Editorial

Chasing shadows: Europe prepares to regulate shadow banking

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Since the onset of the financial crisis in 2008, European authorities have been feverishly attempting to overhaul financial regulation and identify solutions to enhanced system stability, efficiency and competitiveness to generate better and fairer outcomes for consumers. The planned and enacted reforms, taken together, have been sweeping: we have seen plans for structural reforms (such as the retail-ring fence in the United Kingdom); restrictions on naked short-selling and credit default swaps; reforms requiring over-the-counter derivatives to be cleared by central counterparties; greater oversight of credit rating agencies; further transparency and disclosure requirements across the board – particularly in relation to trading; the push towards resolution planning and living wills; more stringent governance and internal controls in financial institutions; and of course, higher capital and liquidity requirements for banks and large investment firms as outlined in the Capital Requirement Directive IV (which will implement the Basel III global framework in Europe).

The nature of supervision has also changed since the crisis: banks are under much greater scrutiny than ever before, and are required, or will be required, to report more regularly and with greater granularity to both national and pan-European supervisors on a host of different areas (such as the common reporting regime that comes into play on 31 December 2012).

Some European Union (EU) countries (for example, the United Kingdom and Ireland) are reforming their institutional regulatory structures – scrapping the single regulator in favour of the traditional central bank model. We have also seen the establishment of pan-European regulators – the European Supervisory Authorities – the establishment of the European Systemic Risk Board charged with macroprudential oversight, and a push towards a single rule book for financial regulation across the EU to help promote the ‘single market’ and reduce regulatory arbitrage and the corresponding concentration of risk in any one country.

Despite the progress that has been made, regulators are not resting on their laurels; implementing many of the agreed reforms is still a long way off and the tricky task of developing detailed rules underpinning these regulations in many cases remains a challenging task (such as designing cross-border resolution regimes across heterogeneous legal structures). Moreover, the financial crisis is still very much *ringing in the ears* of regulators. The dire consequences of the regulatory regime failing to keep up to speed with technological advancements and rapidly changing market conditions is still very apparent to all parties involved.

There is a real concern that financial institutions may circumvent new, and seemingly buffered, regulatory standards and create new markets with new risks and dangers. This *financial innovation*, long a feature of financial markets, is to be discouraged, given the fragility of the system. Clearly, sizeable movements in the market landscape – which may result in less than favourable customer outcomes or which have systemic risk implications – need to be given heightened and sustained attention by regulators. Recent focus on high frequency trading[1] is evidence that regulators are being more proactive than before. While the force of the market may ultimately overwhelm regulators – who are still scrapping for adequate resources[2] – rules need to be applied consistently across all markets to ensure that regulations do not exacerbate swings in the marketplace. As the EU single regulatory rule book starts being populated with new rules and restrictions, financial institutions may start exerting pressure to force these swings; regulators should take note. The expediential growth of exchange traded funds in recent years – whose assets now exceed US$1350 billion[3] – is a clear picture of how the market will continually evolve in response to the conditions it faces (whether a risk adverse customer looking for highly liquid assets, high demand for efficient ways of diversifying a portfolio or regulatory restrictions).

In this regard, since the agreement of the Basel III framework, the global community has been increasingly worried that more stringent regulations and supervision may push banks further into the largely unregulated shadow banking arena. The increased attention on shadow banking is largely a result of the freezing of credit in repurchase transactions (repo markets) following the collapse of Lehman Brothers in September 2010, which regulators believe exacerbated the credit crunch. Although this causal relationship is still debated, regulators increasingly believe that the disorderly failure of shadow bank entities can carry systemic risk (such as repo runs and regulatory arbitrage) and is working on developing recommendations on the oversight and regulation of these entities. However, despite the name, shadow banking activities are not necessarily risky, hidden or precarious and can provide a number of positive benefits to the financial system such as supplying additional sources of funding and bank deposits.

At the November 2010 Seoul Summit,[4] the G20 Leaders identified some remaining issues of financial sector regulation that warranted attention. They highlighted 'strengthening regulation and supervision of shadow banking' as one of these issues and requested that the Financial Stability Board, in collaboration with other international regulators, develop recommendations to strengthen the oversight and regulation of the 'shadow banking system'.

European regulators are right to be concerned by a shift towards shadow banking. European banks are increasingly hamstrung and are finding it difficult to improve their underlying profitability, given weak economic growth prospects in the region, falling investment rates and the need to raise costly capital to replenish their damaged balance sheets. Lower equity prices on European banking stock reflect the negative mood; notwithstanding the recent bump in stock prices following the European Central Bank's provision of cheap credit to the market, equity prices are still relatively rather low.[5]

In October 2011, the Financial Stability Board[6] presented a number of recommendations for effective monitoring and supervision of shadow banking. While the Financial Stability Board stressed the difficulties and complexity associated with this task and the many unknowns still present, it did outline a general roadmap supervisors could follow.

Supervision, first, requires careful analysis of the trends of non-bank credit intermediation (which is unique in each national financial system) that has potential to pose systemic risk, according to the Basel-based institution. To minimise the source of risk inherent in off-balance sheet activities, the Financial Stability Board recommends that supervisors need to pay close attention to a series of connected risk factors, such as liquidity transformation, leverage and imperfect credit risk. Moreover, to ensure that the definition of shadow banking is sufficiently wide, the supervisor needs to also assess the potential impact that the severe distress or failure of certain shadow banking entities/activities would pose to the overall financial system by looking at other factors, such as the interconnectedness between the shadow banking system and the regular banking system. Laudably, the Financial Stability Board called for supervision that is 'flexible, forward-looking and regular', emphasising the need to share information among national supervisors given the international nature of shadow banking. Recognising that authorities will have to continually adapt to changing market trends and therefore create a regulatory framework that is fluid and dynamic is a good first step in the difficult task of effectively identifying and supervising shadow banking activities.

Building on this work and on the invitation of the November 2011 G20 Cannes Summit to develop its work further, the Financial Stability Board has also initiated five work-streams tasked with analysing the issues in more detail and developing effective policy recommendations. The first such work stream is examining whether or not regulated lenders hold enough capital against their transactions with all players in the credit intermediation chain. The next two work streams are tasked with assessing the risks and possible regulatory reforms required in relation to money market funds and non-regulated entities. In addition, the Financial Stability Board is probing the regulation of securitisation, particularly with regard to retention requirements and transparency. A final work stream is investigating the regulation of activities related to securities lending/repos, including possible measures on margins and haircuts. Each work stream is expected to conclude its work this Summer and present its finding to the Financial Stability Board.

In this year's Cass Lecture on 14 March, Lord Adair Turner[7] provided important insights into the Financial Stability Board's evolving understanding of the risks posed by shadow banking. The Financial Stability Board is due to present its final proposals for shadow banking system reform to the G20 leaders by the end of the year. Against this background, on 19 March, the European Commission (Commission)[8] launched a Green Paper looking at the EU's approach, taking the initial step towards a regional regulatory regime.

The Financial Stability Board has defined shadow banking as entailing 'credit intermediation which occurs outside or partially outside the banking system, but which involves leverage and maturity transformation'. This is only the start. As Lord Turner's comments illustrate, the major issue is not just the activities of shadow banks themselves, but the interconnectivity between shadow banking activities and traditional banking and the links to the real economy. According to Lord Turner, the Financial Stability Board's proposals will need to be forward looking, anticipating future developments when markets begin to pick up because 'on some measures shadow banking is now a shadow of its former self', global regulators cannot be complacent as future shadow banking activity is not likely to adopt the 'specific forms' seen in the last crisis. This echoes the Financial Stability Board's recommendations in October for a fluid regulatory regime to encompass shadow banking.

His comments flag some of the potential challenges in conceiving proposals at the international level, in the first instance, and then percolating these proposals down into a 'future proof' regional regime. Lord Turner noted that shadow banking activity was not nearly as prolific in the EU as it has been in the United States before the crisis, but this 'did not insulate the European banking system from shadow banking losses and risks, for key parts of the European banking system were involved in the shadow bank intermediation of credit flow from US savers to US borrowers'. Essentially, he stressed that shadow banking has to be understood as involving in some cases new forms of non-bank interaction between the financial system and the real economy, and as entailing far more complex links within the financial system itself, including between banks and non-bank institutions. The future regime will need to focus on 'the fundamental drivers of instability across the whole financial system', not just at a regional level, according to Lord Turner.

The European Commission's March 2012 green paper on shadow banking picks up on some of Lord Turner's concerns. It suggests that shadow banking is based on 'two intertwined pillars'. The first relates to entities outside the traditional banking system that engage in one or more of the following activities: accepting funds (deposit-like activities); performing maturity and/or liquidity transformation; undergoing credit risk transfer; and using financial leverage. The second pillar relates to activities that could act as important sources of funding of non-bank entities (which captures securitisation, securities lending and repos). The Commission has put forward a non-exhaustive list of entities and activities that relate to shadow banking. These include, special purpose entities, money market funds, some investment funds (such as ETFs), non-bank entities providing credit or credit guarantees and securitisation. Monitoring of these entities has improved in recent years, according to the Commission, but there is still a 'pressing need' to fill the current data gaps on the interconnectedness between banks and the shadow banking system on a global basis. Further disclosure and transparency requirements from non-bank entities may be required in the future, possibly gathered and analysed by global/pan-European regulators.

The green paper suggests that the future supervisory regime needs to be integrated with the macroprudential framework to understand the 'hidden credit intermediation chains' and its systemic importance. Shadow banking issues may also require extending the scope and nature of prudential regulation, although the Commission provides no details at this stage. It does believe, however, that 'a specific approach to each kind of entity and/or activity must be adopted', through complementary actions in terms of indirect regulation, appropriate extension or revision of existing regulation and new regulation specifically directed at shadow banking entities and activities. Some regulatory measures, such as a series of amendments to the Capital Requirements Directive, improvements to International Financial Reporting Standards (in particular IFRS 7, 10, 11 and 12), Solvency II, Markets in Financial Instruments Directive II, Alternative Investment Funds Managers Directive, Undertakings for Collective Investment in Transferable Securities IV already address some of the issues. However, the Commission lists different issues in relation to banking, asset management, securities lending and repurchase agreements, securitisation, and 'other shadow banking entities' that raise questions, and outlines the additional regulatory measures it believes may be required.

The Commission has also organised a public hearing on shadow banking in Brussels on 27 April 2012. Input to the green paper and feedback from the public hearing will inform a 'wide-ranging' consultation later in the year – which may lead to legislative proposals in 2013. In parallel, however, the Financial Stability Board is expected to release a consultation paper in the next few weeks. It will be very important that industry consider these two consultations together, because already embedding any appropriate additional measures into the increasingly complex EU regulatory regime, while still retaining flexibility and reactivity to the future market, is shaping up as a Herculean challenge.

The shadow banking system is large – equivalent to about half of total global bank assets – and is a very important source of liquidity to the economy. Regulators need to be careful not to stifle this market too much and force entities into a 'dark' shadow banking system that is beyond its regulatory reach. Instead, regulations should be designed to support its development while introducing measures to ensure that the system is safe and affords adequate protection for those who avail of its services.

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