MORRISON | FOERSTER

News Bulletin

April 21, 2011

Stepping Into the Shadows

Background

The phrase "shadow banking" has been developed in the aftermath of the financial crisis and has been widely used by the press to conjure up images of a murky, dangerous world capable of destroying unwary financial institutions and wreaking havoc on the wider financial system. This view has developed partly as a result of the impact that the failure of structured investment vehicles ("SIVs") and asset-backed commercial paper programmes ("ABCPs") had during the financial crisis.

At the meeting of the G20 leaders in Seoul in November 2010, the Financial Stability Board ("FSB") was mandated, in collaboration with other international bodies, to develop recommendations to strengthen the oversight and regulation of the shadow banking system. On April 12, 2011, the FSB published a background note setting out the initial views of a taskforce established by it to seek to:

- clarify what is meant by "shadow banking",
- set out potential approaches for monitoring the shadow banking system, and
- explore regulatory measures to address systemic risks and arbitrage concerns arising from shadow banking.

What Is Meant by "Shadow Banking"?

The FSB acknowledges that although the term "shadow banking" has been widely used, it has no clear definition. The term generally refers to activities outside the regular banking system that involve bank-like functions. In its paper, the FSB focuses on activities outside the regular banking system that involve credit intermediation functions.

In reaching a definition of shadow banking that focuses on activities that pose risks to the financial system, the FSB proposes a two-stage approach by regulatory authorities of (i) casting the net wide to consider all non-bank credit intermediation to ensure that data gathering and surveillance covers all activities within which shadow banking risks might arise and (ii) narrowing the regulatory focus to concentrate on activities falling within paragraph (i) giving rise to systemic risk or regulatory arbitrage opportunities.

The FSB therefore concludes that the portion of the shadow banking system that merits particular attention from authorities is "a system of credit intermediation that involves entities and activities outside the regular banking system, and raises (i) systemic risk concerns, in particular by maturity/liquidity transformation, leverage and flawed credit risk transfer, and/or (ii) regulatory arbitrage concerns." It states, as an example of entities that would not fall within the narrow focus, life insurance companies that focus on simple life insurance business where there is usually no maturity and/or liquidity transformation and no securities lending.

The FSB acknowledges that the focus on credit intermediation may not capture all risks to the financial system caused by non-bank activities. Examples of activities not captured within the scope of credit intermediation include equity trading and FX transactions outside the regular banking system, unless they form part of a credit intermediation chain. Trading of credit-related financial instruments, including bonds and hybrid financial products, are however regarded by the FSB as falling under the net of credit intermediation.

The FSB states that its particular concern is in relation to credit intermediation that occurs in circumstances where there is no or significantly less prudential regulatory standards and supervisory oversight than would be the case for banks engaged in similar activities. The FSB is also concerned with interactions between bank and non-bank activities, noting that credit intermediation may be achieved through a chain of multiple entities, some of which may be banks, and banks can be exposed to the shadow banking system through temporary exposures, including warehousing and through providing finance or contingent credit lines to non-bank activities.

Systemic Risk Concerns in Shadow Banking

The FSB notes that funds can be raised in the shadow banking system from a wide range of sources including individuals, corporates and financial institutions through short-term or callable instruments (including repos) that act in a similar way to deposits. These funds can then be transferred, including by way of securitisation, into assets including mortgages, auto loans and other long-term assets or be re-invested to build up leverage. Although banks also provide maturity and liquidity transformation by taking deposits and funding within long-term liabilities and use leverage to achieve credit intermediation, short-term liabilities in the shadow banking sector will not have the benefit of deposit guarantees or be subject to the same prudential standards and supervisions as the banking system. The FSB notes that such maturity and liquidity transformation outside the banking system can give rise to the equivalent of a run on a bank (e.g., the inability of ABCPs to continue to access the commercial paper markets) and undermine the wider financial system.

The FSB also states that the build-up of leverage in the banking system can have a significant procyclical effect, with the volume of funding and leverage being high during a strong economic cycle when asset prices are high and credit spreads, margins and haircuts on secured financing are low. However, as was seen during the financial crisis, a loss of confidence in the market can quickly lead to a collapse on the value of collateral securities and an increase in margins and haircuts, leading to rapid deleveraging and fire sales of assets.

In view of the fact that there is a close interconnectedness between the shadow banking and regular banking systems (either by banks being compromised in or providing explicit or implicit support to a shadow banking chain or investing in shadow banking products) the FSB believes this can exacerbate a procyclical build-up of leverage and increase the effect of asset price bubbles. It believes this interconnectedness can also amplify market reactions in difficult economic cycles where liquidity is scarce.

Shadow Banking and Regulatory Arbitrage

The FSB highlights the fact that non-bank entities operating in the shadow banking system will not be under the same regulatory constraints as banks and will not be required to internalise the true cost of risks in the same way as banks. It believes that this mismatch is therefore likely to create opportunities for arbitrage. It highlights that banks can use shadow banking entities to increase leverage and circumvent regulatory capital or liquidity requirements. The use by banks of ABCP financing or SIVs in place of regular funding in the run-up to the financial crisis (partly driven by the fact that capital requirements for liquidity facilities provided to such entities could benefit from a nil or low regulatory capital risk weighting) are given as a specific example of such arbitrage.

The FSB is concerned such activities can build up economic credit or liquidity risks beyond the regulatory limits for such risks. Although the new Basel III rules address some of the relevant issues, the FSB remains concerned that the incentives for, and risks identified with, regulatory arbitrage are likely to increase as the regulatory environment for banks becomes more difficult.

Potential Approaches for Monitoring the Shadow Banking System

The FSB states that the task force has begun monitoring the shadow banking system through: (i) a macro approach in seeking to estimate the size and growth rate of financial assets in the shadow banking system through quantitative information both in absolute terms and in relation to total debt, relevant GDP and the size of the regular banking system and (ii) a micro approach in using quantitative and qualitative information including survey data and market data from commercial vendors on stocks and flows for related products and counterparty credit exposure data of the banking sector and other financial sectors. Market intelligence from dialogue with market participants and monitoring of regulated entities is also utilised.

The FSB paper states that the task force is continuing an exercise of using relevant data to map the shadow banking system to seek to identify potential problems or inconsistencies that can be used as a basis for proposing improvements and/or new approaches for monitoring the shadow banking system. It states that although this exercise is still at an early stage, it has already identified limitations in its current approaches to monitoring the system including a lack of granularity in relation to flow of funds data and differences in statistical definitions in relation to different types of financial intermediaries across different jurisdictions. These limitations are making it difficult to aggregate information on a global basis. In relation to information at the micro level, it states there is a lack of high-quality data on companies outside the regulated sector, and such information is often basic and covers a short time period. Information is also often inconsistent across different jurisdictions, making comparison difficult. The FSB states that the task force intends to continue to identify information gaps and to develop recommendations for improving the monitoring framework.

Possible Regulatory Measures for the Shadow Banking System

The FSB states that in view of the wide range of activities and entities comprised in the shadow banking system, a single regulatory approach is unlikely to be desirable. It therefore concludes that the approach will need to be balanced and targeted. It also believes the response should be forward-looking and flexible so regulation is not solely aimed at dealing with issues identified during the recent financial crisis but seeks to address issues and problems that may arise as markets adapt and evolve.

It believes the regulatory framework for the shadow banking sector will comprise four categories:

- **Banks' interactions with shadow banking entities.** The FSB believes regulating such activities will reduce the spill-over of risks into the regular banking system. It also believes regulation in this area should seek to reduce opportunities for regulatory arbitrage.
- **Direct regulation of shadow banking entities.** Such regulation should seek to reduce the risk such entities pose to the financial system.
- **Shadow banking activities.** In addition to directly regulating entities engaged in shadow banking, the FSB believes authorities can also target risks affecting particular instruments, markets and activities with a view to facilitating sound credit intermediation.
- **Macro-prudential measures.** The FSB believes that policy measures, including those aimed at mitigating procyclicality or strengthening market infrastructure, can reduce risks of contagion.

Conclusion

The FSB acknowledges the task of seeking to better regulate and reduce risks arising from the shadow banking system is a difficult one. Its focus is on credit intermediation involving entities and activities outside the regular banking system and, in particular, in relation to activities that are perceived as giving rise to systemic risk or significant regulatory arbitrage. It acknowledges, however, that the complexity and opaqueness of relevant structures and activities, and the fact that the market has historically evolved and adapted very quickly to changing circumstances, make it very difficult to monitor and regulate appropriate risks.

There are other ongoing initiatives in this area. In the U.S., the President's Working Group on Financial Markets is undertaking work in this area and has published a recent report looking at issues in relation to money market funds. The UK's Independent Banking Commission's interim report, published on April 11, 2011, also considers the shadow banking system and its relationship with the regulated banking sector. Although not mentioned in detail by the FSB, a number of regulatory changes already effected are likely to impact on shadow banking activities including new large exposure rules under the EU's Capital Requirements Directive which aggregates funds made available to entities which are legally unconnected, but are connected economically (so a failure of one is likely to lead to a failure of the other(s)) and the Basel III liquidity rules.

It should also be borne in mind that the huge amount of regulatory change being enacted at a global level at the moment will have a material impact on the level of regulation across a wide range of financial services with a number of areas including derivatives, investment funds, insurance products and structured deposits being subject to a much greater level of supervision and transparency than was previously the case. There has also been a significant amount of international effort in seeking to create a more level playing field in relation to financial regulation which will help to reduce arbitrage opportunities. Although most of this additional regulation and transparency is not directly targeted at the shadow banking sector, it is likely to make it more difficult for there to be a build-up of systemic risk in the same way that there was in the build-up to the financial crisis, particularly in relation to aspects of shadow banking where there is a close connection between banks and non-banking entities (as there was in relation to SIVs and ABCPs). Greater transparency in relation to the shadow banking system is also likely to assist in identifying potential issues, and it will be interesting to see more specific proposals from the FSB as their work develops in this area. It is, however, to be hoped that any specific recommendations of the FSB take fully into account the impact of other regulatory changes and increased transparency across the financial system and do not impose over-burdensome restrictions on activities in circumstances where other measures have already mitigated any systemic concerns.

The FSB states in its paper that, based on the work of its task force and views received in relation to its paper, it will consider initial recommendations at its plenary meeting in July and submit recommendations to the G20 in time for its meeting in Cannes in November 2011.

Contacts

Peter J. Green
+44 207 920 4013
pgreen@mofo.com

Jeremy C. Jennings-Mares
+44 207 920 4072
jjenningsmares@mofo.com

MORRISON | FOERSTER

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for seven straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.