

LESSONS OF THE CRISIS – THE CHANGING REGULATION OF THE EUROPEAN SHADOW BANKING SYSTEM

Balázs CSEH, Ádám PATAI

Kaposvár University, Faculty of Economic Science, H-7400 Kaposvár Guba S. u. 40.
KPMG Global Services Hungary, H-1134 Budapest, Vaci út 31.

ABSTRACT

This paper intends to present the changing regulation of the European shadow banking system by discussing the major European Union directives which have been created with the aim of treating the macro and microprudential risks that resulted from the international financial crisis between 2007 and 2009. Notably, 2009/111/EC (Basel III), 2011/61/EC (AIFM directive), 575/2013/EU as well as 648/2012/EU directives are examined in a way that on the basis of secondary sources, the paper aims to provide theoretical statements. This article also analyses the Hungarian regulation with the purpose of proving that it is basically the implementation of the directives mentioned above.

Keywords: shadow banking, regulation, European Union, Basel III, AIFM directive

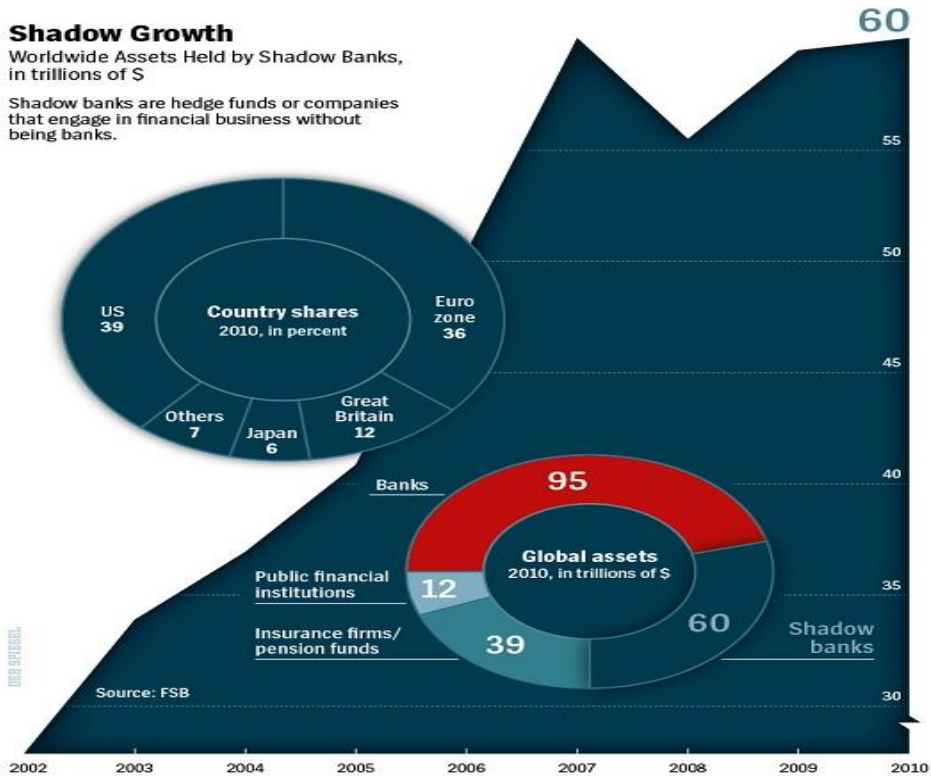
INTRODUCTION

It can be recognized today that the European Union aims to decrease the risks of the shadow banking activities. Due to the economic difficulties caused by the crisis in 2008, the majority of the regulations regarding the financial sector targets the classical banking system. Even though the activities of the shadow banking sector – including, *inter alia*, hedge funds, private equity funds and securitization associations - are similar to banks, it has not been monitored so strictly so far and it has been granted neither central bank support nor securities such as deposit insurance or credit guarantee. The aim of the legislators of the European Union is to elaborate the regulation of the shadow banking system that contributed to the development of the credit crisis. Albeit shadow banking helps the banking sector in gaining liquidity, of late, it has also caused instability in the international financial system. This instability, for instance, contributed to the collapse of the Lehman Brothers in 2008 and in times of the crisis led to the freeze of the global credit markets. (Kevskés, 2016b) The reparation of the issues causing financial instability has become the major aim. Globally, the whole amount of shadow banking instruments reaches more than 50 trillion Euros so it almost doubled in the last ten years. These instruments are almost one third of the financial system of the world and in Europe, the size of the shadow banking system exceeds 23 trillion Euros.¹ (Figure 1)

¹ According to FSB estimations, on the basis of this criteria, the trade of the sector globally increased from 21, 000 trillion Euros of 2002 to 46, 000 trillion until 2010 that is approximately 30% of the financial system of the whole world and is 50% of the banking instruments. (http://europa.eu/rapid/press-release_SPEECH-12-310_en.htm)

Figure 1

Shadow Growth: Worldwide Assets Held by Shadow Banks in trillions of US Dollars



Source: Financial Stability Board (FSB) <https://www.oftwominds.com/photos2012/shadow-banking.jpg>

The shadow banking system, due to its size and owing to the fact that its activities are closely connected to the regulated financial sector, is a potential systemic risk factor for states, governments as well as taxpayers since each lurch can spread over the regulated financial sector as a wave.

THE EVOLUTION OF SHADOW BANKING AND ITS DEFINITION

On the basis of the above, the question might arise why these institutions are called shadow banks and based on their noted characteristics why particular attention ought to be paid on them.

The term 'shadow bank' was firstly used by economist Paul McCulley in the conference of the Kansas City Federal Reserve Bank where he determined shadow banks as nonbank financial institutions that accomplished maturity transformation which he defined as a financial intermediary process during which likely short-term

funds are transformed into long-term loans. Commercial banks do something similar when they turn deposits maturing within a year into long-term (usually 5-10 years) mortgage credits during their banking activities. The difference between the operation of the commercial and the shadow banking system is whether there is an opportunity for external help in case of insolvency of the financial institution. Regarding the commercial banking system, the financial institutions enjoy, on the one hand, the deposit guarantee scheme and, on the other, the help of central banks. (Kecskés, 2016b)

The shadow banking appellation is based on the credit activities of regular banks that these institutions supplement with alternative methods, with a picturesque phrasing as its shadow and its extension as well. It is an approach that is based on misconception that the shadow banking appellation necessarily has a negative connotation or that it would refer to an illegal activity operated in a dark, grey sphere. However, the shadow banking system – albeit not necessarily – is likely to increase the systemic risks of the financial system's operation, that is why the negative overtone that can usually be heard derives from the growth of risks and is traceable to reasonable fears.

This special risk is enhanced by the fact that while the peril of non-compliance that necessarily goes together with credit-granting activities is repelled by the regular banking system through, for instance, capital reserve formation, leverage control, credit insurance or the operation of a special risk management system, shadow banks can solely set the cumulative profit of their investment banking against these guarantees. As for them, it is not an expectation and in accordance with this, it is not a legal obligation to form and operate such guaranteed elements.

It is important to note that the shadow banking system, as a bit fallacious appellation, is not the collection of particular separate financial institutions that can individually be labelled as shadow banks but the use of solutions and methods in the banking sphere which characterize the majority of financial institutions today. In case of those financial institutions which use and operate such solutions and processes, the classical, separated commercial and investment banking activities cast shadow that expand their activities but whose contours are more indistinct and might cast a dark 'blemish' over the activity itself.

In light of the above, an attempt can be made to define the shadow banking system by setting its constitutive differences against the general elements of the banking system. Accordingly, the shadow banking system is the collection of financial institutions operating with miscellaneous (both commercial - and investment banking-type) service portfolios whose inner structure does not distinguish the processes and results of the two classical banking activities but connects them through cross-subsidization. Its service portfolio, from the perspective of commercial banking activities, is restricted to those elements which do not require a separate permission or special guarantees and in case of its own-transformed credit relationship, return is assured through its investment activity. (Kecskés and Bujtár, 2016)

Briefly but to the point, it can be said that the shadow banking system is a) a recently significant segment of the financial system, which b) offers alternative commercial banking services with the c) interlocking of savings and credit

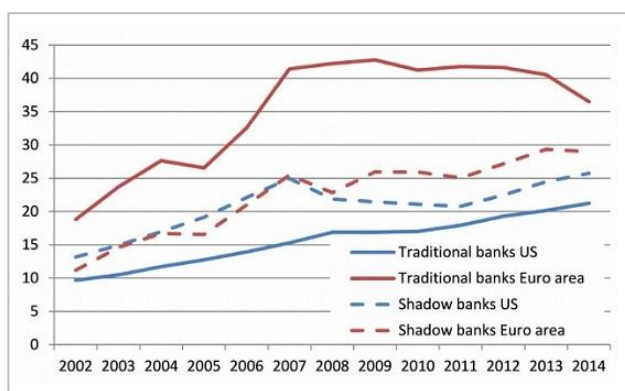
relationships through d) transformation with atypical instruments and e) within a framework that has not been regulated previously on institutional level.

THE SHADOW BANKING SYSTEM IN EUROPE

According to the definition applied on the basis of the above, the operation of numerous shadow banking systems can be identified all over the world. The total assets of the shadow banking systems in both the Eurozone and the USA are increasing. Recently, the public has mostly taken care of the Chinese shadow banking system because its market share in the financial system as well as the amount of state intervention can be thought to be the most outstanding one. (Figure 2) Nonetheless, it can be recognized that shadow banks seem to be of high volume in Europe, too. Out of all instruments of shadow banks in the world, approximately 40% can be found in Europe.² After the financial crisis of 2007-2009, in the Summit of the G20 in Seoul in 2010 the process started within the framework of which the so-called Financial Stability Board. It is worth noting that the Islamic banking system, which is a very important topic of the banking stability (see more in *Varga, 2012*) and whose members are the representatives of the financial authorities and central banks of the most developed countries, was assigned to examine the shadow banking system comprehensively and to propose necessary regulative measures. The comparison of the Islamic and traditional banking systems is a novelty in this topic. (*Bajkó and Varga, 2013*) This committee initiated the strengthening of observance and the regulation of the shadow banking system in its report published on 27 October 2011.

Figure 2

Assets of traditional and shadow banks (USD Trillions)



Source: <https://secularinvestor.com/wp-content/uploads/2016/09/shadow-banking-2.jpg>

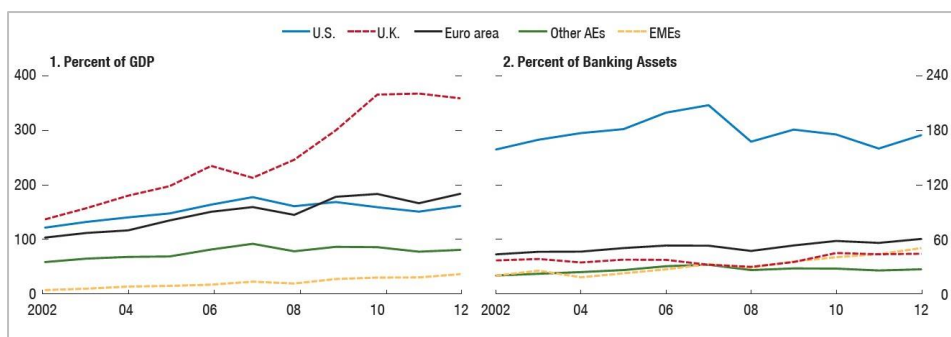
The Financial Stability Board (FSB) firstly determined those principles on the basis of which the monitoring functions and the regulation of the shadow banking

² <http://www.politico.eu/article/barnier-to-target-shadow-banking/>

system can be created by the supervisory authorities, and is working to improve the regulatory framework to address the risks created by shadow banking more effectively. In addition, it also proposed the identification and assessment of such processes of shadow banks that can cause potential and systemic risks, plus, the extension of regulative measures was also suggested. (Figure 3)

Figure 3

Broad Shadow Banking Measures



AE: advanced economy, EME: emerging market economy.

Source: Financial Stability Board; IMF, World Economic database, IMF staff estimates
<https://www.valuwalk.com/wp-content/uploads/2014/10/Shadow-Banking-1.jpg>

The FSB determines the shadow banking system as such a credit-transformational system that includes those operators and their activities which are out of the regular banking system. Consequently, it seems to provide a negative definition.

The FSB defines the operators of the shadow banking system from the perspectives of subject and object. Regarding subjects, the operators are financial institutions which have the following activities:

- Deposit-type fundraising
- Maturity, and/or liquidity transformation
- Credit risk transfer
- Use of direct or indirect leverage

Concerning objects, the FSB delineates the operation of the shadow banking system in a way that it ‘unpacks’ the content of the activities of financial institutions determined from the perspective of subjects. Accordingly, it defines it as a sort of financing provided for nonbank entities. In detail, it determines three forms of financing, namely:

- Securities issue
- Securities lending
- Use of securities repurchase agreements (repo)

The idea behind FSB’s concept is to include in its definition all those operators whose activities can mean a systemic risk. From this point of view, it determined a

non-full-scale list with regards to those entities which it aims to make an object of examination and a subject of regulation. According to this enumeration the pertinent entities might be the following:

- Special Purpose Entities (SPEs) with maturity and/or liquidity transformation
- Money Market Funds (MMFs) and investment funds that deal with deposit-type fundraising which goes together with a strong redemption risk
- Investment funds that grant credits and/or use capital transfer (including ETF as well)
- Financial institutions that grant credits, provide loan guarantee and liquidity and/or maturity transformation without financial institutional powers
- Insurance or reinsurance undertakings that issue or guarantee loan products

To sum up, it can be stated that the Financial Stability Board reaches those entities that are participants of the shadow banking system and that are significant factors of the systemic risks of the financial economy.

However, the FSB did only summarize the volume of the shadow banking systems of the countries included. It did not regulate its operation but forwarded its experiences to the international regulatory working groups (Basel Committee on Banking Supervision, International Organization of Securities Commissions). These organizations received regulatory respect from the FSB, respectively.

The BCBS was asked to determine how the relations between shadow and regular banking systems could be regulated. This task was performed by a working group operating in the headquarters of the Basel Committee. The IOSCO received the task to create regulations decreasing the systemic risk of money market funds. Furthermore, with the help of the BCBS, it had to assess the existing securities transformation conditions and requested to propose further regulative measures in the same topic.

In its reform plan, the European Union suggested that the particular money market funds ought to maintain a cash reserve equalling with at least 3% of their total instruments that would decrease the risk of those large-scale divestitures that have occurred during the financial crisis. It also suggested that daily and weekly levels of liquidity should be prescribed to money market funds, furthermore, it initiated measures that could help envisage large redemptions and would confine the phenomenon of paying too much attention to credit ratings (*Beck and Kotz, 2016*).

For this reason, the EU together with the G20 intends to decrease the risks of shadow banking activities. The recommendations provided by the FSB were approved by the G20 in their Saint Petersburg Summit. By this, the reform of July 2010 of the financial sector enters a new phase and at the same time is on the home straight now – the EU Commissioner for Internal Market and Services said in interviews given to European magazines. According to Michel Barnier, the European legislation: “Today’s proposals are the final cogs in the wheel to complete the regulatory overhaul of the European banking system. This legislation deals with the small number of very large banks which otherwise might still be too-big-to-fail, too-costly-to save, too-complex-to-resolve. The proposed measures will further strengthen financial stability and ensure taxpayers don't end up paying for the mistakes of banks. Today's proposals will provide a common framework at EU

level - necessary to ensure that divergent national solutions do not create fault-lines in the Banking Union or undermine the functioning of the single market. The proposals are carefully calibrated to ensure a delicate balance between financial stability and creating the right conditions for lending to the real economy, particularly important for competitiveness and growth.”³ According to the definition mentioned earlier provided by the G20, the shadow banking system is “the system of credit intermediation that involves entities and activities outside the regular banking system.”⁴

Internal Market and Services Commissioner Michel Barnier said: “The European Union has shown global leadership in implementing ambitious reforms in the area of financial regulation, in particular for banks. What we do not want is for financial activities and entities to circumvent existing and foreseen rules, allowing new sources of risk to accumulate in the financial sector. That is why we need to better understand what shadow banking actually is and does, and what regulation and supervision may be appropriate, and at what level. We must shed light on all parts of the financial sector.”⁵

In accordance with this, the Commission in its Green Paper names those activities and operators to whom the future regulation can refer that might be special investment vehicles, money market funds, investment funds providing credit or leverage, financial companies providing credit or credit guarantees, securities intermediary bodies, insurance and reinsurance undertakings. The Green Paper examines opportunities and possible legislative measures in five key areas: banking activities, questions related to securitization vehicles, securities lending and repurchase transactions, securitization and other shadow banking activities. Those affected could have indicated their reflection until 1 June 2012 in the form of a consultation. (*European Commission, 2012*)

According to the Green Paper, the potential entities can be the following:

- Special purpose entities which perform liquidity and/or maturity transformation; for example, securitization vehicles such as ABCP conduits, Special Investment Vehicles (SIV), and other Special Purpose Vehicles (SPV);
- Money Market Funds (MMF) and other types of investments and products with deposit-like characteristics, which make them vulnerable to massive redemptions (“runs”);
- Investment Funds including Exchange Traded Funds (ETFs), that provide credit or are leveraged;
- Finance companies and securities entities providing credit or credit guarantees, or performing liquidity and/or maturity transformation without being regulated like a bank; and
- Insurance and reinsurance undertakings which issue or guarantee credit products.

³ http://europa.eu/rapid/press-release_IP-14-85_en.htm

⁴ <https://febelfin.be/en/european-commission-green-paper-shadow-banking>

⁵ http://europa.eu/rapid/press-release_IP-12-253_en.htm

Among the activities, the Green Paper highlights securitization, securities lending and repo as possible activities to be examined.

Until these activities and entities are under lower-level regulation and supervision than other parts of the financial sector, the strengthened banking regulation will ‘shepherd’ the majority of banking activities outside the borders of regular banking activities towards shadow banking ones. The lesson of the crisis is, nevertheless, that if a financial institution has banking services or has an active role in the interbank lending markets, it ought to be governed by such strict rules that apply to commercial banks, too. However, this aim can solely be reached by international cooperation.

The European Union in its 2009/111/EC directive (Basel III) regulated the shadow banking system through the regulation of banks and insurance undertakings. Through this, the EU made preventive steps to make financial institutions (banks and insurance companies) unable to eschew the existing regulations on capital charges. The regulation, in this way, determined that stocks could be issued in proportion proper to capital. Besides this, the directive broadened the existing prudential regulations to the area of shadow banking system activities.

Another important element of the European legal regulation is the 2011/61/EC directive that is also known as the Alternative Investment Fund Managers Directive (AIFM Directive) which states that trustees have to pay attention to liquidity risks constantly and at the same time, they have to operate a liquidity management system.

HUNGARIAN TENDENCIES IN LINE WITH THE EUROPEAN UNION

In Hungary, financial institutions belonging to the shadow banking system are of limited volume and number. The financial traditions of our country still leave significant room for classical allotment and transformational activities. The lower likelihood of the population’s risk-taking and the relative limitedness of investment opportunities by the industrial economy are natural parts of this process. At the same time, the lack of information, financial consciousness and the volume of savings do not favor the use of alternative solutions, either. It results in the fact that the Hungarian legal regulation does not approach shadow banking activities expediently; the legislator’s concept can be seen by the synchronous examination of separate but thematically relevant law decrees. The Central Bank (Magyar Nemzeti Bank – MNB) biannually prepares the risk report of the non-banking financial market. In the practice of Hungarian regulatory and monitoring authorities this term is the closest to what is known in the international financial world as shadow banking system. The MNB’s report lists here, for instance, insurance undertakings, retirement schemes, securities intermediaries, investment undertakings, investment fund managements and cooperative credit institutions. The classification of the latter cannot agree from a professional perspective even if the term ‘non-banking financial market’ is understood in the broader domain applied by the MNB since these financial institutions are classical and typical allotment factors and their activities are completely limited to the profile of commercial banks (MNB, 2016).

In accordance with the fact that the shadow banking system is not necessarily innovative and does not apply pioneer solutions, the Hungarian regulation itself is a 'trailblazer,' because either it only implements EU directives such as the AIFM Directive or the Basel III. These legislative acts, certainly, are not born in the form of targeted regulations but through the modification and amendments of capital market and investment service regulations. (*Varga, 2011*)

The MNB was 'a connoisseur' in the treatment of macro – and micro prudential risks resulted from the international financial crisis between 2007 and 2009 owing to the introduction of the so-called countercyclical capital buffer into the Hungarian financial system long before the EU expectations (*Kecskés, 2016a*).

CURRENT TASKS AND TRENDS IN THE EUROPEAN UNION

The aim of the EU legislation is the creation of the bank resolution fund. The purpose of the capital requirements of Basel III is the enlargement of stability and transparency since they are heavy burdens on regular banks and their entering into force can contribute to the shift towards alternative resolutions. In accordance with EU norms such as the prudential requirements for undertakings and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 and EBA Guideline entitled Limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 (2) of Regulation (EU) No 575/2013, the tasks of Member States and in this way Hungary's as well are urgent.

CONCLUSION

Our study intended to apply the lessons of the crisis and to introduce the possibilities. It can be said that during the treatment of exposures to shadow banking entities the Member States have to create effective processes and monitoring mechanisms within the framework of which individual exposures to shadow banking entities and central banks' all potential risks deriving from these ought to be identified, plus, the potential effects of these risks need to be assessed, likewise. In addition, Member States have to create an inner framework for identifying, treating, monitoring as well as moderating risks. Risk management should prepare detailed analysis on the activities of those shadow banking entities to whom the central bank and the Member State are exposed to, what is more, the potential risks and the possibility that the effects deriving from these risks can spread over the given organization should also be taken into account.

The preparation of the analyses needs to be monitored by the risk assessment commission that should properly be informed about the results and that has to assure that it meets the so-called ICAAP requirements. Furthermore, during the planning of the solvency margin, the risk tolerance and the willingness of the institution (exposed to shadow banking entities) to take risks have to be determined as well. Activities between shadow banking entities and the connection of shadow

banking entities with the 'traditional' banking system should also be regulated. Last but not least, it is noteworthy that effective procedures and reporting processes towards the guiding authorities should be formulated regarding its exposure to shadow banking entities.

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Corresponding author:

Balázs CSEH

Kaposvár University, Faculty of Economic Science

H-7400 Kaposvár, Guba Sándor utca 40.

e-mail: cseh.balazs2@ke.hu