most other instruments, the size of the bid-ask spread is probably more relevant.
For loan provision, the support of the parent company has to be defined: does it cover credit facility, guarantee, letter of comfort, investment in bonds or CP or ABCP ..?
<u>Imperfect credit risk transfer:</u>
“Off balance sheet exposures by instruments” is not explicit, as we only consider credit risk. Risk weighted figures implicitly refer to application of banking regulation and it should be discussed whether it is more satisfactory than gross figures.

Leverage:
For intermediation of market activities further details on the liability side of the balance sheet should be monitored with a split between equity, non-core equity, mezzanine, subordinated or senior bonds…
For securitisation further details on the structure of the different tranches and their rank of priority should be provided in order to better assess the level of risk retained by the originator and incurred by the investor in each tranche.

Q4. Do you agree with the policy toolkit for each economic function to mitigate systemic risks associated with that function? Are there additional policy tool(s) authorities should consider?

The report explains that this toolkit is a list of possibilities and not a catalogue of measures to implement at once. Implementation should be selective and appropriate. Amundi shares this appreciation and experiments that different contexts may impact, even within a common market like Europe, local regulations.

Management of cash pools susceptible to runs:
For asset managers used to run UCITS and money market funds, many tools sound self evident: a manager will not take risk inconsistent with the funds objective and this consistency is closely monitored by a team dedicated to risk control. ESMA, formerly CESR, issued rules on total and average maturities, both WAL and WAM, of money market funds. Leverage is also strictly limited for UCITS in general and Money market funds in particular. Eligible assets in UCITS must be liquid and liquidity buffers are considered as good practice in MMFs' management. Any buffer must however be monitored on average over a period, in order to keep a dynamic view of future flows.
However Amundi cannot subscribe to the blunt statement that **diversification** is always an advantage for liquidity. In reality it is better to concentrate on liquid holdings than to diversify in less liquid ones, since, in case of stress, less liquid instruments become totally illiquid and more liquid ones may take advantage of a possible run to liquidity (often accompanied by a flight to quality). Nevertheless, rules of diversification like the 5/10/20/40% ratios of the UCITS directive in Europe proved to be adequate. But it would be inadequate to require, for example, diversification across different sectors as, practically, it is not possible to achieve when issuers are mainly banks on the shorter end of the yield curve. To demand diversification, would prompt inadequate pricing of second rank corporates who will be able to issue paper simply because large funds will be required to diversify their holdings.
To manage liquidity risk, it is possible to mention another tool: reasonable leveraging to face redemptions through a **liquidity line** provided by the custodian for the short time running from sale (T) of the securities to the date of their settlement and payment (T+3). Extension on a slightly longer period and in a very limited amount should be an option open for discussion.
A key question about tools for managing redemption pressures relates to the power to use them: some tools should be considered as a possibility by law which has not to be specifically mentioned or detailed in the prospectus of the fund and **could only be activated with prior information/validation of the local authority**, when other tools should be **totally in the hands of the manager** and clearly described in the prospectus. Redemption gates and redemption fees clearly belong to the second category as there are

many technicalities to decide in the mechanism. Suspension of redemptions clearly belongs to the first category as it is too much of a negative signal for the market to leave it to the manager to decide without the regulator. Side pocketing should be considered as a means to exit the period of suspension of redemptions Except for alternative funds that do not offer redemption on demand but impose both a notice period and monthly or quarterly redemptions and subscriptions, side pocketing should not be described in the prospectus nor implemented without prior approval by the competent authority.
The technique of **swing pricing** should be considered as an efficient tool to prevent redemptions in stressed market conditions. It transfers the market impact of a large redemption order on the redeemer as the NAV will be based on bid prices if there are net redemptions. It is a permanent devise and there is no signal to the market the day it is enacted and it is flexible enough to take into account the fact that bid/offer spread enlarges.

Loan provision dependent on short term funding:
When discussing the need for minimum capital requirement, WS3 points out the countercyclical character of capital. In that respect it is very important to put an incentive for financial institutions, contrary to the present banking regulation, to constitute a **reserve for general cyclical risk** based on their experience of a pluri-annual cycle.

Intermediation of market activities:
As asset manager, Amundi is concerned by the suggested restrictions on use of client assets. We totally agree with the requirement for segregation and the ban on using clients assets to finance own account's business. The provision that the client **may authorize the intermediary to re-use** or re-hypothecate its assets is of prime importance. It brings some flexibility which may be necessary in some types of deals in the framework of the coming regulation, EMIR in Europe and Dodd Frank in the US, on derivatives and their collateralisation.

Facilitation of credit creation:
As many representatives of the buy side, Amundi generally favours the principle of risk sharing and considers that the model of "originate to distribute" failed mainly because of the lack of risk sharing, through retention of first level risk, among all participants.
Otherwise, Amundi feels that insurers are sufficiently regulated and supervised to avoid any new mispricing, largely due to an over-reliance on credit rating agencies.

Securitisation and funding of financial entities:
On the question of maturity transformation through securitisation, it is important to separate two types of securitisation structures. On one hand some transactions are done to **transfer a portfolio** of loans to investors that will bear the risk and receive the profits; there is no transformation in that type of transaction even if the slicing of the structure allows short term tranches to diverge from the average maturity of the portfolio. Overall it is totally transparent. On the other hand some transactions offer a facility to refinance loans through an **intermediary structure that will issue** short term paper to finance longer term loans. It was regulated through the requirement that the structure be able to refinance in any circumstances thanks to a confirmed credit line. The credit line shorter than 365 days was risk weighted 0% and …excessive cheapness led to excessive refinancing. Transparent

one-shot transactions should be encouraged and complex structures with reloading and/or conduits issuing CP should be prudentially regulated.

On the question of eligible collateral, Amundi carefully analyses the collateral that is posted in favour of any of the funds it manages. As fund manager, it may dismiss proposed collateral and demand appropriate securities or cash as collateral. Illiquid assets are not considered as eligible and as a general rule should be financed by own capital. However Amundi considers that it would be counterproductive, especially with the implementation of EMIR and DFA, to limit eligible assets to a short list of a few issuers that would apply to all types of transactions with CCPs, banking counterparties and non bank counterparties. It prefers to allow for a **wide range of eligible collateral with an appropriate level of haircut**.

More than restrictions on exposures, authorities should **regulate the process of securitisation**. Thus, in order to make sure that originator will not lower its standards for lending, a significant and unavoidable risk retention should be mandatory; in order to avoid leverage, synthetic securitisation should be prohibited, except as a total back to back transaction; in order to avoid excessive funding through securitisation, any underlying loan should only be financed once in only one securitisation pool…These rules would be more efficient and could help to restore confidence in securitisation. In that respect, the PCS label supported by AFME is a good initiative.

Q5. Are there any costs or unintended consequences from implementing the high-level policy framework in the jurisdiction(s) on which you would like to comment? Please provide quantitative answers to the extent possible.

Generally, Amundi wants to underline the important costs of implementation that are required by new regulations. More specifically numerous reports have been recently introduced for AIFMs active on derivative markets... Beforehand it would be very helpful and efficient that regulators examine their request with a view on existing reports in order to standardize them as much as possible and to avoid asking new data that will demand heavy structural changes in IT.

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