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Financial Stability Board Paper - Shadow Banking: Scoping the Issues

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TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 29-11
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 24-11 RE: FINANCIAL STABILITY BOARD
PAPER - SHADOW BANKING: SCOPING THE ISSUES

On April 12, 2011, the Financial Stability Board (“FSB”) [\[1\]](#) published a note entitled Shadow Banking: Scoping the Issues (the “Note”). [\[2\]](#) The FSB welcomes comments on the Note by May 16. The Institute intends to submit comments.

According to the Note, the financial crisis has shown that the shadow banking system can be a source of systemic risk, both directly and through its interconnectedness with the regular banking system. In addition, the FSB believes that it can create opportunities for arbitrage that may undermine bank regulation and lead to a build-up of additional leverage and risks. Accordingly, at the November 2010 G20 Summit, the G20 leaders requested that the FSB, in collaboration with others, develop recommendations to strengthen the regulation and supervision of the shadow banking system by the middle of 2011.

As a result of the G20’s request, the FSB formed a task force to develop initial recommendations for discussion to:

1. clarify what is meant by the “shadow banking system;”
2. set out potential approaches for monitoring the shadow banking system; and
3. explore possible regulatory measures to address the systemic risk and regulatory arbitrage concerns posed by the shadow banking system.

The Note describes the current thinking of the task force, particularly on the first item – what is the “shadow banking system.” The FSB intends to consider initial recommendations at its July 2011 Plenary meeting and submit recommendations to the G20 in the autumn. The Note states that a flexible forward looking perspective is crucial to capturing mutations in credit intermediation that can pose risks to the financial system. The Note describes the following approach for developing a definition of shadow banking: (1) authorities should cast a wide net, looking at all non-bank credit intermediation; and (2)

authorities should then narrow the focus to concentrate on a subset of credit intermediation where maturity/liquidity transformation and/or flawed credit risk transfer and/or leverage create important risks. The FSB also notes that since a shadow banking system can be sliced into various pieces and is shaped by the regulatory frameworks in each jurisdiction, it is crucial to approach the shadow banking system by its economic substance rather than by legal form. In addition, since different parts of the intermediation chain are frequently located in different jurisdictions, a global approach is needed for the purposes of monitoring and developing policy responses.

“Shadow Banking System” - Definition

The FSB broadly identifies the shadow banking system as “credit intermediation involving entities and activities outside the regular banking system.” Although the FSB acknowledges that the definition is broad, it notes that it is limited in scope to “credit intermediation,” meaning only activities and entities involved in extending credit (either directly or as part of a chain) or involved in facilitating its intermediation. In further describing “credit intermediation,” the FSB states that credit intermediation encompasses not only on-balance sheet transactions but also derivatives and other off-balance sheet transactions that would be part of the credit intermediation chain.; The FSB states that “pure equity trading” and foreign currency transactions by entities outside of the banking system are excluded, unless part of the credit intermediation chain.; The FSB explicitly identifies the trading of credit-related financial instruments, such as bonds and structured/hybrid financial products, as within the definition of credit intermediation. [\[3\]](#)

On the concept of facilitation of credit intermediation, the FSB recognizes that some entities act simply to facilitate maturity/liquidity transformation and leverage such as through the provision of explicit or implicit support including liquidity facilities or guarantees that reduce the costs of short-term fund raising for the shadow banking system. Some entities incur financial risk exposures like banks, financial guarantors, monoline or mortgage insurers and other protection sellers, but other entities, like credit rating agencies (CRAs), do not. The FSB recognizes that reducing the costs for credit intermediation can be beneficial; however, it may also facilitate the buildup of leverage within the shadow banking system as well as adding to the exposure of the regular banking system to the shadow banking system. In particular, the FSB identifies the concern that many activities for facilitating maturity/liquidity transformation and leverage create contingent exposures that are not transparent and may only become evident during times of systemic stress. [\[4\]](#)

The FSB also states that while the focus is to identify activities that are not covered by banking regulation, it is also important to examine connections between non-bank and bank activities and the possible line of entities forming a chain of credit intermediation where one or more entities in the chain could be a bank or bank-owned entity. For example, the FSB provides examples of ways that banks are exposed to the shadow banking system through connections such as contingent credit lines or through the funding of banks by entities that are part of the shadow banking system, e.g., money market funds. [\[5\]](#)

Although the FSB believes a broad definition is important as a start, it believes authorities should only focus on those elements of non-bank credit intermediation where there are certain concerns. The FSB states that the portion of the shadow banking system that merits increased attention is:

[the] system of credit intermediation that involves entities and activities outside

the regular banking system, and raises i) systemic risk concerns, in particular by maturity/liquidity transformation, leverage and flawed credit risk transfer, and/or ii) regulatory arbitrage concerns. [6]

The FSB defines “maturity transformation” as the activity of issuing short term liabilities (such as deposits) and transforming them into medium-long term assets (such as loans). “Liquidity transformation” is defined by the FSB as the issuing of liquid liabilities to finance illiquid assets. For this purpose, the FSB states that an asset is illiquid when it cannot be easily converted into cash without a loss in nominal value. [7]

Systemic Risk Concerns

The FSB states that the provision of maturity/liquidity transformation and leverage can make credit intermediation by non-bank entities “bank-like” and therefore may create systemic risks. The FSB states that, through the shadow banking system, funds can be raised from suppliers, such as households and corporates, through short-term or callable deposit-like liabilities including repos. The funds are then transformed, including through securitization, into assets such as mortgages and other longer-term or less liquid assets and they also can be re-invested to build up leverage. The FSB acknowledges that banks provide similar maturity/liquidity transformation and use leverage in their credit intermediation activities; however, the FSB asserts that, to a greater extent than in banking, non-deposit instruments are used in shadow banking to raise funds. As examples of non-deposit instruments used in shadow banking, the FSB identifies money market fund shares, issuance of short-term commercial paper (CP), asset backed commercial paper (ABCP), borrowing in the short-term repo markets and taking of cash collateral against securities lending. The FSB states that, like bank deposits, these instruments are typically short-term and highly liquid, but the risk profile vis-à-vis investors is different because these instruments are offered without an explicit official sector backstop and without being subject to the same prudential standards and supervision. [8]

The FSB states that maturity/liquidity transformation within the shadow banking system, especially if combined with high leverage, raises systemic risk concerns because short term deposit-like funding in the shadow banking system can create bank-runs if undertaken on a sufficiently large scale. The FSB states that a withdrawal of “run-able” deposit-like instruments such as short-dated ABCP, short-term repos and money fund shares could undermine the wider financial system. In addition, the FSB states that leverage within the shadow banking system can amplify procyclicality. There are also systemic risk concerns arising from the shadow banking system’s interconnectedness with the regular banking system. The FSB notes that the shadow banking system and the regular banking system are very interlinked, with banks often composing part of the shadow banking chain or providing (explicit or implicit) support to shadow banking entities to enable maturity/liquidity transformation (and thus facilitating shadow banking activities). In addition, banks invest in financial products issued by shadow banking entities alongside other suppliers of funds. This interconnectedness can exacerbate the procyclical build-up of leverage and thus heighten risks. Interconnectedness also can amplify market reactions when liquidity is scarce. The FSB states that banks are therefore likely to be significantly affected by developments in the shadow banking system.

Regulatory Arbitrage

Regulatory arbitrage concerns the FSB because it views the shadow banking system as able to undertake “bank-like” credit intermediation without being subject to the same regulatory constraints as banks. The FSB believes that if parts of the shadow banking system are able

to operate without incurring the true cost of their risks then these entities will have a funding advantage. As such, the FSB believes that this type of situation will create opportunities for arbitrage that could undermine bank regulation and lead to a build-up of additional leverage and risks. Banks also may use shadow banking entities to increase leverage or to circumvent bank capital or liquidity requirements. As an example, the FSB cites the bank practice, before the crisis, of utilizing ABCP financing for regular bank lending because the capital requirements for ABCP back-up lines were lower. In addition, the FSB states that some banks may use funding structures through shadow banking entities that issue daily redeemable shares, with the collected funds being “invested” and lent to the sponsoring bank at longer maturities. The FSB believes that the result of these actions is an increase in economic credit or liquidity risk in the banking system that exceeds the regulatory limits for credit and liquidity risk.

Potential Approaches for Monitoring

The FSB states that the task force members have been monitoring or “mapping” the shadow banking system in their jurisdictions through a combination of quantitative and qualitative information from both a macro or systemwide perspective and a micro or entity/activity-based perspective. Nevertheless, the task force has identified limitations in the two perspectives for purposes of monitoring the shadow banking system. There are issues with respect to the granularity of data in some jurisdictions and other challenges such as issues arising from differences in the definition of financial intermediaries. Data for non-regulated entities also is difficult to obtain. The task force intends to continue identifying information gaps and will seek to develop recommendations to improve the monitoring framework. [\[9\]](#)

Regulatory Measures for Shadow Banking

The FSB concedes that a single regulatory approach is probably undesirable given the wide variety of activities and entities within shadow banking. Nevertheless, the FSB believes that differentiation may be used to account for differences in business model, risk characteristics and any contribution to systemic risk.; Therefore, the FSB believes that any regulatory response to shadow banking should be carefully balanced and targeted to the risks created, taking into account the expected costs and benefits of policy interventions and using appropriate criteria to judge their efficacy. In addition, the FSB states that regulatory responses need to be forward-looking and flexible, so they should not focus solely on the recent crisis but also address issues and problems that may arise as financial markets adapt and evolve.

The FSB concludes that any proposed regulatory response on shadow banking is likely to fit within the following four categories:

1. Indirect regulation: Indirect regulation through the regulation of banks’ interactions with shadow banking entities can be used to reduce the spill-over of risks and opportunities for regulatory arbitrage.
2. Direct regulation of entities: Regulation of shadow banking entities can be used to reduce the risks such entities pose to the system.
3. Direct regulation of activities: To address risks affecting particular instruments, markets or activities, authorities may intervene to address such risks and facilitate sound credit intermediation through the shadow banking system.
4. Macro-prudential measures: Rather than focusing on particular entities or activities,

policy measures can address systemic risk in the shadow banking system more broadly (e.g., regulatory measures for mitigating procyclicality or policies to strengthen market infrastructure to lower contagion risks).

The task force intends to explore possible regulatory options within each of the high level categories, taking into account regulatory measures already in place. [10]

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endnotes

[1] The FSB (<http://www.financialstabilityboard.org/>) coordinates at the international level the work of national financial authorities and international standard setting bodies to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. It brings together national authorities responsible for financial stability in 24 countries and jurisdictions, certain international institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. US members include the Board of Governors of the Federal Reserve, the US Treasury Department and the US Securities and Exchange Commission.

[2] FSB, Shadow Banking: Scoping the Issues, April 11, 2011, available at http://www.financialstabilityboard.org/publications/r_110412a.pdf

[3] Note at section 1.1, pages 2-3.

[4] Note at section 1.3, page 5.

[5] Note at page 3.

[6] Note at footnote 4. The FSB states that this definition excludes life insurance companies that focus on simple life insurance where there is usually no maturity and/or liquidity transformation as well as no securities lending.

[7] Note at footnote 5.

[8] Note at page 4 and footnote 6.

[9] Note at pages 6-7.

[10] Note at pages 7-8.