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European Commission Issues Green Paper on Shadow Banking

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TO: ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 8-12
ETF ADVISORY COMMITTEE No. 8-12
INTERNATIONAL COMMITTEE No. 13-12
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 24-12
SEC RULES COMMITTEE No. 23-12 RE: EUROPEAN COMMISSION ISSUES GREEN PAPER ON SHADOW BANKING

The European Commission recently issued a green paper on the regulation of the “shadow banking” sector. [\[1\]](#) Previously, the Commission outlined a roadmap of its proposed work, but the publication of the green paper is the first step in the Commission’s formal program to implement the forthcoming recommendations of the G20 being developed by the Financial Stability Board (FSB). [\[2\]](#) The paper reflects the Commission’s active participation in the work at a global level and its intention to issue formal legislative proposals in Europe in due course.

The Commission is requesting comment on a variety of issues identified in the paper by the June 1, 2012 deadline. These issues include the definition of shadow banking, the risks and benefits associated with shadow banking, and the need for stricter monitoring and regulation. In connection with this paper, the Commission is organizing a public conference on shadow banking in Brussels on April 27, 2012. Brian Reid, ICI Chief Economist, is participating on the Money Market Funds panel. [\[3\]](#)

Definition of “Shadow Banking”

Despite a number of representations to both the FSB and the International Organization of Securities Commissioners (IOSCO) that the use of the term shadow banking is inherently inaccurate and misleading, [\[4\]](#) the Commission has continued to adopt the FSB’s definition of shadow banking as “the system of credit intermediation that involves entities and activities outside the regular banking system.” The paper notes that this definition implies that the shadow banking system is based on two interconnected pillars.

First, shadow banking entities operate outside the regular banking system, and yet engage

in the following bank-like activities:

- accepting funding with deposit-like characteristics;
- performing maturity and/or liquidity transformation;
- undergoing credit risk transfer; and
- using direct or indirect financial leverage.

The entities that are specified in the report include special purpose vehicles that perform liquidity and/or maturity transformation; money market fund and other types of investment funds or products with deposit-like characteristics; investment funds, including exchange traded funds, that provide credit or are leveraged; finance companies and securities entities providing credit or credit guarantees, or performing liquidity and/or maturity transformation; and insurance and reinsurance undertakings that issue or guarantee credit products.

Second, shadow banking activities are those that could act as important sources of funding for non-bank entities. These activities include securitization, securities lending, and repurchase transactions. The Commission notes that this list should not be viewed as exhaustive, as shadow banking entities and activities can evolve very rapidly.

Risks Related to Shadow Banking

Although the paper acknowledges that shadow banking activities are a useful part of the financial system, it also states that it creates a number of risks. The Commission categorizes these risks as the following:

- Deposit-like funding structures that may lead to funding “runs”—given that the short-term nature of funding is prone to risks of sudden and massive withdrawals of deposits by clients.
- Build-up of high, hidden leverage—that may increase the fragility of the financial sector and be a source of systemic risk.
- Circumvention of rules and regulatory arbitrage—that creates the risk of a regulatory “race to the bottom” for the financial system as a whole, as banks and other financial intermediaries try to mimic shadow banking entities or push certain operations into entities outside the scope of their consolidation.
- Disorderly failures affecting the banking system—since shadow banking activities are often closely linked to the regular banking sector, failures can lead to important contagion and spill-over effects.

The paper notes that some of these risks can be systemic in nature, in particular due to the complexity of shadow banking entities and activities, their cross-jurisdictional reach and the inherent mobility of securities and fund markets, and the links between shadow banking entities and activities with the regular banking system.

Challenges for Supervisory and Regulatory Authorities

Given the potential risks posed by shadow banking, the paper states that it is essential that supervisory and regulatory authorities consider how best to address shadow banking entities and activities, including identifying and monitoring the relevant entities and their activities; determining the approach to supervising shadow banking entities; and considering extending the scope and nature of prudential regulation.

Current Regulatory Measures that Apply to Shadow Banking

The paper identifies a number of legislative proposals with implications for shadow banking entities and activities that are already in place or currently being negotiated by the European Parliament and the Council. These include: the indirect regulation of shadow banking activities through banking and insurance regulation (e.g., the revision of the EU banking capital requirements directive); extending prudential regulation to shadow banking entities (e.g., revisions to Markets in Financial Instruments Directive); and direct regulation of some shadow banking activities (e.g., existing legislation of money market funds and ETFs under the Undertakings for Collective Investment in Transferable Securities (UCITS)).

Outstanding Issues

The paper identifies five main areas in which the Commission is investigating options and recommendations. These include:

- banking regulation—in particular, the consolidation rules for shadow banking entities to ensure that bank-sponsored entities are appropriately consolidated for prudential purposes;
- asset management regulation—specifically, ETFs and money market funds;
- securities lending and repurchase agreements;
- securitization; and
- other shadow banking entities.

Next Steps

On the basis of the outcome of this consultation and taking into account any relevant work carried out by the European Systemic Risk Board (ESRB), the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA), the paper notes that the Commission will decide on the appropriate follow-up regarding the issues outlined in the paper, including legislative measures, as appropriate.

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endnotes

[1] European Commission, Green Paper: Shadow Banking, March 19, 2012, available at http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf.

[2] Shadow Banking: Strengthening Oversight and Regulation – Recommendations of the Financial Stability Board, October, 27 2011, available at http://www.financialstabilityboard.org/publications/r_111027a.pdf.

[3] Conference, Towards a Better Regulation of the Shadow Banking System, available at http://ec.europa.eu/internal_market/bank/docs/shadow/programme_en.pdf.

[4] For example, ICI has made a number of representations in this regard, including in its response to the FSB's April 2011 initial report, available at <http://www.ici.org/pdf/25258.pdf>.

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