Statement by the Committee on Finance 2011/12:FiU48

Green Paper on Shadow Banking

Summary

In this statement the Committee on Finance looks at the Commission's Green Paper on Shadow Banking (COM(2012) 102 final), which was presented on 19 March 2012.

The Committee welcomes the Green Paper's presentation of how the Commission sees the shadow banking sector and of the existing and planned EU legislation. The Committee's opinion is positive; it considers it necessary to take stock of the possibilities offered by shadow banking and the risks it poses. It is important to look carefully at which further regulatory measures might be needed, and the form these should take. It is important to acquire a better understanding of what shadow banking involves and to compile better statistics covering its activities.

The Committee has no objections to the definition of shadow banking proposed by the Commission or to the preliminary list of shadow banking entities and activities.

The Committee notes that shadow banking embraces important functions and therefore can make a positive contribution to the financial system, but at the same time it also harbours risks.

As regards the ongoing regulation of shadow banking, supervision needs to be strengthened. However, regulation and other measures should not take place entirely at national or entirely at EU level. The aim should be rather to work towards as broad a measure of international cooperation as possible.

In the Committee's opinion, special attention should be paid to the risks to consumers which may arise outside the regular banking system. In this connection the possibility of national regulation should also be considered.

Finally, the Committee notes that the extent of shadow banking in Sweden is limited, but that work within the EU and globally on analysing and regulating shadow banking activity is nevertheless of major importance for Sweden, not least against the background of the size of Sweden's regular banking industry.

The Committee supports the Commission's further work to analyse shadow banking and the need for regulation.

The Committee proposes that the Swedish Parliament place its statement on file.

The file includes a reasoned reservation.

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Parliament is placing the statement on file.

Reservation (V) – grounds

The Committee proposes that the matter be decided after a single hearing.

Stockholm, 22 May 2012

On behalf of the Committee on Finance

Anna Kinberg Batra

The following members participated in the decision: Anna Kinberg Batra (M), Fredrik Olovsson (S), Elisabeth Svantesson (M), Pia Nilsson (S), Göran Pettersson (M), Jörgen Hellman (S), Ann-Charlotte Hammar Johnsson (M), Maryam Yazdanfar (S), Carl B Hamilton (FP), Bo Bernhardsson (S), Per Åsling (C), Marie Nordén (S), Staffan Anger (M), Per Bolund (MP), Anders Sellström (KD), Erik Almqvist (SD) and Ulla Andersson (V).

Report on the subject

Subject and preparatory work

The G20 meeting in November 2010 called on the Financial Stability Board (FSB), working in conjunction with other international organisations, to draw up recommendations to reinforce oversight and regulation of shadow banking. In response, the FSB published a report on 27 October 2011[1].

Against this background, on 19 March 2012, the Commission adopted a Green Paper on Shadow Banking (COM(2012) 102 final). The purpose of the Green Paper is to take stock of current developments and present ongoing reflections on the subject to allow for a wide-ranging consultation of stakeholders. The Commission notes that it is important to examine in detail the issues posed by shadow banking activities. It invites all stakeholders to comment on all the issues set out in the Green Paper. The consultation closes on 1 June 2012.

The Swedish Parliament referred the Commission's Green Paper to the Committee on Finance on 21 March 2012.

On 26 April 2012 the Government Offices published a memorandum on shadow banking (2011/12:FPM136).

The National Bank and the Financial Supervisory Authority provided information on shadow banking at the meeting of the Committee on 10 May 2012.

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[1] Shadow Banking: Strengthening Oversight and Regulation – Recommendations of the Financial Stability Board.

Examination by the Committee

Green Paper

Background

An increasingly large credit industry has emerged outside the banking sector. It has not been a prime focus of prudential regulation and supervision. According to the Green Paper, shadow banking performs an important function in the financial system and offers alternatives to bank deposits. However, the phenomenon may also pose a potential threat to long-term financial stability.

The Commission therefore considers that the priority should be to examine the issues which shadow banking may pose. The objective should be to respond actively to problems, increase the resilience of the EU's financial system and ensure that all financial activities are contributing to economic growth. The Commission's purpose in presenting the Green Paper is to take stock of developments and present reflections so as to create the possibility of a wide-ranging consultation.

The FSB is in the process of developing recommendations on the oversight and regulation of shadow banking activity. In its work the FSB has highlighted that disorderly failures in shadow banking can carry a systemic risk, both directly and through the interconnections between the normal banking system and shadow banking. At the same time, reinforced regulation of banks' activities could drive a growing part of banking activities out of the framework of traditional banking.

The FSB has initiated five work-streams tasked with analysing the issues in more detail and developing policy recommendations. These work-streams are as follows:

- The Basel Committee on Banking Supervision (BCBS) will consider how tighter regulation of the interaction between banks and shadow banking entities should be developed. Its report is due in July 2012.

- The International Organisation of Securities Commissions (IOSCO) will work on regulation to mitigate systemic risks relating to money market funds. Its report is due in July 2012.

- The IOSCO, with the help of the BCBS, will carry out an evaluation of existing securitisation requirements and make further policy recommendations in July 2012.

- An FSB subgroup will examine the regulation of other shadow banking players such as special-purpose entities which perform liquidity and/or maturity transformation, investment funds and exchange-traded funds that provide credit or are leveraged, finance companies and securities entities which provide credit or are leveraged, and insurance and reinsurance undertakings which issue or guarantee credit products. Its report is due in September 2012.

- Another FSB subgroup will work on securities lending and repos and report in December 2012.

What is shadow banking?

In the Green Paper the Commission notes that the FSB report from October 2011 represents the first comprehensive international effort to deal with shadow banking. The report defines shadow banking as a system of credit intermediation that involves entities and activities outside the regular banking system. The Green Paper points out that, according to this definition, shadow banking can be said to be based on two intertwined pillars. These are entities operating outside the regular banking system and entities that can act as important sources of funding for non-bank entities.

The entities concerned thus operate outside the regular banking system and are engaged in one of the following activities:

- accepting funding with deposit-like characteristics;
- performing maturity and/or liquidity transformation;
- undergoing credit risk transfer;
- using direct or indirect leverage.

The activities which can act as important sources of funding for non-bank entities include securitisation, securities lending and repurchase transactions (repos).

The FSB roughly estimated the size of the shadow banking system at around €46 trillion in 2010. This is an increase from €21 trillion in 2002 and represents 25–30% of the financial system and half the size of bank assets.

The Commission focuses its analysis on the following possible shadow banking entities:

- special-purpose entities which perform liquidity and/or maturity transformation;
- money market funds and other types of investment fund or products with deposit-like characteristics which make them vulnerable to large-scale redemptions;
- investment funds, including exchange-traded funds, which provide credit or are leveraged;
- finance companies and securities entities providing credit or credit guarantees or performing liquidity and/or maturity transformation without being regulated like a bank;
- insurance and reinsurance undertakings which issue or guarantee credit products.

The activities targeted by the Commission's analysis are:

- securitisation;
- securities lending and repo.

In this section the Commission asks whether the definition of shadow banking is acceptable and whether more entities or activities should be analysed.

What are the risks and benefits related to shadow banking?

It is stated in the Green Paper that shadow banking activities can constitute a useful part of the financial system, since they

- provide investors with alternatives to bank deposits;
- channel resources towards specific needs more efficiently, due to increased specialisation;
- constitute alternative funding for the real economy, which is particularly useful when traditional banking or market channels become impaired;
- constitute a possible source of risk diversification away from the banking system.

The Green Paper notes that shadow banking activities may also create risks, which may be of a systemic nature due to the complexity of shadow banking entities and activities. Activities are also cross-border and cross-jurisdictional in reach. Furthermore, securities and fund markets are characterised by inherent mobility, and shadow banking entities are interconnected with the regular banking system.

Shadow banking activities are associated with similar financial risks as banks, without being subject to comparable constraints imposed by regulation and supervision. For example, some activities are financed by short-term funding, exposing them to risks of sudden and massive withdrawals of funds by clients.

High, hidden leverage can build up. Shadow banking activities can be highly leveraged, with collateral funding being churned several times, but without being subject to the limits imposed by regulation and supervision.

Shadow banking operations can be used to avoid the regulation and supervision applied to regular banks by breaking up the traditional credit intermediation process among legally independent structures dealing with each other. Such fragmentation creates the risk of a regulatory race to the bottom for the financial system as a whole. Banks and financial intermediaries try to mimic shadow banking entities or perform certain operations in entities outside the scope of their consolidation. Operations which circumvent capital and accounting rules and transfer risks outside the scope of banking supervision played an important role in the build-up to the financial crisis.

Shadow banking activities are often closely linked to the normal banking sector. Risks in shadow banking can therefore easily be transmitted to the normal banking sector.

The Green Paper asks the following questions in this regard:

- 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?
- 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?

- Should other channels be considered through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?

What are the challenges for supervisory and regulatory authorities?

The Green Paper notes, given the potential risks in shadow banking, that it is essential for the supervisory and regulatory authorities to consider how the system should be managed. The Commission draws specific attention to three different challenges to the authorities.

The first challenge is to identify and monitor the shadow banking sector. In the EU there are several supervisory authorities with relevant experience, and the EU's supervisory authorities have started building up expertise on shadow banking. However, in the Commission's opinion, there remains a pressing need to fill gaps in the knowledge about the interconnections at global level between banks and non-bank financial institutions. The EU may therefore need to ensure that there are permanent processes for the collection and exchange of information between supervisory authorities in the EU, the Commission, the European Central Bank (ECB) and other central banks. There may also be a need for new specific powers for supervisory authorities within the EU.

Secondly, the authorities have to determine the approach to supervising shadow banking entities. The Commission considers that such an approach should be shaped at an appropriate level, i.e. national or European level. It should also be proportionate and take into account existing supervisory capacity and expertise, and it should be integrated with the macro-prudential framework.

Thirdly, appropriate regulatory responses are needed. In its report the FSB suggested some general principles for the design and implementation of regulatory measures for shadow banking. Such measures should be targeted, proportionate, forward-looking, adaptable and effective, and should be subject to assessment and review. The Commission considers that the authorities should take account of these high-level principles and that a specific approach to each kind of entity or activity in shadow banking should be adopted. This requires achieving the right balance between three possible methods: indirect regulation, an extension of existing regulation, and new direct regulation.

In this section the Commission asks the following questions:

- Do you agree with the need for stricter monitoring and regulation of shadow banking entities and activities?

- 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?

- Do you agree with the general principles for the supervision of shadow banking set out in the Green Paper?

- Do you agree with the general principles for regulatory responses set out in the Green Paper?

- What measures could be envisaged to ensure international consistency in the treatment of shadow banking and avoid global regulatory arbitrage?

What regulatory measures apply to shadow banking in the EU?

The Green Paper contains an overview of the existing tools which are already being used and further developed by the EU to regulate shadow banking. Some Member States have also introduced additional national rules for the supervision of financial activities that are not regulated at EU level.

Indirect regulation

The Green Paper mentions different forms of indirect regulation, such as the second Capital Requirements Directive (CRD II), the third Capital Requirements Directive (CRD III) and the fourth Capital Requirements Directive (CRD IV). CRD II requires, among other things, that both originators and sponsors of securitised assets retain a substantial share of their underwritten risks. CRD III requires banks among other things to comply with additional disclosure rules and hold significantly more capital to cover their risks when investing in complex re-securitisations. The Directive also requires supervisory authorities to take account of reputational risks arising from complex securitisation structures when carrying out their risk assessment of individual banks. In its proposal for CRD IV, the Commission states that explicit liquidity requirements should take effect no later than 2015, including liquidity facilities for special purpose entities and for any other products or services linked to a bank's reputational risk.

In November 2011 the Commission endorsed an amendment to the International Financial Reporting Standards (IFRS) to improve the disclosure requirements relating to the transfer of financial assets.

With regard to the insurance sector, the Commission plans to require originators and sponsors of securitisation products to meet risk retention requirements similar to those which apply under banking legislation.

Enlarging the scope of existing regulations

In the Green Paper the Commission points out that the scope of existing regulations has also been extended to new entities and activities. The purpose of this is to have broader coverage, address systemic risk concerns and make future regulatory arbitrage more difficult. This applies to investment firms subject to the Markets in Financial Instruments Directive (MiFID). In October 2011 the Commission proposed a recast directive and a regulation in order to broaden the scope to encompass, among other things, all high-frequency traders and more commodity investment firms. However, the proposal does not introduce direct capital requirements for those firms brought within its scope, but rather cross-refers to the Capital Requirements Directive. In this way it imposes bank-like regulation on shadow banking entities.

Direct regulation

Certain direct regulation measures for shadow banking already exist within the EU. The Alternative Investment Fund Managers Directive (AIFMD) regulates a number of shadow banking issues. Asset managers looking after funds covered by the definition in the Directive are required to monitor liquidity risks and employ a liquidity management system. Given new methods for calculating leverage and new reporting requirements, the

Commission feels that it will be easier for the authorities to monitor activities such as repurchase agreements or securities lending.

MMFs and ETFs may be covered by existing legislation on undertakings collecting investment in transferrable securities (UCITS). Guidelines developed by the European Securities and Markets Authority (ESMA) in this area regulate eligible investments, weighted-average maturity and net asset value calculations.

Credit rating agencies are not leveraged and do not engage in maturity transformation. Nevertheless, they have an important role in the credit intermediation chain, since they assess others' ratings. In the EU, CRAs are supervised by ESMA, and the Commission has proposed additional legislative measures to strengthen the rules on the credit rating process.

In the insurance sector, Solvency II address a number of shadow banking issues. It provides comprehensive regulation centred on a risk-based and economic approach, along with strong risk management requirements, including a 'prudent person' principle for investments. Solvency II explicitly covers credit risks in capital requirements, a total balance sheet approach, and stringency in respect of credit risk. It also requires Member States to authorise the establishment of an insurance SPV. Detailed rules implementing Solvency II which are currently being considered will include authorisation and ongoing regulatory requirements relating to solvency, governance and reporting as far as insurance SPVs are concerned.

In this section, the following question is asked:

- What are your views on the current measures already taken at the EU level to deal with shadow banking issues?

Outstanding issues

Although the regulatory measures described go a long way towards addressing the subject, the Commission still feels that further progress is necessary, given the evolving nature of the shadow banking system and our understanding of how the system functions. In its Green Paper the Commission focuses on five areas in which it is investigating future options.

Banking regulation

The Green Paper notes that several issues are being examined in this area with the overarching aim of

- recapturing for prudential purposes any flawed risk transfer towards shadow banking entities;

- examining ways to identify the channels of exposures, limiting excessive exposure to shadow banking entities, and improving the disclosure requirements of banks towards exposures to such entities; and

- ensuring that banking regulation covers all relevant activities.

One question receiving special attention is that of the consolidation rules for shadow banking entities. Bank-sponsored entities should be subject to the Basel III framework. It

is also appropriate to study the differences between accounting consolidation and prudential consolidation, as well as the differences between jurisdictions. In this regard the impact of the new international financial reporting standards on consolidation should also be assessed.

As regards bank exposure to shadow banking entities, there are several issues that need to be investigated further.

Existing EU banking legislation is limited to deposit-taking institutions that provide credit. According to the Commission, consideration could be given to enlarging the scope so as to cover more financial institutions and activities. The Commission is currently studying the merits of extending the application of certain provisions of CRD IV to include 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 credit intermediaries.

Asset management

As regards the regulation of asset management, the Commission is monitoring the evolution of both the ETF and MMF markets. As far as ETFs are concerned, the FSB has identified a possible mismatch between liquidity offered to investors and less liquid underlying assets. The regulatory debate focuses among other things on possible liquidity disruptions, the quality of collateral provided in cases of securities lending and derivatives transactions between ETF providers and their counterparties, and conflicts of interest where parties are active within the same group.

ESMA is currently carrying out a review of the UCITS framework, in particular as regards the potential application to ETFs. The guidelines will include recommendations regarding the labelling of ETFs, disclosures to investors and use of collateral.

The main concerns identified in relation to MMFs relate to the risk of runs, which could seriously affect financial stability. According to the FSB this risk stems partly from the credit and liquidity risks inherent to MMFs and partly from the method of valuing MMFs' assets. The risk of runs increases when MMFs value their assets through the amortised cost approach in order to maintain a stable net asset value, even if the values of the underlying investments fluctuate. Investors thus have an incentive to be the first to sell their shares before the net asset value is forced downwards.

Securities lending and repurchase agreements (repos)

Another central issue, according to the Commission, concerns securities lending and repurchase agreements, as these activities can be used to rapidly increase leverage and are a key source of funds used by some shadow banking entities. The ongoing work by the Commission and the FSB is examining current practices, identifying regulatory gaps in existing legislation and looking at differences between jurisdictions.

The Commission feels that special attention should be devoted to global leverage resulting from securities lending and repos. Bankruptcy laws and accounting practices, and their impact on collateral, should also be reviewed with a view to increasing international consistency.

Securitisation

The Commission is of the opinion that it will be important to include an analysis of how effective measures adopted concerning securitisation have been in relation to shadow banking. It is also examining how similar measures can be introduced in other sectors too. This applies to transparency, standardisation, risk retention and accounting requirements. A comparative study on securitisation rules in the EU and USA has been started together with the US Securities and Exchange Commission. Joint work has also been launched within the IOSCO and BCBS to help the FSB to develop policy recommendations.

Other shadow banking entities

Additional work to determine which entities should be covered is also under way within the FSB and EU. This includes identifying gaps in regulation and, where necessary, suggesting additional prudential measures.

Another issue which needs to be considered is data collection. Some national supervisory authorities may not have the necessary powers to collect the data required. Depending on the results, EU legislation on the matter could be necessary. Global cooperation is also desirable. In this context, the creation of a Legal Entity Identifier would be useful.

The Commission considers that further analysis should be undertaken to monitor whether the new Solvency II Framework will be fully effective in addressing any issues raised by insurance and reinsurance undertakings performing similar activities to shadow banking activities.

The Green Paper asks the following questions here:

- Do you agree with the analysis of the issues currently covered by the five key areas where the Commission is further investigating options?
- Are there additional issues that should be covered? If so, which ones?
- What modifications to the current EU regulatory framework, if any, would be necessary in order to properly address the risks and issues outlined above?
- What other measures, such as increased monitoring or non-binding measures should be considered?

The Government's memorandum

In its memorandum on shadow banking (2011/12:FPM136), the Government welcomes the Green Paper's approach of examining the characteristics and functioning of shadow banking and identifying the scope for regulating it. Against this background, the Government welcomes the Commission's Green Paper.

The Government also notes that the Green Paper is of a general nature and provides a basis for debating the Commission's further work, meaning that it is difficult at this stage to gauge its implications for current Swedish regulations.

The Committee's position

The Committee welcomes the Green Paper's presentation of how the Commission sees the shadow banking sector, and of the existing and planned EU legislation. The Committee's opinion is positive; it considers it necessary to take stock of the possibilities offered by shadow banking and the risks it poses. It is important to look carefully at which further regulatory measures might be needed, and the form these should take. It is important to acquire a better understanding of what shadow banking involves and to compile better statistics covering its activities.

The Committee has no objections to the definition of shadow banking proposed by the Commission or to the preliminary list of shadow banking entities and activities. However, it would like to make the point that there are no clear or definitive answers to the questions of how shadow banking should be defined, and the entities and activities involved. It can be assumed that shadow banking will evolve over time in terms of both its size and the entities that comprise it. For example, new regulations in the financial sector can lead to changes in shadow banking. It is therefore important that developments in the sector be closely monitored both within the EU and globally.

The Committee notes that shadow banking embraces important functions and therefore can make a positive contribution to the financial system. For instance, it provides alternative credit options for borrowers. It also makes it possible to spread the risks among more players and contributes to the markets' functioning in terms of pricing, liquidity etc. A market in corporate bonds has emerged, for example.

At the same time, the Committee notes that shadow banking entails risks. There are various systemic risks which can affect the banking system, as normal banking and shadow banking are interconnected. For example, risks can be created within shadow banking as a result of the build-up of high hidden leverage. Shadow banking activities can thus be highly leveraged with collateral funding being churned several times, without being subject to the regulation and supervision imposed on banks.

With the help of shadow banking, normal banks can also avoid the regulation and supervision applied to banking ('regulatory arbitrage'). If the normal credit intermediation process is broken up among legally independent structures, activity can be placed outside the banks' balance sheets.

As regards the ongoing regulation of shadow banking, monitoring of the sector needs to be strengthened. It is also the Committee's opinion that the most appropriate approach is to regulate shadow banking within the framework of banking and insurance regulation, i.e. through indirect regulation.

Both regular banking and shadow banking cross over borders, and activities are global in nature. Therefore, in the Committee's opinion, it is important that further work should place emphasis on the global aspect. Regulation and other measures should not take place entirely at national or entirely at EU level. The aim should be to work towards as broad a measure of international cooperation as possible.

In the Committee's opinion, special attention should be paid in this connection to the risks to consumers which may arise outside the regular banking system. More actors will enter the market to offer credit to consumers without being covered by the regulations applicable to banks and other financial institutions. Major loans for property purchases may be involved. The collapse of such a credit provider can have serious consequences for consumers who have borrowed money. The Committee therefore feels that the risks which such consumer credit can create should be analysed. The same applies to consumer deposits with entities outside the regular banking system. In this connection the possibility of national regulation should also be considered.

Finally, the Committee notes that the extent of shadow banking in Sweden is limited. At the moment, the risks in Sweden are also considered to be limited. Sweden has a bank-dominated financial system and a small number of shadow banking activities consisting, among other things, of securities lending and repurchase transactions (repos), as well as money market funds. However, Swedish banks may have links to shadow banking activities in other countries. Furthermore, there are few statistics at European level, and financial innovations may create new forms of shadow banking. Work within the EU and globally on analysing and regulating shadow banking activity is therefore of great importance for Sweden, not least against the background of the size of Sweden's regular banking industry.

The Committee therefore supports the Commission's further work to analyse shadow banking and clarify the need for regulation.

The Committee proposes that the Swedish Parliament place its statement on file.

Reservation

The Committee's proposal for a decision by the Swedish Parliament and the position the Committee has adopted have given rise to the following reservation.

Green Paper on Shadow Banking – grounds (V)
by Ulla Andersson (V)

Position

Shadow banking harbours major risks. The purpose of creating separate companies – shadow banks – has in many cases been to take risks and assets away from banks' balance sheets to shadow banks, as the latter operate under reduced supervision and regulation. Risks in the accounts are thus moved out and placed in a separate company. This was one of the fundamental causes of the financial crisis, which shadow banking also helped to aggravate.

Shadow banking is also increasing in size. According to the Green Paper the FSB estimates the size of the shadow banking system at around €46 trillion in 2010, an increase from €21 trillion in 2002. This represents 25–30% of the total financial system and half the size of banks' assets. In the USA this proportion is even greater, with an estimated figure of 35–40% of the total financial system. However, according to the FSB's estimates, the share of assets located in the parallel European banking system increased sharply between 2005 and 2010, while the share of USA-located assets decreased.

In Sweden, the total assets of banks, insurance companies and other financial institutions amount to around 600% of Sweden's gross domestic product (GDP), with assets of other financial institutions not forming part of the regular banking system accounting for nearly 100% of GDP. However, the extent of the activities of other financial institutions which come under the definition of shadow banking as proposed by the Commission is not clear. The Left Party (VP) nevertheless considers that their assets are so significant that their activities harbour considerable risks. At the same time, it can be assumed that Sweden's regular banking system has connections with shadow banking both in Sweden and abroad. In my opinion, it is therefore very important to further analyse and tighten up the regulation of shadow banking, not least in view of the size of Sweden's regular banking industry.

The Left Party also considers that EU regulation of the sector should not prevent the individual Member States from adopting more stringent national rules.

With the above rider, I propose that Parliament place the statement on file.

ANNEX

List of proposals considered

European Commission's Green Paper on Shadow Banking (COM(2012) 102 final)