Shadow Banking: Challenges and Approaches

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Overview

• Issues: Balancing risk and function
• Assessing the market
• G20/FSB approach
• Asian context
• References
Shadow Banking

• 2011 report
• “credit intermediation involving entities and activities outside the regular banking system” (FSB, 1)
• G20/FSB mandate:
  – to clarify what is meant by the “shadow banking system”, and its role and risks in the wider financial system
  – to set out approaches for effective monitoring of the shadow banking system;
  – to prepare, where necessary, additional regulatory measures to address the systemic risk and regulatory arbitrage concerns posed by the shadow banking system
G20 Financial Regulatory Reform Agenda

- Capital, leverage, liquidity and procyclicality
- OTC derivatives markets
- SIFIs and resolution regimes
- Accounting standards
- Compensation arrangements
- Macroprudential frameworks
- Shadow banking
  - Credit ratings and credit rating agencies
  - Hedge funds
  - Securitisation
- Adherence to international standards
Defining

• authorities should cast the net wide, looking at all non-bank credit intermediation to ensure that data gathering and surveillance cover all areas where shadow banking-related risks to the financial system might potentially arise.

• authorities should narrow the focus for policy purposes to the subset of nonbank credit intermediation where there are (i) developments that increase systemic risk (in particular maturity/liquidity transformation, imperfect credit risk transfer and/or leverage), and/or (ii) indications of regulatory arbitrage that is undermining the benefits of financial regulation.
Principles

• **Scope:** *Authorities should have an appropriate system-wide oversight* framework in place to gain a comprehensive picture of the shadow banking system and of the risks that it poses to the entire financial system.

• **Process:** *A monitoring framework for the shadow banking system should* identify and assess the risks on a regular and continuous basis.
(2)

• **Data/Information:** *In establishing a monitoring framework for the shadow banking system,* the relevant authorities should have powers to collect all necessary data and information, as well as the ability to define the regulatory perimeter for reporting.

• **Innovation/Mutation:** *Monitoring of the shadow banking system should be* flexible and adaptable to capture innovations and mutations in the financial system which could lead to emerging risks.
(3)

- **Regulatory arbitrage:** In monitoring the shadow banking system, authorities need to be mindful of the incentives to expand shadow banking created by changes in regulations.

- **Jurisdiction-specific features:** In developing a monitoring framework, authorities should take into account the structure of financial markets and regulatory frameworks within their jurisdiction as well as their international connections.
• **Information exchange:** Authorities should exchange *appropriate information* both within and across the relevant jurisdictions on a regular basis to be able to assess the risks posed by the shadow banking system.
Steps

• Scanning and mapping of the overall shadow banking system

• Identification of the aspects of the shadow banking system posing systemic risk or regulatory arbitrage concerns
  – (i) maturity transformation
  – (ii) liquidity transformation
  – (iii) credit risk transfer
  – (iv) leverage

• Detailed assessment of systemic risk and/or regulatory arbitrage concerns
FSB

• Overview
• Shadow banking entities
• Securities lending and repos
• Global Shadow Banking Monitoring Report
2013 Global Shadow Banking Monitoring Report

- 25 jurisdictions (FSB + Chile + Eurozone = 80% GDP / 90% financial assets)
- US$ 71 trillion (2012) (117% of GDP), $5 trillion / 8.1% increase from 2011 (HK: 190%) (-11% Spain - +42% China)
- 25% of total financial system, 50% size of banking system
Cont’d

• Other investment funds: equity, debt, other = $21 trillion (35%)
• Broker-dealers = $7 trillion (12%)
• Structured finance vehicles = $5 trillion (8%)
• Finance companies = $4.5 trillion (8%)
• Money market funds = $3.8 trillion (6%)
• Hedge funds = $2 trillion
5 focus areas

• WS1: Banks’ interactions with shadow banking entities
• WS2: Money market funds
• WS3: Other shadow banking entities
• WS4: Securitisation
• WS5: Securities lending and repos
Banks and shadow banking

- Scope of consolidation
- Large exposures
- Investments in funds
- Mid-2013
MMFs (IOSCO)

• General regulatory framework: collective investment schemes (CIS)
• Valuation
• Liquidity management
• MMFs offering stable net asset value (NAV)
• Use of credit ratings
• Disclosure to investors
• MMFs and repos
Other shadow banking entities

- Economic function approach
- Policy tools
- Information sharing
Economic functions

• Management of client cash pools with features that make them susceptible to runs
• Loan provision dependent on short-term funding
• Intermediation of market activities dependent on short-term funding or on secured funding of client assets
• Facilitation of credit creation
• Securitisation and funding of financial entities
Policy tools

• Principle 1: ability to define the regulatory perimeter.
• Principle 2: collect information needed to assess the extent of risks posed by shadow banking
• Principle 3: enhance disclosure of other shadow banking entities as necessary so as to help market participants understand the extent of shadow banking risks posed by such entities
• Principle 4: assess non-bank financial entities based on economic functions and take necessary actions from the toolkit
FSB: Securities lending and repos

- April 2012 review
- November 2013 consultation
FSB (2012): Market overview

• Securities lending
• Leveraged investment fund financing and securities borrowing
• Inter-dealer repo
• Repo financing
Securities lending (1)

- Lending of securities by institutional investors to banks and broker-dealers against collateral of cash or securities
- Apr. 2012: US$ 1.8 trillion
Leveraged investment fund financing

- Financing of leveraged investment funds’ long-positions by banks and broker-dealers using both reverse repo and margin lending secured against assets held with prime brokers as well as securities lending to hedge funds by prime brokers to cover short positions
- Closely linked to securities lending.
Interdealer repo market

- Primarily government bond repo transactions amongst banks and broker-dealers.
- Finance long positions via general collateral repos or to borrow specific securities via special repos
- Primarily overnight
- US: US$2.1-2.6 tr, EU: US$8.3 tr, Japan: US$2.4 tr
Repo financing market

• Repo transactions primarily by banks and broker-dealers to borrow cash from cash-rich entities, including central banks, retail banks, money market funds, securities lenders, and increasingly non-financial corporations

• Often tri-party

• Collateral includes bonds, structured products, money market instruments and equities
Market drivers

• Demand for repo as a near-substitute for central bank and insured bank deposit money (e.g., because unable to access directly)
• Securities-based financing needs (e.g., replacing unsecured money markets)
• Leveraged investment fund financing and short-covering
• Demand for assisted “collateral mining” from banks and broker-dealers
• Demand for return enhancement by securities lenders and agent lenders
FSB risks (2013) (1)

• Pure shadow banking
  – Using repo to create short-term money-like liabilities, facilitating credit growth and maturity/liquidity transformation outside the banking system
  – Securities lending cash collateral reinvestment

• Spanning banking and shadow banking
• Tendency of secured financing to increase procyclicality of system leverage
• Risk of fire sale of collateral securities
• Re-hypothecation of unencumbered assets
• Interconnectedness arising from chains of transactions involving re-use of collateral
• Inadequate collateral valuation practices
FSB recommendations

• Improvement in transparency
• Regulation of securities financing
• Structural aspects of securities financing markets
Securities lending and repos

- Improving regulatory reporting
- Improving market transparency
- Improving corporate disclosures
- Improving reporting by fund managers to end-investors
- Introducing minimum standards for haircut practices
- Limiting risks associated with collateral reinvestment
• Addressing risks associated with re-hypothecation of client assets
• Strengthening collateral valuation and management practices
• Evaluating the establishment or wider use of central clearing where appropriate
• Changing bankruptcy law treatment of repo and securities lending transactions
Transparency

1: authorities to collect more data with high urgency
2: trade repositories for repo and securities lending markets
3: regular surveys
4: improve public disclosure of financial institutions’ securities lending, repo and wider collateral management activities
5: review reporting requirements for fund managers to end-investors
Regulation (1)

- 6: minimum standards for firm haircut methodologies, focusing on minimising procyclicality
- 7: consultation on possible introduction of system of floors on haircuts for securities lending where there is material procyclicality risk.
- 8: Non-bank regulators to implement minimum standards
(2)

- **9: Regulation of re-hypothecation**
  - Sufficient disclosure to clients
  - Not used to finance own-account activities of the intermediary
  - Only entities subject to adequate regulation of liquidity risk

- **10: Possible harmonisation of client asset rule addressing re-hypothecation**

- **11: Minimum standards for collateral valuation and management for all market participants**
Structural aspects

• 12: Central clearing to be evaluated.
• 13: Changes to bankruptcy laws and development of Repo Resolution Authorities not to be prioritised.
Asia: FSB (2013)

• HK (190% of GDP), SG (50+%)  
• Korea, Japan, Singapore, Australia (approx. 50-100%)  
• India, China, Indonesia (less than 50% but growing very rapidly particularly in China [+42%])
Shadow banking / Non-bank finance

- Money lenders / pawnbrokers
- P2P / B2B
- Microfinance / small lenders
- Traditional and other “syndicates”
- Finance companies
- Islamic finance
- Structured finance
- Money markets / commercial paper
- Securities lending / repos
China

• Main concerns
  – Structured finance: trust / wealth management products (quasi-securitisation)
  – P2P / B2B (brokerage)
  – Commercial paper (bills)
  – Syndicates (Wenzhou)

• Issues
  – Interest rate controls
  – Size: 25-40% + of total financing?
  – Deposit diversion
  – Lack of deposit insurance / resolution framework for banks
  – Government debt: national + provincial / local
Regulatory Structure: Options

- Sectoral (Mainland China, US)
- Institutional (HK and majority of jurisdictions worldwide – sectoral + institutional for banks)
- Functional (Australia)
- Consolidated (South Korea, Japan, Singapore)
- Twin Peaks (UK, Netherlands, France)