CNB opinion and answers to questions asked
on the European Commission consultation material "Green Paper on Shadow Banking"

A) General opinion of the CNB on the Green Paper

The CNB is of the opinion that **the overall approach to shadow banking must be adopted and exercised globally, uniformly and in a coordinated fashion**. The CNB is convinced that the EU approach should not diverge either materially or in terms of schedule from the principles and recommendations of the BCBS, IOSCO and other creators of internationally recognised standards, coordinated by the FSB. The CNB is aware that the Commission declares such an approach to shadow banking in the Green Paper. At the same time, however, in other forums (*internal note: e.g. at the FSC committee meeting in November 2011*) the Commission talks about the need for "European modalities". Also, when comparing the content of the Green Paper and the outputs from global authorities, it is not possible to ignore some deviations by the EU from the approach of the international community, rather the inverse. Hence the CNB considers it necessary to clearly reject any eventual unnecessary deviations from adopted international recommendations. The CNB also maintains this opinion because a different EU approach would be in direct contradiction to the declared objective of the activities in the area of shadow banking, namely to "prevent the circumvention of rules and regulatory arbitrage".

At the same time, however, the CNB emphasises that neither the "traditional" nor "alternative" financial **markets are homogenous, and this is demonstrated by current shadow banking analyses**. In some places shadow banking is very developed and has achieved a high share in the overall financial system, whereas in other places the shadow banking market is less significant from the perspective of systemic risks. In addition to this, many specific accompanying factors, including local ones, also have impacts on shadow banking. Therefore the CNB considers it just as important to **leave in place or create corresponding roles and space** for supervision and evaluating developments, and the adoption of eventual targeted local measures in the area of shadow banking **at Member State level too**. This assumption is fully **in accordance with international recommendations** on shadow banking **and in accordance with the general principle of effectiveness and suitability** of supervision and regulation. In the Green Paper, almost no space is given to the significant aspect of shadow banking described above; any references to it are general and unspecific in nature (e.g. "supervision at national and/or European level").

In addition, in the Green Paper the Commission presents the extensive expansion, supplementation and changes to the regulatory framework in the EU as its own success. The CNB considers that **there is now a threat of over-regulation** as a consequence of this. For this reason, too (additional reasons are given in other places in the opinion), the CNB generally takes **a strongly reserved position as regards the Commission's signalled additional regulatory measures**.

The CNB is convinced that it is now necessary above all to provide space for the implementation of a whole series of on-going regulatory reforms (MiFID, CRD, Solvency, UCITS, AIFMD and so on) and recent changes to the architecture of European supervision (e.g. the origin of ESAs), to ensure both operation in practice and to establish what their cumulative effect will be. The above also fully applies to the area of macro-regulation, where fundamental reform steps and measures have also been recently adopted, including the establishment of the ESRB. The CNB is convinced that it is also necessary to provide some

time for the testing of various possibilities in the use of new micro- as well as macro-prudential mechanisms and instruments in various situations and how they impact each other.

In the opinion of the CNB it is not possible to exclude the possibility that the implementation of the considered steps could lead to undesirable displacement of the users of traditional services, in particular retail, to non-standard institutions.

If the initiatives of the Commission in the area of shadow banking continue, the CNB considers it **necessary to specify, at least generally, the Commission's idea of the overall scheduling** and its key phases and milestones. **For example** it is important to remember that the eventual **implementation** of the mentioned **new monitoring** of selected information about shadow banking entities and activities **could require** in some countries or institutions as long as **several months or even years**, e.g. depending on the deadlines and the actual course of the national legislative process, or the need for changes in information and communications systems of the institution or institutions in question. In the Green Paper this subject is hardly addressed at all, in spite of the fact that the implementation of systematic monitoring of shadow banking is clearly one of its main ambitions.

In view of the above, the CNB summarises its general position on shadow banking through an overview of the principles and measures it considers decisive in terms of the subsequent approach to shadow banking within the framework of the EU.

a) The continuous engagement of the EU in global activities in the area of systemic risks of shadow banking, and the reflection of their results into EU conditions in both material and chronological accord with international recommendations; to provide regular information about developments and to provide clear information in advance about potentially considered deviations, in particular to properly justify the need for them.

b) The thorough use of all existing powers and instruments of supervisory bodies, and the resolute enforcement of existing regulatory requirements, e.g. the enforcement of the obligation of all banks to recognise, evaluate, monitor and reduce all significant risks, i.e. including possible risks in relation to shadow banking also on a consolidated basis.

c) The accelerated completion of the necessary prerequisites to ensure the effectiveness of supervision and regulatory measures, including preventing regulatory arbitrage, through the removal of unjustified differences in the EU legal framework, in particular as regards the following areas of financial market regulation:
   - accounting rules,
   - rules for the performance of consolidation,
   - the scope of the application of regulatory requirements, e.g. the lack of uniformity in the scope of the exercise of existing prudency requirements for leasing companies and other shadow banking financial institutions.

d) Proportionate monitoring, the exchange and evaluation of information about shadow banking in accordance with international recommendations and standards, and this as a priority within the framework of structures and mechanisms already existing in Member States as well as in the EU; perform potential expansion or modifications only if they are shown to be essential. Also ensure proportionate information requirements through appropriately configured importance thresholds and monitoring frequency, and create corresponding time, methodological and other prerequisites for proper preparation by the

entities affected.

B) Opinions regarding individual entities and questions

On the definition of shadow banking

In general:

The CNB is convinced that the definition of shadow banking must be global, and sufficiently flexible to be able to react to rapid changes.

In addition, we recommend making it sufficiently clear, and this not only for the public, that the objective is to target potential new regulation of shadow banking only on systemic and other potential significant risks related with shadow banking (including the risk of regulatory arbitrage), and not all the recognised risks of shadow banking.

An imprecise understanding of the scope of the initiative could lead to undesirable reactions by the market, to unjustified expectations by the public and so on, and in extreme cases to moral hazard or to threats to the reputation of regulatory and/or supervision bodies.

The CNB also recommends introducing, as a direct part of the definition of shadow banking and the list of entities and activities of shadow banking (*whatever their final material content*), the need for flexibility in their interpretation and application, and this in view of the continuous development.

The CNB is convinced that the publication of this initiative will further accelerate the development of various innovations as part of efforts to find responses to envisaged new regulation.

Questions asked by the Commission and draft answers:

a)	*Do you agree with the proposed definition of shadow banking?*

The CNB agrees with the proposed definition of shadow banking as an initial definition of the term. At the same time, it considers it necessary to quickly improve the key terms given in the definition, in particular "credit intermediation" and "the regular banking system". The CNB considers improving the definitions to be essential for the purposes of the envisaged more detailed analyses of the existing regulation of shadow banking, for consistency in the identification of the risks of shadow banking, the intended monitoring of shadow banking, clarification of mutual relations and so on.

b)	*Do you agree with the preliminary list of shadow banking entities and activities? Should more entities and/or activities be analysed? If so, which ones?*

While the CNB does not reject the proposed list, it proposes considering its simplification and structuring according to activity, and only providing the eventual institutional aspect ("entity") as an additional parameter. The CNB considers that such a structuring, respectively the implementation of the "*substance over form"* principle,

would enable, among other things:

- the elimination of potential duplicity (see e.g. the item "securitisation;" and the item "risk transfer"),
- a reduction in the potential negative impact of modalities and differences in labelling and/or in regulatory requirements relating to the "entities" in the list, as such differences appear in the EU; e.g. in some EU Member States leasing companies are subject to regulation and supervision on an individual basis (e.g. in France), while in other countries, including the Czech Republic, leasing companies are not regulated and supervised on an individual basis,
- a bridging over of the potential problem of the (non-)uniform classification and/or definition of some "entities" in the list - see e.g. the proposed entity " … types … or products with deposit-like characteristics, which make them vulnerable to massive redemptions..."),
- the simplification and clarification of the proposal of envisaged regulatory and supervisory measures,
- a reduction in the opportunities for potential circumvention of rules and regulatory arbitrage,
- the strengthening of conformity and the simplification of mapping to FSB recommendations, which defines shadow banking "entities" as follows: "entities that operate outside the regular banking system, and yet engage in the following bank-like activities: accepting funding with deposit-like characteristics, performing maturity and/or liquidity transformation, undergoing credit risk transfer, using direct or indirect financial leverage".

The CNB considers that the potential problematic nature of the proposed basic classification of items in the list as "entities" and "activities" is also indirectly confirmed by the wording of one of the posed questions, namely: "Should more entities *and/or* activities be analysed? If so, which ones?"

In addition, the CNB would like the following to be considered for addition to the list:

- an open, flexible item like: "other activities with characteristics of "*bank-like functions"* performed by entities not subject to special regulation and supervision",
- potentially an item of the type "any other activities not subject to special regulation and supervision, apt through their nature, volume, complexity, lack of transparency, concentration or other characteristics, or a mutual combination of individual characteristics, to represent a mutual risk for the stability of the financial system as a whole or its significant parts, including the risk of contamination".

As regards the risks and benefits related to shadow banking

Questions asked by the Commission and draft answers:

c)	*Do you agree that shadow banking can contribute positively to the financial system? Are there other beneficial aspects from these activities that should be retained and promoted in the future?*

The CNB agrees that shadow banking could be of benefit for the financial system.

Additional possible positive aspects include e.g. the possibility of "legal sanitisation" through the transfer of certain assets, activities and similar outside the regulated system – either for a higher price, or for a loss - e.g. to support the reputation of the regulated entity, and similar. Support for competition (the competitive environment) on the financial market or support for market innovation could also be potentially positive.

d)	*Do you agree with the description of channels through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?*

The CNB agrees with the description of the methods through which shadow banking activities create new risks or transfer them to other parts of the financial system. The CNB is, however, convinced that the above indicated overview is not final, and that the situation must be continuously monitored as the markets will also doubtlessly over time find space in the new regulatory conditions and new alternatives will appear. The creation of new significant risks or methods for their transfer to other parts of the financial system can also occur irregularly, depending on the development of the environment.

e)	*Should other channels be considered through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?*

The CNB considers it expedient to also elaborate in more detail:

- significant risks based on the complexity and/or lack of transparency of products, structures or activities in shadow banking,
- risks with the potential to significantly disrupt the "*level playing field"* through e.g. reduced or zero regulatory costs for shadow banking entities or improper business practices
- significant risks of deceptive or other undesirable presentation of products, structures or activities of shadow banking entities.

The CNB is aware of the possible double-edged nature of detailed definitions, as the accuracy of the description at the same time facilitates the finding of space, which is not expressly covered by the detailed definition. The CNB is, however, of the opinion that more thorough elaboration is desirable in the initial phase for a wider understanding.

Regarding the challenges for supervisory and regulatory authorities

In general:

The CNB is of the opinion that potential internationally coordinated increase in monitoring and potential regulation of shadow banking entities and activities could be useful. At the same time, however, the CNB is convinced that there is not yet any persuasive evidence for the need to rush to adopt completely new measures.

In the opinion of the CNB it is on the contrary possible to justifiably anticipate that the scope and seriousness of shadow banking risks for the reliability and security of the financial system as a whole significantly differ between countries and areas, as there are fundamental differences e.g. as regards the share of shadow banking in the financial system in question, as regards the level of control over it today, as regards the existence of direct and indirect

regulation (or on the contrary support) of entities and activities in the shadow banking system, as regards the economic, legal and other differences in the environments, as regards development trends in the shadow banking sector in question, and so on.

The CNB is also convinced that at the present time it is still not possible to reliably evaluate all the effects and connections of already implemented new or innovated post-crisis, respectively anti-crisis regulation, and there is also the risk of excessive regulation.

Questions asked by the Commission and draft answers:

f)	*Do you agree with the need for stricter monitoring and regulation of shadow banking entities and activities?*

The CNB is of the opinion that there is not yet available sufficient base data and other information for such a fundamental and general assertion. The CNB in general supports

- the continuation of monitoring and the related analyses of shadow banking activities; only on this basis will it be possible to take serious decisions about any eventual implementation of "stricter monitoring and regulation of shadow banking entities and activities",
- the effective and targeted resolution of each potential specifically identified and confirmed systemic or other significant risk, connected with shadow banking, for the reliability or security of the financial system.

g)	*Do you agree with the suggestions regarding identification and monitoring of the relevant entities and their activities? Do you think that the EU needs permanent processes for the collection and exchange of information on identification and supervisory practices between all EU supervisors, the Commission, the ECB and other central banks?*

The CNB in general supports the expedient exchange of information and know-how. At the same time, the CNB considers that neither in this area is it expedient to "anticipate" the working method in relation to shadow banking at international level, as this could lead to inconsistencies or ineffectiveness in the future.

In addition, in this connection the CNB emphasises the need to prevent any eventual reduction in the level of information held by national bodies in connection with the centralisation of shadow banking monitoring and the related risks at EU level.

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

The CNB fully supports the general principles for regulation and supervision of shadow banking, as defined in the FSB report of October 2010. On a related note, the CNB takes a reserved position in relation to their modifications in the proposed Commission principles, as it does not find any convincing arguments justifying deviations from existing international recommendations, for example for the differing categorisation of possible future measures in the area of shadow banking (the absence of the "macro-regulatory measures" category, respectively the absence of a clear differentiation between micro- and macro- regulatory measures in the Green Paper).

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

The CNB in general is of the opinion that "better regulation" does automatically mean "more regulation", and upholds this opinion also for the Commission's plans in the area of shadow banking. Also see the answer to the previous question (letter h) and the related question (letter j).

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

To increase international cohesion, the CNB proposes promoting and supporting, from the position of the EU, all measures directed towards harmonisation, respectively towards the removal of materially unjustified differences (at global level) in areas that are also important from the perspective of the regulation of the risks of shadow banking, which the CNB considers to be, in accordance with the Commission, accounting rules and consolidation rules (accounting, prudence).

For this purpose, EU bodies should also, in the opinion of the CNB

- react faster to the fact that materially unjustified differences in some of the above areas, which are also of key importance from the perspective of shadow banking risks, also appear in the EU – e.g. in accounting rules and in consolidation rules; it is necessary to start here, as this is one of the fundamental prerequisites for effective regulation including restricting room for regulatory arbitration,
- very strictly evaluate the justification for every eventual intended or already promoted EU deviation from internationally recognised standards and recommendations.

In addition, the CNB is of the opinion that the existing regulatory framework, in particular after the implementation of the Basel II and Basel III rules and other international standards, contains, respectively will contain, sufficient effective regulatory instruments. It would therefore be desirable to also focus on the international level, in particular on their timely and consistent implementation and subsequent active use (e.g. Pillar 2 and Pillar 3 instruments, respectively Basel III rules as a whole) by all relevant jurisdictions headed by the jurisdictions represented in the G20. If this is not done, apart from other things, the regulatory arbitrage in question would on the contrary be directly supported.

On the regulatory measures that relate to shadow banking in the EU

Questions asked by the Commission and draft answers:

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

The CNB is in particular in favour of all the already taken measures being subsequently evaluated, and this also as they impact each other, and potentially reassessed if their application will have other than the expected effects, or they are found to be dispensable.

Similarly, the CNB is in favour of evaluating the expediency of the ESMA "soft" rules,

and, depending on the results, deciding on their cancellation, or rectification, and potentially the incorporation of selected recommendations into legally binding regulations to strengthen their enforceability, etc.

Regarding questions that the Commission has labelled as outstanding

Questions asked by the Commission and draft answers:

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

The CNB agrees with the analysis of the five key areas defined by the Commission for further investigation, with certain provisions.

The CNB is not fully in accord with the analysis of area 1-Banking Regulation, where it is not clearly and precisely informed about the current reach of the CRD directive (which the text restricts to "banking") – unless in this case the Commission would place investment firms subject to the CRD into the "banking" sector.

The CNB therefore recommends that, in subsequent outputs regarding shadow banking, the text be further elaborated, or that a wider reach be established for the existing prudency rules of the CRD directive (*credit institutions, investment firms*).

Further, in the analysis of area 2-Regulation of asset management, money market funds, the CNB does not see an adequate assessment of the causes of the origin of this risk which, according to the CNB, is not the existence of the *MMF* as such, but as a rule the misleading presentation of a product by the intermediary (in particular if it is a bank) together with poor understanding of the product by the investor. From the perspective of the CNB, therefore, proper compliance with and supervision of the fulfilment of the rules for offering and presenting a *MMF* product appear to be the most effective regulation to reduce the risk of a "run" on an *MMF*.

m)	*Are there additional issues that should be covered? If so, which ones?*

At the current time the CNB is not proposing other areas over and above the framework of the Commission's proposal and the areas covered through international initiatives on shadow banking.

The CNB, however, puts forward for consideration the performance of targeted monitoring of experience and measures potentially adopted or considered at national level – if the Member State considers them relevant to the issue of shadow banking regulation and supervision. The CNB considers that such targeted monitoring could provide useful cues for subsequent steps within the framework of the EU, and potentially also for international discussions relating to shadow banking issues.

n)	*What modifications to the current EU regulatory framework, if any, would be necessary properly to address the risks and issues outlined above?*

The CNB considers it appropriate to complete the already commenced mapping of

shadow banking in the EU. The CNB, however, does not recommend that the Commission, respectively EU bodies, exceeds the existing framework of initiatives in the area of shadow banking, in particular international activities coordinated by the G20, respectively the FSB.

Regarding any eventually proposed new measures, the CNB considers it of key importance to properly take into account

- the degree to which the proposed new measures are essential – whether or not it would be possible to achieve the desired objective through the full use of already existing regulation and supervisory instruments,
- the effectiveness of the proposed new measures – an objective cost-benefit analysis of the plan,
- the possible side effects of the proposed new measures on already existing or implemented additional new regulation in connection with post-crisis measures.

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

The CNB considers that in the area of the monitoring of shadow banking it is necessary to ensure the greatest possible use of already existing appropriate information by Member States and the EU, so that financial institutions are not needlessly burdened by additional reporting obligations. Also see the reply to the previous question – letter n).