Financial Markets and Information Systems

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Table of Contents

Classification of Financial Market Players 3
Actors 5
Mutual funds 5
Hedge funds: tools and strategies for alternative investments 8
Other Funding Mechanisms 11
Shadow banking 11
Tools for Substainable Finance 14

Classification of Financial Market Players

Classification of players by supply and demand for capital

As the capital market is the place where the supply of capital, provided by investors, meets demand, coming from issuers, as an initial approach capital market players can be broken down into the following three main categories:

- Issuers
- Investors
- Intermediaries

With regard to the role played by intermediaries, that of facilitating contact between investors and issuers, economic theory distinguishes between financing provided through bank loans, so-called "intermediated" financing, to financing through the issuance of securities, "disintermediated" financing.

In the first case (intermediated financing), the resources of agents with a financing capacity (deposits, in particular from households) are made available via banks to agents with financing requirements (companies). The crucial role of banks in this regard is to enable the short-term time horizon of the first group to be transformed into the long-term time horizon (investment) of the latter.

In the second case, agents with financing requirements capture public savings directly through the issuance of securities (stocks and bonds), which are acquired by agents with financing capacity. The description "disintermediated" used for this form of financing is somewhat misleading as intermediaries operating in this second situation are in fact more numerous and diverse than in the previous case, and once again the banks play a central role!

Classification of players by supply and demand for financial products

From the standpoint of the players themselves, the dichotomy is more in terms of supply and demand for financial products. One refers to the "sell-side" and the "buy-side". The sell-side comprises players that originate the products: investment banks which evaluate them through the work of financial analysts, and those that distribute the products, the brokers. The sell-side therefore aims to capture investments and works on behalf of issuers. This category of player is behind financial innovation and remunerates itself through commissions or margins on the transactions it originates.

The "buy side" comprises players that are prepared to buy these same products: pension funds, mutual funds, insurance companies and hedge funds. The buy-side therefore represents investors who wish to build up a portfolio of assets, increase its value and who are remunerated from this activity.

This distinction, more technical, but in common use among professionals, has the disadvantage of focusing very little on the issuers themselves. Furthermore it can generate confusion for the neophyte as the "sell-side" is often represented by so-called "investment" banks, which given the definitions presented above, ought to be on the other side!

In reality, investment banks work on both sides of the divide. They are at the origin of the issuance of financial products, but also acquire such investments in the context of managing their equity capital. This is why, to avoid conflicts of interest detrimental to customers, investment banks are required to create "Chinese walls" between their buy-side and sell-side activities[1].

A wide range of roles assumed by versatile players

As we have begun to see, it will often be impossible to place an institution within a specific category. Ultimately, a universal bank operates everywhere at the same time: it issues securities to cover its own financing needs, assists companies in obtaining financing, or finances them directly via loans or investments. Through the provision of means of payment, the keeping of securities and cash accounts, or through its brokerage or asset management subsidiaries, it plays an essential intermediary role in financial markets.

This is why on fimarkets we will be emphasising well-defined "roles", recognizing that a "player" can often play several roles depending on the particular situation. However the presentation will always focus on financial markets as a whole. Roles exercised within each institution will be dealt with in another section of the site devoted to "functions".

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1. On the difference between "Buy-Side" and "Sell-Side": see this article in Investopedia

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Actors

Mutual funds

Note: this page deals principally with mutual funds as known in France , but most of the principles explained can apply to all European professionally managed collective investments. At least, it may provide useful information to anybody who needs to know how mutual funds are managed in France .

Definition

Mutual funds (known in France as OPCVM, Organismes de Placement Collectif en Valeurs Mobilières = often referred to as UCITS or mutual funds) are companies or quasi-companies whose purpose is to invest the capital subscribed by investment unit holders in financial markets. A mutual fund is thus a manager of collective investment funds, as distinguished from:

- proprietary asset management: the mutual fund invests money collected from third parties (third-party asset managers) and not its own money (proprietary asset management).
- management under mandate: the mutual fund invests the collective funds belonging to a number of third parties and not a single third party (private wealth management).

The liability side of a fund's balance sheet includes capital provided by subscriptions of unit holders.

On the asset side, a mutual fund includes the financial instruments it holds.

Liabilities

Mutual funds' liabilities are broken down into units held by subscribers who are thus the fund's shareholders. Each time an investor subscribes to the fund, the latter issues, in exchange for the subscription amount, new units of which the investor becomes owner. A mutual fund share constitutes a transferable security identified by an ISIN code whose issuer is the mutual fund's management company and whose price is the net asset value.

Assets

Funds use fund-holder money to invest on markets. The fund's assets include all securities held (e.g. equities, bonds, negotiable debt instruments, derivatives, etc.). The fund manager does not have total freedom to invest as he pleases: he operates within the framework laid out by market regulations and the management guidelines defined at the fund's creation.

Net Asset Value

The fund's assets value vary continuously depending on changes in the prices of the financial instruments held. The total of assets held based on the day's prices, divided by the number of units issued, equals the fund's unit NAV (Net Asset Value) or unit value.

As such, the liability side of the fund's balance sheet equals the number of units issued times the value of each unit, the unit NAV. There are two main reasons why the value of the fund's liabilities changes constantly. First, the number of units issued changes depending on unit subscriptions and redemptions. Second, the value of units is continuously changing. One well-know French fund variant is the SICAV (Société d'Investissement à Capital Variable = open-end investment company with variable capital).

How it works

The fund "lives" in the following manner:

Equity is built up by subscription from final investors who receive unit shares in exchange for the funds they bring. One or more units are created with each new subscription.

At the same time, the investor may redeem the amount invested plus or minus any increase/decrease in the fund's NAV since his investment. Each buyback has the effect of destroying one or more fund units. Subscriptions/redemptions are

made at the liquidation price on the day the order is executed.

Certain funds are listed every day, i.e. net asset value is calculated daily. Others are listed just once a week or even once a month.

A fund may have a “known” price, i.e. the NAV on day D is calculated on Day D. Such is the case with equity funds. Subscription/redemption orders may be executed the same day they are received in this case. But a fund may also have an “unknown” price. In such a case, the NAV is known on D+1 or even "very unknown," becoming known only on D+2. The execution of subscription/redemption orders for these funds is held off until the next day or the day after the next day following reception of the order.

The fund's asset value depends on the investment decisions made by the investment management company and its portfolio manager. It operates on regulated markets via investment management companies or via brokers on over-the-counter markets. The execution and settlement/delivery of transactions fall under the responsibility of the fund's custodian bank.

French funds categories

Collective investment management operates under the principles set by a European directive defining UCITS (Undertaking for Collective Investment Schemes in Transferable Securities). Not all funds issued conform to this regulatory framework, which is not adapted to the new asset management trends (e.g. hedge funds).

Mutual funds can be classified according to their legal structure:

- SICAVs (Société d'Investissement à Capital Variable = investment company with variable capital) have legal personality.
- FCPs (Fonds Commun de Placement = open-ended collective investment funds) without legal personality unlike SICAVs and with lower minimum capitalisations.
- FCPE (Fonds Commun de Placement d'Entreprise = company employee savings plan) are used exclusively for employee savings.
- FCPRs (Fonds Commun de Placement à Risques = French Venture Capital Fund) and FCPI (Fonds Commun de Placement dans L'innovation = tax-incentive high-tech venture capital funds) are partially invested in unlisted companies

Mutual funds can also be classified according to their investment focus which also defines their risk profile:

- Shares, which may be specialised by regional area, size of companies, sector,
- Money market: invested in negotiated instruments and deposits (debt instruments)
- Bonds.
- Diversified instruments.
- Formula funds: the management target backed up by a guarantee, generally speaking, on the capital invested.
- Fund of funds (multi-management): these funds invest in other funds' units.

Mutual funds can be differentiated according to management style:

- Active management for the manager consists of choosing in a discretionary way from a large selection of securities that meet the requirements of the fund's profile. The manager may make use of derivative products to hedge against portfolio risk.
- Passive or index management consists of mimicking a benchmark index. This style was created in recognition that over a long period, active managers do not outperform the market.
- Exchange-traded funds (ETFs) are funds index-trackers listed on the stock market and therefore negotiable, unlike usual funds.
- Alternative or hedge funds apply a very targeted strategy with an absolute performance goal.

Role of the various players

Given the numerous investment management players, it is often hard to figure out who does what. First, it is important to note that (at least in France) third-party asset management must be organisationally separated from proprietary investment management, in accordance with market regulations. That is why major banks and insurance companies all have separate asset management subsidiaries, often with the AM (Asset Management) added to the company name.

Asset management is increasingly developing from an internal banking service into a specialised outsourced activity. The increasing sophistication of computer systems and technology has made fast trading and order processing a key

strategic factor in what has become a real industry.

Marketing

Banks have traditionally relied on their branch office network to market their funds (attracting new subscribers). There are also entities that specialise in the marketing funds: these are calles funds distributors.

Liability management

Liability management consists of centralising subscription/redemption orders and keeping the mutual funds accounts.

The transfer agent is the intermediary responsible for centralising subscription/redemption orders and proceeding to exchange funds for subscribed fund units. This exchange, which is a settlement/delivery operation, can be made directly with the fund issuer but many use Euroclear France in France (the French central securities depository).

Custodial management consists of constantly updating the number of funds units issued which, as we noted earlier, changes continuously.

The registrar job in English-speaking countries, where its role is much larger, is referred to as transfer agent. The transfer agent sets up a support structure for distributors. It really acts as the interface between funds and distributors, collecting and executing subscription/redemption orders, keeping positions of external distributors, calculating and recording fees due to them and producing reports to business finders.

Asset management

The fund manager's goal is to make investment decision and take market positions with a view to generating a return on assets under his management. This is a front-office function.

He is aided in this process by financial analysts whose role is to collect information on and relating to listed companies in order to make investment recommendations to investment managers.

Administrative management and accounting

The administrator and accountant manages the fund's trading desk and back offices. It records transactions, forwards settlement/delivery instructions to the depository agent, keeps track of positions and monitors risk.

The account manager is also responsible for calculating the fund's NAV except in those cases where the task is outsourced to a specialist service.

Depository bank

In France the function of the depository service is governed by the AMF (Autorité des Marchés Financiers) which defines its role and obligations in a detailed specifications file. The reader can consult the fund depository services' purpose and functions at the following Web page: [Depositaries of UCITS and AIFs]

The depository bank creates a precise file on the fund including documents approved by the AMF during the fund's creation (authorisation, information note).

The depository bank ensures the settlement/delivery and custody of fund assets. It maintains custody of fund assets, keeps up-to-date security and cash accounts, receives settlement/delivery orders and executes them in conjunction with the central security depository or local foreign sub custodians and informs the fund of securities transactions or other events on its portfolios and processes them.

The depository bank monitors the regularity of the fund's investment decisions (See Function of depository monitoring or trustee, below).

Moreover, the depository bank may take responsibility for the fund's liability management, although not always.

Depository monitoring or Trustee

The depository's monitoring consists of verifying the regularity of the fund's investment decisions and the calculation of NAV. The mutual funds activity being strictly defined in France and the rest of Europe, trustees play an important role

and include many tasks.

Verification includes ensuring compliance with market regulations with respect to asset breakdown and risk distribution (particularly issuer risk).

Verification of the fund's situation means verifying that its investments are in compliance with its management goals as described in its information note.

The depository monitor also verifies the fund's calculation of NAV.

He verifies the documents produced by the investment management company: annual reports, financial statements, periodic reports.

Fund accountant

The calculation of NAV is a complex process because it involves finding/determining a price or calculating a value for each fund asset. These can be numerous, and they may include exotic products or unlisted securities in the case of OTC instruments.

The fund accountant uses calculation tools to propose numerous value-added services to the fund, including reporting, analysis and performance attribution.

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Hedge funds: tools and strategies for alternative investments

Hedge fund management

Hedge fund management refers to a highly varied assortment of strategies to manage assets on well-defined market niches. Hedge funds strive to generate absolute, preferably stable, performance levels, uncorrelated with the general market trend, while minimising risk of loss and protecting the invested capital. Below we review some examples of hedge fund strategies.

Hedge fund tools

Selling short consists of selling underlying securities without actually owning them in the hope of buying them later at a lower price. In order to do this, the manager borrows these same underlyings on the period covered by the contract. (When securities are lent, ownership is transferred to the borrower who then has the right to sell them; he must simply make sure to acquire the same quantity of these securities at the time he must return them!).

Arbitrage consists of taking advantage of unwarranted price spreads: for example, by buying convertible bonds that appear to be undervalued while shorting the underlying share.

The search for **leverage** consists of borrowing cash to bolster the effective size of the portfolio (initially formed with funds brought by investors).

Derivatives (options, futures or forward contracts) are frequently used, either for speculative reasons or to hedge against portfolio losses.

Hedge funds also use microeconomic and macroeconomic **research** with a view to flushing out fundamental trends in the economy or financial markets, or to identify high-potential or struggling firms.

Strategies

Risk/return ratios vary enormously among the different hedge fund strategies. There are many different descriptions of hedge fund strategies. For more information, see: http://www.magnum.com/

Convertible arbitrage entails the investment in convertible bonds that are inefficiently priced on the market. This strategy typical entails the simultaneous purchase of convertible bonds and the short sale of the same issuer's ordinary shares.

Long/short equity consists of taking simultaneous long (buy) and short (sell) positions on selected equities belonging to the same sector or regional zones, with either a market-neutral or long or short bias. It requires full mastery of stock-picking tools.

The **global macro** manager seeks to profit from shifts in the world economy, notably changes in interest rates stemming from governmental economic policies. He/she uses an assortment of instruments or assets as a function of the world economic situation: currencies, indices, yield curves, commodities, etc.

A **fixed-income arbitrage** manager strives to take advantage of shifts and discrepancies in the yield curve. He/she makes use of Treasury securities, futures and rate swaps.

Merger arbitrage is a strategy based on the spread between the announced purchase price and the price at which the target company is actually trading.

In an **event-driven** strategy, the manager seeks to exploit special events that unlock the value of companies: business spin-offs, mergers or distressed securities.

The **emerging markets** manager invests in developing markets. This is a very high-risk strategy, because hedging instruments are not always available on this type of market.

These are the most popular strategies, but there are others.

Hedge funds

A hedge fund operates much like a UCITS or mutual fund, but is unregulated common fund, and therefore has much more investment leeway. Unlike traditional funds, hedge funds performances are uncorrelated with general share or bond market trends.

Note: to hedge means to cover one position by taking another, symmetrical position. This does not mean that all hedge funds follow no-risk strategies; such an approach would prevent them from achieving their performance goals.

The hedge fund field is highly technical and its managers are generally very experienced, independent-minded and often invested in the funds they manage. Fund managers are generally compensated on fund performance.

Because hedge funds base their strategy on a single approach and may make ample use of derivatives, they do not fit traditional mutual fund categories. Hedge funds face little regulatory oversight: they are popular in the United States and offshore sites. A hedge fund generally focuses on a single strategy, which is why there are as many types of hedge funds as there are strategies.

Hedge funds attract wealthy and well-informed investors, due to their positive performances on both growth and slumping markets.

Fund of hedge funds

A hedge fund is expected to focus on a single strategy and consistently stick to it: This is a matter of transparency, and one of the risks of investing in a hedge fund is precisely that of style drift, should the initial strategy not pan out.

The performances of hedge funds vary widely. Since volatility is often high, an investor may seek out a fund offering less return but greater stability, as well as the ability to pull out at will.

Funds of hedge funds were created to meet this need. Managers invest the funds collected in a basket of hedge funds representing the range of known strategies. Despite what one might think, this does not entail creating a sort of melting pot of funds and then letting each manager run his/her fund. A thorough research and financial engineering effort is required to select the fund managers, evaluate risk levels and determine the asset weight of each fund.

One characteristic of charted hedge fund returns is that they never rise as much in times of growth or decline as steeply during downturns as a chart of market returns.

On the Web

A number of highly informative articles can be found at the following sites:

- The hedge funds association: http://www.hedgefundassoc.org/
- HedgeCo.net: http://www.hedgeco.net/
- Magnum funds: http://www.magnum.com/

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Other Funding Mechanisms

Shadow banking

Definition

Shadow banking refers to non-bank financial intermediation activities taking place outside the regulated banking system.
The term shadow banking emerged during the financial crisis of 2007-2009. The origins of the downward spiral in which the markets and banks found themselves in, stemmed from securitisation activities and was fuelled by, among other things, money market funds, two of the activities linked to shadow banking.

Financial (Banking) Intermediation

In order to better understand shadow banking, one needs to first of all explain what banks do. Banks carry out financial intermediation: they transform their financial sources (liabilities) into assets, mainly through loans with different characteristics. This transformation may include several criteria:

- **Maturity**: structurally, the bank finances its assets with shorter-term maturity liabilities.
- This also means that **leverage is used extensively**, which increases profits (return on equity) by relying on debt.
- **Liquidity**: the bank finances illiquid assets, for example loans, with liquid liabilities like certificates of deposit and current accounts.
- **Risk**: Through its assets the bank assumes the risks on behalf of its depositors and creditors, in particular credit risk.

These characteristics, which are very specific to the banking business, may expose the bank to the risk of a bank run. If all the depositors arrive at the same time to make withdrawals of the assets in their accounts, a commercial bank can find itself insolvent from one day to the next. An investment bank can also find itself in great difficulties if it cannot obtain interbank refinancing. This was the case for Lehman Brothers ' failure.

Because of its key role in financing the economy and the fact that it draws on public savings to finance itself, the banking business is highly regulated and benefits, in exchange, from certain guarantees.

- The regulation, as defined by the Basel Committee imposes strict constraints on banks as regards the structure of their balance sheets: solvency ratio, liquidity ratio and leverage ratio. The solvency ratio depends directly on the level of risk taken on by the bank.
- Commercial banks contribute towards a deposit insurance fund (deposit guarantee scheme) that will in the event of default by one of them, compensate depositors up to a ceiling as defined by law.
- Finally, banks have the possibility of obtaining financing from the central bank, who plays the role of « lender of last resort » in the case of a crisis of confidence in the interbank market.

These elements will help us to further clarify the definition of « shadow banking ».

Shadow banking covers all financial intermediary activities (credit risk transfer, maturity transformation and or liquidity and leverage) operating outside the regulatory framework of banking activities and therefore not subject to the constraints and also not covered by the guarantees offered to the banks, but exposed to a major liquidity risk.

Activities

A certain number of activities are clearly within the « shadow banking » scope of designation.

Securitisation

The securitisation SPV (Special Purpose Vehicle) finances illiquid assets and debts with liquid liabilities and securities (CDO, MBS, RMBS) sold to institutional investors. If the default rate on securitised debt exceeds the threshold laid down, the SPV will not be able to meet its payment obligations for securities that have been issued, thereby penalising

investors' profitability.

Hedge funds

Hedge funds employ complex strategies that are difficult to unwind rapidly. Their success depends on their funding (financial) stability but also on a certain lack of transparency. In the case of loss of confidence, they have to rapidly meet massive demands of reimbursement by their investors. Plus, hedge funds use leverage extensively, which enables them to increase profitability of return on capital invested when the markets are rising but also exposes them to large risks in the case of falling prices.

Repos and Securities lending

The case of repos and securities lending is somewhat unusual as it concerns unregulated activities that are carried out by regulated or unregulated entities and not any entity in particular. This over-the-counter market (off-exchange trading only) is based on the value of assets used as collateral for the operations. If there is a loss of confidence for these assets considered as toxic, as was the case during the subprime crisis, the repo market is immediately blocked. And therein lies the problem, as it is precisely via the repos that banks can obtain refinancing from the interbank market.

OTC derivatives market

This is yet another unregulated, off-exchange trading activity that is carried out by regulated entities. The CDS market in particular was at the heart of the financial crisis. This market creates a sequence of credit risk transfers that can be potentially explosive in the case where a default occurs along the chain. The the listed or OTC derivatives derive their value from the underlying assets but the market far exceeds the size of the actual (real) assets. It's a market where leverage comes into full play and as always in both directions. However, this market is being pushed out of shadow banking and into the spotlight by the Dodd Franck and EMIR regulations (see below)

Money market funds

Money market funds invest in reputable securities such as Government securities and guarantee holders a 100% reimbursement of the amount invested. Investors can « park » their cash while waiting for a better opportunity. It pays low returns but there is no risk of loss in value. However, once again this commitment can only hold as long as investors have confidence in the quality of the assets held by the funds. So, if the fund has to meet massive payoff requests on its liabilities and if at the same time there is a fall in the value of its assets, it will find itself in trouble rapidly.

The list of the type of activities that fall under shadow banking should certainly not be regarded as restrictive. On the contrary the FSB (Financial Stability Board) wishes to carry out ongoing monitoring of any type of activity that is similar to a banking activity but is carried out by non or barely regulated entities or within an unregulated framework. This is how commodity brokers appeared on the FSB radar a while ago.

Entities and activities that are not exposed to the risk of massive withdrawal (bank run) on their liabilities are not part of the shadow banking system. These are pension funds, insurance companies and most of the investment funds.

The risks

Literature acknowledges some theoretical advantages regarding the existence of shadow banking. It offers intermediation means that are inaccessible to banks or counterparties that do not have access to bank financing. It makes it possible to disperse risk instead of it being concentrated entirely on banks.

The risks are as real and described in a better way.

If these activities were run in parallel to traditional financing, i.e. with no link between them, there wouldn't really be a problem. This is obviously not the case and anyway we can't really see how it could be possible or even desirable. Banks, institutional investors and « shadow banking » make up a network of relationships and dependencies that are sometimes difficult to assess. Shadow banking activities are either directly carried out by banks (repos, OTC derivatives), or indirectly via subsidiaries (money market funds) or financed by banks (hedge funds) or on the contrary they finance them in turn (securitisation). As for institutional investors they contribute to the financing of shadow banking by purchasing assets it issues (securitisation) or through lending (repos, securities lending), or even by being themselves a part of shadow banking (hedge funds).

Also, due to shadow banking's extensive use of leverage it plays a **pro-cyclical** role, which tends to accelerate the

granting of credit and price increases in periods of expansion and to generate downward spirals during economic contraction.

Finally, as shadow banking concerns poorly regulated entities or activities it is very difficult for the regulator to grasp its volume, the strategies it uses and the dependencies it creates. It's a market that lacks transparency but that is nevertheless legal.

The interdependence, opacity, pro-cyclical effects together with the bank run risks that can rapidly contaminate the whole of an activity (securitisation, CDS, money market funds, the interbank market…) indicate that shadow banking could be the next spark that sets off the fire. In short, shadow banking is an important source of **systemic risk**.

The size of the shadow banking system

The FSB estimates that shadow banking (excluding OTC derivatives) was worth $67 trillion (one million millions) end of 2011, which is roughly the global GDP. The share of shadow banking in financial intermediation has decreased by about 25% after peaking at 27% just before the crisis. Assets held by shadow banking represent more or less half of the assets held by the banking system. The United States has the largest shadow banking system ($23trillion), followed by the Euro zone ($22 trillion) and the United Kingdom ($9 trillion).

Regulation

So what does the regulator do? In fact he is not inactive. Even though regulatory changes take a while to be defined and applied, the time of benign neglect is over. One of the G20 objectives that the FSB and the Basel Committee have been entrusted with is to increase transparency and regulation in shadow banking. There is more information about the proposed reforms in the FSB documents that can be found via the hyperlink at the end of this article.

OTC derivatives will have to progressively move towards more transparency and security via reforms like the Dodd-Franks in the USA and EMIR in Europe.

Hedge funds are increasingly regulated in Europe since the implementation of the AIFM directive.

The Basel Committee has defined an additional capital asset requirement concerning banks' exposure to non-regulated entities (i.e. shadow banking) and aimed at preventing systemic risk. On this subject, it should be noted that although the crisis well and truly stemmed from shadow banking, the first reforms and the ones with the most constraints were aimed at… the banks!

The FSB proposes a certain number of measures aimed at securing shadow banking activities:

- The probability of huge sell-offs (runs) on money market funds will be limited by the new prudential rules. From now on funds must float their net asset values like any other funds and redemption limits have to be defined in the event of a crisis.
- Regulation control of securitisation has also increased with the requirement, in particular, that banks retain some of their securitisation issuances on their balance sheets.
- Rules defining haircuts on collateral are aimed at reducing procyclicality on repos and securities lending transactions.

Naturally, all these prudential regulations are **recommendations** that have been defined internationally so they have to be transposed into each country's or economic zone law before being effectively implemented. This implementation must go through the Basel Committee and the banking regulation authorities (EBA, central banks in Europe) as far as banking regulations go (capital requirements in particular) and through the IOSCO and then the markets authority (ESMA in Europe) as far as market activities are concerned: regulation on securitisation, repos and money market funds.

Conversely, certain interventions by the regulator like the separation of banking activities into classic commercial banks and proprietary trading activities could have the contrary effect of moving activities that were in fact previously kept under the eye of the regulator, as they were present in the bank's balance sheets, into the non-regulated sector.

In a broader sense, the FSB does not intend being surpassed by the events as it exercises monitoring on a constant basis via the national and transnational regulation authorities, not only to evaluate known shadow banking activities but also to detect new potential sources of systemic risk.

Of course one could question the degree of efficiency of these measures, which are proposed by the authorities and by definition always a trifle late. Also, implementation of these measures comes up against powerful lobbies that do all they

can to strip them of their substance. Nevertheless to endorse what one can often read or hear about “governments that don’t do anything” is rather simplistic. The fact that these actions are not sufficiently clear to the public is without doubt partly due to the fact that it is not the governments who are in the front line but supranational bodies like the Basel Committee, ESMA… or national bodies like AMF and ACP, which are non-elected and playing little-known roles.

To find out more

Have a look at the FSB documents on shadow banking via this hyperlink:
http://www.financialstabilityboard.org/list/fsb_publications/tid_150/index.htm

Also, an article on the BCE website "Enhancing the monitoring of shadow banking"

For an informative presentation, this speech by Timothy Lane, Deputy Governor of the Bank of Canada: "Shedding light on shadow banking".

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Tools for Substainable Finance

With climate change, finance just as other economic sectors has no choice but to become sustainable. But using which tools?

What is the point of sustainable finance?

There are various definitions of sustainable finance. In this article we have opted for a definition that is straight to the point:

> Sustainable finance is broadly defined as the whole range of financial instruments and mechanisms for sustainable development.

In the eye of the general public finance suffers from its image as a soulless entity driven exclusively by profitability. Let’s break with convention for a moment: it is precisely this purely rational vision that is its force and of interest to us in this context… as long as the "extra-financial"[1] criteria: human costs and environmental costs, are correctly reintegrated in the long-term profitability studies.

And that is exactly what is happening, spurred by institutional investors such as insurance companies. Here is what Henri de Castries, CEO of AXA, has to say about the matter:

"*We do not have the choice: a world +2°C warmer could be insurable, but a world at +4°C would certainly not be.* "

Sustainable finance as a sort of "gentle" financing, intended to meet the demands of a few hipsters eager to ease their conscience by investing their money in an "ethical" and "responsible" way? This is over. The purpose of finance is ***to optimize the allocation of disposable income to financing needs.*** From now on the environmental aspects will form part of the optimality criteria.

This also means that finance can no longer be considered as an enemy of sustainable development but instead as a powerful means to facilitate energy transition… as long as the right tools are targeted, because it is true that the tools for sustainable finance continue to coexist with those for "mainstream" finance.

Rating the issuers: SRI labeling and sustainable indices

Handing out awards: SRI labels

Keep these two acronyms in mind: **ESG – Environmental, Social and Governance criteria** – and **SRI : Socially Responsible Investment.** For an asset manager SRI means including ESG criteria as part of the selection process of

issuers.

Note the extra-financial and therefore intrinsically non-measurable – and claimed as such – selection criteria (impact on the environment, social policy, governance). Also, the mix of ethical, social and environmental criteria undermines transparency for the investor. The recent (November 2015) AMF report on Socially Responsible Investment points out the "diverse and difficult to grasp" nature of the approach. Especially, the coexistence of SRI funds and "conventional" funds in companies that offer both, raises questions: how much of the offer is truly socially responsible, as opposed to tactical marketing and in other words just greenwashing? Well, in any case let us not forget that "hypocrisy is the homage vice pays to virtue"[2]!

In order to have a clearer picture let us take a look at an outside source like Novethic. Novethic awards an "SRI fund" label to a UCITS that takes into account ESG criteria when selecting portfolio issuers. This label certifies that the SRI approach is not merely a secondary factor in portfolio management.

The SRI uses various methods to select issuers, the best known being the ***best-in-class approach***. Admitting that it is not possible to totally exclude certain controversial issuers, the idea is at least to select the "best bidder" (or the least worst one) in each category or sector, in terms of environmental, social and governance criteria.

Promoting healthy rivalry: sustainable indices

This "best-in-class" approach is used by sustainability indices, such as the Dow Jones Sustainability Index (DJSI), which gathers a family of such indices. In order to compile these indices, one of its promoters, RobecoSAM, publishes an annual review of the 3,400 largest global companies based on extremely comprehensive ESG criteria. The methodology and results are presented in detail on this website: http://www.sustainability-indices.com/.

As far as environmental criteria are concerned, the questionnaire stresses the importance of the company’s transparency in this area, and the presence of quantitative measures enabling the assessment of its environmental impact.

As the indices gather best-in-class companies in each category, the approach promotes a healthy rivalry between the largest global issuers[3] who are encouraged to strive for a spot on the index and then to maintain it. It is worth noting that Volkswagen was immediately removed from the index in October 2015. The latest annual review, which included Volkswagen, had just been published!

The European equivalent is proposed by Vigeo who uses a similar assessment method. Vigeo is also a rating agency that measures the ESG performance of companies, states and public organizations. There is also a special carbon index, the "Low Carbon 100 Europe", developed by Euronext.

Financing green growth: green bonds

Green bonds enable investors to finance projects or activities from companies, local authorities and international organizations that have ***direct environmental benefits***: renewable energy, energy efficiency, climate change adaptation, etc. Issuers adhere to the "Green Bond Principles", whereby they commit to inform investors on the "green"use of the collected capital, not only in the bond issuance prospectus but also over the entire bond lifecycle.

Green bonds only represent 0.5% of the global bond market but investment figures tripled in 2014 and continued to increase in 2015.

Integrating the cost of pollution: emission allowances

In the absence of a regulatory framework, companies and consumers only internalize their direct costs. The externality problem of greenhouse gas emission (GHG) is therefore not taken spontaneously into account. The economic analysis calls for regulation by means of two regulation tools: carbon tax or emission allowances.

It appears that emission allowances are politically easier to implement. The European Union pioneered the implementation of GHG emission allowances. In terms of regulation, governments set a limit or cap on the quantity of carbon dioxide that can be emitted and allocate a certain number of emission permits to companies that are subject to the emission allowances. At the beginning of the year companies are handed out a certain number of allowances corresponding to their objectives. By the end of the year they must return the number of allowances equivalent to their actual emissions during the year.

Companies who have emitted less GHG emissions than expected thus have a surplus of allowances that they can sell to those who have exceeded their objectives via an energy trading platform on dedicated markets such as the EEX. By

acting on the number of allowances in circulation, governments exert pressure on prices in such a way that it is actually more profitable for companies to invest in reducing emissions than to buy allowances.

Emission allowances and the related markets are tools for businesses. There are other tools more appropriate for the general public, such as the CO_2 compensation platforms, which are still confidential but could develop in the future.

Financing, is it the problem or the solution?

According to a recent survey by the Paris Europlace Sustainable Finance Committee, "52% of private investors say that they consider environmental, social and ethical criteria as important or very important when making investment decisions" – but "94% said they had never heard of the SRI and would not know how to define it"! And yet according to institutional investors, "the SRI approach helps investors reduce their risks thanks to the extra-financial criteria that are taken into account".

Finance is changing. Driven by the principle of reality, it is far removed from the incantatory speeches of NGOs that sometimes make you wonder if they don't want to abolish finance instead of trying to understand how it works. As investors we also have a role to play. Besides waste sorting and carpooling we should also ask ourselves where we should place our money!

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1. What economists call the « externalities»: all the human (health) and environmental (pollution) costs engendered by a company and borne by society.
2. La Rochefoucauld
3. Meaning "issuers that emit financial instruments » although there is a good chance that these major companies also emit large quantities of greenhouse gases!

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