

WHAT CAN BANKS DO ABOUT SHADOW BANKS?

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Abstract

Learning a lesson from the financial crisis, Europe is re-evaluating the – increasingly strong – role of the shadow banking sector. When trouble strikes, shadow banks represent a danger of contagion for the traditional credit institutions with which they nevertheless often share overlapping ownership. Shadow banks today remain less transparent and regulated than regular banks, while their liquidity risk is also significant. The European Banking Authority (EBA) recently adopted the recommendation of credit institutions for the limitation of their exposure to shadow banks, which the National Bank of Hungary (MNB) is set to transplant to the domestic banking market through its own recommendation in the near future.

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Some studies show that the role of shadow banks in the financing of the private sector has grown in parallel with the processes of deleveraging in the banking system. Based on the experiences of the financial crisis, problems associated with shadow banks have appeared primarily because their operations entail mostly short-term financing resources and are insufficiently transparent (Pozsár et al., 2012). Their role in the financial system is not necessarily negative, however, since there are also numerous positive elements of their activities – for example, through ensuring adequate liquidity or alternative investment opportunities (Schwarcz, 2012).

Making the task of risk management with respect to shadow banks more difficult, meanwhile, is the fact that not all of these institutions are subject to supervision, or it is not clear which supervisory authority's remit they fall within. Financial enterprises, for example, which are listed among shadow banks, are subject to supervision in certain EU member states (including Hungary), and their regulation – given that they do not collect deposits – is considerably simpler than for credit institutions. However, while supervision of both types of institution is equally robust in Hungary, the same cannot be said of other EU member states.

The primary difference between banks and shadow banks is that while very detailed requirements apply to the prudent and reliable business operation of the former, regulation of the activities of the latter – given that they do not collect

deposits – is considerably simpler. On the one hand, this represents a competitive advantage for shadow banks, while on the other hand it increases their systemic risk and potential negative impact on financial stability.

SHADOW BANKING IDENTIFIED IN WAKE OF FINANCIAL CRISIS

In uncovering the causes of the global financial crisis and drawing conclusions, the spotlight fell on the role of organizations carrying out shadow banking activity. Research revealed that these institutions contributed substantially to magnifying the effects of the crisis. Since 2010, the Financial Stability Board (FSB) has dealt with the management of the banking system's exposure to shadow banks, the role of money market funds in systemic risk, and the further regulation of shadow banks. Based on international developments, the European Commission published a Green Paper in 2012, in which it outlined the possible framework of future regulation. In April 2014, the Basel Committee – in reviewing recommendations with regard to the undertaking of major risks – also touched upon banks' exposure to shadow banking. At the latter committee's recommendation, when banks invest in investment funds or securitized instruments, they must always identify what exposures with respect to other organizations arise indirectly from these risk exposures.

The concept of shadow banks has evolved only gradually, and today defines organizations belonging to the sector partly from the institutional aspect, and partly in terms of their activities. The sector comprises institutions that carry out financial intermediary activity similar to that of banks – maturity transformation, liquidity transformation, leverage or credit risk transfer. With respect to their activity, this also includes securitization and securities financing.

THE NEED FOR EFFECTIVE EU RESPONSES

The activities of shadow banks within the EU have hitherto already been covered by several laws, with prescriptions relating to securitization regulated by the Capital Requirements Regulation (CRR) and Directive (CRD) regulating capital requirements for credit institutions and investment firms, executive directives pertaining to these, and the regulation of the European Commission on transparency of securities financing transactions. Finalization of the regulation of money market funds is also currently under way. It is of utmost importance that further regulation should not respond to the global financial crisis by merely tightening regulations applying to already thoroughly regulated banks,

investment firms and insurance companies. The increasing costs incurred by such regulation would only offer shadow banks an even greater opportunity to expand.

Regulatory plans for shadow banks are quite complex and wide-reaching. From the point of view of microprudential supervision, however, the manner in which credit institutions are connected to the shadow banking sector is especially important, as is the danger of risks arising at shadow banks spreading to the traditional banking sector. The limitation of exposures to shadow banks is also necessary because – due to different regulatory systems – banks may exploit agreements with shadow banks to sidestep their own strict bank regulatory system.

The CRR authorized the European Banking Authority (EBA) to publish its recommendation for the limitation of banks' exposure to shadow banks. The EBA needed to gauge whether the introduction of stricter limits would significantly damage the risk profile of EU banks, or if it would negatively impact lending to the real economy or the stability and adequate functioning of financial markets. Prior to publication of its recommendation, the EBA – with the participation of 184 banks in 22 EU member states – measured and published in December 2015 the size of credit institutions' exposure to shadow banks (EBA, 2015a). This showed that the exposure was greatest in Great Britain and Germany, but also significant in Malta, Luxembourg and France.

The recommendation – which only applies to shadow banking exposures of which the value reaches 0.25% of the bank's eligible capital – clearly determines the sphere of entities falling within the shadow banking sector, as well as the activities they carry out (customary at credit institutions) which classify given institutions as shadow banks (EBA, 2015b). These include the collection of deposits and other repayable liquid assets, credit and leasing services, undertaking of guarantees or participation in the issue of securities.

At the same time, the recommendation excludes numerous types of company from the shadow banking sector. Among others, those not belonging here include financial institutions, other credit institutions and investment firms, insurance and reinsurance firms in the EU (or a third country with equivalent regulation) connected to bank groups and subject to consolidated supervision, as well as employer pension service providers, UCITS funds created in accordance with European guidelines, long-term European investment funds, approved social entrepreneurship funds and venture capital funds, central contracting parties, electronic money issuers and payment institutions. These types of enterprise may constitute exceptions because the EU has adjudged the regulatory system applying to them as sufficiently robust.

However, funds (money market funds) investing in financial assets of less than two years' maturity, or offering yields according to money market rates or preservation of the value of the investment, do not fall among enterprises subject to exemption. In other words, the exposure limits contained in the recommendation are to be applied to these funds.

RISKS AND SIDE-EFFECTS

The EBA identifies several dangers with respect to shadow banks. On the one hand, the liquidity risk is greater in their case compared to traditional banks because they deal in short-term funds, while a high level of leverage also makes them very vulnerable to market volatility; moreover, they have no liquidity prescriptions to guarantee their resistance. Given that shadow banks – through overlapping ownership or loans extended to them – are closely tied to credit institutions, their problems can quickly infect the regular banking sector. Excessive leverage only magnifies the dangers arising from maturity discrepancies and liquidity problems, thereby damaging financial stability. Finally, their activities are difficult to see through clearly. This is already a problem in itself, but in crisis situations market participants tend to prefer safe, transparent investments, so that money invested in shadow banks is vulnerable to rapid flight.

The first regulatory expectation arising from the EBA's recommendation is that banks should employ efficient processes and supervisory mechanisms. In this context, they should be able to identify their individual exposures to shadow banks, implementing an internal framework serving to identify, manage, monitor and mitigate these risks. The identified risks must be taken into consideration during the Internal Capital Adequacy Assessment Process (ICAAP) and capital planning. Banks must determine their own risk tolerance/ inclination to assume risk with respect to exposure to shadow banks, and discover to what extent their own institution is interlinked with the shadow banking sector. They must elaborate processes for reporting to their executive body, as well as action plans to be followed in the event of overstepping the limits.

A natural expectation of EU banking authorities is that the executive bodies of banks adequately control these risks. The executive body must approve and monitor the assumable risk and associated limits (and document their specification), as well as overseeing the risk management process and risk mitigation techniques. It must regularly review the scale of exposure to shadow banks and its proportion compared to the bank's total exposure.

The EBA has prescribed the fixing of individual and combined limits for banks with respect to exposure to shadow banks. In the "primary method" proposed

in the recommendation for this purpose, there is no clear expectation for the specific setting of limits, but only the prescription that banks should themselves determine individual and combined limits for exposure to shadow banks. In the latter process, the bank's own business model must be taken into account, as must the proportion of exposure to shadow banks within total exposure and the degree of interconnection. Individual limits must be established based, among other factors, on the extent of regulation applying to the given shadow bank, its financial situation, the quality of its assets and its financial vulnerability.

The "reserve method" proposed by the EBA must be applied by banks which are unable to elaborate these risk management and monitoring processes or limit systems. The essence of the reserve method is that the bank adds up all its exposures to shadow banks and handles this amount in accordance with the limit for major risk undertakings under the CRR. In other words, the given bank's combined exposure to shadow banks may not exceed 25% of its eligible capital. If a bank is able to carry out the expected risk management and controls with respect to certain shadow banks, then the combined limit of 25% must be applied collectively only to those shadow bank exposures for which it has been unable to gather adequate information.

THE SHADOW DISSOLVES FOR HUNGARIAN BANKS AS WELL

The EBA's recommendation must be applied from 1 January 2017. Given that the topic is important in Hungary as well, it is expedient for the National Bank of Hungary (MNB) to transplant the EU's set of requirements to the domestic banking market through its own recommendation, moreover as soon as possible in order to allow Hungarian banks more time to prepare. With adoption of the EBA's recommendation, the central bank also calls attention to the significance of this risk type. Following appropriate professional consultations, additional supervisory measures may even be proposed for the mitigation of this risk.

The best example of domestic credit institutions' shadow banking risk is their exposure to certain financial enterprises carrying out lending or leasing activity that do not belong to a bank group, to which they will need to pay greater attention once the recommendation has been issued. If the quality of portfolios of such financial enterprises deteriorates or if deliberate damage occurs, then the financing credit institution could suffer substantial losses, as has already happened before.

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