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FINANCING THE FUTURE:
BANK AND NON-BANK COLLABORATION EMERGES FROM THE SHADOWS

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In mid-September, Clifford Chance hosted its second annual conference on non-bank financing – sometimes referred to as shadow banking. The event was attended by more than 100 clients from across the financial services industry, including representatives from banks, funds, insurance companies and regulators. Discussions centred around change in financial services and the challenge for regulators in keeping pace. Here, we provide an overview of the keynote address by Adair Turner, senior fellow at the Institute for New Economic Thinking, and the panel discussions that followed.

Shadow banking, credit creation and financial stability

A year ago, Clifford Chance hosted its first shadow banking conference, looking at the growth of non-bank lending and its impact on the financial services sector. Fast forward a year and much has changed, with advances both from a regulatory perspective and in the commercial levers driving the growth of shadow banking.

In introducing this year's keynote speaker, Adair Turner, Clifford Chance corporate partner Amy Mahon outlined how concerns about shadow banking have evolved. She said: "After the global financial crisis, the emphasis was on reducing systemic risk and less so on promoting growth and the funding needed for growth. Since then, the emergence of a funding gap means the pendulum has swung the other way, and governments are looking for policies that encourage non-bank lending."

At the frontline of such initiatives, Adair Turner has combined careers in business, public policy and academia. He became Chairman of the Financial Services Authority as the financial crisis broke in September 2008, and in 2009 was appointed to play a leading role in the redesign of global banking and shadow banking regulation as chairman of the major policy committee of the international Financial Stability Board (FSB). And yet, five years later, he admits that the task of regulating shadow banking is far from complete: "I will explain just how damned difficult shadow banking is," he said at the beginning of his speech, "why it is a crucial issue, but also why it is like painting the Forth Road Bridge, in that I suspect once we get to the end we will have to go back to the beginning and start again."

The biggest challenge for regulators is that it is an area of rapid change and diverse industry players. And yet the abiding theme of Adair Turner's speech was that historically (at least pre-crisis), the view had been that non-bank credit intermediation ought to be more stable than bank credit intermediation. "And yet," he said: "We keep devising forms of it that are not only equally as unstable as banking, but often more unstable than banking. The principle of telling the difference between good shadow banking and bad, and what we do about each, is the abiding issue."

Adair Turner began his speech by recognising that the conventional wisdom back in 2006 was that the dispersion of credit risk by banks to a broader and more diverse group of investors made the overall financial system more resilient.

"The proposition was that securitisation and other forms of non-bank financing made the world a safer place," he said, "and also that we needed securitisation in order to have enough credit."

However, when looking at the development of the financial crisis in 2007 and 2008, a lot of the events that acted as triggers took place in what we now call the shadow banking market, such as the major losses by market neutral hedge funds, the liquidity and solvency problems for off-balance sheet SIVs, and the liquidity run in the repo and other secured funding markets.

When shadow banking becomes a problem

The challenge for the FSB came in working out what went wrong, and why developments in shadow banking ended up becoming harmful to the whole system.

The conclusion was that by adding a raft of new players into the financial intermediation between deposit-makers and borrowers, the industry created a hugely complicated system with at least three new aspects to it: a new form of credit creation, a new form of holding money, and new cash equivalents, like the repo market, which grew very significantly in the 20 years before the crisis.

"We put in a complicated set of intermediaries that reintroduced leverage and maturity transformation to the banking system itself," said Adair Turner. "They were not actually separate from the banking system, and rather linked into the banking system through a whole series of liquidity lines."

The FSB defines shadow banking as:

"Credit intermediation involving entities and activities (fully or partially) outside the regular banking system, but involving maturity transformation and leverage"

The FSB reached the conclusion that shadow banking poses risk because it can introduce exactly the same concerns as sit around bank financing, namely, maturity transformation and leverage, and then exacerbates them by developing so many links in the financing chain, such that if one link pulls out or fails, liquidity runs are created.

Likewise, with so many links, there becomes a perception that these risks have been shared, as each participant thinks they have a secured money equivalent on the next person in the chain because of the security afforded by the collateral. This in turn creates credit and asset price cycles where mark-to-market accounting and VAR-based risk management lead to incredibly strong upward spirals in credit extension. The

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Adair Turner Senior Fellow, Institute for New Economic Thinking downside is the hardwired procyclicality in secured funding contracts, such that when asset values fall, haircut percentages increase, assets are sold to cover margin calls and a downward spiral takes hold.

The policy response

Figures from the FSB show the percentage share of total financial assets held in shadow banking has not increased significantly since the crisis, and in fact the most notable growth is in the holdings of central banks. Shadow banking grew before the crisis, caused the crisis, but has since not grown in a way that causes regulators concern, Adair Turner said.

He added: "Non-bank credit intermediation that doesn't involve leverage and maturity transformation, and doesn't involve lots of links in the chain, could be a good thing for the financial system. When that's not the case, we need to know we have created something potentially incredibly unstable, and we need to lean against that with a set of rules."

Re-engineering regulation to reflect shadow banking policy

Clifford Chance partner Simon Gleeson, who specialises in financial markets law and regulation, went on to outline the regulatory response to shadow banking. He noted some of

the possible tools that might be used, such as mandatory minimum haircuts and restrictions on permissible collateral types.

One big challenge for regulators is the way the conversation has shifted from regulating 'shadow banks', to regulating 'shadow banking', he explained. "We have stopped talking about shadow banks and started talking about a set of activities," Gleeson said. "The reason that matters so much is the question of whether you are writing a set of transactional rules, where everyone engaged in a certain type of activity must do it this way, or are you writing a set of institutional rules saying certain institutions must do certain things."

This activity-based approach is more akin to securities regulation than it is to typical banking laws. But control of interaction between banks and shadow banking requires both regulation of 'shadow banking', and identification of 'shadow banks'.

While there are some elements of a definition of a shadow bank in the existing regulatory structure, with CRD IV's risk premium for exposure to "financial entities" for example, there is still little coherent basis for policy development.

So far, regulation of shadow banking appears to fall into two buckets. The first focuses on restricting quasi deposit takers, as seen in the proposed Money Market Fund Regulation, by seeking to avoid short-term funding being used to fund longer-term asset purchases. The second aims to limit the creation of credit, as in the proposed Repo Regulation, by avoiding the inflation of the amount of credit in the system by borrowing on the security of credit assets.

Gleeson said: "One of the effects of all these rules will be the generation of multiple new classes of business whose primary reason for existence is to create credit or liquidity mismatches while falling outside the existing list of regulated entities. Regulators will have to continue to expand their definitions of regulated activities." And he added: "That is why I agree with Adair Turner that the whole process of regulating shadow banking is like painting the Forth Road Bridge."

Bank and non-bank finance – opportunities for collaboration?

Talk in the banking industry has been moving toward opportunities for collaboration that may exist with the shadow banking world. One example is the tie-up between BlueBay Asset Management, a direct lending fund, and Barclays, to provide unitranche loans in the mid-market.

Anthony Fobel, partner and head of private lending at BlueBay, said: "When we moved into private lending, it was in response to a gap opening up in the lending markets as a result of retrenchment by banks. For a couple of years we had little competition, and then we saw banks wake up to the consequences of the debt funds moving

"When we moved into private lending, it was in response to a gap opening up in the lending markets as a result of retrenchment by banks. For a couple of years we had little competition, and then we saw banks wake up to the consequences of the debt funds moving into their markets, which was that they were losing corporate business they were keen to retain."

Anthony Fobel Partner and Head of Private Lending, BlueBay Asset Management into their markets, which was that they were losing corporate business they were keen to retain."

At that point, Fobel said, many high street banks woke up to the opportunity for collaboration. He explained that for Barclays, the arrangement with Blue Bay allows participation in mid-market financings, and lets it provide low leveraged loans and ancillary services to businesses it may otherwise lose out on were these deals to be done by other banks or direct lending funds. BlueBay tends to lead the negotiations on the loans, even though it is taking the second-out piece, Barclays takes a first-out piece and ancillary facilities and the borrower benefits from a blended-rate product structured as a single loan.

Rob Lee, global head of finance at Clifford Chance, said: "We are seeing a lot more of these structures coming along. Over the last three years we have seen people realise, on both sides, that there's a lot of merit in collaboration." Other instances see funds providing mezzanine loans and banks providing senior; funds taking bonds in transactions and teaming up with bank lenders for super senior revolving credit facilities; and funds underwriting large transactions in the real estate finance market and syndicating the senior debt to banks.

The predicted tension between regulated and non-regulated providers of finance as competitors has not materialised, as shadow banks instead fill a gap left by traditional lenders in the wake of new capital requirements post-crisis.

Brad Gans, Chief Legal Officer, EMEA at Citi, said: "For the most part, we view shadow banks as playing an important and necessary role in today's marketplace. They play a complementary role to regulated financial institutions, providing a variety of services from small business lending to facilitating the transfer of risk."

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Rob Lee Global Head of Finance, Clifford Chance

He pointed to the area of payment services as another place where non-banks like GooglePay and PayPal are increasingly treading on banks' toes.

Fobel went on to point out that there are still only about 60 debt funds in Europe with a combined €33bn of capital – "we are under no illusions that we are at the very early stages of what should be an emerging asset class," he said. He also explained that there is no systemic risk created by credit funds, which are backed by investors in the same way the private equity funds are. He said: "Our fund is backed by pension funds, insurance companies and other sophisticated investors. The great merit of that is that if we do well, we get more money from our investors for another fund. If not, we don't get any more money, and we don't get to do any more business – but there is no knock-on systemic risk."

The impact of recent regulatory developments on the landscape of finance

Chris Bates, head of Clifford Chance's financial regulatory practice, highlighted two competing tensions currently at play in shadow banking around the world – the story of regulation in restricting and addressing the risks, and the story of a new agenda encouraging alternative finance to promote growth.

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Marc Benzler Partner, Clifford Chance

For example Jonathan Hill, newly appointed Commissioner for Financial Stability, Financial Services and Capital Markets Union, is specifically tasked with seeking appropriate ways to revive sustainable and high quality securitisation markets, and to develop alternatives to our dependence on bank funding. "That is very different from the story of 2008," Bates said.

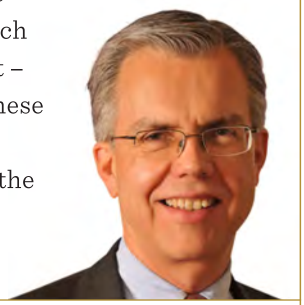
These conflicting pressures were then looked at around the world. Rick Watson, managing director and head of capital markets at the Association for Financial Markets in Europe, said that from a policymaker's perspective, there has been an enormous change in the last few months toward focusing on growth.

He said political support for good quality securitisation has increased significantly in that time, adding: "We do think the key is global co-ordination of regulatory policy, because we are finding the Federal Reserve, the European Commission and other bodies don't have the same views on how to fix the problem."

Marc Benzler, a partner with Clifford Chance in Frankfurt, said that there have been initiatives in a number of European jurisdictions, where there is a need for more funding, to relax rules to encourage direct lending by insurance companies. In Italy, for example, the government added a specific carve-out to the general prohibition on lending by insurance companies.

"National initiatives on shadow banking are not high on the agenda," Benzler said, "but rather it's the need to find new sources of funding that means existing regulations could be relaxed."

From Beijing, Clifford Chance partner Ying White talked about shadow banking growth from a very different perspective. In China, licenses are required for bank lending and bank deposit taking, but a rapid growth of online money market funds is now shifting deposits away from banks towards unregulated online service providers that are non-bank institutions. Three of China's biggest online businesses – e-commerce site Alibaba, search engine Baidu, and social media site Tencent – are moving into financial services, and Chinese savers have rushed to online money funds because they have much higher yields than the interest rates on bank deposits.



"We do think the key is global co-ordination of regulatory policy, because we are finding the Federal Reserve, the European Commission and other bodies don't have the same views on how to fix the problem."

Rick Watson Managing Director and Head of Capital Markets, AFME

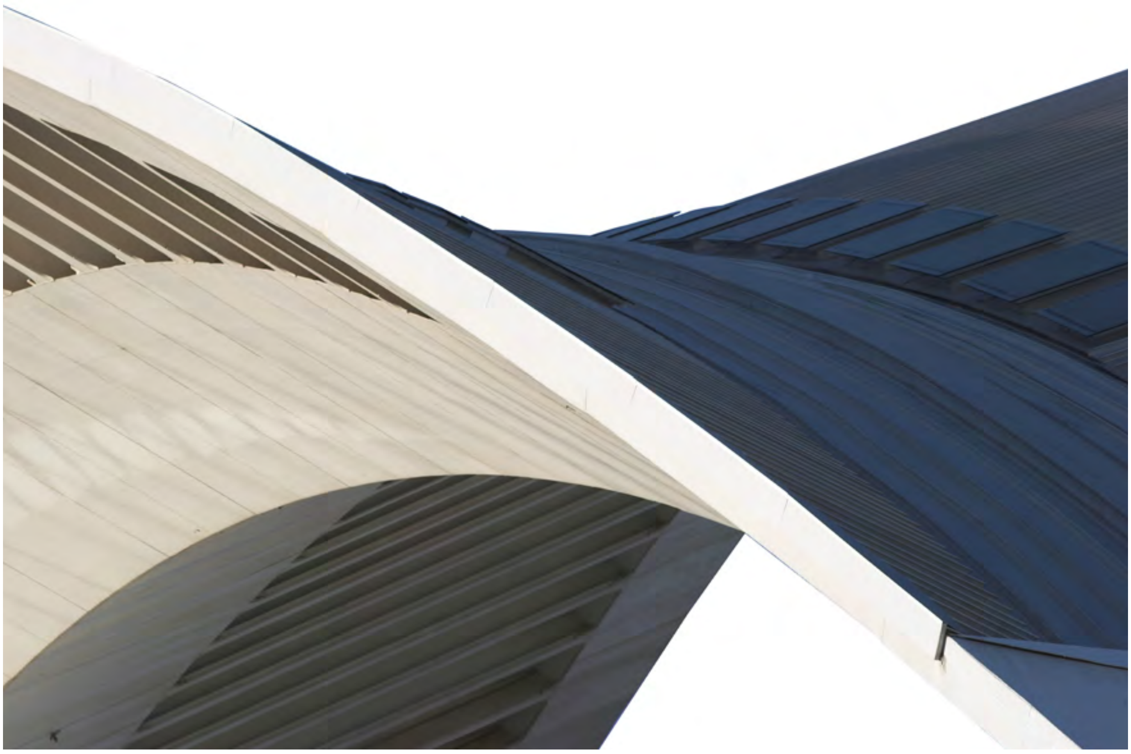
White said: “This is a phenomenon and the banks are losing out to non-regulated online providers. The state-owned banks are pressing for regulation, but the Chinese President is more inclined to letting it grow in a “regulation-lite” environment.”

In April the boom in internet money funds was seen as driving the People’s Bank of China publicly to commit to interest rate liberalisation within two years. The funds are also providing a welcome alternative source of loans to small and medium-sized businesses, often overlooked by the large state-owned banks focused on lending to state-owned enterprises.

In the United States, shadow banking is nothing new and non-bank lenders have been active for decades. Corporate partner Robert Villani said: “None of the regulations put in place since the crisis specifically target shadow banking. The objective is to strengthen the financial system to avoid another meltdown. The focus is on liquidity, increasing capitalisation, and non-banks are now subject to regulation and oversight if they are large enough.”

From London, Habib Motani, global head of the firm’s derivatives practice, said that while the promotion of alternative forms of finance is being encouraged, the securities financing market has been regarded with suspicion for many years, even though central banks themselves are significant participants in this market.

Regulators around the world are looking both to increase the visibility they have of activity in that market, by introducing reporting requirements,



and to increase disclosures to investors about the activities that funds will engage in.

Motani said: "One issue is that reporting requirements and potentially controls on transactions themselves, through controls on haircuts and margin requirements, are likely to be more readily coped with by banks and investment firms, but non-bank lenders may find the additional infrastructure requirements add significantly to their costs and potentially affect the economics of participating".

To conclude, Clifford Chance partner Simon Crown said that regulation in the shadow banking space faces many challenges, and may not in fact be the most effective way forward. He said: "What we are trying to regulate has a very dynamic element. We need rules focusing on substance rather than legal personality, and rules that are going to be capable of responding dynamically. It is possible that regulation may not in fact be the most efficient way forward."

To view Adair Turner's keynote address and Simon Gleeson's plenary address from Clifford Chance's second annual conference on shadow banking, please visit: www.cliffordchance.com/thought_leadership/shadow_banking.html

Working Group on Shadow Banking and Market Finance

The Group of Thirty will commence a study on shadow banking and sustainable market finance in December 2014. The Steering Committee will be led by Adair Turner as chairman, with Jacques de Larosière and Masaaki Shirakawa serving as vice chairs. The study will focus on identifying how shadow banking risks are evolving and the appropriate policies required to encourage sustainable market finance. We expect the results to be published in 2015. For further details, please visit: http://www.group30.org/workprogram.shtml

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