



IMF/FRB of Chicago 16th Annual International Banking Conference
"Shadow banking within and across national borders"
November 7-8, 2013

Shadow banking in the EU

Session 6: Cross-border implications

Important disclaimer: The views expressed in this presentation are my own and are not necessarily those of the European Commission and do not prejudice the position of the European Commission.

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Structure of my talk

Shadow banking in the EU: cross-border implications

- *A bird's eye perspective*
- *Recent shadow banking initiatives at EU level*
- *Main messages*

Shadow banking in the EU: BIRD'S EYE PERSPECTIVE

EU financial system is bank-intermediated

Relative size of EU, US and Japanese banking sectors

	EU	USA	Japan
Total banking sector assets (€ trillion)	43	9	7
Top 10 bank assets (€ trillion)	15.0	4.8	3.7*
Total banking sector assets/GDP	3.5**	0.8	1.7
Top 10 bank assets/GDP	1.2**	0.4	0.9*

Notes: * Top 6 banks only. ** EU GDP in denominator. End 2010 data.

Source: European Banking Federation (2011).

Underlying factors for EU/US discrepancies:

- *Impact of accounting (IFRS/US GAAP treatment of netting of derivatives);*
- *Mortgages (on-balance-sheet versus GSEs);*
- *(Regulated) Bank lending represents $\approx 75\%$ of the financing of non-financial corporates in the EU.*

Relative size of regulated and shadow banking in the euro area (ECB, 2012)

Table 2 Share in total financial institutions assets in the euro area

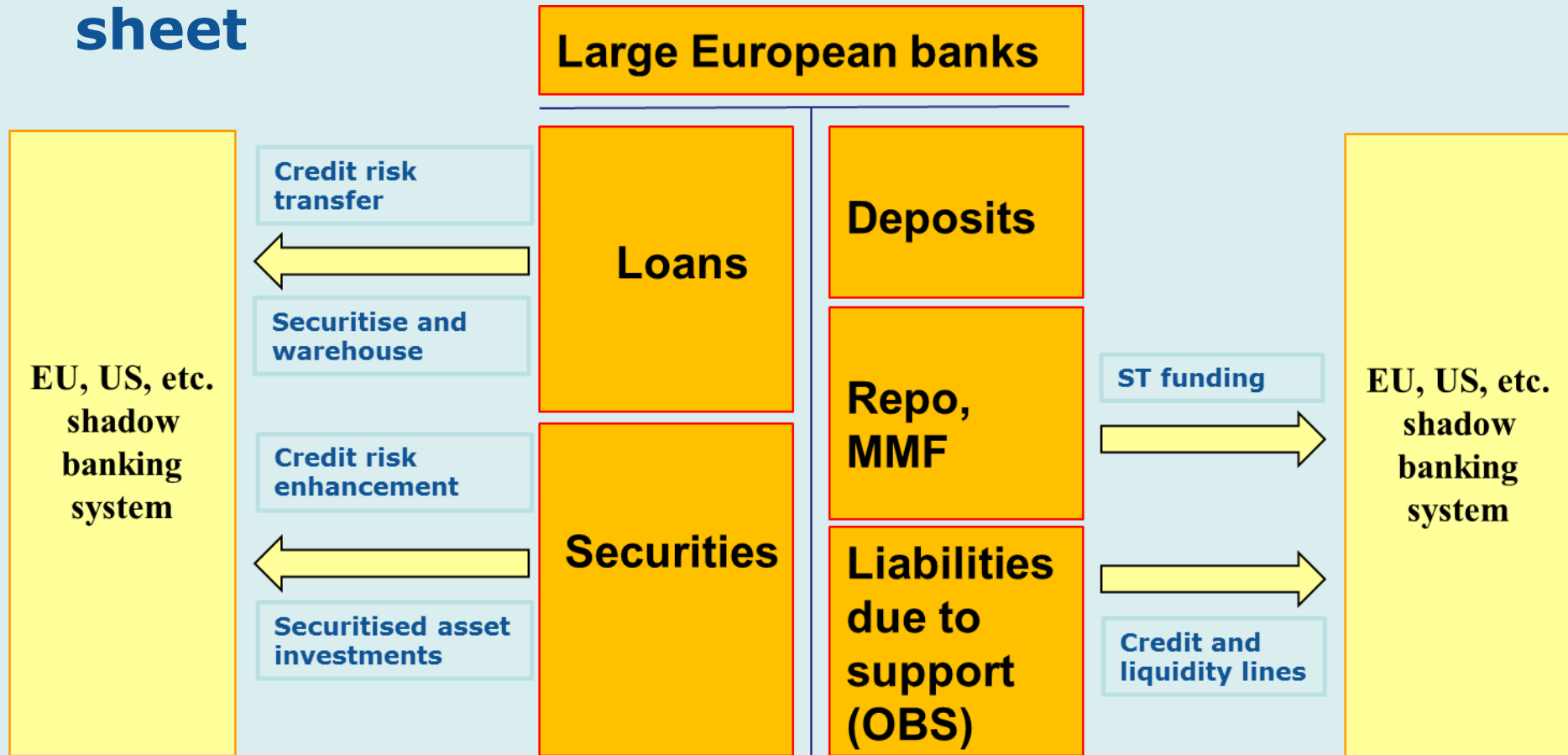
(EUR trillions and percentages)

	2007Q2		2011Q2	
	EUR trillions	% total	EUR trillions	% total
Banks	25.6	54.0	28.0	51.5
Other intermediaries	8.5	17.9	10.8	19.9
<i>Money market funds (MMFs)</i>	<i>1.2</i>	<i>2.5</i>	<i>1.1</i>	<i>2.0</i>
<i>Financial vehicle corporations</i>	-	-	<i>2.2</i>	<i>4.1</i>
<i>Other miscellaneous intermediaries¹⁾</i>	<i>7.3</i>	<i>15.4</i>	<i>7.6</i>	<i>13.9</i>
Eurosystem	1.6	3.5	3.1	5.8
Investment funds other than MMFs	5.5	11.6	5.6	10.3
<i>of which, hedge funds</i>	-	-	<i>0.1</i>	<i>0.2</i>
Insurance corporations and pension funds	6.1	13.0	6.8	12.6
TOTAL ASSETS OF FINANCIAL INSTITUTIONS	47.3	100.0	54.4	100.0
<i>Memo: Repo market outstanding value (lending and borrowing) in the EU</i>	<i>6.8</i>		<i>6.1</i>	

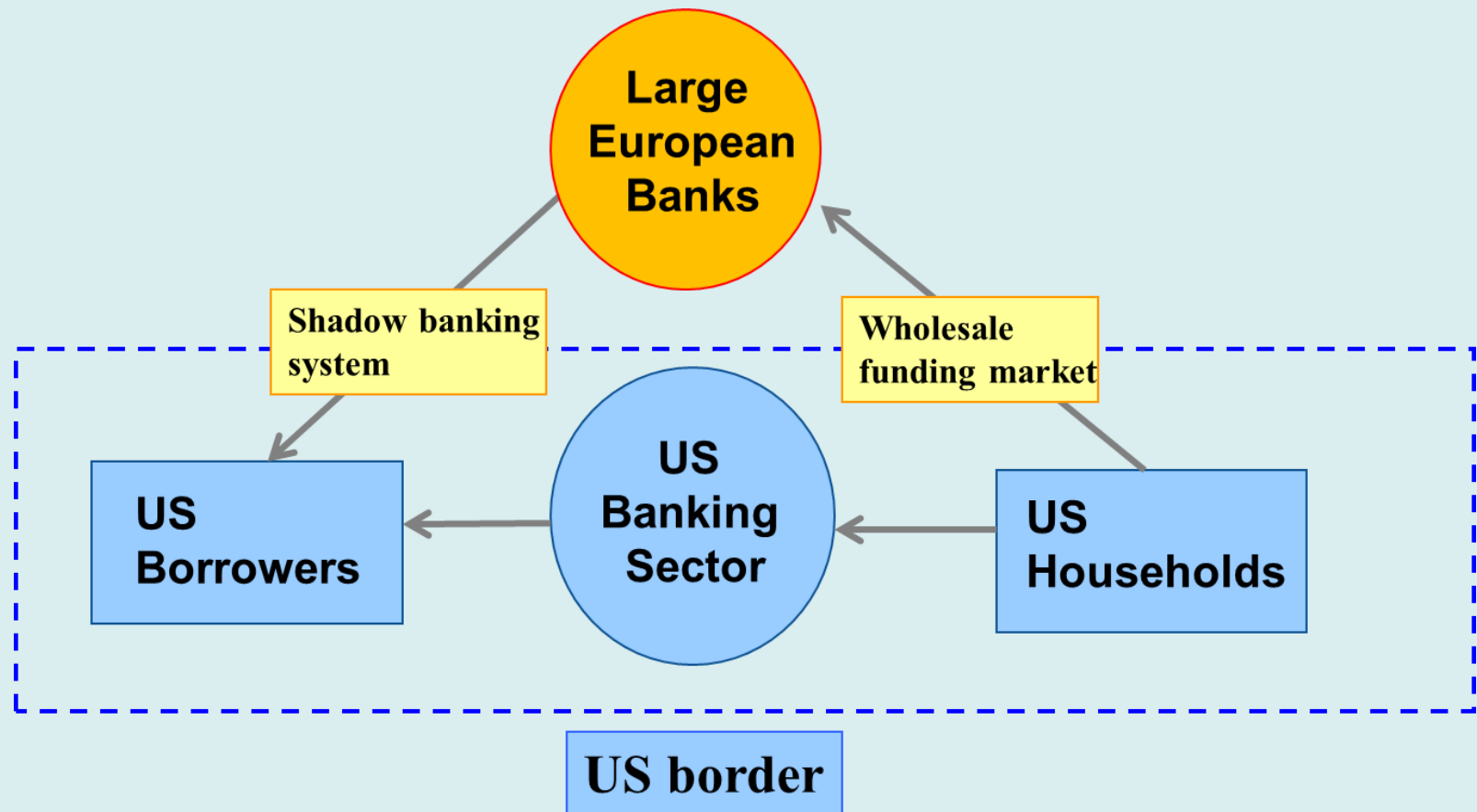
Source: EAA (ECB and Eurostat) and monetary statistics (ECB). For memorandum item on repos, ICMA European repo market survey (numbers 13 – conducted in June 2007, published in September 2007 – and 22 – conducted in December 2011 and published in January 2012).

1) Venture capital companies, leasing and factoring corporations, securities dealers, financial holding companies, financial auxiliaries and other miscellaneous financial corporation.

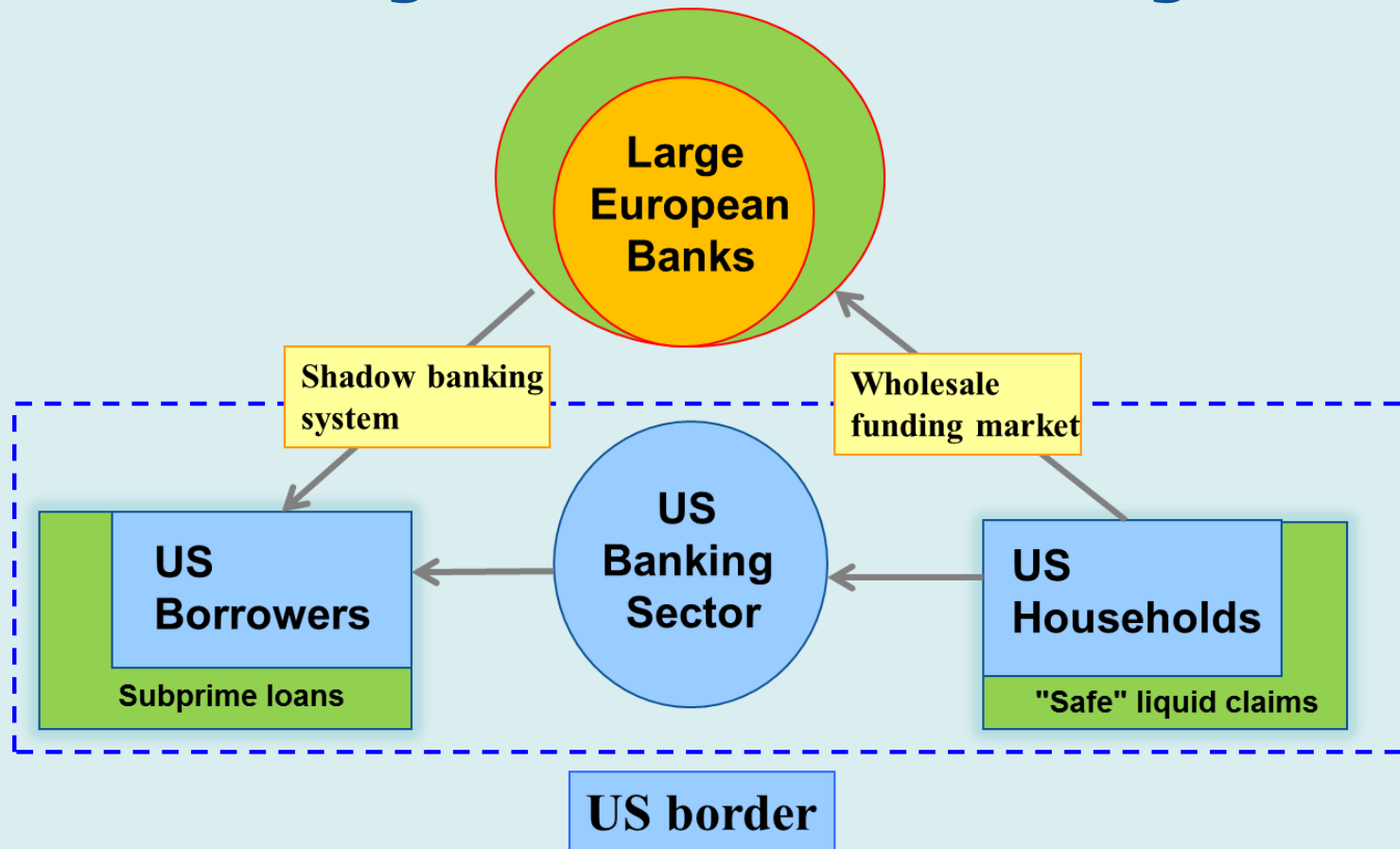
Shadow banking system interaction with regulated banks on *both sides* of the balance sheet



EU banking groups intermediate in US financial system through US shadow banking sector



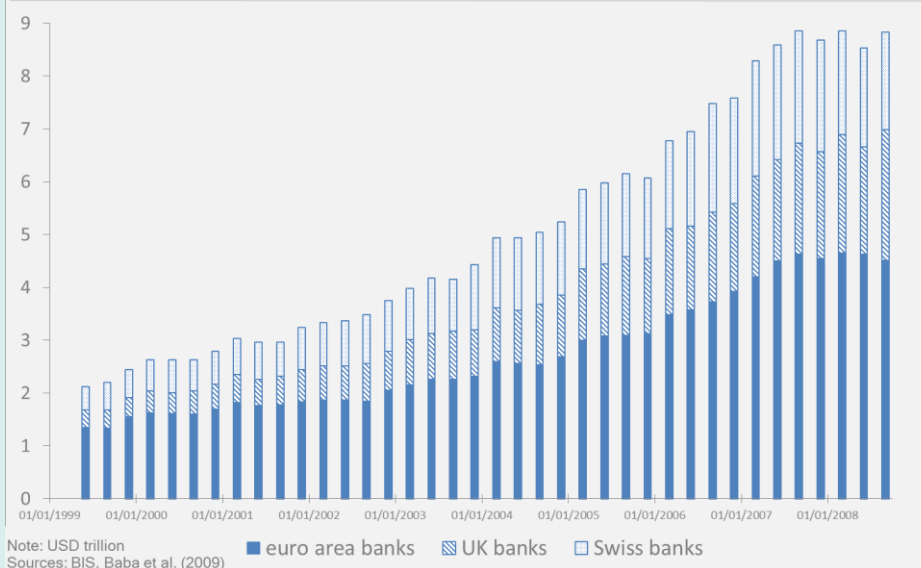
EU banking groups intermediate in US financial system through US shadow banking sector



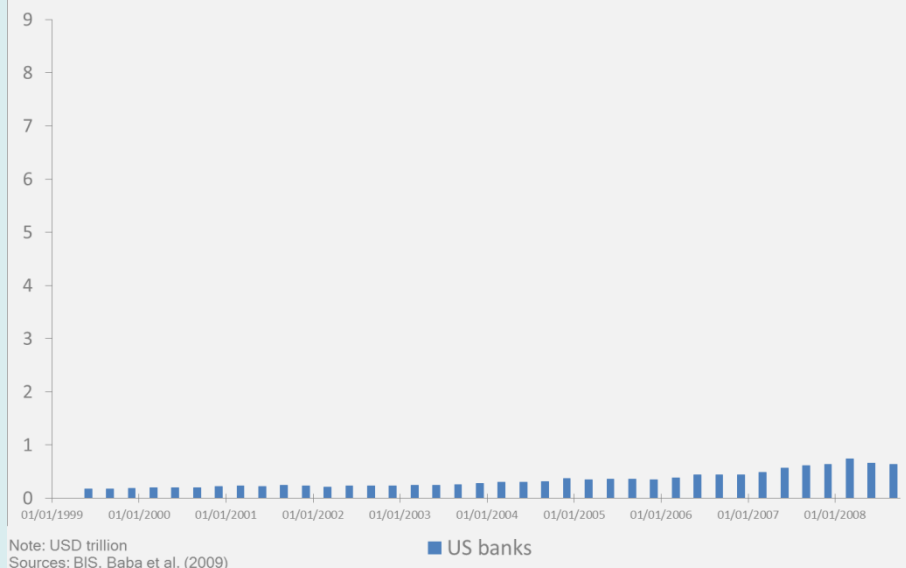
US border

Asymmetry in European-US banking system

EU banking group USD assets



US banking group EUR, GBP, and CHF assets

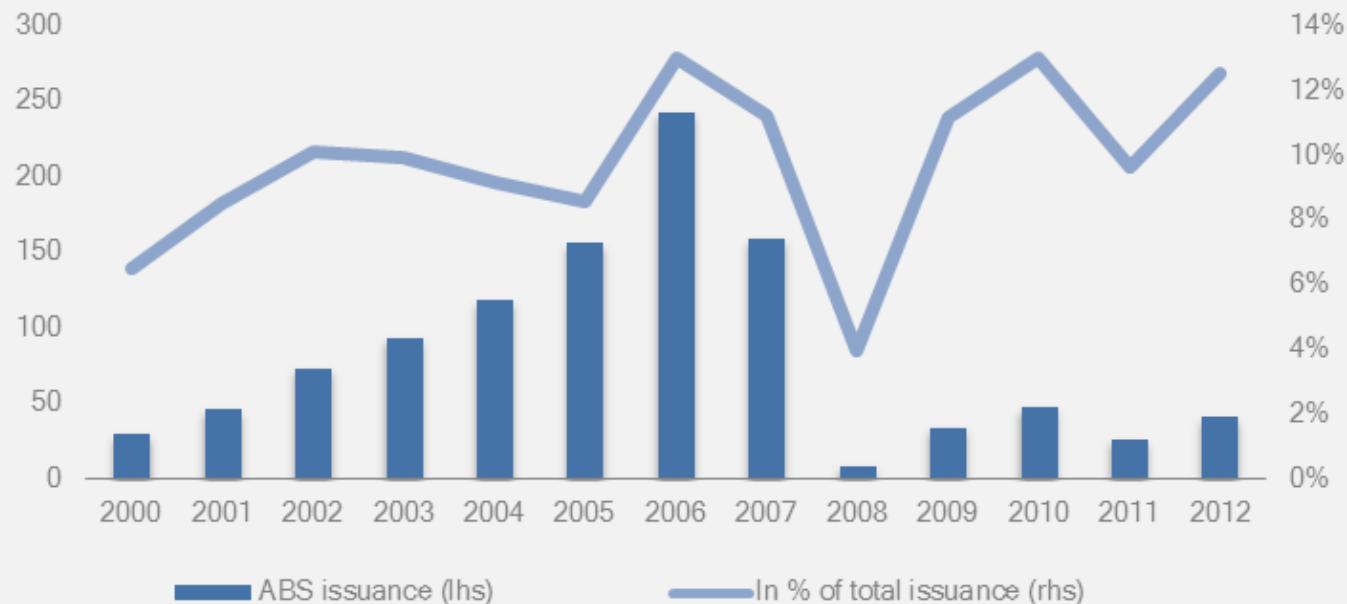


- **European banks rapidly built up significant amounts of *USD assets* (and *USD liabilities*)**
 - => **European banks have a significant impact on US intermediation and overall credit conditions through the shadow banking sector;**
 - => **Banking system asymmetry makes *FX swap market vulnerable to shocks*;**
- ***Drivers of asymmetry?* Project and trade finance in USD? Corporate borrowing? Forward guidance Fed? Securitisation in USD? Shadow banking? Basel II?**

Large European banks are exposed to the US shadow banking system...

... as issuers of US ABS in the broad sense (ABS, MBS, CDO...):

US ABS issuance performed by European institutions



Large European banks are exposed to the US shadow banking system...

... as the main pre-crisis sponsors of USD ABCP :

USD ABCP has collapsed to 293bn USD end 2012 and 264 bn USD in September 2013.

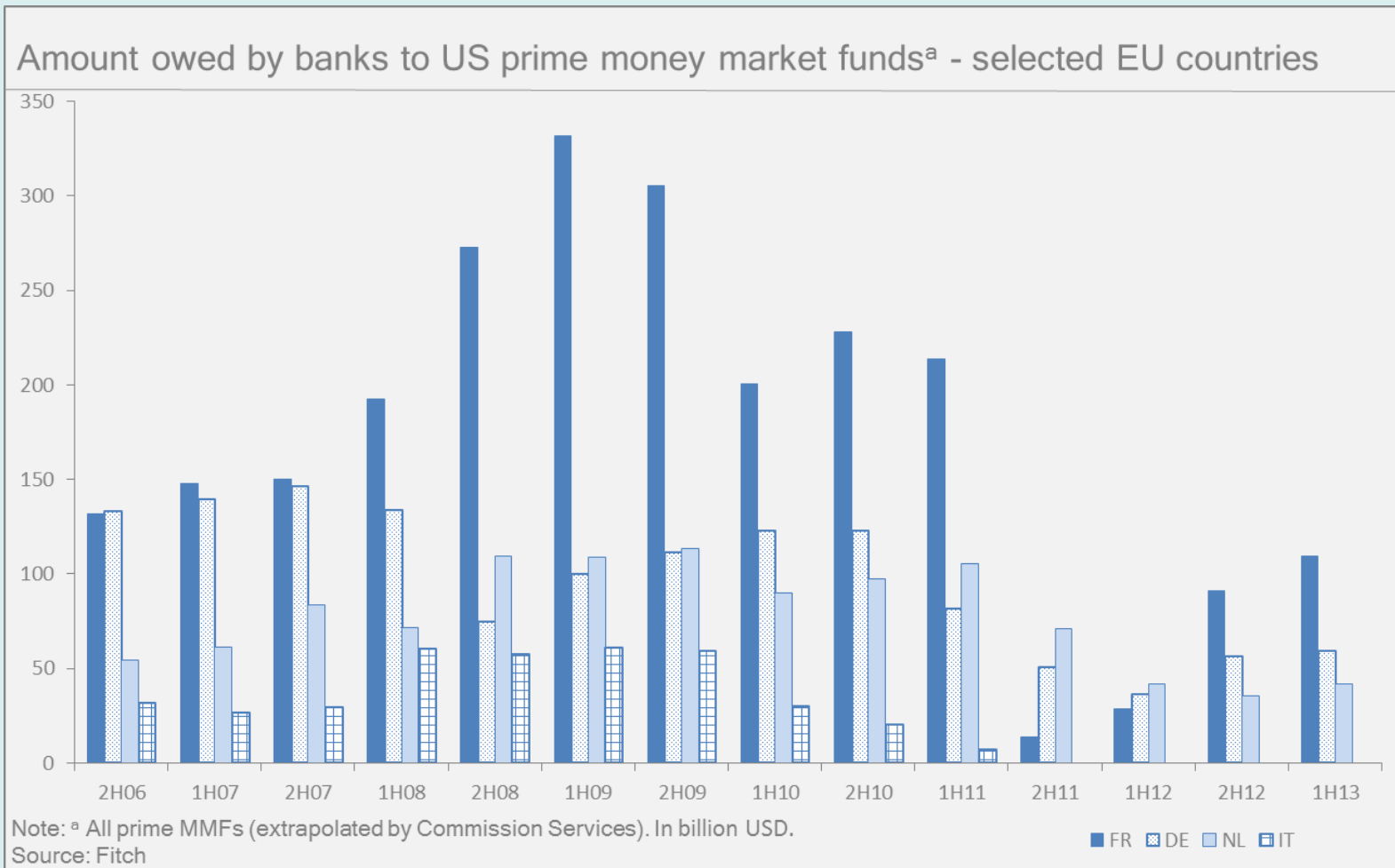
ABCP sponsor location and funding currency (January 2007)

Country/area	USD	EUR	Other	Total
US	302	0	3	305
DE	139	63	3	205
UK	93	62	3	158
NL	57	66	3	126
FR	51	24	1	76
BE	30	5	0	35
JP	18	0	23	41
SW	13	0	0	13
DK	2	0	0	2
SE	2	0	0	2
IT	1	0	0	1
	744	219	36	963
Europe	388	219	10	618
US	302	0	3	305
Other	24	0	23	41
Total	714	219	36	963

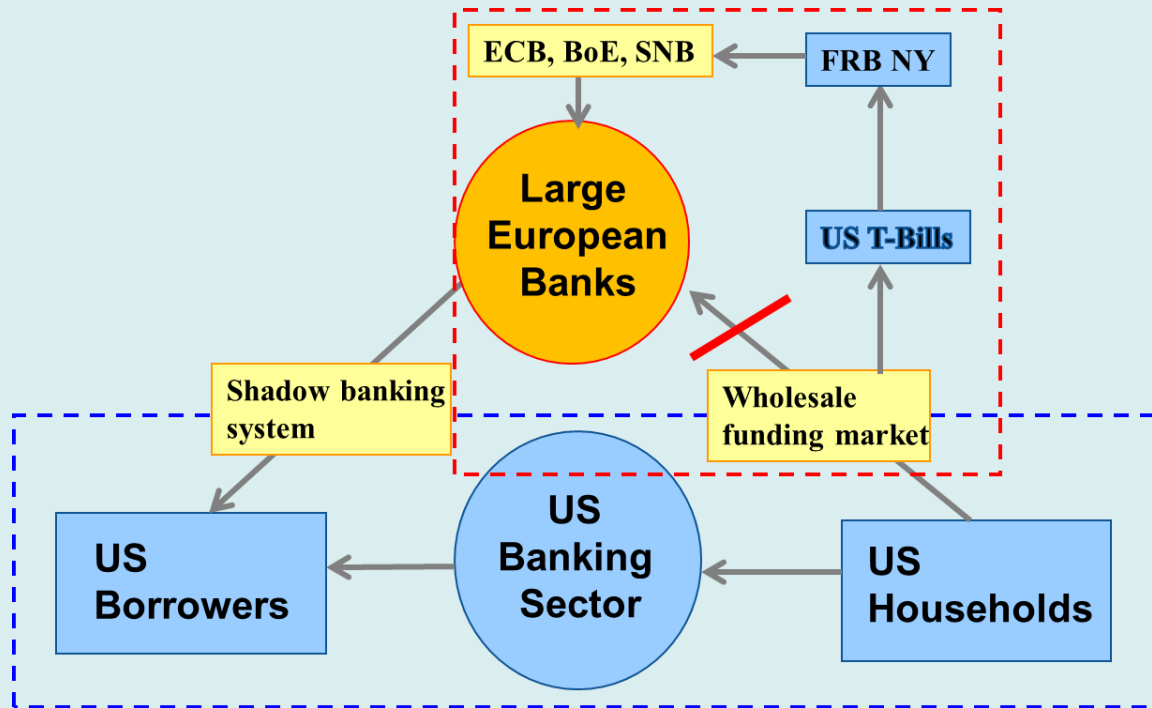
Source: Acharya and Schnabl (2009) based on Moody's rating reports

Large European banks are exposed to the US shadow banking system...

... by relying on US MMF funding:



The importance of public safety nets



European banks get USD funding from US MMFs, sponsor ABCP conduits, etc.

=> Vulnerability to "runs" on European banks.

=> Liquidity backstops provided by central banks through dollar swap lines.

Shadow banking in the EU: RECENT INITIATIVES AND NEXT STEPS

European Commission initiatives

Earlier relevant measures:

- **AIFMD** (harmonized framework for activities of hedge funds, private equity funds, etc.);
- **CRD** (interaction banks with unregulated actors); **CRD 2** (improved risk retention of securitisation transactions); **CRD 3** (increased capital requirements re-securitisations)
- **EMIR** (improved regulatory regime for derivatives trading);
- **CRA, CRA2, CRA3** regulation

Recent measures

- **Regulation on MMFs** proposed in September 2013;
- **EC Communication on shadow banking** adopted in September 2013;

Next steps for the European Commission

*Action plan in September 2013 **EC Communication:***

- 1. Improving **transparency** (trade repository for repo and SL transactions);*
- 2. Addressing risks by non-banks that perform bank-like activities (stock-taking EBA, **MMF regulation**);*
- 3. Reducing leverage and procyclicality risks linked to **repo and SL transactions**;*
- 4. Addressing **interactions** between banking sector and shadow banking sector;*

EU actions in line with FSB and to be completed in light of international discussions and dynamics of shadow banking risks.

*Role for **bank structural reform?***

Issue to be addressed?	Main measures/tools
Limit spillovers between shadow banking entities and the regular banking system	CRD, (SR)
Reduce vulnerability of money market funds to runs	MMF regulation (proposal)
Identify and control systemic risks from new and unregulated shadow banking entities	ESRB, ESAs, (structural bank reform)
Assess and align incentives associated with securitisation	CRD, (SR)
Dampen risks and pro-cyclicality associated with securities lending and repos	SLL (proposal), (SR)
Data gaps and transparency	ESRB, ESA, LEI, EMIR, etc.
Resolution tools for non-banks	R&R of CCPs, etc.

Shadow banking in the EU: Main messages and issues for discussion

Main message 1

- *The EU financial system is bank-intermediated => urgency to **map and understand the role of large EU banks in shadow banking activities;***
- *EU legacy of national crisis prevention tools => **urgency for ESAs and ESRB to produce consistent data, indicators, risk metrics;***
- *Shadow banking is a system-wide phenomenon that defies institutional boundaries => **EU legislation needs to develop financial system-wide approach.***

Main message 2

- *Crucial to understand the **underlying drivers of the asymmetry in EU-US (shadow) banking.***
- *The EU and US financial systems are **intimately linked and connected**, notably through the shadow banking sector:*
 - **EU banks (i) rely on US MMFs funding, (ii) sponsor USD ABCP vehicles, (iii) repo with US collateral, (iv) invest in US MBS & ABS, etc.**
 - **Large EU banks have a significant impact on US credit conditions through the shadow banking sector.**

Main message 3

In order to regulate shadow banking activities appropriately going forward, EU regulators need to

- *Understand the **drivers of shadow banking** (arbitrage, money demand, etc.) and the **drivers of instability in modern financial systems** (procyclicality, long intermediation chains, etc.).*
- *Acknowledge the importance of **preventing excessive leverage and maturity mismatch** in undermining financial stability;*
- *Identify the (implicit, explicit, public and private) **safety nets behind shadow banking activities** (and/or market makers and broker dealers); Ensure that the public safety nets cover (i) activities essential to the economy and (ii) liquidity (\neq solvency) risk only so as to curtail moral hazard and aggressive and inadequate growth of shadow banking activities;*
- *Understand the **underlying market failures** (fire sales without externalities do not require regulatory intervention);*

Useful references

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