Shadow Banking: Challenges and Approaches

Professor Douglas W. Arner
Head, Department of Law
University of Hong Kong
Douglas.Arner@hku.hk

Overview

- Issues: Balancing risk and function
- Assessing the market
- G20/FSB approach
- Asian context
- References
  - R. Weber, D. Arner, E. Gibson & S. Baumann, "Addressing Systemic Risk: Financial Regulatory Design", 49 Texas International Law Journal (forthcoming 2014).
  - R. Buckley, D. Arner & M. Panton, "Financial Innovation in East Asia", 37 Seattle Law Review (forthcoming 2014).

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.

(4)

- *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 (eg because unable to access directly)
- Securities-based financing needs (eg 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

(2)

- 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

(2)

- 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)