EBA BS 2012 139

Opinion of the European Banking Authority on the Commission's Green paper on Shadow Banking

Introduction

On 19 March 2012, the European Commission's Services issued a Green paper on Shadow Banking for public consultation. In accordance with Article 34(1) of Regulation No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing the European Banking Authority (EBA), the Board of Supervisors of the EBA has adopted this opinion with regard to the Green paper.

General Comments

As one of the main stakeholders addressing Shadow Banking issues, the EBA welcomes the opportunity to answer the European Commission's Green Paper on Shadow Banking.

First, the EBA considers it is paramount to achieve a higher level of consistency – *i.e.* an international level playing field – in the regulatory framework and oversight. The recent experience shows that regulatory arbitrage emerges and prospers by regulatory fragmentation, different international standards and uneven enforcement. This is even more so, in a rapidly evolving environment, where cross-border consolidations, transactions or other kinds of international deals are increasingly important.

A second fundamental point concerns the regulatory perimeter. Juxtaposing different legal regimes shows that a wide regulatory perimeter may prove very useful in containing “shadow risks”. Such perimeter has two dimensions: regulation on entities and regulation on function/activities tackling the shadow system following also a “functional” approach is essential, given that “shadow activities” continuously mutate as the market and regulatory environment changes.

The EBA is cognizant of the difficulties arising from implementation and enforcement. Many risks related to “shadow activities” have a regulated entity as interface: unconsolidated entities (in some cases due to loose and formal interpretation/enforcement of consolidating rules), contingent liquidity lines to “sponsored” high leveraged vehicles, warehousing, mispriced credit risk transfer, various regulatory arbitrage mechanisms, inadequate valuation of counterparty risks are some examples. Certainly, contingent as well as stand alone “shadow entities” should be given the same attention.

In this regard, ability to react swiftly is critical: regulators and supervisors need to have powers to prompt changes in the perimeter of regulation in order to respond more quickly to risks. An efficient coordination at the Union as well as the global level will prove key to identify new sources of unregulated systemic risks and successfully respond to these threats.

DEFINITION OF SHADOW BANKING

The EBA agrees with the definition of Shadow Banking proposed in the FSB recommendations (e.g. *Shadow Banking : Scoping the Issues - 12 April 2011*). Entering more into the components, the EBA sees shadow banking as a system of intermediaries, instruments, entities or financial contracts generating a combination of bank–like functions *outside the regulatory perimeter or under a lightly regulated regime* and without access to central bank liquidity facility or public sector credit guarantees. The bank-like functions would cover, for example: non-deposit funded credit intermediation, use of leverage, liquidity services, and maturity transformation.

FUNCTIONAL APPROACH

“Shadow banking” is an oxymoron: banking is by definition a regulated business, and as such there should not be any banking - or banking like – activity carried out in the shadow of the regulation.
However, one should keep in mind that some of the activities which are currently commonly included under the label of “shadow banking” can have beneficial effects as regards financing of the real economy and fostering growth.. On the contrary, the functional risks generated by Shadow Banking activities should be properly regulated. From a prudential viewpoint, such risks can be classified as follows:

Liquidity and maturity transformations - Contrary to banks, “shadow intermediaries” do not have access to central bank liquidity support or government guarantee programs like banks. Unlike deposit-takers, who fund themselves with insured deposits – backstopped by access to the central bank’s liquidity facility – “shadow intermediaries” typically fund themselves with uninsured instruments, which may or may not be supported through liquidity lines by banks or other entities. “Shadow entities”, particularly if unregulated and unconsolidated, are potentially vulnerable to runs (withdrawn of deposit-like assets due to panic, early redemptions due to a confidence crisis) and/or liquidity problems (liquidation of assets at fire sale prices). Thus the disruption risks they may cause in credit or liquidity channelling should be regulated and/or supervised. In particular, policy measures should be introduced for MMFs applying Constant-NAV in order to remove potential systemic risks posed by these funds.

Interconnectivity - The shadow entities, asset classes or contracts are highly correlated and interconnected to the regulated entities due to various factors (lines of credit, sponsorships, investments, etc.) and can, directly or indirectly, generate “systemic risks” through a contagion or “domino effects” both between “shadow entities” (along an integrated intermediation chain) or between such entities and traditional banks. In particular, it is necessary to settle an appropriate framework to limit aggregate leverage obtained from re-hypothecation or re-use.

Excessive leveraged positions set-up by shadow entities or instruments - The maturity and liquidity risks are exacerbated by excessive leverage. Highly leveraged structures (not only intermediaries, including securitization vehicles, but also other entities) are more likely to become insolvent in case of unexpected negative events. The crystallization of such events can trigger a confidence crisis. Non-bank entities or instruments with shadow characteristics could, in principle, be a source of systemic risk even without or with modest maturity mismatch and liquidity risk.

Setting up a system based solely on identification of functions without considering the entities which carry out these functions would be too challenging and probably not appropriate. However, there is a need to emphasize more the functional approach to regulation and supervision in order to close the loopholes which inevitably emerge over time due to market adaptation. A precise definition of functions which deserve prudential attention to avoid banking -risks- like contagion is sought and should probably cover credit risk extension, maturity and liquidity transformation.

The European System of Financial Supervision can promote an efficient functional approach if it is given a specific monitoring mandate (e.g. through a report to the European Commission) and the related necessary powers (e.g. to adapt the regulation perimeter through technical standards) to capture shadow banking activities identified as potential threat to the financial system.

PROPOSALS TO RECONSIDER BANKS' DEFINITION, REGULATORY PERIMETER AND REGULATION ABILITY

A) The EBA believes that the point made by the Commission's green paper on the legal definition of banking deserves strong attention: "*existing EU banking legislation is limited to deposit-taking institutions that provide credit. It could be considered to enlarge the scope of financial institutions and activities covered by the current legislation. The Commission is currently studying the merits of extending certain provisions of CRD IV to non deposit-taking finance companies not covered by the definition in the Capital Requirements Regulation (CRR). This would also limit the scope for future regulatory arbitrage for providers of credits.*" The regulatory framework across the EU is very different as regards this feature. Some Members States qualify various providers of credit as banks, others do not follow this path but nevertheless impose bank-like prudential requirements and supervision if these entities pass certain thresholds regarding the size of the activity.

As a recent survey has shown, in the case of finance companies, few Member states describe additional regulation but where this does exist it is often quite significant. In a few Member states finance companies – both mortgage and non mortgage – are either brought within the scope of banking regulation as is the case in France, Germany and Austria, or are subject to comparable supervision and other requirements as banks like in Italy. Spain operates a specific regime for credit institutions that provide credit but cannot accept deposits that includes solvency and accounting requirements at the same level as those applied to deposit takers. In some instances mortgage lending attracts additional scrutiny, and the UK applies a capital requirement to non-banks for some types of mortgage lending. Similarly most Member states' treatment of broker dealers does not extend beyond the parameters of the CRR/D but with some exceptions. In France, Austria and Spain the CRD is essentially extended to all broker dealers. In Spain there are certain exemptions for those investment firms with limited activities, which- in any case- are subject to consolidation. In the UK all broker dealers are within the scope of the domestic liquidity regime. This fragmentation could be source of risks when implementing EU-wide measures to banks, such as the forthcoming resolution regime for instance.

The issue needs to be examined in detail to ensure consistency across the EU and strike the right balance, also taking into account that the costs of regulatory compliance may not be in all cases justified. The application of the functional approach would anyway require that the credit granting capacity of entities is supervised. Under this perspective qualitative and quantitative thresholds to account for dimension/interconnection and other potential risks for financial stability and markets' integrity could be considered.

B) There is also a need to further examine the issue of consolidation, from a prudential as well as accounting standpoint. One of the recommendations of the FSB report on Shadow Banking (27 October 2011) is the need to ensure that all shadow banking entities that a bank sponsors are included on the balance sheet for prudential purposes. In this regard, the BCBS is currently undertaking a very relevant work to consider whether shadow banking entities are consolidated for accounting and prudential purposes and to clarify whether there are differences in regulatory consolidation practices across jurisdictions. This analysis will serve to see if there is a need improve the consistency of the regulatory consolidation or to assess if some shadow banking entities need to be consolidated for prudential purposes.

Accounting as well as prudential consolidation – as currently applied - are however not likely to deliver the results that are sought, especially as regards shadow banking entities that are not directly related to banking institutions. Therefore, reconsidering prudential consolidation with a view of taking on board other issues could include: prudential consolidation of Securitisation SPV - in particular possible differences in various GAAPs; consideration of reputational risk; or the relationships with Hedge funds and other shadow banking entities.

C) The large exposures regime should act as a backstop regime also to 'shadow activities' and tackle the risk of interconnectivity by making sure interconnections are duly identified (and considered as groups of 'connected clients' for the purpose of the limits' calculation).

One relevant aspect is the treatment of exposures to schemes with underlying assets. Exposures can arise not only through direct investments by institutions, but also through investments in schemes - such as collective investment undertakings (CIUs) and structured finance/structured finance vehicles (e.g. securitisations) - which themselves invest in underlying assets.

The CRD makes clear that institutions have to separately assess, for large exposure purposes, schemes with underlying assets in order to determine the existence of groups of connected clients. Institutions are required to assess whether the scheme itself, its underlying assets or both are interconnected with the institution's clients (including other schemes). The CRD does not, however, specify under what circumstances the scheme or the underlying exposures or both have to be assessed.

In December 2009 CEBS has already issued guidelines on the revised large exposures regime (CRDII). Among other aspects this document provides guidance on the treatment of exposures to schemes with underlying assets, as there was some evidence that institutions' exposures to such schemes were not being consistently (or prudently) treated for large exposures' purposes. In the context of "shadow banking", it is the EBA's view that – and in addition to the scheme - the underlying assets of a scheme should be taken into account when calculating exposures for large exposures' purposes.

D) The EBA stands ready to prevent regulatory arbitrage and assess the needs for regulation ability. "Shadow banks" can take various forms depending on the scope of regulation within each jurisdiction. Banks may use "shadow banks" to find ways of reducing their regulatory capital or liquidity requirements. Banks can also use bank-sponsored money fund composed of callable funds which then lends to the sponsoring bank at longer maturities. The net effect of these actions is an increase in credit and liquidity risk outside the "radar" of the regulator. In perspective, the risks of regulatory arbitrage could even increase as a response to the overhaul of the ongoing requirements under Basel III. In fact, to prevent this kind of potential distortive response by the industry seems to be a crucial complementary underpin to Basel III.

Given the EBA's role in ensuring uniform regulation and consistent enforcement across the EU, the Authority is in the appropriate institutional position to detect new risks stemming from regulatory arbitrage and inadequate risks management practices. Thanks to adequate flows of information from national supervisors the EBA could contribute to prompt appropriate responses to these kind of threats to financial stability by assessing the need to extend regulation to areas not covered yet and/or enforcing corrective actions, if need be.