Briefing note
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Shadow Banking and the Funds Sector

Shadow Banking is one of those terms, along with bail-ins, living wills, CoCo's and alternative investment funds, that has crept into our vocabulary since the onset of the global financial crisis. Like many of these terms, it can mean different things to different people. As regulators begin to consider what regulatory measures to put in place to address the perceived risks arising from shadow banking, we consider how funds and fund managers may be caught up in the rush by regulators to close a perceived regulatory loophole and how the funds industry might respond to proposals specifically designed to regulate shadow banking.

The role of funds in credit markets

Funds are already important participants in the credit markets and they are likely to fulfil an increasingly significant role in the future. Following the international credit crisis, with banks' appetite for lending significantly reduced, there is no doubt that funds – with the appropriate strategy and structure – have taken up some of the slack. In our view, it is likely that more funds will seek out these opportunities. With their heterogeneous risk appetites and sheer variety and diversity, funds are often more adaptable than the major banks – particularly now that many of these banks have severely constrained risk appetites and will be subject to higher capital and liquidity requirements (e.g. under Basel III). This inevitably means that bank lending will become more expensive for borrowers. However, currently, most funds do not have either the strategy or structure to focus on the credit markets in the same way as the major banks. To the extent this changes - in what undoubtedly is a constantly changing business and regulatory environment - means that some funds will likely fulfil at least some of the role of banks. This in turn leads regulators to consider whether these types of funds should be regulated like banks, but of course how do you define them?

Perceived regulatory risks of shadow banking

The Financial Stability Board (FSB) published a background note on 12 April 2011 exploring the potential regulatory risks arising from shadow banking. This note tackles the definition of shadow banking, proposing to cast the net wide and classing shadow banking as "the system of credit intermediation that involves entities and activities outside the regular banking system". This is a very wide definition and would certainly catch many fund activities, including those of all credit funds. However, the FSB paper then proceeds, helpfully, to narrow down the activities that regulators should be focussing on to the activities of maturity/liquidity transformation, leverage and flawed credit risk transfer.

The primary concern of regulators, noted by the FSB, is that such arrangements can pose a systemic risk and this is a particular concern because much of the

shadow banking market operates through unregulated entities, or at least through entities that are more lightly regulated than entities which have traditionally held a monopoly over credit intermediation and maturity transformation activities, i.e. banks.

However, the FSB paper also expresses concerns over closing regulatory arbitrage loopholes more generally – in other words, regulators may decide to impose additional regulations on shadow banking operations, if failure to do so could be seen as giving shadow banks an unfair advantage in the market compared to traditional banks.

It is important that any move, either internationally or by individual regulators, to impose additional regulations are proportionate and only apply where there is a clear risk, either to the financial system or to investors, particularly retail investors, that is not being addressed by regulatory requirements as they currently apply. We would submit that this should be the real focus of regulators, rather than looking to "level the playing field" where they perceive a difference in regulatory burden between different types of participants in the financial sector. First, this is because there are many reasons why banks are regulated as they are, resulting from their unique role in the economy, a role that shadow banking can only ever partially fulfil – retail deposit taking, for example, will inevitably remain largely the preserve of banks. Secondly, we would argue it is not the role of regulators to promote competition in the financial sector – that is the role of the competition authorities. It is also important to note at the outset, that funds are operated by fund managers that are now, or soon will be, subject to strict regulation in all major jurisdictions around the world, for example in EU by the new Alternative Investment Fund Managers Directive and in the US by the Dodd-Frank Act.

So, given the need for regulators to focus on and consider carefully the risks entailed in particular activities before imposing additional regulations, what are those risks and do they amount to systemic risk?

Systemic Risk: maturity transformation, leverage and liquidity

Systemic risks arise when activities that could adversely impact the financial system are undertaken on a sufficiently significant scale. It is difficult to see how simply being a creditor of commercial loans could ever constitute a systematic risk. However, a structure that achieves maturity transformation on a highly significant scale could be systemically risky, as could a structure that was massively leveraged.

But before simply imposing additional regulation, it is important to analyse both the nature and scale of those risks, to determine if they indeed constitute systemic risk and if so, the best means of regulating those risks.

As mentioned above, maturity transformation i.e. converting short term liabilities into long term assets, is only systemically risky if undertaken on such a scale that it has the potential to affect the entire financial system. So, for example, one way in which a fund manager could achieve maturity transformation, is by supporting its lending/credit activities through short term liabilities such as repo's. Where these short term liabilities are used to fund the purchase of longer term loan assets, maturity transformation then occurs. If this occurs on a large scale, it is certainly possible that this could have an equally systemic impact as a bank going insolvent – as economically the fund and a bank would be fulfilling the same role. Similarly, a fund structure that is highly leveraged, or one that facilitates significant leverage, can pose systemic risks e.g. through cash collateral reinvestment from securitisations. However, it is comparatively very rare that fund structures effect such maturity transformation on anything approaching a systemic level.

Of course, fund strategies are very diverse and it is therefore important not to assume that all credit funds give rise to the same exposures and risks. Some hedge funds engage in activity that results in maturity and liquidity transformation, but the transformations run in the opposite direction to banks – i.e. investors are subject to lock-in, but the debt invested in by the funds can be traded, compared to the position of a bank that typically has short term and call deposits against longer term loan and other investment assets. Indeed, the most recent FSA survey of the hedge fund sector shows that hedge fund liability profiles are typically opposite to that of a bank, so that the funding maturity is longer and therefore less liquid than the liquidity of the asset portfolio. The same FSA survey found that the sector is, if anything, becoming less dependent on short term funding "... with a reduction in short-term financing of between 5 and 30 days and an increase of funding terms of 31 to 180 days".

Another major concern highlighted by the FSB is the potential for a build-up of leverage in the shadow banking sector, particularly at times when risks are growing elsewhere in the financial system e.g. due to overheating in the economy during periods of rapid economic expansion. However, leverage levels in funds are typically much lower than the levels of leverage in banks. Hedge fund leverage is typically no more than 2 or 3 times investor funds, compared to 15 to 30 times equity in the case of banks. It should also be noted that under the Alternative Investment Fund Managers Directive, EU regulators will have rights to access information concerning leverage taken on by all private funds and will have the ability to place limits on the levels of leverage incurred by funds.

A further risk that is intrinsic to banks, but which is controlled and/or a much lesser risk in the case of funds, is liquidity risk caused by the principal source of funding being withdrawn. In the case of banks, depositors can easily and swiftly withdraw their funds. In the case of most funds, there are arrangements in place to restrict redemptions in stressed conditions, such as redemption suspensions, which the manager is able to exercise as the need arises. Indeed, investor expectation in the funds markets is for long initial lock-up periods which prohibit redemption before the lock-up period expires.

Controlling risk – one size does not fit all

Aside from risks associated with maturity transformation, liquidity and leverage, other risks have been noted by regulators as affecting the banking system which in turn have lead to increased regulation. However, this does not automatically mean that the same should apply to funds.

As mentioned above, it is not clear that a fund that participates in commercial loans poses any more of a risk to the financial system than a fund that invests in debt securities. And arguably this risk is minimal. The fund is owed money by commercial creditors. Any default by one or more of those creditors will certainly impact returns for investors, but this is not a systemic risk and is best dealt with as it is presently - through adequate risk disclosure to investors, investors that are sophisticated investors. Indeed current requirements in this area will be further enhanced in the EU with the implementation in mid 2013 of the Alternative Investment Fund Managers Directive with its extensive requirements for appropriate disclosures to be made to the investors in relation to the risks of investing in relevant funds along with extensive additional regulatory obligations that will be imposed on the private funds industry. Similarly, an expanded universe of US fund managers that will be required either to register with the SEC, or report information on their funds to the SEC once the Dodd-Frank changes to the US Investment Advisers Act are implemented, will increase the amount of information on US based credit funds accessible to the SEC.

There are, of course, certain jurisdictions where regulations permit only banks to undertake lending activity, even in the traded, secondary lending market. This issue can be dealt with, however, through funds taking loan interests via sub participation or employing a bank as an agent to acquire the interests in the loans. However, these rules generally operate in this way due to a historically wide definition of banking activities, rather than because the local regulator or legislator was particularly concerned about systematic risk.

Inadequate segregation of information is often cited as an additional risk. It is true that issues relating to segregation of information arise for participants in the loans markets who are also active in the securities markets, the requirement being to ensure that the information available to loan participants is not available to the securities market and used for securities trading. The risk otherwise is of a charge of market abuse/insider dealing. Arguably these are issues that larger banks may be more familiar with than funds. However, these laws apply irrespective of the function of the relevant participant and funds are familiar with these requirements. They are also, of course, not specific to shadow banking.

Another example is moral hazard. It should be borne in mind that the moral hazard that is arguably often present when a major bank takes on excessive risk – i.e. the expectation that the bank will be "too big to fail" and will be bailed out by its domestic government – is not present with funds that participate in the credit markets.

Protection of retail investors has been a key feature of regulatory reform in a number of jurisdictions. However, funds do not have depositors that require special protection. The category of investors who will typically be damaged by a fund collapse are sophisticated investors who have taken an informed and considered assessment of the level of risk being run. This contrasts with the position in relation to banks who service retail depositors and place depositor funds in loans and other assets in relation to which the depositors have no control or visibility.

Remuneration has been another thorny issue for regulators, especially within the banking industry, with attempts to control bonuses and align incentive pay with the long term interests of the relevant bank. It is worth noting that many fund managers already receive a large proportion of their pay in the form of interests in the fund that they manage, thereby aligning their personal interests with those of their investor base and ensuring that they are completely focused on the risks incurred by their funds.

In summary, we would submit that the potential risk in the case of the vast majority of funds that, or are likely to, participate in credit activities are risks incurred by the investors in those funds and specifically not systemic risks to the market as a whole.

Targeted Regulation

Not only are the risks not “systemic”, the issues can be adequately dealt with through existing regulatory provisions and mechanisms. No new regulation, specific to the credit activities of funds, is required. Therefore it seems inappropriate to impose on funds regulations devised to cater to systemic risk limitation and prevention, particularly those that are more applicable to banks. Regulations designed for banks are simply not appropriate or warranted in the case of funds.

This point is made, in particular, by reference to the capital standards devised by the Basel Committee – most recently though Basel III. By its nature, a fund is a very different entity to a bank; its investors are its shareholders and if the fund suffers loss those losses will be absorbed by the investors. Apart from being a very odd idea, in the context of funds, to impose capital standards relating to risk weighted assets of funds, either on the funds themselves or on their managers, it is also not apparent how this could be done or what it would achieve. To add any form of additional capital requirements in relation to the funds themselves would be disproportionate, probably non-workable and would serve no purpose in relation to achieving either investor protection – something which, in a funds context, is best achieved through adequate risk and associated disclosures – or systemic protections, as funds do not generally pose any form of systemic risk.

Duplication of regulatory measures must also be avoided, as there is a danger that additional regulation of entities carrying on shadow banking activities is duplicative of regulation already in place. For example, concerns over whether regulators have adequate information relating to shadow banking activities of funds can be fully addressed in the EU though obligations to report to regulators under, for example, the Alternative Investment Fund Managers Directive, which is due to be implemented in mid 2013.

Similarly, where structures are already subject to “skin in the game” type retention requirements, aimed at addressing risks associated with securitisations and other, similar tranched structures, additional regulation to cover the same risks is not required unless and until it can clearly be shown that the “skin in the game” requirements have not worked.

Taking a step back

What is more, commercial enterprises continue to require finance. This is true both in first world countries as well as the emerging markets. To the extent that the banks de-risk (particularly in relation to emerging markets) and/or bank lending becomes more expensive, then that financing must be sourced from somewhere. That “somewhere” is your shadow bank. To the extent this role is filled by funds (as opposed to any other pools of capital) it is important to note that fund managers are already subject to increased regulatory scrutiny.

In conclusion, when considering what, if any, additional regulatory requirements to impose on shadow banking arrangements, particularly those organised as funds, regulators should take a step back and carefully analyse the structures and participants in this sector to determine the nature and extent of systemic and other risks being faced and incurred by these organisations. Only on that basis and having satisfied themselves that there really are risks - and that they are systemic - that are not being adequately captured or dealt with through existing regulations, should regulators attempt to craft additional requirements.

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