EUROPEAN PARLIAMENTARY FINANCIAL SERVICES FORUM

EPFSF Briefing
"Shadow Banking"

Summary

Shadow Banking has been identified as one of the last remaining regulatory issues in the quest for more resilient financial markets. Largely parallel efforts are currently underway at both the G20 and the EU level to enhance the supervisory and regulatory framework on shadow banking. Any future regulation clearly requires a workable definition of shadow banking. Moreover, shadow banking comprises many different actors and instruments, which differ widely in terms of their risk profile and their interconnection with the traditional banking sector and the real economy. Regulation will therefore need to be targeted, risk-based and take these differences duly into account.

1. Definition of Shadow Banking

Defining characteristics: The FSB, in an October 2011 paper[1], has defined as "the system of credit intermediation that involves entities and activities outside the regular banking system". A recent Green Paper by the Commission[2] also employs that definition. As the FSB observes, systemic risks can stem from four key factors, i.e. maturity transformation, liquidity transformation, imperfect credit risk transfer, and leverage. These risk factors are often linked to credit intermediation, but they can also be present in other activities. The definition of shadow banking may therefore encompass, in addition to credit creation, further activities, such as (i) using direct or indirect financial leverage, (ii) accepting funds with deposit-like characteristics, (iii) engaging in maturity or liquidity transformation, (iv) engaging in credit risk transfer. The common feature of shadow banking activities and the banking system is that they create leverage and engage in maturity transformation.

Dynamic definition: Considering that financial sector activities and products can evolve, a flexible definition of shadow banking, rather than a closed list, appears useful so as to be flexible as regards the regulatory scope. As, inter alia, the FSB suggests, it is advisable that supervisors cast their net wide in monitoring the activities within the shadow banking system so as to gain a complete overview about potential risks to the financial system. Based on a broad overview of the system, the scope of supervisory and regulatory activity can then be narrowed down to those institutions / structures that appear to pose particular risks to financial stability.

Functional, rather than legal approach: The definition of shadow banking should follow a functional rather than a legal approach. Supervision should not be limited to the identification and monitoring of non-bank financial *institutions*, but cover all financial *activities* that count towards shadow banking in case they pose a systemic risk from a credit intermediation process.

Examples for entities within scope: While the definition of shadow banking is dynamic, institutions such as the following have been suggested by the authorities as possible candidates for inclusion in a definition of shadow banking activities: Money market funds; SIVs, Special Purpose Vehicles (SPVs) used for securitisations, other firms providing credit or credit guarantees, and repo markets.

1 FSB: Shadow Banking: Strengthening Oversight and Regulation
2 European Commission: Green Paper Shadow Banking, COM(2012) 102 final

2. Assessing the size

Given the difficulty of properly defining the shadow banking system, it is unsurprising that there is no commonly agreed estimate of the shadow banking system, either. In a first attempt to map the shadow banking sector, the FSB used flow of funds data to gauge the scale of non-bank credit intermediation. According to the FSB assets in the shadow banking system, as proxied by assets held by “other financial intermediaries”, were about $60 trillion in 2010. The Commission estimates of the size of the sector vary between a fourth and a third of the regular banking system, or around EUR 46tr in 2010. For Europe, this would estimate the size of the shadow banking system at between EUR 10-17 bn. The smaller size of the European shadow banking system reflects the different structures of both financial systems: In Europe, a greater part of financial flows are still intermediated by banks. Generally, the volume of shadow banking activities has shrunk after the financial crisis.

The scope and structure of the shadow banking sector varies substantially between different jurisdictions. Overseeing and regulating the shadow banking system will thus require far more extensive and granular information for the supervisor.

3. Drivers for growth

Reflecting the diversity of the shadow banking sector there are numerous drivers for growth of this market segment. One key driver certainly has been investor demand for products that combine features of banking and capital markets products and thereby reflect investor preferences. Another has been regulatory arbitrage. The latter is particularly interesting and important in light of the growing corpus of regulation for the regular part of the banking system, which has created incentives for investors and suppliers to shift financial activity and, by extension, risk, to the shadow banking system, as we saw in the run-up to 2008.

4. Benefits

Shadow banking activities can have a number of beneficial effects. First, they enlarge the available spectrum of assets for investors. Second, shadow banking can help to re-allocate risk within and beyond the financial system (in some cases taking risk out of the regulated sector entirely). In doing so, it enhances the financing capacity of the financial system. Third, the same purpose is served by attuning financing structures more closely to the financing needs of firms and to the preferences of investors. Overall, shadow banking contributes to the bio-diversity of the financial system. A healthy bio-diversity diversifies funding sources in an economy and, specifically, can help to mitigate the impact on the macro-economy should the regular banking system become dysfunctional. Both aspects help to ensure a steady flow of credit to the economy, including a steady financing volume for SMEs.

5. Potential Risks

Risks within the shadow banking sector are as varied as the sector itself; their relative relevance varies across the different parts of the shadow banking system.. First, there is a concern about a lack of transparency about shadow banking activities. While some shadow banking entities are monitored regularly, others are outside of the scope of regular financial supervision. This is, secondly, compounded by the concern that some shadow banking activities comprise complex entities and transactions. Thirdly, the interconnection between the regular banking system and the shadow banking system is critical, as difficulties in the shadow banking system could contaminate the former. One example for this was the fact that many banks were forced, during the financial crisis in 2007/8, to re-consolidate investment vehicles they had previously pushed off their balance sheets. Repercussions of failures in the shadow banking system could be felt either directly through credit exposures by banks to shadow banks, through reputational linkages, or indirectly through forced asset sales that impact market prices. Fourthly, some segments of the shadow banking system can also become a source of systemic risk; for instance, short-term deposit-like funding of non-bank activities can lead to “runs” if market confidence is lost. Fifth, parts of the shadow banking market are strongly procyclical, because of the pervasive use of mark-to-market accounting and collateralisation requirements.

6. Activities taken so far

The scope of attention is very much aligned at both the global and the European level. The G20 have established five work-streams: (i) the Basel Committee will look into the interaction between banks and shadow banking entities; (ii) IOSCO is tasked to examine regulatory action related to MMFs; (iii) IOSCO and the Basel Committee will jointly review securitisation requirements; (iv) a FSB Subgroup will examine other shadow banking entities and (v) another FSB subgroup securities lending and repos.

Supplementing these work-streams, the Commission's Green Paper also suggests that, in coordination with FSB-guided efforts, focus be on (i) securitisations, (ii) securities lending and repos, and (iii) other shadow banking entities. In addition, the Commission proposes to look into asset management issues, specifically ETFs and MMFs, as well as into the appropriateness of current banking regulation to mitigate risk from the interaction of banks and shadow banking entities.

7. Alternative ways of addressing shadow banking activities

The term "shadow banking" suggests potentially dangerous activities. However, the balance between benefits and potential risks clearly differs across activities and will differ even more in future in response to regulatory activity and industry efforts. Hence, in the future it may be useful to, instead, make a distinction between such "shadow banks", and "parallel banking", as suggested by the New York Fed (2010). It should also be noted that some activities in the shadow banking system are already indirectly subject to supervision and regulation. Thus, e.g., the strengthened rules on securitisations as enshrined in CRD 2 and CRD 3 or the AIFM Directive address risks in the shadow banking system.

To draw up a more complete and more detailed picture of the shadow banking sector, supervisors plan to enhance their data collection efforts. This will include a number of measures: (i) linking existing national and international databases, such as credit registers and data gathered by clearing houses and CCPs; (ii) enquiries to regulated entities; (iii) in the longer run, supervisors consider directly identifying and mapping non-bank financial institutions that are marked part of the shadow banking system. As a first step into that direction, supervisors plan to implement a legal entity identifier (LEI) system, which allows identifying and registering all financial services institutions. In order to avoid unnecessary data collection efforts, authorities are committed to make use of existing data as much as possible and available.

As is the case with banking regulation, the primary objective of regulation should not be to prohibit shadow banking activities. Rather, the objective should be to regulate it where appropriate in order to monitor, limit and mitigate potential risks stemming from the sector: this can best be controlled through a diligent use of micro-and macro-prudential supervisory tools. This may necessitate extending the scope of prudential regulation and supervision. In many cases, monitoring and registration might be fully sufficient as a supervisory response; in others, where activities are not covered by existing regulatory regimes, additional action might be required. Extended regulation and supervision may target shadow banking activities either directly or indirectly by addressing the linkages between the regular and the shadow banking sector. Regulation must also identify the right level of supervision, i.e. global, European, or national. As a general rule and considering the diversity of the shadow banking sector, targeted measures dealing with the specific risk identified will be more effective than one-size-fit-all rules.

Any regulation should be adapted to the sometimes fundamentally different financial systems –especially the difference between the US and the European financial system could lead to the need for different interventions in both systems. A risk-based approach to the issue of shadow banking that balances an assessment of the benefits and potential risks from certain activities should make it possible to differentiate regulatory and supervisory responses across jurisdictions, taking into account the relative importance of these activities in various markets. Thus, for example, it should be noted that the European market for residential mortgage securitizations is not only far smaller, but also experienced far lower losses during the crisis than its US counterpart, because asset quality was higher and originate-to-distribute business models were less prevalent.

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