

30 May 2012

## **The ESRB's reply to the European Commission's Green Paper on Shadow Banking**

### **I. Introductory comments**

As an institutional stakeholder, the European Systemic Risk Board (ESRB) has an interest in responding to the European Commission's consultation on shadow banking<sup>1</sup> for two reasons. First, Regulation (EU) No 1092/2010 establishing the ESRB (the ESRB Regulation) provides that the ESRB is responsible for the macro-prudential oversight of the financial system within the EU.<sup>2</sup> The ESRB Regulation defines the financial system in broad terms<sup>3</sup> and therefore also covers the shadow banking sector. Second, the ESRB membership is cross-sectoral and its member institutions include macro- and micro-prudential supervisory authorities as well as central banks; this makes it particularly suited to deal with shadow banking issues. In line with its mandate, the ESRB focuses in its reply on the systemic risks that may arise from shadow banking. The ESRB does not object to the publication of its reply.

Against this background, the ESRB welcomes the Commission's consultation. The ESRB has already carried out some initial work on shadow banking, some of which is still ongoing, targeting specific issues of concern within this broad field. The ESRB considers it to be one of the key areas of its work programme. The ESRB stands ready to share the results of this work, once final, with the Commission services.

The recent financial crisis demonstrated that shadow banking is a potential source of significant risks, including systemic risk both in its cross-sectional and time dimensions. The cross-sectional dimension results from the interconnectedness between the "regular" banking sector and the shadow banking sector, and between the shadow banking entities and activities, leading to complex and opaque intermediation chains. The time dimension (such as leverage and pro-cyclicality) arises for the most part from within the shadow banking sector owing to less stringent restrictions on maturity and liquidity mismatches and leverage, as well as the prevalence of securities-based financing, market price-based valuation, haircuts and margins in this sector. Measures to address the systemic risks that result from shadow banking therefore need to target both the cross-sectional and the time dimension of systemic risk.

---

<sup>1</sup> *Green Paper on Shadow Banking*, European Commission, 19 March 2012.

<sup>2</sup> Article 3.1 of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board. OJ L331, 15.12.2010, p. 1.

<sup>3</sup> See Article 2 of the ESRB Regulation.

The relative importance and characteristics of the shadow banking sector strongly differ between the United States and the EU and across individual EU Member States. For this reason, it is important to recognise the specificities of the European financial system as well as those of its individual Member States.

In particular, the regular banking sector continues to be very important in the EU. As a consequence, it is vital to understand how the shadow banking sector may potentially affect the regular banking sector through various interconnectedness and pro-cyclicality channels. For example, for their short-term US dollar funding, EU banks rely to a significant extent on shadow banking entities such as US money market funds, which recently proved to be flighty during the European sovereign debt crisis.<sup>4</sup> It is especially important to take into account the relationship between regular banks and their own shadow entities and activities; this was a key element in the 2007-08 financial crisis. The financial soundness of the regular banking sector and its robust risk management therefore remain central. For example, sound underwriting standards should apply for loans that may later be securitised, and the liquidity, funding and counterparty risks resulting from financial links between regular banks and their shadow banking entities and activities should be adequately assessed.

Looking forward, the current changes underway in the European financial system, notably the ongoing deleveraging process in the banking sector and the impact of new rules such as Basel III, the Capital Requirements Directive and regulation (CRD IV/CRR)<sup>5</sup> and Solvency II, may alter its structural characteristics. This could include the flow of business from regular banks to the shadow banking sector. It is important to keep abreast of such changes, understand their systemic implications and identify appropriate policy responses vis-à-vis entities operating in the shadow banking sector.

## **II. Defining shadow banking**

### **Question a): Proposed definition of shadow banking**

The ESRB agrees that the Financial Stability Board (FSB) definition should be used as a starting point.<sup>6</sup> Given the important cross-border nature of shadow banking (not only within the EU but on a global basis) and the resulting need for cross-border cooperation between authorities, it is important to have an internationally accepted definition. The challenge, however, is to make the general FSB definition operational, that is to

---

<sup>4</sup> See, in that respect, Recommendation of the European Systemic Risk Board of 22 December 2011 on US dollar denominated funding of credit institutions (ESRB/2011/2), OJ C 72, 10.03.2012, p. 1.

<sup>5</sup> The Commission's proposals, published in 2011, for a revised Capital Requirements Directive and a regulation, the purpose of which is to implement Basel III in the EU.

<sup>6</sup> *Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board*, Financial Stability Board, 27 October 2011.

implement it in a monitoring, regulatory and supervisory context. Given its mandate and composition, the ESRB (together with its member organisations) should play an important role in implementing this definition in the EU.

In order to dispel any ambiguities, it would be useful if the Green Paper also elaborated on what shadow banking is not. In particular, the Green Paper could clarify that the shadow banking sector is not the same as the “non-bank financial sector”. In line with the FSB’s approach, the entities and activities included in the shadow banking sector definition should be those demonstrating the key risk factors of banking that increase systemic risk, namely the provision of monetary or liquidity services alongside maturity transformation, leverage and imperfect credit risk transfers. In some cases, it might initially be difficult to identify the presence of these key risk factors and therefore, in a first stage, a general monitoring of entities and/or activities might be required (see the comments below on the stepwise monitoring framework adopted by the FSB).

It should also be noted that shadow banking is not per se linked to the degree, type or absence of regulation. Indeed, a shadow banking entity or activity can be (partly) regulated or unregulated, with differences also across countries. For example, the regulatory status of finance companies (i.e. non-bank entities providing credit such as leasing, factoring, consumer credit and financial guarantees) varies in the EU depending on the country. Furthermore, the FSB definition of shadow banking refers to regulatory arbitrage which undermines the benefits of financial regulation. It is emphasised that such regulatory arbitrage is not necessarily performed outside the regular banking system and may also involve banks.

#### **Question b): Preliminary list of shadow banking entities and activities**

The shadow banking sector is a “moving target”: it is constantly evolving and new forms of regulatory arbitrage are, among others, an important driver. For this reason, an activity-based approach supplemented by an entity-based approach might prove to be the most effective. In defining the perimeter of shadow banking a flexible and holistic approach is necessary; an exhaustive or fixed list of shadow banking entities and activities in the EU or worldwide would not be appropriate. In that respect, the ESRB notes that the possible shadow banking entities and activities mentioned in the Green Paper are not a closed list. Indeed, for example hedge funds that are involved in credit intermediation, that are leveraged or generate any of the shadow banking risks mentioned above should for example also be included in the shadow banking sector. Going forward, it is important to clarify which EU body will be involved in identifying shadow banking entities and activities that may give rise to systemic concerns. The ESRB, given its mandate and drawing on the knowledge of its wide membership, is well placed to undertake such a task.

### **III. Benefits and risks**

Assessments of the trade-off between the possible benefits and risks of shadow banking are crucial in the policy approach pursued, however difficult they may prove to be in practice owing to the absence of empirical analyses. In addition to identifying the benefits and risks, it is vital to better understand the fundamental demand and supply factors behind the development of shadow banking. These include, for example, investor preference for safe and liquid assets, regulatory arbitrage, the interaction between market liquidity and funding liquidity, the role of mark-to-market accounting and credit ratings. Knowledge and understanding of the drivers of shadow banking must be a key consideration in identifying and developing policy action.

#### **Question c): Beneficial aspects of shadow banking**

The term “shadow banking” should not have a pejorative meaning per se. With appropriate safeguards in place, such as, inter alia, transparency and disclosure, the supply of financial services by the shadow banking sector can bring benefits, as listed in the Green Paper. For example, against the backdrop of the ongoing deleveraging process in the European banking sector, a well-functioning securitisation market would support the supply of credit to the real economy. The ESRB also believes that the shadow banking sector can be a source of financial innovation, which may result in increased efficiency and more complete financial markets. In addition, the shadow banking sector can provide financial services that regular banks do not necessarily offer, such as market making, thereby improving market liquidity. This could also be mentioned in the Green Paper.

A key lesson from the run up to the recent financial crisis, however, is that the potential benefits of shadow banking should not be taken at face value and their sustainability should be critically assessed in view of the risks. For example, financial innovation may mask regulatory arbitrage; risks that are transferred or diversified away may re-emerge and be highly correlated in crisis situations (“tail risk”).

#### **Questions d) and e): The channels through which shadow banking activities create new risks or transfer risks**

The ESRB agrees with the list of potential risks contained in the Green Paper.

Among the factors that make shadow banking activities more susceptible to “runs”, the Green Paper could add that the shadow banking sector does not benefit from the official safety net designed to limit the risk of runs on regular banks. The shadow banking sector can only obtain indirect access to this safety net to the extent that regular banks step in to provide private backstops, such as liquidity lines or credit enhancement. If these backstops have not been adequately priced by banks and if the systemic implications

have not been internalised within the banks' risk management, banks themselves become less resilient and a risk for financial stability is created.

The reputational risk that shadow banking may entail for regular banks should also be mentioned in the Green Paper. Even in the absence of direct financial links between regular banks and the shadow banking sector, risks may nevertheless arise where banks sponsor, implicitly support and/or associate their brand with shadow banking entities or activities.

A further risk concerns the potential role of the shadow banking sector in inducing a misallocation of resources within the economy. For example, the supply of financial services on unsustainable terms to one or more sectors of the real economy has consequences for the allocation of resources between economic sectors and therefore for the composition of economic growth and its sustainability. This could be exacerbated by a "race to the bottom" if banks and other regulated entities seek to compete on such terms. Imbalances in the real economy can, in turn, feed back and may pose financial stability risks.

#### **IV. Regulatory and supervisory challenges**

##### **Question f): The need for stricter monitoring and regulation**

The Green Paper focuses to a large extent on regulation. Although (public) disclosure and enhanced monitoring cannot be substitutes for regulation, they can represent a first step in the presence of potential systemic risk and in view of the insufficient knowledge about certain shadow banking entities or activities. For example, at the present juncture there is still insufficient information about repo markets and the channels through which financial collateral is (re)used to adequately assess their systemic implications.

In addressing the regulatory and supervisory challenges, the ESRB fully supports the stepwise monitoring framework adopted by the FSB. In a first step, a broad assessment of the scale and trends in non-bank credit intermediation is made ("macro mapping"). Then, the analysis is further narrowed down to entities or activities that have the potential to pose systemic risks and/or regulatory arbitrage concerns. Finally, detailed assessments of particular entities or activities and appropriate responses are identified.

Implementing the FSB's approach will require a clear definition of responsibilities in the EU for such monitoring, analysis and, if deemed necessary, the adoption of policy measures. There also needs to be a well-defined and rapid process in place for obtaining access to the information necessary to monitor the shadow banking sector and to assess the systemic risks to which it gives rise. Finally, a set of instruments should be developed that may be activated to prevent and mitigate those risks.

**Question g): Identification and monitoring of the shadow banking sector**

In terms of responsibilities, within the EU, the ESRB should be given a mandate to coordinate the regular monitoring of the shadow banking sector according to the FSB's stepwise approach. This monitoring will need to be carried out in close cooperation with the ESRB member organisations.

Such regular monitoring by the ESRB, which is also essential for developing effective regulatory measures, will require gathering data and other information from various sources: supervisory data from banking, insurance and market supervisors; data from market infrastructures such as trade repositories and central counterparties; and monetary and financial statistics from central banks and national macro-prudential authorities. In addition, information derived from accounting perspectives and market intelligence should be used. Some of the information will be aggregate in nature, and some will be entity or activity-specific. The former will be particularly important in implementing the first step of the FSB approach and the latter for the second step, not least because some critical features of the shadow banking sector, such as the opaque and complex intermediation chains, may be obscured by aggregate data. Other information will necessarily be anecdotal or qualitative, taking into account the evolving nature of shadow banking and will be useful in capturing financial innovations.

In establishing an ESRB monitoring framework, it is important that the existing mandates at the national and European level are fully utilised and – whenever needed – adjusted to enable a broad investigation and the swift collection of relevant (quantitative and qualitative) information. Such a regime should be premised on the assumption of the widest possible access to the required data, subject to strict confidentiality rules, but avoiding any additional time-consuming barriers. Data will need to be collected in close coordination with the ESRB member organisations and other data-gathering bodies to ensure that information already available is used to the maximum and that any additional reporting burden is kept to a minimum. The principle of proportionality with regard to the potentially different systemic importance of the various segments of the shadow banking sector will also need to be taken into account.

**Questions h) and i): General principles for the regulation and supervision of the shadow banking sector**

Since shadow banking is a moving target, an approach based on economic substance and activity, rather than on fixed and narrowly-defined regulated entities, is more effective. As a consequence, regulation should take an increasingly horizontal perspective. Mechanisms are needed to ensure that both existing and new sectoral rules can be applied to the activities of regulated and non-regulated entities where those activities are regulated under different sectoral rules than the entity itself. For example, entities that act as quasi-banks – that is, providing services involving the creation of



“money-like” liabilities and/or maturity and liquidity transformation possibly in combination with leverage – should be subject to similar or equivalent regulation and supervision as banks. As a rule, the regulatory and supervisory responses to the shadow banking sector should be commensurate with the systemic risk and regulatory arbitrage concerns raised, in line with the principle of proportionality.

Upcoming new rules such as CRD IV/CRR and Solvency II may drive some entities or activities out of the “regular” banking sector and into known and yet unknown parts of the shadow banking sector, thus triggering regulatory arbitrage. Therefore, in the assessment of new regulations, attention should be paid to the fact that banks might adapt to the regulatory environment in this way. For example, the new rules mentioned above will create a high demand for high-quality, liquid assets. It has been observed that some banks satisfy this demand using collateral or liquidity swaps with insurance firms and (sometimes) in-house exchange-traded funds. Although this should not be a reason to water down the proposed rules, the authorities should be aware of such side-effects.

More emphasis is needed on how macro-prudential instruments can be used to address the systemic risk concerns raised by the shadow banking sector. This should include an analysis of how shadow banking can undermine the application of macro-prudential measures to address risks in regulated sectors. Instruments are needed to address the links between regulated entities or activities and the shadow banking sector, and to take action on shadow banking entities or activities that fall outside the regulatory perimeter or are insufficiently regulated when they give rise to systemic risk.

Regarding the links between regulated entities or activities and the shadow banking sector, a number of micro-prudential instruments may potentially also be used for macro-prudential purposes, for example, bank capital buffers; sectoral capital requirements, such as specific risk weights on intra-financial system exposures; large exposures and activity limits; funding concentration limits; and minimum and “through the cycle” margin and haircut requirements for secured lending and financing transactions.

As regards the shadow banking entities or activities, the ESRB is well placed to identify the financial innovations and regulatory arbitrage that raise systemic concerns, and to make the necessary recommendations for action in order to address those concerns. Recommendations regarding the regulatory perimeter and the use of macro-prudential instruments will be particularly important. The ESRB should perform these tasks drawing on the know-how of its member organisations and, in particular, that of the European Supervisory Authorities (ESAs). In this way, the ESRB’s systemic risk perspective would be complemented by the ESAs’ micro-prudential and consumer protection perspective.

#### **Question j): International consistency**

The cross-border dimension is very important in shadow banking. A consistent global definition of the shadow banking sector is therefore essential to create a level playing

field and reduce the scope for regulatory arbitrage. The work in the EU building on the FSB definition should therefore be closely coordinated with global and third country initiatives. In that respect, it should be noted that the ESRB is already required to coordinate its actions with those of international financial organisations, such as the FSB, as well as the relevant bodies of third countries on matters related to macro-prudential oversight.<sup>7</sup> Furthermore, a framework must be established for cooperation and data sharing both across the EU and with non-EU jurisdictions, such as the United States. The European and national authorities should have appropriate powers to collect the necessary harmonised data from the shadow banking sector and to share that data at the European and international level.

Where macro-prudential instruments are used in different EU jurisdictions to address shadow banking concerns, consistency in their definition and application must be ensured, as well as flexibility in their calibration to match the extent of the underlying systemic risks. Since the relative importance and characteristics of the shadow banking sector differ strongly across individual EU Member States, it is important to duly recognise the specificities of individual Member States. Work is ongoing at the ESRB to identify, analyse and ensure consistent practices in the application of macro-prudential instruments generally, which can also be applied to the risks associated with shadow banking.

In that respect, the Green Paper should underline that risks related to the shadow banking sector are currently mitigated to a varying extent across jurisdictions in the EU, not only because of differences in regulation but also because of differences in interpretation and enforcement.

## **V. Current EU measures and outstanding issues**

### **Questions k) to o): Current EU measures and any other issues**

To ensure global consistency in the treatment of shadow banking, it is important that the EU reflects fully and consistently, both in EU and national law as appropriate, the policy initiatives agreed at international level, notably those emanating from the FSB. The ESRB agrees with the five key areas selected by the Commission. As they correspond to the work streams established by the FSB, in this way the application of the FSB's work to the European shadow banking sector is facilitated. In this context, a balanced use of direct and indirect regulation (as defined in the Green Paper) would also be appropriate.

The ESRB welcomes the various measures already taken. However, it cannot suggest amendments to the existing regulations until the forthcoming FSB proposals are released. For example, at the request of the FSB, the Basel Committee on Banking

---

<sup>7</sup> Article 3.2 (i) of the ESRB Regulation.



Supervision is investigating how to address the links between regulated banks and the shadow banking sector, e.g. through applying large exposure limits and the capital treatment of liquidity and credit lines. The outcome of the Basel Committee's work will be particularly relevant for the European banking sector and the European financial system.

The ESRB must be able to respond to the FSB proposals in a timely manner. In its first year and a half of existence, the ESRB has already carried out some initial work on shadow banking, some of which is still ongoing, targeting specific areas of concern in this broad field. This work includes, for example, identifying and assessing potential systemic risks associated with European money market funds and with securities financing transactions. In line with the more broad spectrum of recommendations issued by the FSB in 2011, the ESRB also aims to set up a general framework for monitoring and identifying potentially risky developments stemming from shadow banking activities through a dialogue between ESRB member organisations based on both qualitative and quantitative information. Initiatives to gauge the size of the shadow banking sector in the EU have already been conducted, but are not yet final. As mentioned above, the ESRB is ready to share the final results of its work on the risks associated with shadow banking with the Commission services.

At this stage, the ESRB would only make the following observations. First, while the ESRB in general supports the European legislative trend towards full harmonisation of the definition of prudential standards ("single rule book"), a framework should be set up allowing macro-prudential authorities some "constrained discretion" – with workable safeguards – in setting higher standards to deal with financial stability risks in their jurisdiction arising from shadow banking.<sup>8</sup> Second, subject to such constraints and safeguards, the EU legal framework needs to allow for the flexible and targeted application of macro-prudential instruments to sectors, entities and activities. Furthermore, it should include a process enabling new instruments to be activated swiftly when the need arises to address specific systemic risk concerns, for example resulting from financial innovation or regulatory arbitrage. Finally, further work is needed to better understand any significant cross-sector inconsistencies that may exist between existing and forthcoming regulation in the EU (such as CRD IV/CRR and Solvency II) and that may prove to be an important driver for systemic risk arising from regulatory arbitrage.

---

<sup>8</sup> In the context of the capital requirements legislation, the ESRB has clarified the elements of such a framework in a letter to ECOFIN, the European Commission and the European Parliament, *Principles for the development of a macro-prudential framework in the EU in the context of the capital requirements legislation*, 29 March 2012. The letter is available on the ESRB's website ([www.esrb.europa.eu](http://www.esrb.europa.eu)).