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European Commission Green Paper on 'Shadow Banking'

On 19 March 2012, the European Commission launched a consultation in the form of a Green Paper on regulation of the 'shadow banking' sector.

Background

Financial regulatory reform has traditionally focused on banks. Given the increasing constraints on bank lending imposed by regulations prompted by the financial crisis, non-bank credit activity is anticipated to become ever more important. Alternative credit providers are an important source of funding to borrowers as they are currently less regulated than banks (for example, Basel III does not apply to them). The current size of the global 'shadow banking' system is estimated to be around €46 trillion.

Although 'shadow banking' has an important role in the financial system, regulators are concerned about whether it poses a potential threat to long-term financial stability. Regulators are therefore seeking greater rights to supervise the sector. The European Commission's consultation represents its active participation in the ongoing work of the Financial Stability Board ("FSB") to develop recommendations on the oversight and regulation of 'shadow banking' entities and activities. The FSB published a report on its recommendations in October 2011.¹

The chairman of the UK's Financial Services Authority, Lord Turner, has recently commented that 'shadow banking' poses a constantly changing threat to broader financial stability, and it therefore has to be closely supervised and regulated to ensure that it does not lead to "unsafe" borrowing and exacerbate systemic risk. Given the changing nature of 'shadow banking', Lord Turner has urged regulators to take a broad approach by focusing on the function being regulated (i.e. the extension of credit outside of banks), rather than on particular forms of 'shadow banking'.

Lord Turner's views are important and are closely watched as he is also chairman of the Standing Committee on Supervisory and Regulatory Cooperation, which heads up the FSB's initiative on 'shadow banking'.

¹ "Shadow Banking: Strengthening Oversight and Regulation – Recommendations of the Financial Stability Board", 27 October 2011

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In launching the Green Paper, Michel Barnier, Internal Market and Services Commissioner, commented that “*no financial market can avoid prudential supervision*”.² Depending on their scope, proposed regulations on ‘shadow banking’ could impact the ability of the sector to provide a competitive alternative source of finance to bank lending.

The stated purpose of the Green Paper is to “*take stock of current developments and to present on-going reflections on the subject to allow for a wide-ranging consultation of stakeholders*”

What is ‘Shadow Banking’?

The FSB report defines the ‘shadow banking’ system as “*the system of credit intermediation that involves entities and activities outside the regular banking system*”. The Commission interprets this definition as comprising two intertwined pillars:

Source of credit intermediation	Characteristics	Examples
Entities outside the regular banking system	One or more of the following: <ul style="list-style-type: none"> • accept funding with deposit-like characteristics • perform maturity and/or liquidity transformation • undergo credit risk transfer • use direct or indirect financial leverage 	<ul style="list-style-type: none"> • Securitisation vehicles such as ABCP conduits, SIVs and other SPVs • Money Market Funds and other types of investment funds or products which are vulnerable to massive redemptions (“runs”) • Investment Funds, including Exchange Traded Funds • Unregulated finance companies and securities entities providing credit or credit guarantees • Insurance and reinsurance undertakings which issue or guarantee credit products
Activities outside the regular banking system	Provision of funding to non-bank entities	<ul style="list-style-type: none"> • Securitisation • Securities lending • Repurchase transactions (“repos”)

The list of examples is not intended to be exhaustive, as ‘shadow banking’ entities and activities can evolve rapidly. Based on the proposed definition, ‘shadow banking’ entities could include private equity funds, investment funds, structured finance vehicles, hedge funds, pension funds, insurance companies and special investment vehicles.

Why regulate ‘Shadow Banking’?

‘Shadow banking’ activities are a useful part of the financial system, as they provide funding and constitute a source of risk diversification from banks.

² EC press conference, 19 March 2012

This role is recognised by the FSB and the Commission. However, they also consider that ‘shadow banking’ entities and activities may create a number of risks, such as:

- The build up of leverage – as ‘shadow banking’ activities are not subject to the same limits as banks, they can be highly leveraged.
- Short-term deposit-like funding can lead to “runs” in the market.
- Rules and regulatory arbitrage – ‘shadow banking’ operations can be used to avoid regulation or supervision applicable to banks. This creates a risk that banks will try to push certain activities into entities outside the scope of their consolidation (i.e. outside the scope of banking supervision).
- Disorderly failures which could affect the banking system – ‘shadow banking’ activities are often closely linked to the banking sector as banks often provide part of the ‘shadow banking’ credit intermediation chain or provide support to ‘shadow banking’ entities.

According to FSB estimates, the global ‘shadow banking’ system currently represents 25 to 30 per cent. of the total financial system and half the size of bank assets. This equates to a doubling in the size of the sector over the last decade.

FSB Workstreams

The FSB report also specifies five workstreams which it has launched to analyse key issues in more detail and develop effective policy recommendations:

Workstream	Responsibility	Reporting Date
Regulation of banks’ interactions with ‘shadow banking’ entities (This will include looking at consolidation for prudential regulatory purposes, limits on bank exposure to ‘shadow banking’ entities, and risk weights for bank exposures to ‘shadow banking’.)	The Basel Committee on Banking Supervision (the “ Basel Committee ”)	July 2012
Regulatory reform of MMFs	The International Organization of Securities Commissions (“ IOSCO ”)	July 2012
Regulation of securitisation (This will focus in particular on retention requirements and transparency.)	IOSCO, with the help of the Basel Committee	July 2012
Regulation of other ‘shadow banking’ entities (i.e. entities other than MMFs) (Regulation of such entities to be assessed and enhanced from a prudential point of view, i.e. capital and liquidity)	FSB Task Force subgroup	September 2012

Workstream	Responsibility	Reporting Date
regulation.)		
Regulation of securities lending and repos (To be assessed and further enhanced from the prudential perspective as necessary.)	FSB Task Force subgroup	December 2012

The above workstreams bring together the EU and other major jurisdictions, including the U.S., China and Japan, which are each considering appropriate regulatory measures. The FSB will review the workstreams through its Standing Committee on Supervisory and Regulatory Cooperation.

The FSB report also suggests five general principles which regulators should apply in designing and implementing regulatory measures for 'shadow banking'. These provide that measures should be: (i) targeted to the risks; (ii) proportionate to the risks; (iii) forward-looking and adaptable to capture innovations in the sector that could lead to systemic risk and arbitrage; (iv) effective (i.e. balancing the need to address risks and avoiding creating cross-border arbitrage opportunities); and (v) subject to assessment and review.

The Commission is participating in the FSB workstreams detailed above. The aim of the Green Paper is to reach a consensus on what 'shadow banking' actually is (i.e. what is to be regulated), and to examine existing measures and propose an approach to ensure comprehensive supervision of the 'shadow banking' system.

Existing and Proposed EU measures

The Green Paper also sets out how existing and proposed EU measures already address 'shadow banking' activities. For example:

- Indirect regulation through banking and insurance regulation. For example, the Capital Requirements Directive and the International Financial Reporting Standards.
- Enlarging the scope of current prudential regulation to make future regulatory arbitrage more difficult. This is the approach taken with investment firms; the Markets in Financial Instruments Directive will be extended to cover all high frequency traders and more commodity investment firms.
- Direct regulation of some 'shadow banking' activities. For example, investment funds will be regulated by the Alternative Investment Fund Managers Directive and insurance companies will be regulated by Solvency II.

Although these existing measures go some way towards addressing 'shadow banking' entities and activities, the Commission believes that there is still further progress to be made. In particular, the Commission has stated that the risks of 'shadow banking' may require an extension to the scope and nature of prudential regulation.

The Commission is investigating the following five key areas in terms of options and next steps:

Topic	Issues to be examined
Banking regulation	Consolidation rules for 'shadow banking' entities to ensure bank-sponsored entities are appropriately consolidated for prudential purposes and are subject to Basel III. Ways to limit excessive exposure to 'shadow banking' entities and improve disclosure requirements on banks of their exposures. Ensuring banking regulation covers all relevant activities, including the merits of extending provisions of CRD IV (which implements Basel III) to non-deposit taking finance companies in order to limit the scope for regulatory arbitrage.
Asset management regulation issues	In relation to ETFs, the possible mismatch between liquidity offered to investors and less-liquid underlying assets. In relation to MMFs, the risk of massive redemptions by investors.
Securities lending and repurchase agreements	Ways to improve transparency for the markets and for supervisory authorities.
Securitisation	Whether existing measures have been effective in addressing 'shadow banking' concerns. Transparency, standardisation, retention and accounting requirements.
Other 'shadow banking' entities	The entities that could be covered. Gaps in current supervisory and regulatory regimes. Additional prudential measures. Data collection, as some national supervisors may not have powers to collect data on all 'shadow banking' entities.

The Commission also requests comments on measures which could help ensure international consistency in the treatment of 'shadow banking', in order to avoid global regulatory arbitrage.

Next Steps

The Commission's consultation closes on 1 June 2012, with a stakeholder conference due to take place in Brussels on 27 April 2012. On the basis of the outcome of the consultation, the Commission will decide on appropriate follow ups, including any necessary legislative measures.

Whilst the Green Paper is important, the key proposals will probably emerge from the FSB's workstreams. The Commission's work will inform its input into these workstreams.

Michel Barnier has stated that the Commission's aim is to have regulations in respect of 'shadow banking' in place at the same time as the Basel III requirements come into effect. This is to prevent the opportunity for, and to discourage, regulatory arbitrage, which could otherwise cause new sources of risk to accumulate in the financial sector.

Practical Implications

The proposals for regulation of 'shadow banking' are still in their early stages. It is not yet clear what the scope of the regulations will be, if there will be any regulation beyond existing measures (such as Solvency II), and, therefore, what impact any further regulations will have on the sector.

Both the FSB and the Commission view 'shadow banking' as being prone to the risks of sudden and massive withdrawals of funds by clients given their reliance on short-term financing. This would suggest that future regulation will subject 'shadow banking' to a similar regime on capital and liquidity requirements as banks.

Many commentators believe that this would be a mistake and that introducing enhanced transparency requirements ought to be sufficient. However, the likelihood must be that the Commission will seek to impose more regulation than simply enhanced transparency this debate will intensify over the next year.

If the 'shadow banking' sector is subjected to prudential requirements similar to those applicable to banks, this could limit the role played by the sector and will lead to increased pricing for such sources of finance. This will particularly be the case if, as planned, the regulations are introduced at the same time as the Basel III rules begin coming into effect, as this further reduces the opportunities for regulatory arbitrage. However, the scope for regulatory arbitrage will also depend on whether international consistency is achieved as to the regulations. If it is not, then this could provide opportunities for the 'shadow banking' sector in more favourable (i.e. less regulated) jurisdictions.

The Commission's Consultation Questions

1. Do you agree with the proposed definition of 'shadow banking'?
2. Do you agree with the preliminary list of 'shadow banking' entities and activities? Should more entities and/or activities be analysed? If so, which ones?
3. Do you agree that 'shadow banking' can contribute positively to the financial system? Are there other beneficial aspects from these activities that should be retained and promoted in the future?
4. Do you agree with the description of channels through which 'shadow banking' activities are creating new risks or transferring them to other parts of the financial system?
5. Should other channels be considered through which 'shadow banking' activities are creating new risks or transferring them to other parts of the financial system?
6. Do you agree with the need for stricter monitoring and regulation of 'shadow banking' entities and activities?
7. Do you agree with the suggestions regarding identification and monitoring of the relevant entities and their activities? Do you think that the EU needs permanent processes for the collection and exchange of information on identification and supervisory practices between all EU supervisors, the Commission, the ECB and other central banks?
8. Do you agree with the general principles for the supervision of 'shadow banking' set out in the Green Paper?
9. Do you agree with the general principles for regulatory responses set out in the Green Paper?
10. What measures could be envisaged to ensure international consistency in the treatment of 'shadow banking' and avoid global regulatory arbitrage?
11. What are your views on the current measures already taken at the EU level to deal with 'shadow banking' issues?
12. Do you agree with the analysis of the issues currently covered by the five key areas where the Commission is further investigating options?
13. Are there additional issues that should be covered? If so, which ones?
14. What modifications to the current EU regulatory framework, if any, would be necessary properly to address the risks and issues outlined above?
15. What other measures, such as increased monitoring or non-binding measures should be considered?

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