Into the Light: A response to the EU Commission Green Paper on Shadow Banking

1 June 2012 marked the original closing date of the consultation on the EU Commission Green Paper on Shadow Banking. The Green Paper has generated a great deal of interest, perhaps explaining why the consultation period has been extended until 15 June. It represents the EU's participation in the wider debate on how to regulate "shadow banking", which was initiated by the G20 in Seoul in 2010 and which has been gaining traction recently, notably under the auspices of the Financial Stability Board (FSB), the body charged by the G20 with thought leadership on how to regulate shadow banking.

Clifford Chance responded to the Green Paper[1], and in this briefing, we take the opportunity to examine some of the issues raised, reflect on where the debate is heading and discuss the wider implications of regulating shadow banking.

Issues raised in the Green Paper

What is Shadow Banking?

The Green Paper raises the thorny issue of defining shadow banking. In fact, "shadow banking" is a term of art that is very difficult to define precisely. Everyone knows shadow banking exists, but regulators and policy makers are struggling to come up with a definition of what it is and what risks it poses.

The Commission has taken the FSB definition – "the system of credit intermediation that involves entities and activities outside the regular banking system" - and focused on "two intertwined pillars" of entities and activities that may engage in shadow banking, noting that this "dynamic definition" may change as financial markets evolve. Both the FSB definition and the preliminary list of activities and entities suggested by the Commission are vague and imprecise, with the resulting danger that "inappropriate" regulations will be proposed, that do not control systemic risk and have the unintended consequence of inhibiting economic recovery.

In our view, the focus should clearly be on activities rather than entities, but only those activities that can actually pose a significant systemic risk to the financial system should be regulated. Many activities potentially caught by the definition of shadow banking, or on the Commission's preliminary list, are (or will be) regulated already, pose no real risk to financial stability and, in fact, benefit the real economy. For example, hedge funds and private funds are or will be regulated under AIFMD, and some ETFs and money market funds are regulated under UCITS. Accordingly, we believe there is a risk in trying to define "shadow banking" that regulators and government authorities will lose sight of the actual activities of real systemic concern.

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The risks and benefits related to Shadow Banking

The call to regulate shadow banks has clearly gained traction recently. We see almost daily calls from regulators to reign in shadow banks, although most are imprecise on which activities should be the focus and where the risk that causes those concerns arises. Despite this imprecision, these calls are likely to continue as the debate progresses into the second half of 2012, culminating in the FSB presenting its proposals on shadow banking reform to G20 leaders by the end of the year.

Amidst the clamour for regulation, there is a danger that the benefits of shadow banking are being overlooked. One such benefit is providing funding to the real economy. Banks are currently "de-risking" their balance sheets: they are having to add more capital and are lending less in order to comply with Basel III and other regulatory requirements. In addition, European banks are pulling out of emerging or growth markets and other existing market investors, such as CLOs, are unlikely to have the capacity to lend as much as they have in recent years. At the same time there is a pressing need for finance: governments wish to promote economic growth in their countries, which will need to be financed, businesses need financing, and numerous existing loans in the market need to be refinanced. If banks cannot or will not provide the financing required, alternative sources of financing must be forthcoming.

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A number of securitisation products and vehicles contribute positively to the real economy. For instance, a typical RMBS securitisation allows a pool of residential mortgages to be funded without a maturity mismatch or leverage and this contributes towards a more balanced financial system. Additionally, large corporates who are unable to access the capital markets directly can fund the working capital needs of their business through an ABCP conduit which advances funds against the receivables that corporate generates – this allows them to diversify their funding sources and make them less reliant on direct bank funding.

These beneficial aspects of shadow banking should be retained and promoted in the future in order to boost economic recovery and growth, spread risk and promote liquidity. This all needs to be done without unnecessarily contributing to systemic risk. The regulators should bear in mind that not all activities that look the same pose the same risks, e.g. there

"… it is very important to ensure international consistency in any proposed regulation and this needs to be at a global level … In the context of derivatives clearing … the industry is grappling with the ongoing … challenge of complying with conflicting and overlapping regulatory requirements…"

are regulatory concerns around maturity and liquidity transformation – but maturity and liquidity transformation in the funds space is different from that of banks. The process is different - using a prospectus containing risk disclosures, defined liquidity for investors, lock-ins etc. If funds have been set up properly, there should be very little systemic risk deriving from liquidity and maturity transformation issues and there are various techniques that could be put in place, such as side pockets or redemption gates - to reduce "run on the bank risk". It is also important to remember that the investors in these products are not, for the most part, retail investors. They are mostly institutional, professional or sophisticated investors that understand and can accept more risk if they are rewarded for that risk.

The challenges for supervisory and regulatory authorities

There is no doubt that supervisory and regulatory authorities face an enormous task. The Green Paper cites three main challenges: identifying and monitoring the relevant entities and their activities; determining the approach to supervision and formulating appropriate regulatory responses. No detail is given on tackling each challenge although it appears that the Commission is taking into consideration the FSB general principles[2].

In our view, improvements need to be made to the means of monitoring activities that may potentially pose a genuine risk to the system, but importantly this applies to all activities that pose risks and not just those conducted by shadow banks. Given the significant cost and administrative burden of monitoring activities, reporting requirements must be consistent globally and focus on the information that is actually needed by supervisors in order to identify systemic risk in the system and existing reporting mechanisms should be used wherever possible. Supervision should be co-ordinated on a global basis so as to avoid inconsistency and the potential for regulatory arbitrage.

Perhaps the biggest challenge to regulators is getting the balance right – proportionate regulation which controls systemic risk while nurturing economic growth.

Regulatory measures on Shadow Banking in the EU

The Green Paper quite rightly acknowledges that there are regulatory measures in place or in the pipeline that cover shadow banking activities. The AIFMD would be one such example, UCITS regulation of ETFs and MMFs is another. This acknowledgment is important as there is a general perception, typically in the media, that shadow banking is unregulated. It is also important to remember that many of the regulatory reforms intended to tackle the ills of shadow banking haven't come into force yet. There is real merit in adopting a "wait and see" approach, assessing whether further measures are needed after the regulatory reforms that are currently in the pipeline have come into force rather than impose another layer of regulation that will increase the regulatory burden and might have unintended consequences.

Where is the shadow banking debate heading?

The Green Paper does not contain any specific policy proposals. However, it does suggest areas where there are "outstanding issues". Here we reflect on some of the possible proposals, with emphasis on issues where there appears to be broad consensus with other policy makers such as the FSB and the ECB. With regard to any policy proposals we would hope, as a preliminary, for two things: first, that there is a genuine debate on whether regulations are needed, accompanied by a thorough cost/benefit analysis, and that further regulation is not a "foregone conclusion"; second, that any regulations are globally consistent. The moves towards clearing and reporting of OTC derivatives illustrates that the industry is grappling with the hugely expensive challenge of complying with the conflicting and overlapping regulatory requirements of the EU and the US and this should be avoided in other sectors.

More Transparency

All regulatory bodies involved in the shadow banking debate lament the lack of transparent market data. As a result of these views, we would anticipate globally co-ordinated moves for regulatory bodies to extract data from the shadow banking industry. This trend, in all probability, will accompany moves towards central clearing in certain sectors, e.g. repo markets, which will facilitate the process and strengthen market infrastructure.

Move to on-balance sheet activities and increased capital requirements

It is likely that regulated banks will not be allowed to operate businesses off balance sheet in an unregulated environment. We would anticipate moves to consolidate shadow banking vehicles back onto bank balance sheets and to enforce higher levels of capital provisioning against such liabilities. Connections between banks and shadow banks will be made less opaque and more expensive given the demand for increased capital provision.

Repo Markets and Money Market Funds

Despite the absence of "hard" data, it appears that a strong consensus has already emerged amongst policy makers that it is in the areas of money market fund and repo and securities financing markets that regulation is required. It is these markets, in the eyes of the regulator, that drive what they view to be the core risks of shadow banking activity, namely: leverage, maturity transformation, pro-cyclicality and the creation of long complex intermediation chains which increase the dangers of funding runs and make it difficult for the authorities to monitor all the above risks. There is particular concern that these markets connect the key activities of a regulated banking sector with a relatively under-regulated shadow banking industry.

After the 2008 crisis, money market funds are seen as posing systemic risks as there is a belief that they are prone to "runs" and play an important role in short term funding for banks. In particular, C NAV funds are seen as more like high risk, unregulated banks that provide immediate deposit like liquidity to their investors. Looking at the comments of the various policymakers involved and at the IOSCO Report[3] on this issue to the FSB, we would anticipate a combination of the following measures: firstly, money market funds would be required to choose between the offering of V NAV funds or C NAV funds. C NAV funds should be subject to increased capital requirements. All funds should be subject to gates and other measures that could be used to delay withdrawals and reduce the risk of runs.

The main thrust of concern in repo and securities financing is likely to be directed by a desire to reduce leverage and the perceived pro-cyclicality of these markets. The preferred route appears to be increased and minimum haircuts on margin levels with the relevant authorities empowered to alter such levels in the light of market circumstance. Haircuts are tools to be used prudently by financial institutions as part of their credit risk management, rather than a requirement to be imposed by regulation. It is quite possible, for example, to have a repo in a structure where the overall structure more than fully addresses the credit risk relating to that repo, so that a mandatory haircut requirement would in fact distort the credit risk position. We would therefore encourage measures to improve collateral management practices as a more appropriate alternative. We also think

"It should be borne in mind that even if an activity (e.g. provision of liquidity) looks the same it might not be, and might not pose the same risks to the financial system. The provision of liquidity by funds does not pose the same systemic risks as traditional bank lending."

that a more appropriate tool for controlling leverage would be at an institutional level, possibly via leverage limits and capital ratios, rather than by singling out repos for special treatment, which has the potential to cause distortions.

In our view, the debate should be solely focused on activities where there is maturity/liquidity transformation which pose genuine and significant systemic risk to the financial system, which lack transparency or which cannot be appropriately managed or mitigated through existing legislation or regulation. We should not lose sight of the fact that many investors do understand and can price risk, and that this helps to spread risk across the broader economy and gives access to much wider sources of credit and liquidity.

The wider implications of regulating shadow banking

It is important to stop and consider the wider implications of imposing regulations on shadow banking. While there is undoubtedly a need to learn the lessons from the financial crisis, reduce systemic risks and promote financial stability, there is also a pressing need to bolster the global economy and boost growth. At a time when banks are trimming their balance sheets, non-bank financial intermediation – the shadow banks - are filling the funding gap. This is not in competition with the regulated banking sector but complementary to it and an essential component of economic recovery. Regulators are walking a tightrope and they need to get the balance right – we need a proportionate and considered regulatory response that provides requisite safeguards by properly analysing where systemic risk truly lies, promotes stability in the financial sector and lays a firm foundation for growth and prosperity in the real economy.

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[1] Green Paper on Shadow Banking: https://onlineservices.cliffordchance.com/online/viewContent.action?key=Ec8teaJ9VaqwEAvhMrEQoKKQHLBboS3WdMEY50ix2a%2F%2B117I9cEJMnNVtCYvmHTedHzaXGZg8qps%0D%0AWg%2Fh4myq2Q%3D%3D&nav=FRbANEucS95NMLRN47z%2BeeOgEFCt8EGQLgG0HP2%2BI9M%3D

[2] "*Strengthening Oversight and Regulation of Shadow Banking*" – FSB (Report 27 October 2011)

[3] "*Money Market Fund Systemic Risk Analysis and Reform Options*" – OICU-IOSCO Consultation Report (27 April 2012)

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