"Shadow Banking: Impact on corporate and bank funding"

Growing the role that markets, and the non-bank sector more broadly, play in financing the economy is a key aim of the Capital Markets Union initiative, which aims to tackle the barriers to the flow of capital in the EU and diversify the funding base for European companies. At the same time, however, policymakers have sought to ensure that the so-called 'shadow banking' sector is properly regulated and understood.

The term 'shadow banking' has been used to refer to the process of credit intermediation conducted outside of the regular banking system. This represents a diverse ecosystem spanning wholesale markets-based credit intermediation and alternative lending channels and is key to unlocking the growth of more market-based financing in Europe.

Under the FSB's definition, examples include, among others, money market funds, which invest in money market instruments that provide vital short-term funding to banks and other corporates; securities financing transactions (repos and securities lending) as well as the re-use or re-hypothecation of collateral for further financing; and securitisation vehicles, such as asset-backed securities, which transfer credit risk among different investors.

'Shadow banking' has also been used to describe alternative lending channels including a variety of non-bank loan companies, micro-finance companies specialising in credit provision to small enterprises, trust companies, peer-to-peer lending and various forms of retail-oriented loan provision.

If provided with the right regulatory framework, shadow banking can support the channelling of funds through to the real economy and expand the pool of capital available to corporates, as well as diversifying risk and lowering funding costs. Adequate transparency of shadow banking is also necessary to give regulators the tools to ensure any risks are appropriately identified and managed.

The Pre-Crisis Shadow Bank System

At its core, according to the FSB definition, the shadow bank credit intermediation process typically involves short-term funding or borrowing to facilitate longer-term lending or investment in less liquid assets, resulting in maturity transformation, liquidity transformation, credit risk transfer, or leverage.

These kinds of credit intermediation grew rapidly in the early 2000s prior to the financial crisis in 2008. But this growth coincided with the build-up of risks in the banking sector, which were subsequently manifested in the financial crisis, including complex and opaque financing vehicles, poor governance and lax underwriting standards surrounding loan origination, and excessive system-wide leverage, to name but a few.

These risks became most evident following the collapse of Lehman Brothers in September 2008, which revealed a highly leveraged institution inappropriately using short-term repo funding that failed when credit markets dried-up. The failure of Lehman Brothers set off a chain reaction in financial markets. As haircuts rose on a range of collateral types for secured borrowing, asset values and liquidity declined in a procyclical manner.

This experience demonstrated the need to better understand the entities that lie at the heart of the nonbank credit intermediation process – such as money market funds, securities broker-dealers, and securitisation vehicles – but also the activities (e.g. repo funding, leverage, secured borrowing) that connect these entities with each other and with the banking sector. A parallel factor is the role of credit rating agencies (CRAs), which effectively act as enablers of credit risk transfer by assigning the ratings to such entities and activities.

The above discussion implies that nonbank credit intermediation forms a core part of the financial system, and where not properly monitored, may transmit systemic risk. This has prompted regulators around the world to embark on a course of unprecedented reforms over the past five years, with many still being finalised.

Yet shadow banking also plays a crucial role in the financing of the economy, and in this respect, the term "shadow" banking is somewhat mis-placed. As bank lending becomes more constrained under stricter bank capital and liquidity requirements, markets-based financing will need to play a greater role in channelling funds to corporate enterprises, particularly small and medium-sized enterprises (SMEs).

Indeed, it is arguable that the higher prevalence and wider availability of non-bank credit channels in the United States than in Europe are relevant factors of the former's stronger economic performance since the crisis (see e.g. Veron, 2013).[1]

As part of the ongoing financial reform efforts in the wake of the financial crisis, and in recognition of the need to revitalise economic growth in an era where bank lending is likely to be more constrained than before, policy makers around the world are developing measures to both regulate and stimulate shadow banking. These efforts focus on creating more standardised, transparent, and simpler financing structures, and safer investment vehicles. These policy initiatives are being led at the global level by the Financial Stability Board (FSB), and are supported by the development of specific regulations in the European Union, United States, and other national jurisdictions.

Securitisation

Securitisation can be seen as one component of the shadow banking system. Securitisation is also a primary focus of current policy initiatives such as the EU Capital Markets Union. Securitisation transforms pools of loans into tradable debt securities. By creating a tradable financial instrument with a different risk profile from the underlying assets, securitisation provides an important source of non-bank finance as well serving to facilitate risk transfer. Because they are (mostly) structured as pass-through securities, securitisations carry little refinancing risk, and also create less encumbrance on bank balance sheets than other forms of asset-based finance such as covered bonds.

[1] Veron, N. 2013. "Bank versus Non-Bank Credit in the United States, Europe and China." Bruegel Policy Contribution, Issue 2013/07 (June).

Securitisations that are collateralised by loans and receivables are referred to as asset-backed securities (ABS). In a similar vein, debt securities backed by mortgages are referred to as mortgage-backed securities (MBS). European securitisations backed by these assets (predominantly originated by regulated banks) have performed very strongly in both credit and price terms in recent years. Another type of securitisation is the issuance of asset-backed commercial paper (ABCP), which is a typically short-term security sponsored by banks and collateralised by other financial assets such as trade receivables.

Before the crisis, securitisation techniques were also used to create collateralised debt obligations (CDOs); these were debt instruments collateralised by pools of debt, including securitised debt backed by mortgages, bonds, and loans (re-securitisations). CDOs therefore involved multiple layers of credit intermediation. Since the financial crisis, however, tougher capital requirements and lack of investor demand have meant that CDOs have not been issued in material volumes. Despite some pick-up in issuance in recent years, CDO volumes remain low compared to pre-crisis levels, and for various reasons, CDOs are unlikely to fall within the definition of "qualifying securitisation" which is the focus of current policy initiatives.

There are considerable benefits from securitisation, including risk transfer and more diversity in credit provision and access to finance. In order to realise these benefits, securitisation must not be used in a manner in which product complexity and opacity (for example in re-securitisations, CDOs and "CDO-squared" transactions) hinder appropriate investor due diligence and limit demand.

Existing regulatory measures related to securitisation have primarily addressed the potential misalignment of interests between originators and investors along the chain from loan origination to issuance, as well as strengthening transparency over issuance structures and collateral. The key regulatory elements related to securitisation in the context of shadow banking include (i) a greater degree of alignment of interest (as above), and due diligence requirements; (ii) prudential rules; (iii) prospectus and transparency frameworks; and (iv) the identification of "high quality" (or qualifying) securitisation.

Overcoming issues related to product and market fragmentation, transparency and illiquidity are central elements to help the securitisation market revive so that it can once again be a strong tool to support bank lending and economic growth. Much progress has been made in recent years, and the recent establishment by the ECB of its ABS purchase programme is also a noteworthy development. Greater clarity of issuance structures, combined with greater transparency, may facilitate investor due diligence, reduce monitoring costs, and stimulate demand. Further, reduced capital charges for qualifying securitisations, and consistent prudential treatment across regulations, may incentivize supply of desirable or "high quality" issuances.

Money Market Funds

Money Market Funds (MMFs) are an important tool for companies to manage their short-term cash flows. In contrast to a bank account, where a depositor will have counterparty risk to the bank, an MMF diversifies its exposure by providing short-term finance to financial institutions, corporates and governments. Around EUR 950 billion were invested in European MMFs at the end of 2014. MMFs are a particularly important funding source for banks – allocating nearly 85% of their assets to securities issued by banks, which accounts for approximately 38% of the short-term debt issued by banks. MMFs also account for about 22% of the short-term debt issued by companies or governments.[2]

The European Commission's legislative proposal for a regulation on MMFs, which is currently under discussion in the European Parliament and Council of Ministers, is intended to make MMFs more resilient and limit potential contagion channels to the banking system. The Parliament's recent Impact Assessment suggested, however, that the regulation could have wide-ranging consequences, including a significant decrease in the use of MMFs and therefore a decline in their role in providing short-term finance to companies and the banking sector in particular.

[2] European Commission. 2013. "Impact Assessment Accompanying the Proposal for a Regulation on Money Market Funds." Commission Staff Working Document SWD (2013) 315 final (4 September).

As the negotiations progress, it is important to keep in mind that whilst the potential risks posed by European MMFs for the stability of the financial system may be disputed, the importance of the role played by MMFs in corporate and bank funding is widely recognised. The adoption of a sufficiently robust prudential framework consisting of a strong set of requirements may also open the door to move MMFs outside the scope of the definition of "shadow banking" for regulatory purposes given that the primary purpose of putting the MMF regulation in place is to ensure stability in MMFs.

Conclusions

Policy makers are assessing the entities and activities that constitute the financial ecosystem and the potential risks they could pose. In Europe, and elsewhere, the focus has extended beyond banks, brokers, and exchanges to a wide range of entities and activities that have been broadly labelled 'shadow banking'. The broad application and, according to some, negative connotation, of this term create a degree of controversy since many activities often included under this umbrella term play important roles in the provision of savings and retirement income, and the connection of those savings to productive investment in the 'real economy'.

Consequently, the term 'market-based finance' is more objective and appropriate in the European context. Market-based finance can help ensure companies obtain the financing they need to operate and grow their businesses and preserve the efficient functioning of capital markets.

Additionally, in order to avoid potential detrimental effects on the functioning of certain market-based financing tools, it should be thoroughly examined as to whether some entities and activities within the scope of the wide FSB definition of shadow banking are appropriately classified. Classification of certain entities or activities as "shadow banking" may incorrectly imply that these entities and activities are currently outside of the scope of a regulatory regime, when in fact many channels of market finance are already regulated.

Indeed, enabling market-based finance to develop in a sustainable fashion is central to achieving the aim of growing the pool of capital available to European companies and supplementing traditional bank lending – key aims of the Capital Markets Union.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Secretariat or the Chair of the Financial Industry Committee.

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