Green Paper

SHADOW BANKING

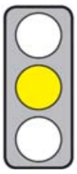
cep **Policy Brief** 2012-27 of 25 June 2012

Centrum für Europäische Politik

KEY ISSUES

Objective of the Green Paper: The Commission defines which entities and activities are regarded as "shadow banking" and presents first reflections as to how to regulate them.

Parties affected: Banks, insurance companies, money market funds, hedge funds, investment funds, special-purpose undertakings, exchange traded funds, finance companies and supervisory authorities.



Pros: (1) The main focus of the Green Paper is quite rightly systemic risks, as problems in shadow banking can trigger banking crises.

(2) The available data on the activities of shadow banking entities is to be improved.

Cons: (1) The term "shadow banking" is misleading, for many shadow banking entities are already covered by various Directives and Regulations.

(2) The rules for preventing the abrupt withdrawal of capital from money market funds ("runs") should take account of the differences between CNAV and VNAV funds.

(3) The legislator and not the supervisory authorities should determine the supervisory concept for shadow banking.

CONTENT

Title

Green Paper COM(2012) 102 of 19 March 2012: **Shadow Banking**

Brief Summary

► **General and background**

– During the G20 Summit in Seoul in 2010, the Financial Stability Board (FSB) – an international organisation that coordinates the national financial market supervisors and issues recommendations for regulations – was given the task of developing recommendations for enhanced regulation and oversight of shadow banking (p. 2). The European Commission's current Green Paper takes up key aspects of the FSB report of October 2011.

– The FSB defines shadow banking as a "system of credit intermediation that involves entities and activities outside the regular banking system" (p. 3). The FSB estimates the size of the global shadow banking system at around € 46 trillion in 2010, which is "half the size of bank assets" (p. 4).

– According to the Commission, shadow banking "has not been the prime focus of prudential regulation and supervision", although there is a danger of "systemic risks" and tighter banking regulation drives business transactions towards shadow banking (p. 1).

– In its Green Paper, the Commission mainly addresses four issues:
  - What are shadow banking entities and which activities do they perform?
  - What are the benefits and risks associated with shadow banking?
  - How has shadow banking been regulatated until now?
  - What form should the regulation of shadow banking take in future?

► **Types and activities of shadow banking**

– "At this stage" the Commission deems the following entities as shadow banking entities (p. 43):
  - Money market funds (MMF). These are investment funds that invest in liquid money market papers (short-term bonds with in general a term of a maximum of one year).
  - Investment funds. According to the Commission these include:
    - hedge funds that use leverage and provide credits;
    - exchange traded funds (ETF) that reflect a certain market (e.g. S&P 500, DAX).
  - Finance companies and securities entities that provide long-term credits which are financed through short-term credits taken from the capital market instead of through deposits.
  - Special purpose entities. These are entities affiliated to banks that carry out securitisations. Securitisations bundle several exposures (e.g. credits) and convert them into tradable securities.
  - Insurance and reinsurance undertakings "which issue or guarantee credit products".

– According to the Commission, the main activities of shadow banking are (p. 3):
  - securitisation;
  - repurchase agreements (repo): the purchase and sale of securities subject to the provision that they are resold or repurchased later; and
  - securities lending: lending securities subject to the provision to recapture them or equal securities later.

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- **Benefits and risks of shadow banking**
  - Benefits: according to the Commission shadow banking entities can (p. 5):
    - provide alternatives for investors to invest their monies in funds instead of in bank deposits;
    - channel resources "more efficiently" between different market actors;
    - constitute alternative funding for the real economy compared to bank credits; and
    - diversify risks.
  - Risks (p. 4 and 5):
    - With shadow banking entities with "deposit-like" funding characteristics (e.g. money market funds), there is the danger of sudden redemptions ("runs") by investors.
    - If shadow banking entities (e.g. hedge funds) deal with a high share in leverage, systemic risks are created.
    - Banks can undermine strict banking regulations by pushing certain typical banking operations such as the provision of credits to shadow banking. The Commission sees in this the risk of a "regulatory race to the bottom".
    - As shadow banks can be closely linked to regular banks, there is the danger of mutual congestion, in particular in times of crisis.
- **Existing provisions to regulate shadow banking**
  - **"Direct regulation" of shadow banking**

    According to the Commission, direct regulation concerns provisions directed solely at shadow banking entities (p. 9). This includes the following provisions:
    - MMF and ETF "may be" covered by the existing legislation on undertakings for collective investment in transferable securities (UCITS, 2009/65/EU, s. CEP Policy Brief). In addition, the European Securities and Markets Authority (ESMA) has developed guidelines regarding the definition of MMF which entered into force on 1 July 2011. (p. 10)
    - Alternative investment funds (AIF) – including hedge funds – are regulated by the Alternative Investment Fund Managers Directive (AIFMD, 2011/61/EU, s. CEP Policy Brief). It requires that the manager of such funds employs a liquidity management system to monitor liquidity risks. Moreover, the stipulated reporting requirements and methods for calculating the leverage make it easier for the supervisory authorities to monitor the funds. (p. 9)
    - Insurance and reinsurance undertakings are regulated by the Solvency II Framework Directive (2009/138/EC), according to which insurances must take account of credit risks in capital requirements. Special purpose companies established by them are subject to the Member States' prior approval. (p. 10).
  - **"Indirect regulation" of shadow banking in banking and insurance law**

    According to the Commission, indirect regulation means a regulation of the regular banking sector covering shadow banking (p. 8). This includes the following provisions:
    - Credit institutions which securitise assets ("originators") and those who manage securities ("sponsors") must, according to the Capital Requirements Directive (CRD II, 2009/111/EC, s. CEP Policy Brief), retain a substantial share of their underwritten risks (p. 8).
    - Pursuant to the Capital Requirement Directive (CRD III, 2010/76/EU; s. CEP Policy Brief) banks are subject to stricter capital requirements where "complex re-securitisations" are affected (p. 9).
    - As of 2015, the Commission wishes to introduce binding liquidity requirements. They are to apply also to "liquidity facilities", which are granted to special-purpose entities at fixed conditions [CRD IV, COM(2011) 452, s. CEP Policy Brief] (p. 9).
    - The Commission intends to subject originators and sponsors of securitisations investing in reinsurance undertakings to risk retention requirements "similar to those" set out in banking legislation. The Commission intends to implement this plan in connection with the implementation of the Solvency II Directive (2009/138/EC). (p. 9)
  - **Enlarging the scope of current prudential regulation to shadow banking activities**

    The MiFID Directive (2004/39/EC) forms the legal framework for the provision of investment services. It is currently being revised [COM (2011) 652 and 656, s. CEP Policy Briefs]:
    - The provisions are to be broadened to cover:
      - exchange traders, who carry out purchase and sales orders within milliseconds per transaction ("high frequency traders"); and
      - further commodity investment firms.
    - A tightening of the transparency requirements for transactions with "non-capital instruments" (e.g. bonds and derivatives) is to make it easier to detect risks in shadow banking transactions. New intervention powers for supervisory authorities are to help curb the risks more easily. (p. 10)
- **New future provisions directed at the regulation of shadow banking**
  - **Data collection and exchange**
    - The Commission wishes to "identify and monitor" all shadow bank entities and their activities, as well as to establish "permanent processes" for the collection and exchange of information between supervisory authorities, the EU Commission, the ECB and other central banks (p. 6).

- The Commission wishes to consult national supervisory authorities on their powers to collect data on shadow banking and, where necessary, issue a draft law at EU level (p. 14).
- According to the FSB, it would be reasonable to allow supervisory authorities to collect data globally and to introduce a "global Legal Entity Identifier (LEI)" (p. 13).

– **Supervision concept:**
  - The "authorities" are to develop a "concept" for the oversight of shadow banking entities and define therein whether supervision is to be carried out at national or EU level (p. 6).

– **Regulation of banks**
  - The Commission wishes to recapture any "flawed" risk transfer from banks to shadow banking entities and their channels of exposures which "limit" excessive "exposure" of banks to shadow banking entities and extend the reporting obligations of banks on these "exposures" (p. 11).
  - In detail, the Commission wishes to (p. 11):
    - assess whether bank-sponsored shadow banking entities are consolidated "appropriately";
    - adjust leverage accounting rules, e.g. for investment funds;
    - review whether the Capital Requirement Directive (CRD II) rules for credits and liquidity facilities from banks to special-purpose undertakings should also be extended to include shadow banking entities;
    - review the national supervisory rules for "implicit support" – granting support beyond the degree contractually agreed upon – of banks to their shadow banking entities; and
    - review whether EU banking legislation should be extended to include financial undertakings which operate without any revenues.

– **Regulation of MMF and other investment funds**
  - The European Securities and Markets Authority (ESMA) is currently reviewing the full integration of ETF into the UCITS framework (2009/65/EU, s. CEP Policy Brief) and intends to submit the respective guidelines in 2012. The Commission sees risks for ETF and other investment funds in connection with the liquidity supply of investors, as well as in the quality of the collateral provided in cases of securities lending and derivative transactions. (S. 12)
  - In relation to MMFs, the Commission's main concerns relate to the risks of runs, which, according to the FSB, become more likely where funds (so-called Constant Net Asset Value Funds or CNAV-Funds) value their assets, despite market fluctuations through the amortised cost approach, in order to "maintain a stable" net asset value (NAV). For this practice creates an incentive to investors to withdraw their capital if market prices are under pressure. By contrast, Variable Net Asset Value Funds (VNAVs) value their assets at market prices (p. 11).

– **Securities lending, repurchase agreements (repos) and securitisations**
  - Securities lending and repurchase agreements are a key source of funds used by some shadow banking entities; they serve to increase the return of assets through leverage (p. 12). The Commission wishes to take a closer look at the following transactions (p. 12):
    - management of collateralised securities and their rehypothecation;
    - reinvestment practices of cash received against collateralised securities; and
    - improved transparency for market participants and supervisory authorities.
  - With regard to securitisation rules, the Commission wishes in particular to review "transparency, standardisation, retention and accounting requirements". (p. 13)

Statement on Subsidiarity by the Commission

The Commission does not address the issue of subsidiarity.

Policy Context

Following the G20 summit in November 2011 in Cannes, the FSB initiated more in-depth work on five aspects: the Basel Committee on Banking Supervision (BCBS) will work on how to further regulate the interaction between banks and shadow banking entities (report in July 2012); the International Organization of Securities Commissions (IOSCO) will work on regulation to mitigate the systemic risks of Money Market Funds (MMFs) (report in July 2012); the IOSCO, together with the BCBS, will assess existing securitisation requirements (report in July 2012); an FSB subgroup will examine the regulation of other shadow banking entities besides the MMF (report 2012); another FSB subgroup will work on securities lending and repos transactions (report in December 2012).

ASSESSMENT

Having published its proposals for increased banking regulation last year [new capital requirements COM (2011) 452 and 453, see CEP Policy Brief], it now addresses shadow banking. This is appropriate, since banks are pushing traditional banking operations towards shadow banking, in order to avoid the increasingly strict banking regulation and thereby to gain a competitive advantage ("regulation arbitrage"). This must be prevented, for the regulation of the banking sector introduced key steps directed at strengthening liability for risks taken, responsibility for losses and the stability of the financial markets. These targets must be central to shadow banking regulation, too.

The Commission is right to address systemic risks primarily in its Green Paper. Systemic risks exist where contagion effects must be feared in relation to other – systemic relevant – financial market participants which jeopardise the stability of the financial markets. **Strict regulation is necessary in order to prevent such risks**. For the rest, provided investors are thoroughly informed as to the risks of a fund and the lack of security mechanisms, there is no need for the increased hedging of funds against the potential default of funds, at least not where professional investors are concerned.

A connection between shadow banking entities and traditional banks can lead to a situation whereby the problems caused by shadow banking can create a systemic banking crisis. The trigger for such a crisis can be an abrupt withdrawal of capital ("runs") from money market funds or failed investments of hedge funds with high leverage shares. Therefore, consideration can be given to the idea of restricting the granting of credit by banks to shadow banking entities. Stricter capital or liquidity requirements would be an option. As proposed by the Commission, banks should be obliged to include the risks of shadow banking entities – to which they are either affiliated or which they fund – in their own balance sheet. This would improve transparency and risk management.

However, **the term "shadow banking"** is somewhat misleading, for it **suggests that all entities and activities** which the Commission defines by this term operate "in the shadow", i.e. **are subject to no or to less strict regulation than "regular" banks,** or even are illegal. **This is not the case**. For instance, as the Commission itself states, the major part of money market and investment funds, including the ETF, are subject to the UCITS Directive (2009/65/EC, s. CEP Policy Brief) or the AIFM Directive (2011/61/EU, s. CEP Policy Brief), which take account of many risks addressed by the Commission. The Commission's call for additional regulatory measures regarding money market and other investment funds should be critically examined. Nowadays there are already ceilings for most of these funds regarding borrowing leverage, criteria for the type of investments made by investors' capital and limits for the granting of credits by such funds to banks. Moreover, in 2011 ESMA adopted guidelines for money market funds directed at reducing the term of investments by funds, in order to curb the danger of liquidity bottlenecks in the case of sudden runs. **Rules to prevent sudden runs in money market funds should take account of differences between CNAV and VNAV funds**. Unlike the USA, the European market is dominated by VNAV funds, where the likelihood of runs is much lower.

The existing data and statistics on activities by shadow banking entities are, as the Commission itself rightly states, **insufficient**. Risks can be controlled through regulation or supervision only if they are known to authorities. **Therefore, it is necessary to tighten rules** regarding data collection and exchange and therewith **the entities' information obligation** vis-à-vis supervisory authorities.

However, **supervisory authorities should not be obliged to define "concepts" for the supervision of shadow banking entities**. Authorities can have the role of important counsels to the legislator. **The responsibility for defining a concept must,** however, **lie in the hands of the legislator**. This applies particularly to the question of whether supervision should take place either at national or EU level, for systemic risks are related to enormous costs.

Possible Follow-up EU Action

The Green Paper serves for the Commission as a basis for discussion and remains rather vague. Decisive for possible future regulations are therefore the results of the appointed FSB working groups, which should be submitted by the end of 2012. Moreover, the Commission is planning single consultations in autumn 2012 relating to the topics and activities named in the Green Paper. Therefore, legislative measures to regulate the shadow banking sector can be expected as of 2013.

Conclusion

The main focus of the Green Paper is quite rightly systemic risks. Between shadow banking and traditional banks there are connections which can lead to problems in shadow banking resulting in banking crisis. The subsequent necessity for regulation, however, has already at least partially been taken account of. Many so-called "shadow banking entities" are already covered by various Directives and Regulations. Rules to prevent the sudden withdrawal from capital from money market funds ("runs") should take account of the differences between CNAV and VNAV funds. The existing data and statistics on the activities of shadow banking entities are insufficient; therefore, the obligation for entities to provide information should be tightened. The legislator and not the supervisory authorities should determine the supervision concept for shadow banking.