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DRAFT REPORT

on Shadow Banking
(2012/2115(INI))

Committee on Economic and Monetary Affairs

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CONTENTS

	Page
MOTION FOR A EUROPEAN PARLIAMENT RESOLUTION	3
EXPLANATORY STATEMENT.....	7

MOTION FOR A EUROPEAN PARLIAMENT RESOLUTION

on Shadow Banking (2012/2115(INI))

The European Parliament,

- having regard to the G20 conclusions of 18 June 2012 which call for the completion of work on shadow banking in order to achieve full implementation of reforms,
 - having regard to its resolution of 6 July 2011 on the financial, economic and social crisis: recommendations concerning the measures and initiatives to be taken¹,
 - having regard to the interim report of the workstream set up by the FSB on repo and security lending published on 27 April 2012, and to the consultation report on money market funds (MMF) published by IOSCO on the same day,
 - having regard to the occasional paper (No 133) of the ECB on shadow banking in the euro area, released on 30 April 2012,
 - having regard to the Commission's Green Paper on shadow banking (COM(2012)0102),
 - having regard to the working document of the Commission services of 26 July 2012 entitled 'Product Rules, Liquidity Management, Depositary, Money Market Funds and Long-term Investments for UCITs',
 - having regard to the report of the FSB published on 27 October 2011 on strengthening oversight and regulation of shadow banking, in response to the invitations issued by the G20 in Seoul in 2010 and Cannes in 2011,
 - having regard to Rule 48 of its Rules of Procedure,
 - having regard to the report of the Committee on Economic and Monetary Affairs (A7-0000/2012),
- A. whereas the concept of shadow banking (SB) as defined by the FSB covers the system of credit intermediation which involves entities and activities outside the regular banking system;
- B. whereas, according to FSB estimates, the size of the global SB system was approximately € 46 trillion in 2010, having grown from € 21 trillion in 2002; this represents 25-30 % of the total financial system and half the size of bank assets;
- C. whereas despite certain potential positive effects, SB can weaken the system, especially through regulatory arbitrage and increased systemic risk;

¹ Texts adopted, P7_TA(2011)0331.

- D. whereas proposals on shadow banking and on the structure of lenders' retail and investment arms are important elements of a European banking union;
- E. whereas SB as a global phenomenon requires a coherent global regulatory approach, based on FSB recommendations;

A. Definition of shadow banking

- 1. Welcomes the Commission's Green Paper as a first step towards the stricter monitoring and supervision of SB; endorses the Commission's approach based on indirect regulation of SB, at the same time underlining the need for direct regulation of some of its aspects in a functional way while avoiding overlap and ensuring consistency with existing regulations;
- 2. Agrees with the FSB's definition of SB as 'a system of intermediaries, instruments, entities or financial contracts generating a combination of bank-like functions but outside the regulatory perimeter or under a regulatory regime which is either light or addresses issues other than systemic risks, and without access to central bank liquidity facility or public sector credit guarantees'; underlines the challenge involved in implementing this definition in a monitoring, regulatory and supervisory context;

B. Mapping of data and analysis

- 3. Points out that since the crisis some of the practices of SB have vanished; notes, however, that the innovative nature of the SB system may lead to new developments that may pose a source of systemic risk, which should be tackled; stresses, therefore, the need to collect more and better data on shadow banking transactions, market participants, financial flows and interconnections, in order to obtain a full overview of the sector;
- 4. Believes that a fuller overview and better monitoring and analysis will allow the identification of both those aspects of the SB system which have beneficial effects for the real economy and those raising concerns related to systemic risk or regulatory arbitrage; stresses the need for stronger risk assessment procedures, disclosure and oversight, for all institutions presenting a concentrated risk profile;
- 5. Supports, therefore, as a first step, the creation by the ECB of a central EU database on euro repo transactions, and invites the Commission to submit a legislative proposal for the creation of such a database by the end of 2013, after undertaking a feasibility study;
- 6. Stresses, further, the need to obtain a fuller overview of risk transfers by financial institutions, in order to determine who has purchased what from whom and how the transferred risks are supported; invites the Commission, therefore, to undertake a study (in early 2013) and submit a report (by mid-2013) regarding the feasibility of setting up a public non-profit utility as a central registry for risk transfers, which should be able to capture and monitor risk transfer data in real time;
- 7. Stresses that these new tasks will require a sufficient level of new resources;

C. Tackling the systemic risks of shadow banking

8. Emphasises that some SB activities and entities may be either regulated or unregulated depending on the country; notes further that the financial interdependence between the banking sector and shadow banking entities is currently excessive;
9. Stresses that the reports of the Committee on Economic and Monetary Affairs on CRD IV¹, currently being discussed with the Council, represent an important step in tackling shadow banking in a positive way by imposing capital treatment of liquidity lines to structured investment vehicles and conduits, and by setting the large exposure limit of 25% of own funds for all unregulated entities;
10. Believes further that the proposed extension of CRD IV to non-deposit-taking finance companies not covered by the definition in the Capital Requirements Regulation (CRR) is necessary;
11. Stresses the need to ensure that all SB entities having a bank sponsor or linked to a bank are included in the bank's balance sheet for prudential consolidation purposes; invites the Commission to examine, by the beginning of 2013, means of ensuring that entities which are not consolidated from an accounting perspective are consolidated for prudential consolidation purposes;
12. Underlines the need to ensure greater transparency in the structure and activities of financial institutions; invites the Commission, taking account of the conclusions of the Liikanen report, to propose legislation to separate commercial and investment banks, in particular in order to avoid the financing of SB activities via savings;
13. Takes note of the importance of the repo and security lending market; invites the Commission to adopt measures, by the beginning of 2013, to increase transparency, as well as to allow regulators to impose minimum haircuts or margin levels for the collateralised financing markets;
14. Believes that incentives associated with securitisation need to be adequately addressed; invites the Commission to examine the securitisation market and to submit a legislative proposal at the latest by the beginning of 2013 for limiting the number of times a financial product can be securitised; calls on it to impose particular requirements on suppliers of securitisation (e.g. originators or sponsors) to retain part of the risks associated with securitisation and of measures to achieve transparency, by the introduction of an external valuer of the underlying assets and standardisation of securitisation products as well as resolution processes;
15. Recognises the important role money market funds (MMFs) fulfil in the financing of financial institutions in the short run and in allowing for risk diversification; recognises the different role and structure of MMFs based in the EU and the US; recognises that the 2010 ESMA guidelines imposed stricter standards on MMFs (credit quality, maturity of underlying securities and better disclosure to investors); notes, however, that some MMFs, in particular those offering a stable net asset value to investors, are vulnerable to massive

¹ Texts adopted, P7_TA(2012)0000 and P7_TA(2012)0000.

runs; stresses, therefore, that additional measures need to be taken to improve the resilience of these funds and to cover the liquidity risk; invites the Commission to submit a legislative proposal at the beginning of 2013 requiring MMFs either to adopt a variable asset value with a daily evaluation or, if retaining a constant value, to be subject to capital requirements;

16. Recognises the benefits Exchange Traded Funds (ETFs) provide by giving retail investors access to a wider range of assets (such as commodities, in particular), but stresses the risks ETF carry in terms of complexity, counterparty risk, liquidity of products and possible regulatory arbitrage; invites the Commission, therefore, to submit a legislative proposal at the beginning of 2013 to tackle these potential structural vulnerabilities;
17. Instructs its President to forward this resolution to the Council and Commission.

EXPLANATORY STATEMENT

Since the start of the financial crisis in 2007, the G 20 decided upon a whole series of regulatory measures to make the financial system safer and more sustainable. Since then, amongst a lot of other measures, capital requirement for financial institutions have been strengthened, a first step towards stricter regulation of rating agencies has been taken and a new financial supervision architecture has been developed. In despite or may be due to these new regulatory frameworks, a huge part of the credit intermediation still remains insufficiently monitored and regulated. As such, shadow banking takes place via entities or financial contracts generating a combination of bank-like functions but outside the regulatory perimeter or under a regulatory regime which is either light or addresses issues other than systemic risks, and without access to central bank liquidity facility or public sector credit guarantees. Entities like SPV, conduits, special investment vehicles, MMF, ETF, investment funds are, according to the EC green paper, possibly seen as shadow banking entities. Amongst shadow bank activities, the EC distinguishes repo transactions, security lending and securitisation.

As a global phenomenon, the Financial stability board (FSB) has taken the lead into better monitoring and regulating of the shadow bank system. Five different workstreams have been appointed on different aspects of shadow banking. The Basel Committee on Banking Supervision (BCBS) will work on how to further regulate the interaction between banks and shadow banking entities; the International Organization of Securities Commissions (IOSCO) will work on regulation to mitigate the systemic risks (including run-type risks) of Money Market Funds (MMFs); IOSCO, with the help of the BCBS, will carry out an evaluation of existing securitisation requirements; an FSB subgroup will examine the regulation of other shadow banking entities and another FSB subgroup will work on securities lending and repos. Once the final outcome of the different workstreams is published, the FSB will present some recommendations to tackle the shadow banking system. Following the work initiated by the FSB, the EC presented a green paper on shadow banking earlier this year in which it focus on potential risks of the shadow banking system in the EU and how this can be tackled from a regulatory point of view.

It is obvious that shadow banking does not exist on its own. Indeed, during the crisis, banks were seriously affected not only by the overall market dislocation, but also by their exposure to the shadow banking system. Banks invested in securitized products (as investors, banks refinanced these securitised product by using them as collateral in repo transactions) and provided support to many entities of the shadow banking system in the form of credit guarantees. In despite of the possible positive effects of securitisation, the banks remained interlinked with the off balance entities and took most of the losses. Indeed, the financial crisis started when market realized that the securitization of loans was subject to flawed incentives and led to low lending standards (e.g. subprime loans). The SIVs and asset-backed commercial paper (ABCP) conduits and other vehicles that bought the securitized products could not roll over their funding and had to be rescued by their sponsors, mainly banks. Credit hedge funds, banks and other institutions who had invested in securitized products incurred large mark-to-market losses. Those hedge funds and banks also funded their investment in securitized products through repos, using these securitized products as collateral. When the value of securitized products, most notable those containing subprime loans, fell, repo

counterparties increased the haircuts on collateral (forcing borrowers to provide more collateral) or refused to roll over funding. This contributed to the default of the borrower (such as Lehman) or forced mother institutions to provide massive support (such as Bear Stearns to its hedge funds).

Therefore, the interconnectedness between ‘traditional banks’ and off balance vehicles and activities should be made more transparent and tackled from a regulatory viewpoint.

In despite of this potentially dangerous interconnectedness, it is your rapporteur’s opinion that some of the entities and activities involved in shadow banking as defined by the FSB, could have beneficial effects for the regular economy and fostering growth, by contributing to better risk spreading outside the traditional banking sector. However, better risk spreading can only be beneficial to the regular economy provided it happens in full transparency and without increasing systemic risk. Therefore, there should be a clear break between the originating banks and the SPV for securitisation. We should try to make a distinction should be made between desirable and undesirable effects of shadow banking.

As underlined by the Commission’s green paper, different measures have already been taken to tackle the systemic risks caused by shadow banking. The market has also reacted, and since the start of the crisis some of the practices of SB have vanished. However, given the innovative nature of shadow banking system may lead to new developments that may pose a source of systemic risk, which should be tackled To do this adequately, the necessary monitoring tools should be created to get a concrete view on the whole system of credit intermediation.

Firstly, in order to get a complete overview on the shadow bank landscape, more and reliable data and analysis capacities is urgently required. I believe that the ECB (with the ESRB) should play in this regard an important role. The initiative on a repo data warehouse can be a crucial step towards more transparency. Further, in order to shed light on risk transfers in the financial sector and to identify who has purchased what from whom and how the transferred risks are supported, the feasibility of the creation of a public utility should be urgently considered by the EC.

Secondly, this data mapping exercise should allow the identification of the aspects of the shadow banking system which have beneficial effects for the real economy and those posing systemic risk or regulatory arbitrage concerns, like excessive maturity and liquidity transformation, leverage and regulatory arbitrage.

Once these systemic risks are identified, they should be tackled by an improved monitoring and regulative response. Your rapporteur is therefore of the opinion that the following proposals should/could be seriously considered in the coming months:

A. According to the Econ line in the CRD IV file, imposing capital treatment of liquidity lines to siv (structured investment vehicles and conduits) and by setting the large exposure limit of 25% of own funds to all unregulated entities; further the extension of CRD IV requirements to non banking entities should be seriously considered.

B. To make bank balances more reliable, the Commission is invited to examine by beginning of 2013 the way to ensure that entities which are not consolidated from an accounting perspective are consolidated for prudential consolidation purposes.

C. The rapporteur invites further the EC to come up with a legislative proposal for a separation of retail and investing activities of banks;

D. The repo and security lending market fulfil an important function in financing financial institutions. However, more transparency is urgently needed; therefore regulators should be allowed to impose minimum haircuts or margin levels for the collateralised financing markets

E. the technique of securitisation can have positive effects in risk distribution. However, more transparency is absolutely needed. Therefore, the EC should come up by beginning 2013 with a legislative proposal to put a cap on the number of times a financial product can be securitized. Further, more steps have to be taken in the direction of more standardisation of securitisation products as well as imposing stricter retention requirements.

F. mmf has played an important role in the financial crisis. Recognises the differences between mmf in the EU and USA; invites the EC to come up with a legislative proposal beginning 2013 imposing an mmf to either become variable asset value with a daily evaluation or to require mmfs retaining a constant value to be submitted to capital requirements.

G. The rapporteur recognises the importance of exchange traded funds as an investment tool. However, as ETF carry risks in terms of complexity, counterparty risk, liquidity of products and possible regulatory arbitrage. A legislative proposal beginning 2013 should tackle these structural vulnerabilities.