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## SHADOW BANKING IN THE SPOTLIGHT

**THE EU'S OTC DERIVATIVES LEGISLATION HAS BEEN AGREED, REVISION OF BANKING AND MARKETS LEGISLATION ARE UNDER NEGOTIATION, AND THE CRISIS MANAGEMENT/RESOLUTION PROPOSAL IS IN PREPARATION.**

**HOWEVER, THE NEXT ITEM FLOWING FROM THE G20 AGENDA IS LOOMING: SHADOW BANKING. THE EUROPEAN COMMISSION WILL CONSULT THE MARKET THROUGH A COMMUNICATION IN LATE MARCH AND A CONFERENCE IN APRIL ON THE NEXT REGULATORY STEPS IN SHADOW BANKING.**

### A GLOBAL ISSUE

Shadow banking is defined as *"the system of credit intermediation that involves entities and activities outside the regular banking system"*. At the Seoul G20 Summit in November 2010, international work on shadow banking was launched. This led to the publication of the Financial Stability Board (FSB) report on 27 October 2011, which represented the first comprehensive international effort to deal with shadow banking. It focuses on:

- The definition of principles for the monitoring and regulation of the shadow banking system
- The initiation of a mapping process, the identification and assessment of systemic risks involved in shadow banking
- The identification of the scope of possible regulatory measures

The FSB estimated the size of the global shadow banking system at around € 46 trillion in 2010, which represents 25-30% of the total financial system and half the size of bank assets. Shadow banking activities can constitute a potentially useful part of the financial system, such as:

- Providing alternatives to uninsured bank deposits
- Channelling resources towards specific needs more efficiently due to increased specialisation;
- Constituting alternative funding for the real economy
- Representing a possible source of risk diversification away from the banking system

However, there is also an internationally shared concern that shadow banking activities entail a number of risks, including some of a systemic nature:



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- Unregulated deposit-like funding structures may lead to bank-like "runs" (risks of short-term funding)
- Build-up of high, hidden and unregulated leverage (increasing the fragility of the financial sector)
- Circumvention of rules and regulatory arbitrage (risk of regulatory "race to the bottom")
- Disorderly failures affecting the banking system (important contagion and spill-over effects)

G20 Finance Ministers and central bank Governors will take stock of progress at their meeting on 20 April in Washington D.C. In July and September, several reports on different strands of work by IOSCO, the Basel Committee on Banking Supervision and an FSB subgroup will be published.

### COMMISSION COMMUNICATION

In the wake of this international focus on shadow banking activities, the European Commission is currently drafting a Communication, in which it will take stock of the situation in the EU. This Communication will also serve as a stakeholder consultation document.

The financial crisis has resulted in a stricter regulatory framework for banks, insurance companies and

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investment firms. Banks, especially, will have to hold more and better capital, improve their liquidity and better manage their risks. The largest banks, known as Systemically Important Banks (SIBs), will be required to have even higher capital. The result of this tighter regulation is that it creates incentives to move bank-like activities to shadow banks, which carry out similar functions and often escape regulation. Through its Communication, the Commission is investigating ways of monitoring and regulating these institutions more closely, to avoid an excessive build-up of unregulated risk and regulatory arbitrage.

## TACKLING SHADOW BANKS

The Commission considers that outstanding regulatory work on shadow banking can be divided into several categories. Indeed, the scope of the Commission's analysis of shadow banking currently extends – but is not limited – to:

- Special-purpose entities which perform liquidity/maturity transformation, e.g. Special Investment Vehicles (SIV) or Special Purpose Vehicles (SPV)
- Money Market Funds (MMF) and other types of investment funds with deposit-like characteristics
- Credit or leveraged investment funds including Exchange Traded Funds (ETF)
- Finance companies providing credit or credit guarantees without being regulated like a bank;
- Securities entities falling outside banking regulation which perform maturity transformation and/or undergo credit risks;
- Securities lending and repurchase transactions ("repo")
- Insurance and reinsurance undertakings which issue or guarantee credit products.

In the area of **banking regulation**, the aim will be to recapture – for prudential purposes – any inappropriate risk transfer towards shadow banking entities and examine ways to limit exposures to shadow banking entities. It will account for the real amount of risk inside shadow banking entities and ensure that banking regulation covers all relevant activities.

In **asset management**, the evolution of both the ETF and the MMF markets will be studied. On ETFs, the investigation will focus on the possible liquidity mismatch and the quality of collateral. With regards to MMFs, the main concern identified relates to the risks of runs – massive simultaneous redemptions by investors – on MMFs.

On **securities lending and repurchase agreements**, the Commission and the FSB are examining current

practices and identifying possible regulatory gaps and inconsistency between jurisdictions, including prudent collateral management, reinvestment practices of cash received against collateralised securities, re-use of collateral, ways to improve transparency both in the markets and for supervisory authorities, and the role of market infrastructure.

On **securitisation**, the Commission and the SEC are comparing securitisation rules in the EU and in the US, with a view to achieve sounder practices mainly on issues of transparency, standardisation, retention and accounting requirements.

## PUBLIC CONSULTATION

The Communication will list the issues that could lead to possible future regulatory proposals which the Commission will consider. The main policy objectives of this Communication are:

- To clarify the definition of shadow banking
- Take stock of regulatory measures already taken
- Present possible options for addressing shadow banking in the EU

As stated, this will mainly cover MMFs, ETFs, securitisation, bank interaction with the shadow banking system, securities lending and repurchase agreements. To that end, the Commission will invite stakeholders to comment on the issues set out in its upcoming Communication before **1 June 2012**. In addition, a conference on shadow banking will be organised by the Commission in Brussels on **27 April 2012**.

Based on the outcome of the consultation, the ongoing international work, and the work of the European Supervisory Authorities, the Commission will decide on the appropriate follow-up, including possible legislative measures. Any regulatory follow-up will take into account the results of the work of the high-level expert group on structural banking reforms recently appointed by the Commission and chaired by Erkki Liikanen, Finnish Central Bank president, member of the European Central Bank's Governing Council and former European Commissioner.

## FOR FURTHER INFORMATION

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