European Economic and Social Committee

INT/643
Shadow banking

Brussels, 15 November 2012

OPINION

of the
European Economic and Social Committee
on the
Green Paper – Shadow banking
COM(2012) 102 final

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On 19 March 2012 the European Commission decided to consult the European Economic and Social Committee, under Article 304 of the Treaty on the Functioning of the European Union, on the

Green Paper – Shadow banking
COM(2012) 102 final.

The Section for the Single Market, Production and Consumption, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 25 October 2012.

At its 484th plenary session, held on 14 and 15 November 2012 (meeting of 15 November), the European Economic and Social Committee adopted the following opinion by 208 votes to 2 with 3 abstentions.

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1. Conclusions and recommendations

1.1 The EESC supports the Green Paper, which it considers to be a step in the right direction.

1.2 Although the financial system's need for liquidity - which. since before the financial crisis, has depended to a large extent on the shadow banking system - is unquestionable, the lesson to be drawn from the crisis is that the regulatory process should give priority to the stability of the financial system, which is indispensable.

1.3 In practice, governments, central banks and deposit guarantee schemes have had to deal with the losses caused by shadow banks, even though the law does not provide for them to do so.

1.4 Avoiding the risk of regulatory arbitrage must be one of the key objectives of the Green Paper.

1.5 The early Basel Accords were the driving force behind the development of shadow banking, because bank balance sheets were rigorously regulated while off balance sheet activities were not controlled. In the view of the EESC, the later Basel Accords, transposed by the EC into the CRD III and CRD IV directives will close these loopholes. In effect, there should be no such thing as "shadow" activities: the shadow banking system should be subject to the same regulatory and prudential requirements as the financial system as a whole.

1.6 The new rules should also have as an objective a high level of protection of European consumers.

1.7 The EESC emphasises the importance of coordinating global supervision and exchanging information.

1.8 The financial system in all its forms must serve the real economy, not speculation.

1.9 The EESC emphasises the vital role of the financial system in investment, job creation and the well-being of society as a whole.

1.10 The new financial market rules are essential in order to restore the sustainability of the economy.

2. ***Background***

2.1 The shadow banking system can be defined in general terms as "the system of credit intermediation that involves entities and activities outside the regular banking system". (Financial Stability Board - FSB).

2.2 Two factors contributed to the development of the shadow banking system. The first can be found in the deregulation of the financial system which began in the 1980s and which also led to banking activities becoming highly concentrated in large institutions. The second was the effect of the early Basel Accords which, by regulating bank balance sheets, drove speculative activity off balance sheet.

2.3 In the United States, shadow banks proliferated following the relaxation of rules preventing banks from operating on the securities market, and following the major amendments made in 1999 to the 1933 Glass-Steagall Act.

2.4 In some European countries, banks and their offshore branches operated in the context of the Basel I reform and became major investors in securities and AAA-rated CDOs, which have lower capital requirements.

2.5 Size of the shadow banking system

Globally: EUR 46 trillion, or between 25% and 30% of the financial system as a whole (FSB). Euro area: EUR 10.9 trillion, or 28% of the total (ECB, end 2011).

2.6 International political responses to the crisis have come through the G20 which, at its Seoul (November 2010) and Cannes (November 2011) summits, sought the cooperation of the FSB. The Green Paper, which constitutes the European response, focuses its analysis in the first instance on:

– two activities:

a) securitisation,
b) securities lending and repurchase transactions (repo); and

– five types of entity:

a) those which perform liquidity or maturity transformation,
b) Money Market Funds (MMFs),
c) investment funds,
d) finance companies and other bodies performing credit or liquidity transformation without being regulated as banks,
e) insurance and reinsurance undertakings which issue or guarantee credit products.

2.6.1 In addition, the FSB has proposed five workstreams which will lead to reports in 2012 on:

– the interaction between ordinary banks and shadow banking entities (to be carried out by the Basel Committee on Banking Supervision, BCBS),
– the systemic risks of Money Market Funds (to be carried out by the International Organisation of Securities Commissions, IOSCO),
– securitisation requirements (IOSCO and BCBS),
– other shadow banking entities (FSB), and
– securities lending and repos (FSB).

3. The EESC's view

3.1 The EESC believes that the Green Paper is an important step in the right direction and provides a timely analysis of the problems linked to the shadow banking system.

3.2 Traditionally, banks financed their operations with equity capital and commercial deposits. In order to increase their lending capacity, securitisation of loan books became standard practice. In certain cases, securitisation can be useful but it was abused in the run-up to the crisis because loan books were of low quality (sub-prime) and securities were repeatedly recycled (derivatives) to inflate bank accounts. The volume of business conducted by banks is determined by the amount by which the bank's assets are leveraged. While the Basel Accords regulated balance sheet leverage, off balance sheet leverage was unregulated and of a huge scale. Sub-prime abuse and excessive leverage were implemented via shadow banking. Furthermore, the basic business of banks – maturity transformation – turning shorter term assets into longer term loans, became excessively high risk as banks became excessively reliant on short-term inter-bank funding. This dependency precipitated the liquidity crisis as the markets in derivatives collapsed. Unsurprisingly, the new Basel Accords will regulate derivatives, leverage and liquidity.

3.3 The business of banking has changed profoundly as a result of deregulation. Because of the crisis, traditional commercial banking, which had for decades contributed to prosperity and helped increase people's standards of living, has been more or less crippled. As they eliminate the gross excesses of the shadow banking system, the regulators should now give priority to the stability of the financial system, which is indispensable.

3.4 Shadow banks have transformed maturity and liquidity in a similar way to traditional banks. Although, unlike traditional banks, they **formally** lack access to lenders of last resort (central banks), **in practice**, as recent experience has shown, public bodies have had to deal with the losses caused by shadow banks using various mechanisms. The biggest loser has been the taxpayer.

3.5 The shadow banking system was not subject to the same prudential rules as traditional banks. However, there are many ways in which shadow banks replicate traditional banks, and most shadow banks were controlled by traditional banks. Avoiding the risk of regulatory arbitrage must be one of the key objectives of the Green Paper.

3.6 The FSB report rightly concentrates on the role that macro-prudential supervision can play in spotting the accumulation of systemic risk. Close monitoring of inter-connectedness and of the channels through which risk can be transmitted from the shadow banking system to the regulated sector is important. The EESC considers it appropriate to bear in mind the distinction between:

- the traditional banking system,
- non-bank financial institutions, and
- the shadow banking system.

There should be no such thing as "shadow" activities: the shadow banking system – to the extent that the new regulations leave any place for it – should be subject to the same regulatory and prudential requirements as the financial system as a whole. The reforms that are either already in force or are in preparation – CRD III, CRD IV, Solvency II, Basel III – should contribute to this goal.

3.7 The EESC considers that **protecting European consumers** through transparency of the products offered to them should also be one of the objectives of regulation of the shadow banking system. Customers have the right to fair, impartial advice. The Committee has already advocated establishing a European Agency for Consumer Financial Protection, similar to the Bureau of Consumer Financial Protection set up by the Dodd-Frank Act[1], to strengthen consumer protection by improving transparency and allowing effective resolution of complaints.

1 OJ C 248, 25.8.2011, p. 108.

3.8 The EESC has also supported the provision of incentives and protection for whistleblowers, in the form of legal arrangements guaranteeing them immunity when they report the commission of illegal acts to the authorities, to help clean up the financial system.

3.9 What is needed is a global approach to the problems of the shadow banking system and the proposal of political responses. Emphasis should be laid on coordinating global supervision and exchanging information. In any event, absence of agreement in international forums must not prevent the EU introducing appropriate legal measures.

3.10 One lesson that needs to be drawn from the great financial crisis is that the financial system, in all its forms, must serve the real economy. Abandoning the traditional rules that had governed banking business for decades led to explosive growth of speculative products, which ended up having extremely damaging consequences for the economy,

3.11 Historically, banks and other state-regulated financial institutions have played a vital role in the economy, as depositories and channellers of individual and corporate savings for the financing of investment, job creation and the well-being of society as a whole. In the years leading up to the crisis, this role was not always to the fore.

3.12 The EESC proposes that social responsibility in the financial sector and the objective of "ensur[ing] all financial activities are contributing to economic growth" be among the objectives of the Green Paper. The new financial market rules are an essential instrument for restoring the sustainability of the economy.

3.13 In light of the rules that have either come into force in recent years or are currently being brought in, the EESC recalls the objective of **good lawmaking**, with an approach based on simplicity and clarity. It is important to avoid duplications and distortions that could lead to regulatory uncertainty and arbitrage opportunities.

3.14 The bodies created for the purpose of prudential supervision – chief among them the European Systemic Risk Board (ESRB) – should be responsible for monitoring the development of the financial system, and of the activities of shadow banks in particular, so as to spot the appearance of systemic risks and propose measures to mitigate those risks.

3.15 The EESC emphasises that the European Union must contribute to the FSB's work on shadow banks and must coordinate its initiatives with the FSB to ensure consistency in terms of timing as well as content.

3.16 The EESC insists on the need for prudential regulatory standards and supervision to prevent unfair competition within the financial system.

4. Responses to the questions put by the Green Paper

4.1 What is shadow banking?

a) Do you agree with the proposed definition of shadow banking?

Yes. The breadth of the terms allows the definition to cover the full set of financial entities and activities that make up the shadow banking system. In any event, the absence of an agreed definition should not prevent the authorities taking regulatory and supervisory action.

b) Do you agree with the preliminary list of shadow banking entities and activities? Should more entities and/or activities be analysed? If so, which ones?

– Credit rating agencies should be included, due to their role in the securitisation process.

– It should be clarified whether credit default swaps (CDS) and instruments issued by first and second lien lenders are specifically included.

– Attention should also be drawn to the market for insurance policies for investment purposes ("euro funds"), which exist in some EU countries and can often be used by policyholders as demand deposits.

4.2 What are the risks and benefits related to shadow banking?

a) Do you agree that shadow banking can contribute positively to the financial system? Are there other beneficial aspects from these activities that should be retained and promoted in the future?

The shadow banking system contributed to the financialisation of the economy and to the property bubble which from 2007 affected various developed countries, bringing their economies to the brink of collapse. As a result, it can be considered fundamentally, even if not exclusively, responsible for the major recession which has affected the United States and many EU countries.

The financial system as a whole must serve the real economy.

b) Do you agree with the description of channels through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?

Agree. The four groups of risks are in line with the experience drawn from the financial crisis.

c) Should other channels be considered through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?

– Among other things, re-use or re-hypothecation of financial collateral.

4.3 What are the challenges for supervisory and regulatory authorities?

a) Do you agree with the need for stricter monitoring and regulation of shadow banking entities and activities?

b) Do you agree with the suggestions regarding identification and monitoring of the relevant entities and their activities? Do you think that the EU needs permanent processes for the collection and exchange of information on identification and supervisory practices between all EU supervisors, the Commission, the ECB and other central banks?

c) Do you agree with the general principles for the supervision of shadow banking set out above?

d) Do you agree with the general principles for regulatory responses set out above?

The answer to all four questions is yes. The EESC highlights the need for global supervision covering all areas of the financial system and for supervisory and regulatory bodies at all levels to have sufficient qualified staff and financial means.

e) What measures could be envisaged to ensure international consistency in the treatment of shadow banking and avoid global regulatory arbitrage?

It is essential that there be coordination and full agreement within the G20. The Legal Entity Identifier (LEI), as proposed by the FSB on 8 June 2012, will help deal with statistical deficiencies, improve risk management by businesses, improve the assessment of macro- and micro-prudential risk, curb market abuse and check financial fraud.

4.4 What regulatory measures apply to shadow banking in the EU?

a) What are your views on the current measures already taken at the EU level to deal with shadow banking issues?

The EESC has supported the measures adopted by the EU in several opinions, including: the MiFID Directive[2], the AIFM Directive[3], the rules and regulations on Credit Rating

2 OJ C 220, 16.9.2003, p. 1.

3 OJ C 18, 19.1.2011, p. 90.

Agencies[4] etc. The CRD III[5], CRD IV[6] and Solvency II[7] directives are particularly worthy of note.

4.5 Outstanding issues

a) Do you agree with the analysis of the issues currently covered by the five key areas where the Commission is further investigating options?

Yes. It is essential that regulation be made as effective as possible, not only in Europe but also at international level. MMFs, for example, are mainly based in the US.

b) Are there additional issues that should be covered? If so, which ones?

c) What modifications to the current EU regulatory framework, if any, would be necessary properly to address the risks and issues outlined above?

Answer to b) and c): ten proposals by Paul Tucker, Deputy Governor at the Bank of England and member of the Financial Stability Board (Brussels Conference, 27.4.2012):

– Shadow banking vehicles or funds that are sponsored or operated by banks should be consolidated on to bank balance sheets.

– The draw-down rate assumed in the Basel 3 Liquidity Coverage Ratio should be higher for committed lines to financial companies than for lines to non-financial companies. That is, banks should hold more liquid assets against such exposures.

– Bank supervisors to limit the extent to which banks could fund themselves short-term from US money funds and from other fragile/flighty sources, including CNAV money funds domiciled elsewhere.

– If they are financed materially by short-term debt, they should be subject to bank-type regulation and supervision of the resilience of their balance sheets.

– Only banks should be able to use client moneys and unencumbered assets to finance their own business to a material extent; and that should be a clear principal relationship. Legal form should come into line with economic substance.

4 OJ C 277, 17.11.2009, p. 117 and OJ L 145, 31.5.2011, p.30.

5 OJ C 228, 22.9.2009, p. 62.

6 OJ C 68, 6.3.2012, p. 39.

7 OJ C 224, 30.8.2008, p. 11.

– For non-banks, any client moneys and unencumbered assets should be segregated and should not be used to finance the business to a material extent. It should, however, remain permissible for non-banks to lend to such clients on a collateralised basis to finance their holdings of securities (margin lending).

– There should be greater market transparency, perhaps ideally via a Trade Repository with open access to aggregate data, so that the world can see what is happening in these very important but opaque financing markets. (That would be helpful for market participants themselves).

– Financial firms and funds should not be able to lend against securities that they are not permitted or proficient enough to hold outright.

– Non-bank financial firms should be regulated in how they employ cash collateral.

– The authorities should be able to step in and set minimum haircut or margin levels for the collateralised financing markets (or segments of them). (That would need to be pursued at international level. It might be linked to central bank haircuts).

d) What other measures, such as increased monitoring or non-binding measures should be considered?

The EESC suggests:

– Protecting consumers of financial products from possible unfair commercial practices concerning this type of products and services. such as misleading promotional sales and pyramid schemes, and ensuring that consumer contracts do not contain unfair terms.

– Considering *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First-Century Financial Markets*, a proposal made on 23 February 2012 by Eric A. Posner and E. Glen Weyl, professors at the University of Chicago, that before any new product is launched it should have to be government-approved as being at the service of the real economy, with that approval being denied if its aim is purely speculative.

Brussels, 15 November 2012

The President
of the
European Economic and Social Committee

Staffan Nilsson