

Regulation of systemically important financial institutions and of the shadow banking system

Panel - Shadow banking: How can we assess and limit risks effectively?

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Introduction

Ladies and Gentlemen,

I am delighted to have been invited by the CDU-CSU Fraktion to participate in its Congress, and to present you with my views on the current, and future, state of shadow banking in the EU.

From ESMA's perspective, as the EU's regulatory and supervisory authority for financial markets, shadow banking is, and remains, a crucial issue for financial stability and the EU has taken a number of key measures to address the risks. Allow me to make clear at the beginning of my remarks that shadow banking should continue to be a central concern for policy makers and supervisors of the financial system.

Shadow banking has many different shades. Let me focus on two aspects which are of particular relevance. First, I will highlight the risks from

shadow banking for financial stability, the actions taken to address these risks, and what remains to be done to mitigate them. Afterwards, I will make a few comments on the potential role shadow banking can play in financing our economies.

Risks from shadow banking

Despite important progress in our work – and let me share with you a few milestones in a minute – shadow banking remains a vulnerable activity, and a key concern for regulators and supervisors alike. I see three broad areas of risk:

- First, complexity and opacity. Shadow banking links investors and borrowers in complex ways. The various forms of intermediation typically provide leverage and maturity transformation, and include various complicated interactions involving money market funds and other institutional investors, special purpose vehicles, banks, as well as leveraged investors. All of these are linked with one another through the stages of securitisation, repo funding, securities lending, tranching, and prime brokerage. Not surprisingly, our statistical knowledge of shadow banking, at present, remains far behind our insight into other financial activities.
- The second area of risk is the inter-linkages with the financial system. Shadow banking is not a system parallel to conventional banking or finance, but interwoven with our financial system in an organic manner. As a result, risks can easily transmit from traditional finance

into shadow banking, and vice versa, and, much to our discomfort, are likely to reinforce each other at times of distress.

- The third risk pertains to the size of the shadow banking system. The EU's shadow banking sector accounts for 9 trillion euros of assets, or one-fifth compared to the EU's banking liabilities. Given its relative size, stability in the shadow-banking world remains a key concern for regulators and supervisors. However, the recent decline in the sector's size – down 15% from its 2010 peak – does not imply that risks are fading. They remain as pressing as before.

One of the strongest reactions to the crisis has been the broad international agreement to bring light into the world of shadow banking: to understand it better, and to provide legal, regulatory and supervisory instruments to address the risks associated with it. In a first step of measures, the EU contained risks indirectly, by tightening the existing rules governing the activities of banks and other intermediaries.

- These measures included the revision of EU bank capital requirements (CRD2, CRD3) to place strict rules on asset securitisation, one of the causal agents of the crisis, and to require strong disclosure so prospective investors have access to all relevant data.
- To shed further light on securitisation and financing vehicles, the EU endorsed changes to the International Financial Reporting Standards



(IFRS) requiring transparency on asset transfers (IFRS 7) and consolidation of structured vehicles (IFRS 10, 11, 12).

Most importantly still, the EU has taken direct regulatory action in relation to the shadow-banking sector.

- Alternative asset managers, especially hedge funds, are now regulated under EU law by the Alternative Investment Fund Managers Directive (AIFMD), and will be directly supervised by national EU securities regulators. In addition, ESMA will be able to collect data on these alternative funds, and as a result will, for example, be able to monitor their level of leverage.
- Money market funds (MMFs) and Exchange traded funds (ETFs) are covered by existing legislation (UCITS) and ESMA guidelines, and are now subject to strict rules. For example, ESMA's guidelines, published last year, contain strict requirements for investment funds involved in securities lending and repo transactions.
- Finally, we at ESMA, together with the other European supervisory authorities (EBA, EIOPA) and the ESRB have stepped up market surveillance to identify trends and vulnerabilities in the EU's financial system, in order to in a be better position to deal with emerging risks in shadow banking than we were before.

Before I move on, I should also mention another fundamental change that is relevant for the functioning of the shadow banking system. Credit Rating

Agencies (CRAs), who played an important role in the securitisation problems leading up to the crisis, are now subject to stringent regulation and are directly supervised by ESMA.

However, we need to be realistic. A lot needs to be done to make the shadow banking system a safer place. The EU is planning an improved legal framework for funds and money market funds, UCITS6, and the planned legal framework for Money Market Funds. We still need a better understanding of the complex interaction of secured financing markets – repo, prime brokerage finance, securities lending and cash collateral reinvestment – which connects commercial banks, broker dealers, asset managers, money market funds and hedge funds. If deemed necessary, the EU should consider further regulatory action.

On the latter, I would particularly like to mention our information on, and knowledge of, the shadow banking system, which, as I stated earlier, is lagging behind our knowledge of other parts of the financial system. While the transparency of shadow banking will improve significantly, through new legislation, after its implementation and working with the new data, we need to assess whether there are still dark areas in the system that need more light and thus further regulatory steps.

Potential positive role of shadow banking

Let me now turn to what we can expect from shadow banking in positive terms. The starting point of that debate is, again, the banking sector, which, it is no secret, is suffering problems. Many are concerned that we may face

a financing gap if banks find it more difficult to lend to the EU's real economy.

Looking for alternative sources of lending, the question has been raised as to what extent shadow banking might play a positive role in filling such a potential gap. I believe that any hope in this regard should be cautious.

Hypothetically, of course, shadow banking can play such a role. Shadow banking has come to be recognised as an important part of the financial system, and some channels may indeed contribute to final financing. I would especially like to mention securitisation here as a source of funding, for example for residential mortgages and Small and Medium Sized Enterprises (SMEs). I know that European banks are jointly trying to revive this activity. This is positive subject to the condition that it occurs under a much better set of arrangements than existed before the crisis.

Still, in practice, the current and future potential of shadow banking is limited:

- At 20% of bank liabilities its current role in EU financing flows is clearly constrained;
- The contribution of shadow banking to the financing of real economic activity remains contested. Much of the financing flows remain within the financial system, and their positive impact on real investment finance may, at best, be indirect; and

- With its 15% decline since its 2010 peak, shadow banking certainly is not a driver of financing. In any case, its contraction is stronger than the stagnation we are witnessing in EU bank lending. And tightened regulatory and supervisory standards may require business model adjustments in shadow banking.

Conclusions

Ladies and gentlemen, let me conclude with a strong commitment to containing the risks from the shadow banking system together with the other actors in the European System of Financial Supervision. The EU has made important strides in casting light on the shadows of this part of the financial system and has introduced some key rules to better regulate it. However, adding the remaining pieces to the puzzle should be our top priority.

Thank you for your attention.