European Parliament

Shadow Banking: what kind of Macroprudential Regulation Framework?

From research to policy actions

The original full study[1] analyses a part of the financial services industry commonly called "shadow banking", which also goes under other names such as "non-bank financial intermediation", and it provides policy recommendations for the prudential regulation of this still largely unregulated sector.

Check out the original full study by scanning this QR code!

Background

Shadow banking (SB) is a form of **credit intermediation** that takes place in an environment where regulatory standards and supervisory oversight are looser than for regular banks. On the one hand, it may make the financial services industry more diverse and resilient, providing additional opportunities to non-financial companies and individuals, but on the other, it generates "bank-like" systemic risks due, for example, to excessive leverage and flawed credit risk assessments. As no official liquidity backup is available, shadow banks are vulnerable to "**runs**", that is, situations where a large number of investors suddenly withdraw their financial support.

By "credit intermediation" the authors mean the transformation of assets in terms of: **maturity** (loans usually have a longer maturity then deposits); **liquidity** (a significant share of bank liabilities is made of demand deposits, that is, money); and **credit risk** (bank liabilities are considered low-risk, while bank assets are not).

Shadow banking includes several "core" SB components, such as **money market mutual funds** and other **mutual funds** using **leverage** and **derivatives**, financial corporations engaged in **lending**, **securities** and **derivatives dealers**, entities performing **securitisations**, securities financing transactions and **derivatives**. Some new segments of the financial system also lie close to shadow banking, including digital lenders/marketplaces and **stablecoins**.

While traditional banks produce multiple services "under one roof", **shadow banks often work as a chain** where functions are broken down among several interdependent institutions. These chains may become complex networks with multiple interactions and feedback loops. As a result, shadow banking is hard to monitor (as entities analysed on a stand-alone basis may appear not to perform any actual "credit intermediation") and more vulnerable to shocks and extreme events.

Key findings

The rise of shadow banking has largely been the outcome of banks moving part of their activities out of the regulated sector in response to innovation and tighter regulatory constraints. Shadow banking is not, in itself, destabilising, nor

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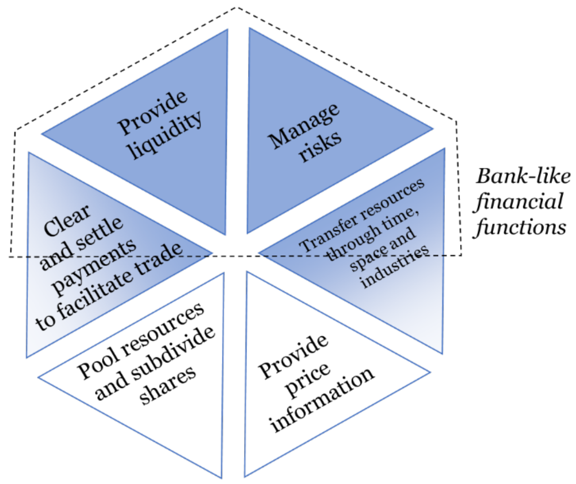
is it an intrinsically more efficient form of financial intermediation: it should co-exist with banking within a diversified ecosystem, not supersede it because of lower regulatory costs.

The macroprudential regulation of shadow banking can be improved in several ways: e.g. "lowvolatility net asset value (LVNAV)" mutual funds can be reformed to **impose gates** and **redemption fees** to slow down and **discourage withdrawals**; similar mechanisms can be introduced for openended funds investing in less liquid assets; additionally, closed-end funds should be limited from providing investors with an expectation that their shares can be liquidated. **Simple, transparent and standardised (STS) securitisations** can be further encouraged by enhancing the regulatory benefits they bring to institutional investors. Minimum haircuts and margins should be imposed on securities financing transactions (SFT) and derivatives.

Stage one of definition process by the authors



The number of excellent definitions and categorisations of shadow banking made available by institutions and academics is huge, which in itself is enlighting. However, the plethora is not always helpful when attempting to analyse this sector as a whole. The authors elaborate their own methodology in order to put their study's conclusions on a solid footing. Shown here is the start of their definition process.

Bank-related **regulations** can help discipline shadow banking through measures aimed at cutting back red tape on traditional banks, while ensuring that capital buffers imposed on traditional lenders be mirrored by similar measures for **non-bank entities**. Structural limitations on the size and operating latitude of mega-banks should be brought back into the policy debate, as there is still a risk that large institutions use their **too-big-to-fail** (TBTF) status to provide mispriced implicit support to shadow banking entities. **FinTech lenders** should be covered by fully harmonised **EU-wide regulations**; stablecoin issuers investing in assets other than those to which their "coins" are pegged should be treated like banks or subjected to a simplified regime that closely mimics **banking supervision**.

The authors also make five key "horizontal" recommentations: (1) **Make it safe, then make it work**. Policy makers must first ensure that business models are not plagued by inconsistencies, conflicts of interest and moral hazard, and therefore remain viable over the long term; (2) **Reduce the risk of a sudden deleveraging**. The risk of sudden drops in leverage and liquidity squeezes should be addressed by imposing minimum buffers in times of financial expansion. Rule makers should also avoid mechanisms that create cliff effects; (3) **Draw clear lines as shadow banking thrives in ambiguity**. Shadow banking is built on the expectation that the liabilities issued by a non-bank entity - or chain of entities - remain liquid under most market scenarios. Ambiguity is key to this configuration; to discipline SB, it is essential that regulation be unequivocal and that grey areas are minimised; (4) **Regulate banks to address shadow banking**. In financial services there is a limit to the desirability of letting market forces and novel technologies find an equilibrium through competition between new players and the incumbents; (5) **Consider bold decisions to bring down complexity**. Simple "don'ts" that apply across all forms of financial intermediation should not be left out of the policy debate.

[1] Resti, A., Onado, M., Quagliariello, M., Molyneux, P., 2021, *Shadow Banking: what kind of Macroprudential Regulation Framework?*, Publication for the committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg. Available at: https://www.europarl.europa.eu/RegData/etudes/STUD/2021/662925/IPOL_STU(2021)662925_EN.pdf.

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