Limits on exposures to shadow banking entities

Response from the Association of Investment Companies to EBA consultation paper 2015/06

The Association of Investment Companies (AIC) is the trade body for closed-ended investment companies; an industry comprising some 400 funds with approximately £136 billion assets under management. The majority of closed-ended investment companies are listed on the London Stock Exchange.

The AIC welcomes the opportunity to respond to the EBA’s consultation on limiting exposures to shadow banking entities and supports the efforts of the EBA to mitigate systemic risk in financial markets. However, there are issues addressed in this consultation paper that are of significant concern for the investment company sector. In particular, the AIC wishes to raise the following broad points:

* Investment companies do not pose a systemic risk to financial markets and should not be automatically included in the definition of shadow banking entities;
* Extensive stock exchange and listing rules and regulatory requirements ensure that investment companies are regularly and effectively monitored by the regulatory authorities;
* Including investment companies in the definition of shadow banking entities could inappropriately restrict the industry’s positive contribution to achieving the goals of the EU Commission’s flagship Capital Markets Union project; and
* The EBA should clearly define shadow banking entities and ensure that the rules are targeted on those institutions.

# Responses to consultation questions

1. **Do you agree with the approach the EBA has proposed for the purposes of defining shadow banking entities? In particular:**

* **Do you consider that this approach is workable in practice? If not, please explain why and present possible alternatives.**
* **Do you agree with the proposed approach to the exclusion of certain undertakings, including the approach to the treatment of funds? In particular, do you see any risks stemming from the exclusion of non-MMF UCITS given the size of the industry? If you do not agree with the proposed approach, please explain why not and present the rationale for the alternative approach(es) (e.g. on the bases of specific prudential requirements, redemption limits, maximum liquidity mismatch and leverage etc).**

No. The EBA provides no justification to include all AIFs in the definition of shadow banking entities.

Further, the AIC does not consider that the approach proposed by the EBA in this consultation paper is workable in practice and sets out (below) an alternative approach to defining shadow banking entities.

The definition of an AIF is set out in Article 4(1)(a) of the Alternative Investment Fund Manager Directive (Directive 2011/61/EU) as follows:

*“‘AIFs’ means collective investment undertakings, including investment compartments thereof, which:*

1. *raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and*
2. *do not require authorisation pursuant to Article 5 of Directive 2009/65/EC;”*

An AIF can take any legal form, including a company, limited partnership or unit trust.

This definition is intentionally broad. The European Commission’s impact assessment of the AIFMD states that AIFs *“…do not form a homogenous class of investment fund”.* The ESMA guidelines on key concepts of the AIFMD (ESMA/2013/600) estimated that it captures approximately 25,000 funds across the EU. The number of non-EU funds that are captured by the AIF definition is likely to be in the hundreds of thousands.

The EBA appears to have included all AIFs in the definition of a shadow banking entity without recognising how broad the range of funds captured by the definition of AIF is, or whether including all of these funds provides any regulatory benefits. For example, all investment companies marketed and/or managed in the EU are AIFs. However, the unique structure of investment companies means they do not create systemic risks for the real economy as they do not generate the concerns identified in section 3.1.1 of this consultation paper. Also, most investment companies do not carry out any of the functions of a shadow banking entity.

## Characteristics of investment companies

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| Characteristic of investment company | Impact |
| Market-traded | EU regulated markets are subject to high levels of regulation, ensuring transparency for investors and the relevant national competent authority (See below ‘Workable approach to defining shadow banking entities’ for further detail). |
| Closed-ended structure | The closed-ended structure of investment companies means that an investment company issues a fixed number of non-redeemable shares.  Generally, investors wishing to sell their shares will do so on the secondary market. This means that investment companies do not have to sell assets in order to meet redemption requirements, which allows investment managers to maintain a stable portfolio offering a spread of risk. It also precludes the company from any obligation to sell assets in falling markets. |
| Oversight of an independent board | The IMF has previously expressed concerns that, where investors cannot observe an investment manager’s activity, funds create risks of ‘herding’ or excessive risk taking.  These problems are addressed in investment companies by the oversight of the independent board.  The board has overall responsibility for the performance and compliance of the investment company, including setting the investment policy and level of gearing for the fund. The board can also take decisions regarding the continued appointment of the investment manager. |

### Size of the investment company industry

According to European Commission’s communication on shadow banking (COM(2013)614) the total figure of shadow banking assets is in the region of EUR 51 000 billion. As mentioned at the beginning of this paper, the investment company sector has assets under management of approximately £136 billion, or EUR 188 billion, which represents approximately 0.37% of the shadow banking sector as it is currently defined.

Due to its size, and the fact that the vast majority of the sector does not engage in relevant activities, any suggestion that the investment company sector poses a systemic risk to the real economy is not valid.

As the investment company sector poses little systemic risk, the AIC **recommends** that the EBA does not automatically include investment companies in the shadow banking entity definition.

### Regulation of the sector

The EU’s Financial Services Action Plan initiative to improve the EU single market has introduced comprehensive and rigorous legislation in order to harmonise the regulation of EU markets. The initiative is enacted through four EU Directives, which set standards of disclosure and transparency for securities admitted to an EU regulated market. These are the Prospectus Directive (PD), the Market Abuse Directive (MAD), the Transparency Directive (TD) and the Markets in Financial Instruments Directive (MiFID).

As well as complying with requirements set out in these Directives, investment companies are also subject to the Alternative Investment Fund Manager Directive (AIFMD) and other listing rules set by the national competent authorities. This significant regulatory framework ensures a high standard of disclosure, transparency and reporting from both investment companies and their boards and should be considered equally as robust as the regulatory requirements placed on institutions for the purposes of defining shadow banking entities.

## The priorities of the better regulation agenda

The EU Commission has recently launched a Regulatory Fitness Programme (REFIT), calling for rules that are fit for purpose, effective, and proportionate. The AIC does not consider that the EBA has taken into account these considerations in its proposal to include all AIFs in the definition of shadow banking entities. Given the size and role of the investment company sector, for example, including investment companies in the definition of shadow banking entities is not effective or proportionate.

The AIC **recommends** that the EBA produce a full impact assessment, in line with the EU Commission’s better regulation guidelines, of the impact of including all AIFs in the definition of shadow banking entities.

## Building a Capital Markets Union (CMU)

The characteristics that mean investment companies do not pose a systemic risk to the real economy, as detailed above, are the same characteristics that would allow investment companies to play a significant role in the building of a Capital Markets Union. Specifically, investment companies:

* **Use EU stock markets to pool capital** which is then allocated to investment opportunities according to the company’s investment mandate.
* **Mitigate systemic risks** that arise in other fund structures. The IMF has warned that open-ended funds create risks of ‘herding’ and excessive risk taking, particularly where investors cannot observe or oversee the portfolio manager. These issues are mitigated in investment companies by the oversight of the manager provided by the board on behalf of shareholders. Concerns that redemptions can cause the sale of liquid assets in falling markets do not arise as these funds do not offer redemptions.
* **Deliver more** **effective capital allocation** than open-ended funds, particularly when investing in illiquid assets (such as infrastructure). Open-ended funds hold cash or liquid assets to ensure they can meet redemptions. This consideration does not arise for investment companies.
* **Attract capital from a wider range of sources** for investment in assets such as unquoted SME securities or infrastructure. UCITS are unable to hold these assets directly. Investment companies can. Also, unlike structures such as limited partnerships, they are well suited to direct investment by retail investors. For example, Venture Capital Trusts (VCTs) are held almost exclusively by retail investors; pension funds with ‘listed securities only’ mandates; and global investors already familiar with investing via EU stock markets.
* **Offer a competitive investment proposition** with lower charges and the potential to outperform other funds. Investment companies can maintain long-term holdings without any need for the underlying portfolio to be disrupted by asset sales required to satisfy redemption requests. The independent board oversees the portfolio manager to optimise performance and secure value for money. The cumulative impact of each element of the investment company structure which delivers incremental performance improvements has the potential to deliver significantly enhanced investor outcomes over the longer-term.

Including all AIFs in the definition of shadow banking entities will unnecessarily increase regulatory burdens on the sector and compromise the ability of investment companies to contribute effectively to the development of a CMU in the EU.

## Defining shadow banking entities

Very few investment companies will undertake any of the credit intermediation activities listed in Annex 1 of the Capital Requirements Directive (CRD).

Some of the credit intermediation activities are not clearly defined and the EBA risks inappropriately including a number of funds in the definition of shadow banking entities. For example, activity 2, lending, should not include the purchase of corporate bonds issued through an initial public offering (IPO). It should also make explicit that purchases of corporate bonds on the secondary market should not be construed as lending. If these activities are not excluded a huge range of investors could become shadow banks, with major negative impacts on the market for corporate bonds.

Further, some investment companies investing in peer to peer (P2P) lending platforms may be considered to carry out lending (though this depends largely on the structure of the investment as no fixed or universal structure exists). Defining all P2P activity as shadow banking, irrespective of the volume involved, as credit intermediation activities is likely to deter investors; going against the aims and intentions of the CMU.

The AIC **recommends** ensuring the definition of a shadow banking entity is targeted effectively and in line with the priorities of the CMU. The EBA should clearly define the activities listed in Annex 1 of the CRD. The AIC recommends excluding the purchase of corporate bonds and P2P lending platforms from the definition of lending under the list of credit intermediation activities.

The definition of a shadow banking entity should also be proportionate. Small funds, including investment companies, do not pose a systemic risk. The EBA’s objective to mitigate market risk and protect the real economy is not met by including all AIFs in the definition of shadow banking entities.

To achieve proportionality, the AIC **recommends** excluding all undertakings with a total exposure of less than €500million.

This exempts all small funds from the definition of a shadow banking entity as these do not pose a systemic risk to the market or real economy.

The AIC also **recommends** excluding collective investment undertakings which:

1. *have a total exposure of less than €5billion;*
2. *are within the meaning of Article 4(1)(a) of Directive 2011/61/EU; and*
3. *are admitted to trading on an EU regulated market.*

This slightly larger threshold applies an exemption to non-systemic entities whilst also providing some additional protections. Part i) of this approach excludes smaller funds. Part ii) ensures that those funds report to the competent authorities under the AIFM Directive (so giving regulators sight of any risk they might create). Part iii) also provides an extra layer of transparency. All these factors make identifying these entities as shadow banks inappropriate.

1. **Do you agree with the approach the EBA has proposed for the purpose of establishing processes and control mechanisms? If not, please explain why and present possible alternatives?**

It is not appropriate to establish processes and control mechanisms before finalising the definition of a shadow banking entity.

The AIC **recommends** that the EBA finalise the definition of a shadow banking entity with a full impact assessment before agreeing further details.

1. **Do you agree with the approach the EBA has proposed for the purposes of establishing appropriate oversight arrangements? If not, please explain why and present possible alternatives.**

It is not appropriate to establish oversight arrangements before finalising the definition of a shadow banking entity.

The AIC **recommends** that the EBA finalise the definition of a shadow banking entity with a full impact assessment before agreeing further details.

1. **Do you agree with the approaches the EBA has proposed for the purposes of establishing aggregate and individual limits? If not, please explain why and present possible alternatives.**

It is not appropriate to establish the approaches for setting aggregate and individual limits before finalising the definition of a shadow banking entity.

The AIC **recommends** that the EBA finalise the definition of a shadow banking entity with a full impact assessment before agreeing further details.

1. **Do you agree with the fallback approach the EBA has proposed, including the cases in which it should apply? If not, please explain why and present possible alternatives. Do you think that Option 2 is preferable to Option 1 for the fallback approach? If so, why? In particular:**
   * **Do you believe that Option 2 provides more incentives to gather information about exposures than Option 1?**
   * **Do you believe that Option 2 can be more conservative that Option 1? If so, when?**
   * **Do you see some practical issues in implementing one option rather than the other?**

It is not appropriate to establish a fallback approach to setting exposure limits before finalising the definition of a shadow banking entity.

The AIC **recommends** that the EBA finalise the definition of a shadow banking entity with a full impact assessment before agreeing further details.

1. **Taking into account, in particular, the fact that the 25% limit is consistent with the current limit in the large exposures framework, do you agree it is an adequate limit for the fallback approach? If not, why? What would the impact of such a limit be in the case of Option 1? And in the case of Option 2?**

It is not appropriate to establish a fallback approach to setting exposure limits before finalising the definition of a shadow banking entity.

The AIC **recommends** that the EBA finalise the definition of a shadow banking entity with a full impact assessment before agreeing further details.

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