Shadow banking

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PURPOSE: to examine the issues posed by shadow banking activities and entities with the goal of avoiding new risks in the financial sector (Commission Green Paper).

BACKGROUND: the global crisis of 2008 crisis revealed numerous inadequacies within finacial services : regulatory gaps, ineffective supervision, opaque markets and overly-complex products. The response has been international and coordinated through the G20 and the Financial Stability Board (FSB).

The European Union has shown global leadership in implementing its G20 commitments. In line with EU's Roadmap for Financial Reform, the Union is very advanced in implementing the reforms linked to the G20 commitments. Most of the reforms are now going through the legislative process.

However, **there is an increasing area of non-bank credit activity, or shadow banking, which has not been the prime focus of prudential regulation and supervision.** Shadow banking performs important functions in the financial system. For example, it creates additional sources of funding and offers investors alternatives to bank deposits. But it can also pose **potential threats to long-term financial stability**.

At the November 2010 Seoul Summit, the G20 Leaders identified the need to strengthen regulation and supervision of shadow banking and requested that the FSB, in collaboration with other international standard setting bodies, develop recommendations to that end.

In response, the FSB released a report on 27 October 2011 on strengthening oversight and regulation of shadow banking. The FSB defined the shadow banking system as "the system of credit intermediation that involves entities and activities outside the regular banking system".

Against this background, the Commission is at this stage focussing its analysis on the following possible shadow banking entities and activities :

- Money Market Funds (MMFs) and other types of investment funds or products with deposit-like characteristics, which make them vulnerable to massive redemptions ("runs");
- Investment funds, including Exchange Traded Funds (ETFs) and hedge funds, that provide credit or are leveraged;
- Finance companies and securities entities providing credit or credit guarantees, or performing liquidity and/or maturity transformation without being regulated like a bank;
- Insurance and reinsurance undertakings which issue or guarantee credit products;
- Securitisation;
- Securities lending and repo.

The FSB has roughly estimated the size of the global shadow banking system at around € 46 trillion in 2010, having grown from € 21 trillion in 2002. This represents 25-30% of the total financial system and half the size of bank assets.

CONTENT: the Green Paper describes existing measures and those proposed by the EU to deal with shadow banking activities.

The EU has taken important steps indirectly to address shadow banking issues raised by securitisation structures to deter banks to circumvent existing capital requirements and other legislation:

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the revision of the EU banking capital requirements directive in 2009 (the so-called Capital Requirements Directive, or "CRD II"), which Member States should have transposed into national law by October 2010, required both originators and sponsors of securitized assets to retain a substantial share of their underwritten risks;
- the amendments in the subsequent revision of the directive in 2010 (the so-called "CRD III") further strengthened capital requirements in line with the recommendations published by the BCBS in July 2009;
- in its proposal for the latest revision to the directive (the so-called "CRD IV") the Commission has proposed the introduction of explicit liquidity requirements as of 2015, including liquidity facilities for SPVs and for any other products or services linked to a bank's reputational risk.

The EU has also already adopted measures to regulate shadow banking entities and activities directly :

- as far as investment funds are concerned, the Alternative Investment Fund Managers Directive (AIFMD) already addresses a number of shadow banking issues, provided that the entities concerned are captured as alternative investment funds under that directive;
- in relation to insurance regulation, Solvency II also addresses a number of shadow banking issues as it provides comprehensive regulation centred on a risk-based and economic approach, along with strong risk management requirements including a "prudent person" principle for investments.

Although these measures go a long way to addressing shadow banking entities and activities, **there is still further progress to make** given the evolving nature of the shadow banking system.

In coordination with the FSB, the standards setting bodies and the relevant EU supervisory and regulatory authorities, the aim of the Commission's current work is to examine existing measures carefully and to propose an appropriate approach to ensure comprehensive supervision of the shadow banking system, coupled with an adequate regulatory framework.

In this context, the Commission is further investigating options and next steps in five key areas.

1) Banking Regulation: several issues are being examined with the overarching aim to:

- recapture for prudential purposes any flawed risk transfer towards shadow banking entities;
- examine ways to identify the channels of exposures, limit excessive exposure to shadow banking entities and improve the disclosure requirements of banks towards exposures to such entities;
- ensure that banking regulation covers all relevant activities.

2) Asset management regulation issues: as far as ETFs are concerned, the FSB has identified a possible mismatch between liquidity offered to ETF investors and less-liquid underlying assets. The current regulatory debate focuses on possible liquidity disruptions; the quality of collateral provided in cases of securities lending and derivatives (swap) transactions between ETF providers and their counterparties; and, conflicts of interest where counterparties in these transactions belong to the same corporate group. In relation to MMFs, the main concerns identified relate to the risks of runs (i.e. massive simultaneous redemptions by investors).

3) Securities lending and repurchase agreements: the ongoing work by the Commission and the FSB is examining current practices, identifying regulatory gaps in existing regulation and looking at inconsistency between jurisdictions.

The specific issues to be covered could include: prudent collateral management; reinvestment practises of cash received against collateralised securities; re-use of collateral (re-hypothecation); ways to improve transparency both in the markets and for supervisory authorities, and, the role of market infrastructure.

4) Securitisation: the Commission assesses that it will be important to include an examination of whether the measures relating to securitisation set out earlier in this Green Paper have been effective in addressing shadow banking concerns.

The Commission is currently examining how similar measures can be taken in other sectors, notably transparency, standardisation, retention and accounting requirements.

5) Other shadow banking entities: additional work on other shadow banking entities is also underway within the FSB and the EU in order to: (i) list the entities that could be covered; (ii) map the existing regulatory and supervisory regimes in place; (iii) identify gaps in these regimes; and, (iv) suggest additional prudential measures for these entities, where necessary.

Follow up : the Commission will decide on the appropriate follow-up regarding the shadow banking issues outlined in this Green Paper, including legislative measures, as appropriate.

Stakeholders are invited to send their comments before 1 June 2012.

A conference on shadow banking will be held in Brussels on 27 April 2012.