

Pentti Hakkarainen: Shadow banking – what kind of regulation for the (European) shadow banking system?

Notes by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, for the panel discussion at the SAFE Summer Academy 2014 “Shadow Banking: Evolution, Background, Perspectives”, Brussels, 3 September 2014.

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A viable and well-functioning shadow banking system is beneficial for the real economy

Before going to the actual topic of today’s panel and presenting some thoughts on regulation of the (European) shadow banking system, let me start with a few words on how I see the shadow banking system. I will not go too much into the details of the definition and coverage of the shadow banking system as it has been a topic of another discussion earlier today. Let me just say that it is very important to have a clear understanding of what we are talking about and hence what we potentially try to regulate and supervise.

I would like to highlight that I see many benefits in a viable and well-functioning shadow banking system. Shadow banking is a modern, sophisticated, and complementary way to share risks efficiently. It is also an alternative way to allocate resources in the economy outside the regular banking sector, upon which we here in Europe are particularly dependent. We may even be too dependent on banks according for example to the Advisory Scientific Committee of the European Systemic Risk Board.¹ Thus it is important to revitalise and strengthen alternative funding channels which can further support sustainable growth in the real economy.

Competition with reputation rather than heavy regulation

My short answer to the question expressed in the topic of this panel (What kind of regulation for the European shadow banking system) is that calls for regulation are justified. However, the shadow banking system should not be regulated in the same way as the regular banking sector. Let me elaborate on this view.

First, we must ensure that regular banking activities and shadow banking activities should not be mixed or confused with each other. It should be crystal clear for investors in for example money market funds that they do not enjoy any coverage comparable to a deposit insurance system. Similarly, it should be clear to entities in the shadow banking system that they will not be supported by the government (the same applies to banks as failing banks will not be supported or bailed-out as the new recovery and resolution framework has been fully implemented) nor that they have access to the liquidity support of the central bank. If shadow banking entities were under similar regulation and supervision as regular banks, this might give a misleading signal to the market that they implicitly also enjoy a similar safety net. Formal surveillance by authorities can also reduce the incentives of outsiders to monitor shadow banking entities.

Shadow banking entities have to earn the trust of investors and counterparties on their own merits. They have to be able to compete independently by prudently managing the business and maintaining sufficient buffers. Appropriate disclosure of information and sufficient transparency of operations enable efficient monitoring and are instrumental in building trust.

¹ ESRB (2014) Is the EU overbanked? Reports of the Advisory Scientific Committee 4.

Secondly, in spite of our best efforts, supervisors tend to follow a step or two behind the actions of those we supervise. This is the case also with regular banks, which operate in and adjust to a continuously changing environment. Still I would argue that the banking business is more stable. Moreover, there are more similarities across regular banks than there are across the heterogeneous group of shadow banking entities, making regular banks easier to supervise. Thus regulating and supervising the shadow banking system might be particularly challenging, if not even impossible. A better option might be to make sure they have the right incentives to do their job well.

Regulating systemically important shadow banking entities and the importance of separation between the regular banking and shadow banking system

However, there are some exceptions to the ideal situation I have tried to picture, making more comprehensive and stricter regulation warranted. First of all if a shadow banking entity becomes systemically important its failure may have devastating effects on the rest of the financial system and eventually on the real economy. As some risks are likely to shift to the shadow banking system due to the tighter regulation in the regular banking sector, risk concentrations may very well be built up in the shadow banking system. There is an externality that calls for regulation. Here the US has taken the lead and already allows the authorities to ensure that the perimeter of prudential regulation can be extended as appropriate to cover systemically important (and significant) shadow banking institutions.² This avenue is one option to be considered in Europe.

Secondly, the systemic risk building up in the shadow banking system and the failure of a shadow banking entity should not cause contagion to the regular banking sector. Thus there is a need to regulate and supervise the link between the regular banking sector and the shadow banking system.

Much has already been done to this end. For example the Risk Retention Rule guarantees that an originator has a skin-in-the-game as it must keep a certain part of the risks at its own balance sheet and thus the bank will measure the risk of the link to the shadow banking system appropriately. Similarly the due diligence requirement reduces the information asymmetry in securitisation structures and makes them more transparent. This facilitates the understanding of risks taken by regular banks in the shadow banking system. The objective of the proposed Regulation of Money Market Funds is to ensure that the risk of MMFs is properly accounted for by the investors among which regular banks are frequently found. The distinction between insured deposits and this important source of funding for shadow banking entities is clarified. To further strengthen the securitisation process the EU Credit Rating Agency (CRA) regulations improves the transparency and accountability of rating agencies. Finally, the capital requirements related to securitisations have been reformed to ensure that the parties involved in the process are sufficiently protected against potential shortcomings and failures.

Also, there is an ongoing discussion on reforming the structure of banks in the European Union based on the work of the High-level Expert Group chaired by governor Liikanen, the member of which our panel chairman, prof. Jan Pieter Krahen also was. Based on the final report of the Group, the Commission proposed Regulation on structural measures to improve the resilience of EU credit institutions. One element of this proposal is to curb the link between banks and the shadow banking system, by imposing a ban not only on proprietary trading, but also on exposures to shadow banking entities engaging in proprietary trading

² See for example the speech by Daniel Tarullo on “Shadow banking and systemic risk regulation” held at the Americans for Financial Reform and Economic Policy Institute Conference, Washington DC, 22 November 2013.

and exposures to hedge funds and entities sponsoring hedge funds. Similar rules are already implemented in the US through the Volcker-rule.

In January 2014, the Commission also published a proposal on Regulating shadow banking system transparency. The aim is to improve the reporting and increase the efficiency of supervision on securities financing transactions so that the links to the banking sector are properly understood. Moreover, the proposed rules on how client assets can be reused as collateral clarify the complex chains of rehypothecation. The transparency of the collateral chains, in which both regular banks and shadow banking entities are involved, is also improved. During the financial crisis we learned that opacity and uncertainty about the extent of rehypothecation and the risks involved can severely undermine confidence in counterparties.

The ABS market in Europe

Continuing on the development of a particular shadow banking activity, I would say that a step towards the right direction has been taken as the new regulation supports the ABS market (or securitisation market in general) and endeavors to ensure growth, while for example the proposed regulation on structural reform in EU aims to better separate shadow banking from the traditional one. Furthermore, it enhances the market discipline, which in turn, provides a decent and solid ground for well-functioning shadow banking system.

As the ECB Governing Council decided in June 2014 to “intensify preparatory work related to outright purchases in the ABS market (to enhance the functioning of the monetary policy transmission mechanism)”, I would also like to say a few words about the ABS market in Europe and its potential.³

The current ABS market in Europe is small and impaired: public issuance of asset backed securities is minimal and the market is shrinking. It is unfortunate as the ABS-market has a good potential to contribute to unlocking the Europe’s credit market, by offering a viable complementary funding source for the real economy, in particular for the SME sector.

Considering the weakness of the securitisation market, it is obvious that the market is still suffering from the stigma it received when the global financial crisis erupted and the failures of the securitisation market were uncovered. The market suffers from a reputation as a capital arbitrage tool of banks that turned out to be disastrous for financial stability. The stigma is persistent and mutual, even though the European ABS market performed relatively well during the crisis compared with the respective American one.

Another reason behind the small and weak European securitisation market may be the heterogeneity of the European securitisation market, namely the differences in for example lending criteria, banking institutions, rating standards and default laws among the European countries.⁴ Diminishing these differences would enable a better-functioning European securitisation market. Harmonising some standards and enhancing relevant data availability could dispel the risk that banks would off-load bad parts of their balance sheets with securitisation activities. Moreover, common rules and standards would support the development of the currently very fragmented market to a pan-European one in a single market spirit.

Finally, considering the potential role of the ABS market in the monetary policy transmission mechanism, a central bank should avoid a situation in which it could become the only buyer

³ See also the joint paper by ECB and BoE “The impaired EU securitisation market: causes, roadblocks and how to deal with them”.

⁴ An interesting discussion on alternative ways to develop the ABS-market in Europe can be found in the recent Bruegel Policy Contribution “Asset-backed securities: the key to unlocking Europe’s credit markets?”.

in the ABS market. It is thus utterly important to enhance the development of the private market in ABS. So far the ABS market has probably played a minor role in private sector debt financing; its main driver may have been the collateral needs of banks. From the view point of regulation these facts should not be forgotten. It is desirable to make regulation such that it restricts neither the supply nor the demand side of the ABS market.

Concluding remarks

To conclude, I would like to highlight the following points.

In principle, shadow banking system is beneficial, and one must be careful with its regulation. As professor Bengt Holmström has reminded: “Of special concern is the tendency to demonize or ban innovations that backfired, not because they were fundamentally wrong, but because the particular implementation was flawed. The originate-and-distribute model and MBSs [or securitisation in generally] will certainly have an important place in the future.”⁵ Thus, we should learn from the fundamental analyses of what went wrong last time, and keep restoring the confidence to the securitisation market.

Finally, one thing that should be kept in mind is a possible post-crisis reinvention of the financial system that Andy Haldane, Chief Economist of Bank of England, talks about in his recent publication.⁶ As a consequence of the crisis, some part of financial activities will migrate outside the banking system, inducing the shape and form of risk itself to change. This could have further implications for stability of the financial system and the broader economy. Haldane continues that as risk changes its composition, not its quantum, the financial system may exhibit a new strain of systemic risk that is even more related to shadow banking entities.

Therefore, regulators must follow intensively the development of the post crisis financial system that might result in new type of systemic risks, and be ready to adjust regulation accordingly in a proactive manner.

⁵ Bengt Holmström (201) Comment on “The panic of 2007” by Gorton subsequently published in 2009 as “The Subprime Panic” in the *European Financial Management* 15 (1).

⁶ Andrew Haldane (2014) “Halfway up the stairs”, *Central Banking Journal*.