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THE NON-BANK FINANCIAL SECTOR IN THE AFTERMATH OF THE FINANCIAL CRISIS: HOW TO REGULATE AND SUPERVISE TO ENSURE FINANCIAL STABILITY

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11 May 2016

MOTIVATION

- Non-bank financial sector might be on the rise, but this sector is not new: a "shadow" sector has always existed

- Why did it gain prominence?

  - Some risks emerged during the financial crisis (mainly in US)

    Non-consolidated securitization vehicles (such as conduits or SIVs) had support by the banks

    MMFs were important providers of short-term funding for the regular banking system and they needed large scale support from sponsors and the official sector

OUTLINE

i. Definition

ii. Regulatory strategy

  a. *Monitoring*

  b. *Regulation development*

iii. European approach

iv. Conclusions

WHAT IS SHADOW BANKING?

- It is difficult to define "shadow banking": it encompasses an heterogeneous group of entities/activities with differences across jurisdictions and evolves over time (dynamic)

- Sometimes, the term "shadow" is associated to non-regulated activities and this creates additional confusion because:

    - *A large share of the shadow banking sector is subject to regulation (although different from banking regulation)*

    - *Not all the shadow banking sector should be regulated if we consider the risks that they generate*

- This "pejorative/derogatory" term has hidden positive aspects such as the increase in competition, alternative sources of funding, financial innovation or financial inclusion

    - *From shadow banking to market-based financing*

THE CONCEPT OF MARKET-BASED FINANCING

- The FSB has been working to take shadow banking out of the shadows. The starting point has been to shed light to the definition:

    - *"Credit intermediation involving entities and activities fully or partly outside the regular banking system"*

- Under this definition, it is key that market-based financing can create bank-like risks while it is not subject to bank-like regulation and supervision; has no access to the safety net; and has not disclosure requirements (which hinder market discipline)

- Therefore, we might conclude that similar risks with different regulation and supervision might lead eventually to risks to financial stability

MONITORING MARKET-BASED FINANCING
"CASTING THE NET"

- FSB initial approach was to identify **entities** involved in market–based financing activities (entity-based approach)

  - *Focus on non-bank entities of the financial system with a particular focus* ***on Other Financial Intermediaries (OFIs)***

Broadly speaking, all the entities of the financial system which are not:

- banks,

- insurance companies, or

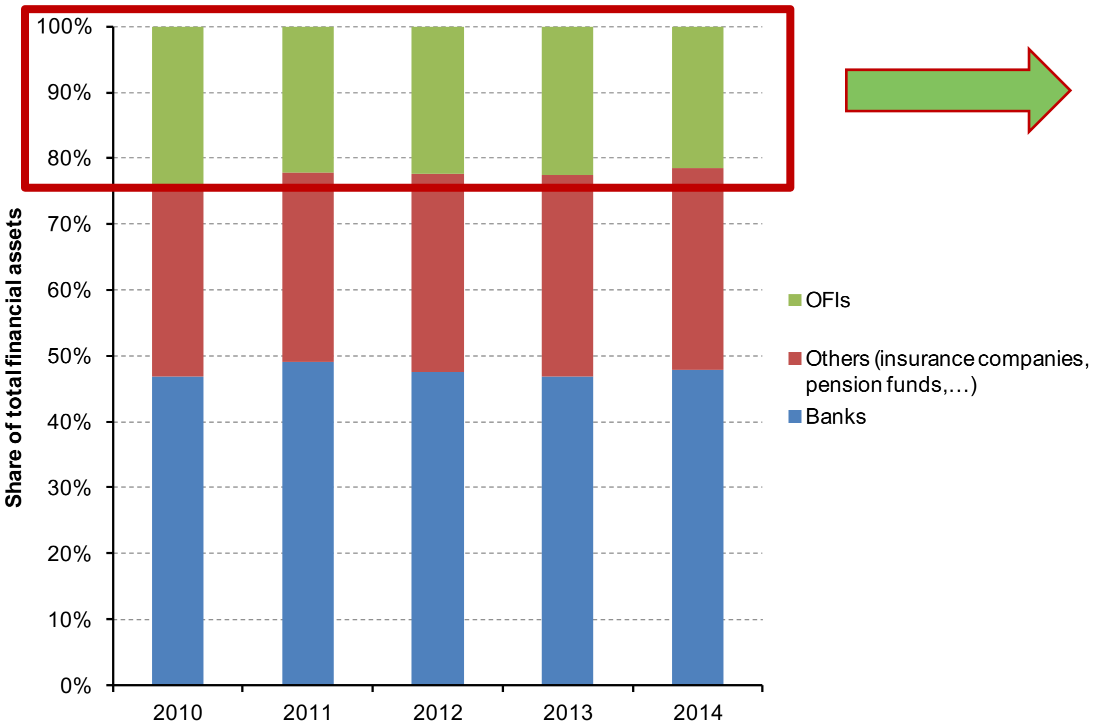
- pension funds

MONITORING MARKET-BASED FINANCING
OTHER FINANCIAL INTERMEDIARIES (OFIS)

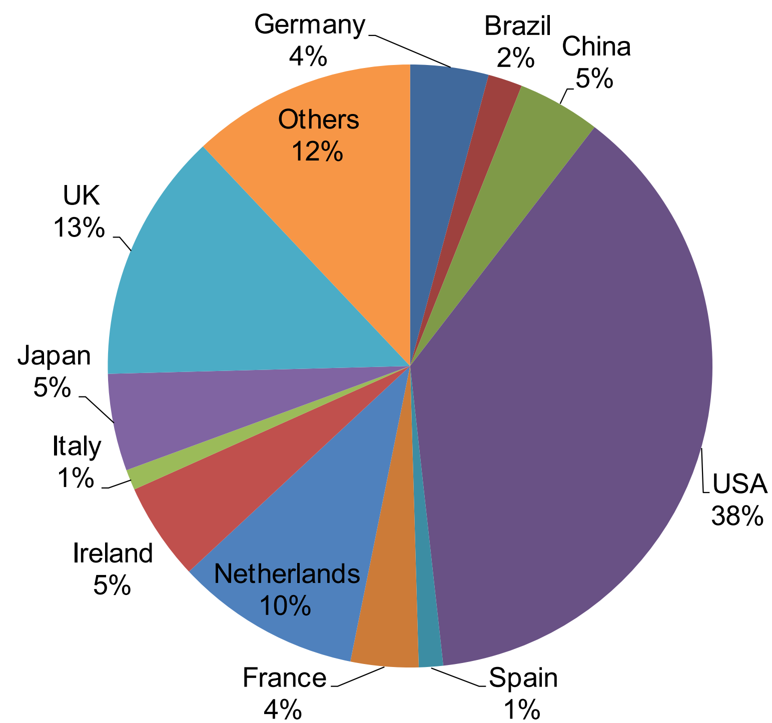
➢ OFIs is a relatively small sector of the financial system although size and relative importance vary across countries.

➢Most of OFIs are located in US (20% in continental Europe)

Structure of the financial sector (2010-2014)



OFIs distribution (2014)



Source: FSB (data collected from the 24 FSB jurisdictions, Ireland and Chile)

MONITORING MARKET-BASED FINANCING
A MORE FOCUSED RISK-BASED APPROACH

- However, OFIs is a broad measure that has two main shortcomings:

  - *Some OFIs do not perform credit intermediation*

  For instance, equity funds are excluded from the narrow measure because they are not part of the credit intermediation chain

  - *Some OFIs are consolidated into banking groups and therefore are subject to prudential banking regulation which avoids bank-like risks.*

  For instance, most of the secutitization funds in Spain are consolidated into banks' balance sheets and, thus, their risks are captured by prudential regulation

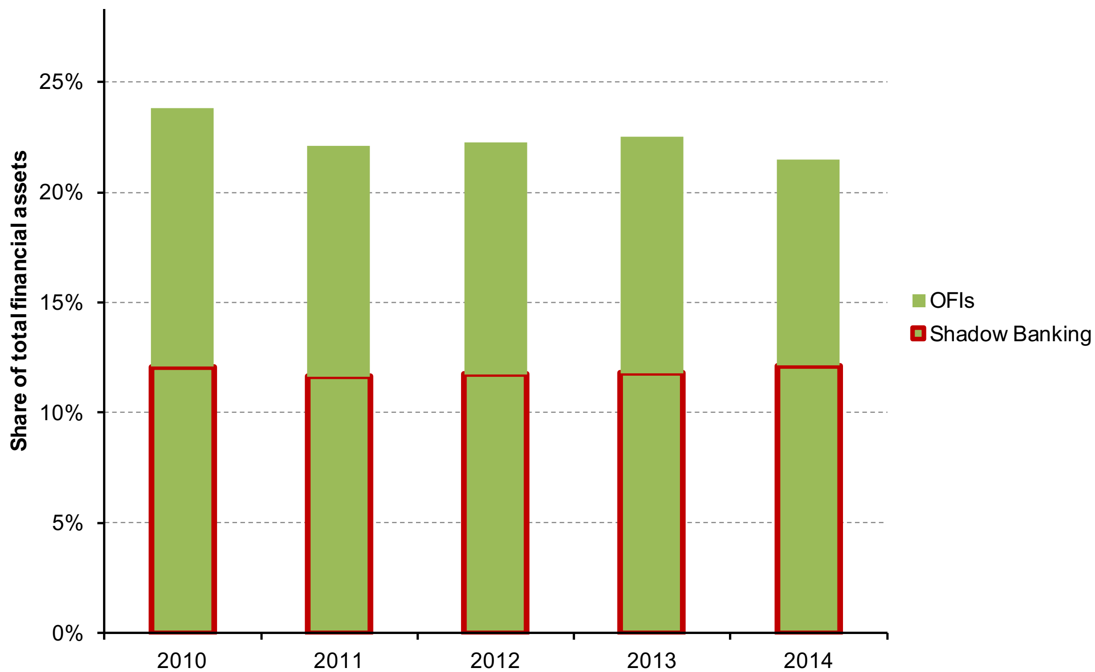
- This is the reason why the FSB has developed over the last year **a new activity-based approach** that, in addition, classifies entities according to the potential risks that they may pose to the system

MONITORING MARKET-BASED FINANCING
THE NARROW MEASURE

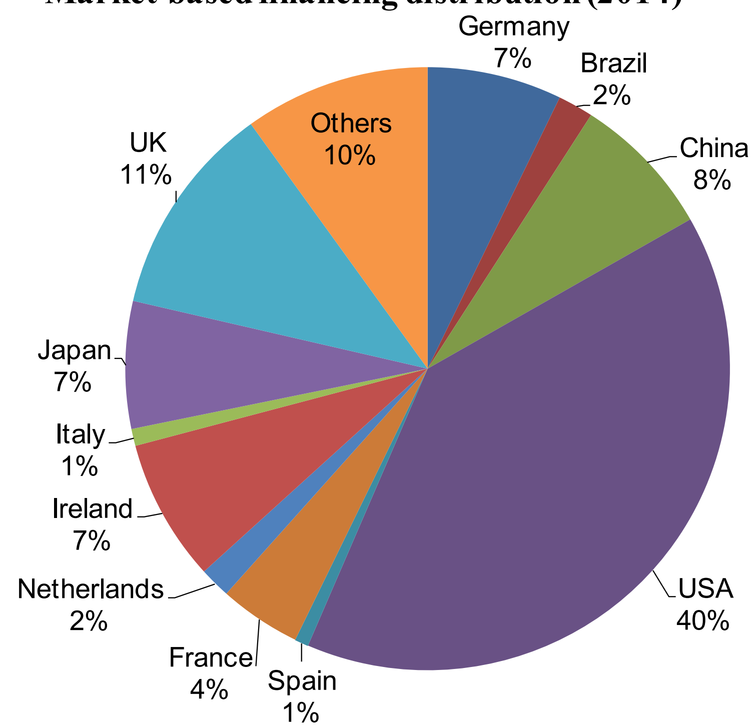
➢ The narrow measure (activity-based) implies a significant decrease in the amount of market-based financing and improves the monitoring and identification of risks.

➢ A significant part of the volume of the narrow measure is still in the US (15% in continental Europe). Collective investment vehicles represent 60% of the narrow measure and they have experienced the highest growth in recent years.

OFIs vs. market based financing (2010-2014)



Market-based financing distribution (2014)



Source: FSB (data collected from the 24 FSB jurisdictions, Ireland and Chile)

MONITORING MARKET-BASED FINANCING
POTENTIAL IMPROVEMENTS

- This narrowing-down process - through the activity-based approach - has been an important step for the identification of bank-like risks. However, there is still room for improvement:

  - *Non-FSB countries should be involved in the measurement process given the cross-border nature of the sector (FSB RCG for the Americas report is a good example of the benefits)*

  - *Information gaps (entities not registered at any supervisor and cross-border transactions/interconnections)*

  - *Improvement in the analysis of risks identified designing tailored risk metrics to achieve a better understanding of the risks posed*

REGULATION DEVELOPMENT

- The development of regulation should take into account that the monitoring exercise is in its initial phase and, therefore, data should improve to have a better understanding of risks

- Regulation should be tailored to address bank-like risks. These risks may stem from:

1. Regulatory arbitrage: Banks trying to avoid regulation

2. Other entities which decide to compete with banks without being subject to prudential regulation

REGULATION DEVELOPMENT

1.Indirect regulating through banking regulation	2. Direct regulation to market-based financing activities/entities.	
Example (banking regulation): BCBS consultation paper: **“Identification and measurement of step-in risk”** (Dec 2015) •**Step-in risk**: Risk that a bank may need to provide support to an entity beyond its contractual obligations (e.g., due to reputational risk) •**Target**: Capturing structured entities that pose “step-in risk” to a bank through the regulatory perimeter Is it necessary to expand the regulatory perimeter, or **would a correct application of accounting standards be enough** (i.e. by considering entities potentially subject to step-in within the scope of consolidation)?	*Past examples*: **Securitization:** IOSCO policy recommendations (November 2012) **MMFs:** IOSCO policy recommendations (October 2012)	*Example. Work in progress:* **Investment funds and asset managers:** FSB will lunch public consultation (mid-2016) on policy recommendations to address: -Funds' liquidity mismatch; -Leverage within funds; -Operational risk and challenges in transferring investment mandates; and -Securities lending activities

EUROPEAN APPROACH

- Market-based financing is a concern for European regulators
  - ECB has highlighted it as one of the four key risks for the Euro area financial stability

"All these factors – size, interconnectedness and opacity – suggest that the potential for systemic impacts emanating from this sector is increasing. The bulk of the increase in total assets in the shadow banking sector stems from the investment fund sector. From a financial stability perspective, concerns about the risks posed by investment funds relate to the implications for the wider financial system and the real economy arising from the sector's increasing role in credit intermediation and capital markets." **Financial Stability Review – November 2015**

Table 1

Key risks to euro area financial stability

pronounced systemic risk medium-level systemic risk potential systemic risk	Current level (colour) and recent change (arrow)*
Abrupt reversal of compressed global risk premia amplified by low secondary market liquidity	↑
Weak profitability prospects for banks and insurers in a low nominal growth environment, amid incomplete balance sheet adjustments	→
Rising debt sustainability concerns in the public and non-financial private sectors amid low nominal growth	→
Prospective stress in a rapidly growing shadow banking sector, amplified by spillovers and liquidity risk	↑

* The colour indicates the cumulated level of risk, which is a combination of the probability of materialisation and an estimate of the likely systemic impact of the identified risk over the next 24 months, based on the judgement of the ECB's staff. The arrows indicate whether the risk has increased since the previous FSR.

Source: ECB – Financial Stability Review (November 2015)

EUROPEAN APPROACH

- After the crisis, European regulatory response has mirrored FSB initiatives and has taken on board most of its recommendations

1. Monitoring and analysis of risks
   - *ESRB (EU macroprudential authority) is developing a framework for monitoring structural changes and risks with the goal of aligning its approach to the FSB methodology as it evolves*
   - *In 2016, ESRB will publish for the first time its EU Shadow Banking Monitor. It follows a dual approach in which the entity-based approach (similar to FSB) is complemented by an activity-based approach (aimed to capture activities not restricted to specific entities – repos, derivatives,..)*

2. Design of policy measures if necessary. Examples:
   - *Securitization – Proposal for EU regulation within the context of the Capital Markets Union initiative to develop simple, transparent and standardized securitization*
   - *MMFs – Proposal for a specific European framework designed for MMFs*
   - *Investment funds - UCITS Directive (July 2014) and Alternative Investment Fund Managers Directive (July 2011)*
   - *Securities Financing Transactions (STFs) - Regulation on reporting and transparency of STFs – securities lending, repo and re-hyphotecation (November 2015)*

CONCLUSIONS

- Measurement of market-based financing
  - It is necessary to achieve a more homogenous measure and assessment of risks. Activities-based approach is welcome to obtain a better understanding of the sector but gaps should be addressed

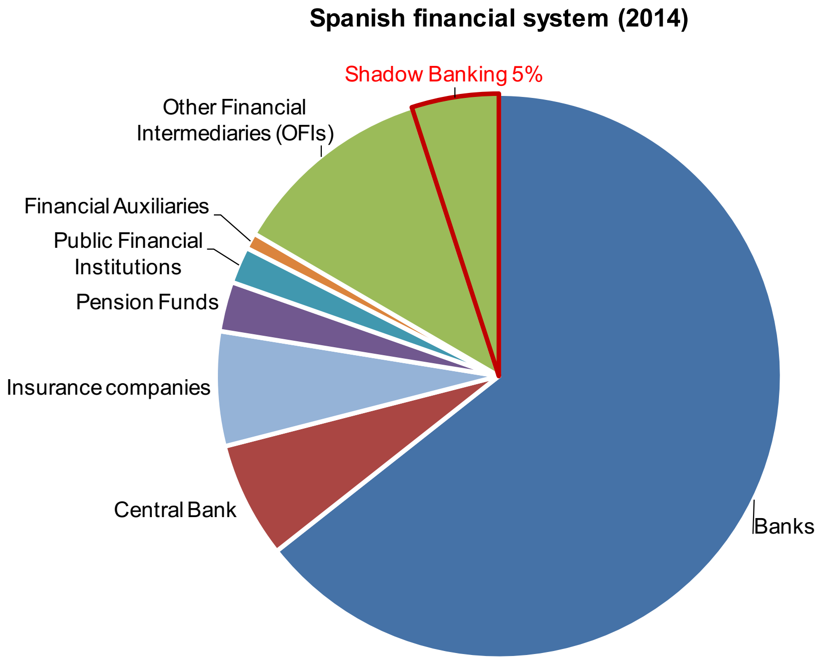
- Regulation
  - Regulatory effort is now focused on investment funds and asset managers due to their volume, growth and risks. In principle, funds are not banks (risks should be addressed differently)

- Market-based financing should not be stigmatized and regulation should be balanced
  - Risks should be addressed but without blocking the benefits brought by market-based financing and without protecting the banking sector interests (competition)
  - Regulation should be a consequence of risks/failures identified in the monitoring part and not a product of an "general regulatory approach"

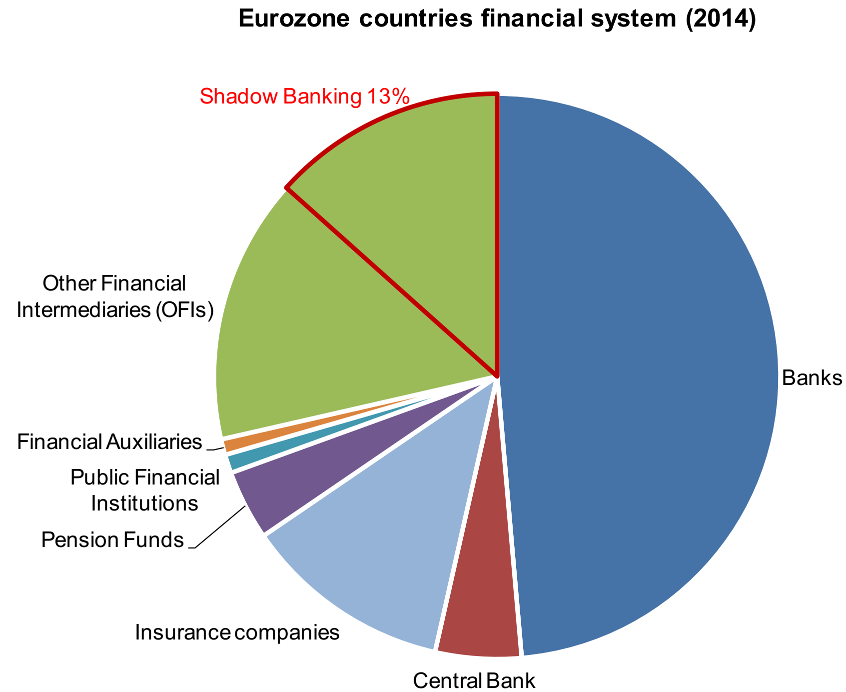
- Efforts should be global and coordination among jurisdictions is key given the nature of the sector
  - European approach follows international strategy: this sector is global (international markets)

CONCLUSIONS

➢ Market based-financing risks assessment is necessary but we cannot ignore its relative importance in the financial system and that other parts of the system can be more important in terms of risk generation



Source: Bank of Spain – Flow of Funds Statistics



Source: FSB (data for France, Germany, Ireland, Italy, Netherlands and Spain)

THANK YOU FOR YOUR ATTENTION

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