19 May 2011

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002, Basel, Switzerland

Submitted by email to: fsb@bis.org

Re: FSB background note “Shadow Banking: Scoping the Issues”

JPMorgan Chase & Co. (JPMC) is pleased to provide comments on “Shadow Banking: Scoping the Issues – A Background Note of the Financial Stability Board” (the Shadow Banking paper, or the paper). We support the Financial Stability Board’s (FSB) phased approach to identifying the appropriate regulatory measures with respect to shadow banking.

JPMC has been consistently supportive of efforts to improve the stability and effectiveness of financial markets. We note the Shadow Banking paper highlights the need to consider appropriate regulatory measures to address systemic risks and regulatory arbitrage caused by the shadow banking sector and we endorse this objective.

We believe that some of the policy actions being taken or contemplated with respect to regulated banking activity, especially regulations related to capital and liquidity, may drive certain activities towards the shadow banking system, raising competitive issues for traditionally regulated banks. In this context, we believe regulators should apply similar prudential standards to sectors of the shadow banking system, where necessary and appropriate, to avoid undue competitive distortions and regulatory arbitrage. This may be particularly important where shadow banking entities (either individually or collectively) are seen as systemically important.

In the following paragraphs we provide brief comments on the three sections of the Shadow Banking paper.

A definition of “shadow banking system”

JPMC supports the FSB’s two-stage approach in defining the “shadow banking system”. The shadow banking system should cover traditional ‘banking’ activities carried out in unregulated or lightly regulated entities, with specific reference to prudential regulation. The paper suggests that the focus in the second stage should be on a narrow set of activity covering “maturity/liquidity transformation and/or flawed risk transfer and/or leverage” within the credit intermediation chain, and suggests that securitization is ‘flawed risk transfer’. We believe that the scope of shadow banking should cover both credit and risk intermediation that occurs outside regulated banking entities, and should encompass lending, investing and other risk intermediation activities.
Further, the paper seems to suggest that securitization is ‘flawed risk transfer’ and we do not believe that to be an accurate description of securitization activity. Securitization provides the financial system with an effective and transparent means of funding the real economy. A significant number of regulatory initiatives have been undertaken in the last few years with an aim to strengthening the risk management and transparency of securitization activity in banks.

**Potential approaches for monitoring the shadow banking system**

Macro-prudential monitoring of the shadow banking system, supported by entity / activity level monitoring where appropriate, is a reasonable approach in developing an understanding of the risks in the system. We believe that supervisors should focus on rapid increase in leverage in the unregulated sector as this may be an indicator of increased systemic risk, and this may also be a consequence of the increased prudential requirements on regulated banks driving activity to the shadow banking sector.

**Categorisation of the possible regulatory measures for the shadow banking system**

We believe that a proportional regulatory framework should be developed for the shadow banking system including, where appropriate, prudential standards and macro-prudential supervision to address the systemic risk contribution of the shadow banking sector. Banks’ interaction with shadow banking entities is already the subject of prudential regulation, which the paper refers to as ‘indirect regulation’. Indirect regulation of shadow banking has been increased with higher capital charges on banks and an increased focus on risk management and measurement. We think the indirect regulation needs to be complemented with regulatory measures focusing on those aspects of shadow banking which contribute to systemic risk or create competitive inequity.

In conclusion, we believe that the FSB should consider the following guiding principles when determining their recommendations to the G20 Leaders.

- The supervisory and regulatory frameworks should be adapted to avoid inconsistencies and prevent arbitrage between traditional and shadow banking sectors.
- In determining systemic risks and interconnectedness, including systemic risks ascribed to individual banks, the contribution of the shadow banking sector to systemic risks should be considered.
- In light of the fluid nature of shadow banking structures / entities, any framework developed should be flexible enough to focus on the wide range of activities in the sector and address the regulatory arbitrage concerns.
- The scope of shadow banking should encompass all activity that could cause systemic risk, which could include risk intermediation activity in addition to credit intermediation.

We would welcome the opportunity to discuss issues related to shadow banking with you.

Yours sincerely

[Signature]