Shadow Banking
Out of the Shadows and Into the Light

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Today’s Topics

• What is meant by “shadow banking”

• FSB recommendations and workstreams
  ➢ interaction of regular banking system with shadow banking
  ➢ money market funds
  ➢ systemic risks posed by other shadow banking entities
  ➢ securitisation and excessive leverage
  ➢ securities lending / repos and other secured financing transactions

• SEC proposed amendments to Investment Company Act 1940 to address systemic risks posed by money market funds

• EU Commission Communication on shadow banking and draft Regulation on money market funds
Meaning of “Shadow Banking”

• FSB background note – 12 April 2011:
  ➢ no clear definition
  ➢ generally refers to activities outside the regular banking system that involve bank-like functions
  ➢ focus on non-bank credit intermediation
  ➢ particular concern on activities that give rise to systemic risks, in particular by maturity or liquidity transformation, leverage and flawed credit risk transfer
Meaning of “Shadow Banking” (cont.)

• EU Commission Green Paper published in March 2012 approved FSB definition and set out non-exhaustive list of entities and activities it believes fall within the ambit of shadow banking

Entities

• Special purpose entities performing liquidity and / or maturity transformation (eg ABCP conduits, securitisation SPVs, SIVs)
• Money market funds and similar vehicles with deposit like characteristics making them vulnerable to runs
• Investment funds providing credit or that are leveraged (eg ETFs)
• Finance companies / securities entities providing credit or guarantees or unregulated liquidity / maturity transformation
• Insurance / reinsurance undertakings issuing or guaranteeing credit products

Activities

• Securitisation
• Securities lending and repos
FSB Policy Objectives

- FSB has issued various further consultative documents
  - ahead of G20 meeting at St. Petersburg on 5/6 September 2013, FSB published policy recommendations on oversight and regulation of shadow banking

- G20 “Roadmap” to strengthened oversight and regulation of shadow banking
Monitoring Shadow Banking (cont.)

- FSB believes it is essential for regulatory authorities to monitor transactions and arrangements that can give rise to systemic risk outside the regular banking system.

- FSB conducts an annual monitoring exercise. Most recently for 2012:
  - 25 jurisdictions monitored
  - Shadow banking system is about half the size of the regular banking system.

- Netherlands, U.S., Hong Kong, UK, Singapore and Switzerland all have significant shadow banking sectors compared to regular banking sectors and/or GDP.

- Still a lack of granular information on categories of activity.
FSB (in conjunction with BCBS and IOSCO) has developed five general principles for regulatory measures relating to shadow banking:

- Measures should be designed to target the externalities and risks posed by shadow banking to the financial sector
- Measures should be proportionate to the risks shadow banking poses to the financial system
- Measures should be forward-looking and adaptable to emerging risks
- Measures should be designed and implemented in an effective manner balancing need for international consistency and minimisation of arbitrage potential against the need to reflect differences in financial structures and systems
- Regulators should regularly assess the effectiveness of regulatory measures and make adjustments as appropriate
Interaction of Regular Banking System with Shadow Banking

- Various amendments have been made to banks’ capital requirements under Basel II.5 and III measures that have been or are in the process of being adopted:
  - increased capital requirements for banks’ exposures to resecuritisations and liquidity facilities provided to securitisation vehicles
  - increased capital requirements under the IRB approach for exposures to regulated financial institutions whose total assets are equal to or greater than US$100bn and to unregulated financial institutions
  - enhanced banks’ internal capital adequacy process under Pillar 2 for securitisation risk, reputational risk and implicit support
  - enhanced Pillar 3 disclosure requirements in relation to securitisation

- BCBS is developing guidance to improve international consistency of consolidation for prudential regulatory purposes
  - policy proposals to be published during 2013
Interaction of Regular Banking System with Shadow Banking (cont.)

• BCBS developing large exposure regime taking into account risks typically arising from shadow banking, e.g. interconnectedness and opacity:
  ➢ consultation paper published in March 2013 – to be finalised during 2013

• BCBS is developing an international framework for banks’ investment in the equity of funds:
  ➢ consultation paper published in July 2013 – to be finalised during 2013

• BCBS decided not to examine capital requirements related to short term liquidity facilities provided by banks to shadow banking entities outside the scope of the Basel III framework
Regulation of other Shadow Banking Entities

- FSB has examined the extent to which non-bank financial entities (other than MMFs) pose systemic risks
- Focus on economic functions carried out by relevant entities rather than focussing purely on legal names or forms
- FSB recommends that regulatory authorities identify shadow banking risks in non-financial entities by focussing on a framework of five economic functions:
  - management of cash pools with features making them susceptible to runs
  - loan provision that is dependent on short term funding
  - intermediation of market activities dependent on short term funding or on secured funding of client assets
  - facilitation of credit creation
  - securitisation and funding of financial entities
Regulation of other Shadow Banking Entities (cont.)

• FSB recommend that authorities should adopt overarching principles and apply policy tools from a menu of optional policies

• Overarching principles are:
  ➢ regulatory authorities should have the power to define the regulatory perimeter
  ➢ authorities should collect information to assess risks posed by shadow banking
  ➢ authorities should enhance disclosure by such entities to help market participants understand the extent of shadow banking risks posed by such entities
  ➢ authorities should assess non-bank financial entities based on their economic functions

• FSB has identified policy toolkits to address shadow banking risks from each of the economic functions above

• Regulatory authorities should share information to maintain consistency in applying policy framework:
  ➢ detailed procedures for information sharing to be developed by FSB by March 2014
Securitisation and Excess Leverage

• FSB has accepted that securitisation can have benefit to real economy:
  ➢ resumption of orderly securitisation markets stated to be a goal of the wider financial reform programme

• Concerns, however, that certain complex structures gave rise to various risks:
  ➢ misaligned incentives as between originators and investors
  ➢ imperfect credit risk transfers leading to concentration of risk in banking system
  ➢ opaqueness of structures led to lack of transparency
  ➢ some structures were specifically designed to circumvent Basel capital requirements

• BCBS/IOSCO undertook investigation of requirements relating to transparency and risk retention

• IOSCO policy recommendations published in November 2012
Securitisation and Excess Leverage (cont.)

• IOSCO recommendations include:
  - enhanced monitoring of incentives / retention requirements and the impact of differences in approach, particularly between EU and US
  - improving disclosure by issuers on stress testing and scenario analysis of pooled assets
  - encouraging standardisation of securitisation products, particularly in relation to disclosure templates

• IOSCO to undertake peer review in 2014 to assess implementation of incentive alignment approaches in its member jurisdictions
Regulation of Securities Lending and Repos

• FSB acknowledge securities and repo markets are vital in supporting secondary market liquidity for many securities:
  - central to financial intermediaries’ ability to make markets and facilitate risk management and collateral management strategies
  - core funding markets for some financial institutions
  - key to money market and refinancing operations in many jurisdictions
  - can, however, lead to bank like activities including maturity and liquidity transformation and leverage
• FSB’s specific concerns include:
  ➢ ensuring competent authorities have sufficient visibility on the build-up of leverage and illiquidity
  ➢ extent of reinvestment of cash collateral given for securities lending (and the potential for maturity and liquidity transformation)
  ➢ potential for securities financing to cause pro-cyclicality in the banking system
  ➢ tendency of creditors in repo and securities lending sectors to sell collateral securities immediately upon a counterparty default, potentially causing a downwards spiral
  ➢ possibility of re-hypothecation of client assets causing risks to financial stability if there is uncertainty as to the treatment of re-hypothecated assets in the event of an insolvency
• FSB has developed 11 policy recommendations for this workstream, including:
  ➢ improving regulatory reporting to obtain more granular information on exposures
  ➢ improving collection of trade level data and regular snapshots of outstanding balances for repo markets (particularly through trade repositories)
  ➢ total national and regional data for repos and securities lending should be aggregated by FSB
  ➢ improving reporting by fund managers to end-investors
  ➢ limiting risks associated with cash collateral reinvestment
  ➢ addressing risks associated with re-hypothecation of client assets
  ➢ strengthening collateral valuation and management practices
  ➢ evaluating the establishment or wider-use of central clearing
  ➢ changing bankruptcy law treatment of repos and securities lending transactions

• FSB published proposals for consultation on 29 August 2013 on minimum standards for methodologies in calculating haircuts and for a minimum haircut framework
Regulatory Reform of Money Market Funds

• FSB has stated that MMFs are an important element of the shadow banking system:
  ➢ provision of maturity and liquidity transformation
  ➢ important source of short-term funding for banks

• Historically MMFs have been regarded as a safe investment with a stable NAV

• During financial crisis some MMFs suffered large losses due to holdings of ABS and other financial instruments:
  ➢ significant drop in NAVs of some funds
  ➢ prompted investor redemptions and instability
  ➢ in 2008, the Prime Reserve Fund in the US “broke the buck” due to large holdings in Lehman Brothers paper

• IOSCO Reports: April 2012 and October 2012
Regulatory Reform of Money Market Funds (cont.)

- IOSCO identified on-going vulnerabilities of MMFs which could destabilise the financial system:
  - stable NAV features gives impression of safety but MMFs are subject to credit, interest rate and liquidity risk
  - “first mover advantage” for investors who redeem MMF shares at first sign of market distress – stable NAV feature means losses are borne by remaining shareholders
  - discrepancies between published NAV and realisable value of assets
  - implicit support from sponsors results in investors perceiving MMFs as less risky than they are
  - importance of ratings in MMF regulations
Regulatory Reform of Money Market Funds (cont.)

- IOSCO final report makes 15 policy recommendations, which have been endorsed by the FSB, including:
  - MMFs should be explicitly defined in regulation of collective investment schemes
  - need for compliance with general principles of fair value when valuing securities in portfolio
  - holding of a minimum amount of liquid assets to meet redemptions and prevent fire sales
  - MMFs that offer a stable NAV should be subject to measures designed to reduce specific risks associated with the stable NAV feature
  - MMF regulation should strengthen internal credit risk assessment practices
  - documentation should disclose the absence of a capital guarantee
  - regulators should, where necessary, develop guidelines strengthening the framework applicable to the use of repos by MMFs

- IOSCO to launch peer review process to examine implementation of its recommendations by national and regional authorities
SEC Regulation of Money Market Funds

- Following publication of initial IOSCO Report, a majority of SEC Commissioners released a statement in May 2012 stating that SEC representatives should oppose publication of the Report
  - in August 2012, lacking sufficient votes, the SEC Chairman tabled the MMF reform proposals
- In November 2012, the U.S. Financial Stability Oversight Council (FSOC) voted unanimously to propose MMF reform
- The FSOC presented three options for reform:
  - mandatory requirement for floating NAV
  - keeping a constant NAV feature but with a capital buffer to be built up to absorb variations in fund’s NAV
  - keeping a constant NAV feature but with a risk based NAV capital requirement of 3% and other standards including diversification and minimum liquidity levels and robust disclosure requirements
- FSOC recommendations are not binding on the SEC
In June 2013, the SEC voted to propose changes to MMF regulation. The SEC has proposed two alternatives. Possibility of adoption of only one alternative or some combination of the two. The comment period ended on 17 September 2013.

First alternative: Floating NAV

- Institutional prime MMFs would no longer be allowed to use the “amortised cost” method of valuing securities (acquisition cost + premium or discount amortised to maturity) which currently allow them to maintain stable share price.
- “Penny rounding” no longer permitted – rounding to fourth decimal place required (government and retail MMFs (defined as those limiting daily redemptions by any one shareholder to $1 million) would still be able to round to nearest penny).
- Daily market valuations would be required.
- Would become effective two years after final approval.
SEC Regulation of Money Market Funds (cont.)

• Second alternative: liquidity fees and redemption gates:
  ➢ liquidity fees: if non-government MMF’s “weekly liquid assets” fall below 15% of total assets, the MMF must impose a liquidity fee of 2% on all redemptions (the fund board can impose a lesser or no fee if determined to be in the fund’s best interests)
  ➢ redemption gates: if weekly liquid assets fall below 15%, the board may suspend redemptions for up to 30 days (gates limited to a maximum of 30 days in any 90 day period)
  ➢ government MMFs are not bound by fee and gate requirements but could impose them if disclosed in the prospectus
  ➢ MMFs can continue to use the penny-rounding method but not the amortised cost valuation
  ➢ would become effective one year after final approval
SEC Regulation of Money Market Funds (cont.)

- SEC made further additional proposals in respect of MMFs including:
  - daily website disclosure of certain information including NAV per share
  - additional disclosure requirements re portfolio holdings, assets and cash holdings and subscriptions and redemptions
  - additional disclosure requirements in relation to financial support received from the sponsor or other affiliate
  - removal of 25% bucket for guarantees or demand features from a single institution
  - other amendments which promote greater diversification
  - additional stress testing requirements

- Additional proposals would become effective 9 months after final approval
In December 2012 the European Systemic Risk Board published four broad recommendations in relation to MMFs:

- a mandatory move to variable NAV in most cases
- greater requirements for monitoring of liquidity risks and having measures in place to deal with liquidity constraints
- greater public disclosure of absence of capital guarantee, valuation practices and redemption procedures
- enhanced reporting requirements
Draft EU Money Market Fund Regulation

• Draft Regulation published by EU Commission on 4 September 2013

• Departs from earlier ESRB recommendations in a number of respects

• Draft Regulation proposes to limit investment by MMFs to:
  • money market instruments (with high internal credit rating)
  • deposits of no more than 12 months (or on demand) with eligible credit institutions
  • financial derivatives (for hedging maturity and fx risks only)
  • reverse repos (maximum close-out facility of two working days)
Draft EU Money Market Fund Regulation (cont.)

- **Investment restrictions, including:**
  - no short selling of money market instruments
  - no direct or indirect exposure to equities or commodities
  - no entry into of securities lending or borrowing arrangements
  - no cash lending

- **Diversification and concentration:**
  - maximum 5% issuer limit for money market instruments
  - 5% limit on deposits with a single credit institution
  - aggregate 10% limit on securitisation exposure
  - aggregate 10% limit on issuer exposure
Draft EU Money Market Fund Regulation (cont.)

• NAV Buffers for constant NAV MMFs:
  ➢ MMF will be required to maintain, on a continuous basis, a capital buffer of at least 3% of aggregate value of all MMF assets
  ➢ buffer to be held in a reserve account in cash
  ➢ sole permitted use of buffer is to meet difference between constant NAV per share and the actual value but for such feature
  ➢ ESMA to be notified if buffer decreases by 10 basis points below 3% minimum level
  ➢ buffer can be built up to 3% over three year period
  ➢ the constitutional documents of the MMF must set out clear procedures for conversion to a non-constant NAV fund
Other relevant provisions:

- Portfolio of MMF must have weighted average maturity of no more than 60 days and a weighted average life of no more than 120 days.
- MMF prohibited from obtaining an external credit rating.
- MMFs with stable NAV feature may value assets using the amortised cost method. Otherwise, valuation should be marked to market daily.
- Apart from the buffer for MMFs with stable NAV feature, no external support may be provided.
- Provisions to stress test liquidity and quality of assets.
Other EU Developments

• EU Commission published Green Paper on shadow banking in March 2012 and sought feedback on a number of issues including:
  - FSB definition of shadow banking
  - EU Commission list of types of entities regarded as engaging in shadow banking
  - need for stricter monitoring and regulation of shadow banking
  - general principles for supervision of shadow banking
  - how to obtain international consistency in shadow banking regulation and avoid regulatory arbitrage
  - current measures already in place in EU to deal with certain shadow banking issues

• EU Commission published summary of responses to Green Paper in December 2012
Other EU Developments (cont.)

- EU Commission Communication published on 4 September 2013
- Commission reports that most respondents to its Green Paper supported the laying down of clearer rules for shadow banking
  - general support for FSB definition of “shadow banking”
  - concern at the term “shadow banking”
  - consensus on need to reduce opportunities for regulatory arbitrage
- EU Commission Communication sets out financial reform measures it has implemented or is in the process of implementing that will address some of the concerns raised by the FSB / IOSCO including:
  - securitisation risk retention provision under CRD3
  - enhanced disclosure requirements for off balance sheet exposures under IFRS 7
  - the risk based approach under the Solvency 2 Directive
  - harmonised framework for investment fund managers under AIFMD
  - greater transparency of derivative transactions under EMIR reporting requirements
Other EU Developments (cont.)

- EU Commission Communication identifies 5 “priority areas” for additional measures to address risks associated with shadow banking
  - Increased transparency
    - development of monitoring framework for collection and exchange of data
    - establishment of central repositories in connection with EMIR transaction reporting requirements
    - implementing a “Legal Entity Identifier” for financial counterparties
    - increased transparency of securities financing transactions
  - Enhanced framework for investment funds
    - finalising draft EU regulation for money market funds
    - review of UCITs funds including how they use securities financing transactions
  - Reducing the risks associated with securities financing transactions
    - EU Commission considering a legislative proposal covering securities lending and repo transactions and rehypothecation of securities
Other EU Developments (cont.)

• Strengthening prudential framework to limit contagion and arbitrage risks:
  ➢ from 2014 banks must report principal exposures to unregulated entities and exposures to repo and securities lending arrangements
  ➢ possible extension of prudential rules to non-banking entities to reduce arbitrage risks

• Greater supervision of shadow banking sector:
  ➢ member states to ensure risks inherent in shadow banking are identified and monitored
  ➢ European regulatory authorities to step-up and co-ordinate work on assessment, identification and monitoring of entities and risks posed by shadow banking
Next Steps

• Finalisation of FSB workstreams
  - Basel Committee work on large exposure and banks’ investment in equity funds
  - FSB to finalise proposals on haircut practices in securities lending transactions
  - FSB / IOSCO to review securitisation markets
  - FSB expects group to develop standards and processes for securities financing markets
  - FSB to develop procedure for information sharing
  - FSB to finalise implementation timetable
Questions?