World Future Council

"Strengthening Oversight and Regulation of Shadow Banking"

Comment on Consultative Documents of the Financial Stability Board (FSB)

by Suleika Reiners, Policy Officer Future Finance, 14/1/2013

"Banking is so inherently risky that we need powerful public policy interventions to make it stable. But these banking risks can be present and indeed can be even more severe in a shadow banking system, or in a system which involves inter-linkages between bank balance-sheets, shadow bank balance-sheets, and capital markets."

"Given the enormous cost which instability can produce, and given the uncertain benefits which this complexity has delivered, our regulatory response should therefore entail a bias to prudence – a bias against complex interconnectivity, against procyclical market contracts, and against allowing maturity transformation or high leverage to develop in unregulated institutions or markets."

Adair Turner, p. 19 and p. 36

1 Overarching remarks

The Financial Stability Board (FSB) mentions key issues of shadow banking such as excessive maturity liquidity transformation, immense leverage, procyclicality, highly complex and deeply intertwined credit intermediation chains as well as regulatory arbitrage. The FSB also provides a complex framework of meaningful measures. In order to make these measures effectively implementable, the following points are of relevance for all three consultative documents.

1.1 Appropriate policies: more courage instead of less

The FSB intends to design an approach which is proportionate to financial stability risks. However, quantitative specifications of the proposals are still missing. Even in the regular sector, standards are often far too low. A recent example is the renewed weakening of Basel III rules in terms of liquidity standards (Master). In order to be effective, the proposed measures must be substantial enough. Hence taking care in weighing the pros and cons of a policy means in particular not to overestimate any alleged cons, not to underestimate the pros, and especially not to underestimate the opportunity costs of remaining too weak.

That applies, for example, to the:

- size and composition of capital and liquidity buffers (to be suitable for every-day fluctuations as well as against stress scenarios of runs)
- limits on leverage
- weighted average remaining maturity for assets and liabilities (to avoid maturity mismatch between assets and liabilities)
- standards to calculate collateral haircuts
- collateral reinvestment guidelines.

Money market funds should indeed use the market value of their assets for pricing their shares, in lieu of rounding up the prices by an amortised cost accounting convention. This proposal of the FSB has also been strongly supported by Caliari: A fixed per share pledge fosters an expectation of safety and creates a “fictitious liquidity”. That is inconsistent with the fact that money market funds face credit, interest rate and liquidity risks as well. Regulators should withstand the argument of certain lobbyists, that this might reduce the attractiveness of the vehicle. As Caliari succinctly puts it: “This might well be the consequence if the vehicle's only benefit was its capacity to hide true risks. But, then, would their disappearance of shrinking size be such a bad thing?” (Caliari, p. 5) It is important not to weaken the fair value pricing requirement through exemptions. Unfortunately, the FSB has already opened the door to probably unnecessary exemptions by mentioning that amortised cost method can still to be used in limited circumstances (consultative document 1, p. 7).

1.2 Leverage and crisis are common bedfellows: limiting financial leverage

Excessive leverage is a major concern in shadow banking. It is nearly impossible to close highly levered financial institutions without systemic consequences. Moreover: Changes in leverage routinely contribute to drive financial and economic booms and busts like asset bubbles and debt crashes. Leverage can be more important to economic activity and prices than interest rates. Therefore managing leverage should become part of central banking as well. For this purpose, Sukhdev suggests substantial reserve requirements, which saved India's financial system both in the Asian crisis and the financial crisis of 2008 (Sukhdev, p. 142f). Regulating leverage should also be based on loan-to-value ratios (asset-based leverage) rather than solely according to debt-equity ratios of entire institutions (investor leverage), in order to include shadow banking. A

central bank could, for instance, simply say: “You cannot loan at 2% down on houses.” (Geanakoplos, p. 224)

Nonfinancial corporations are involved in shadow banking as well. Managers can make leveraged bets with almost no leverage constrains. Thus, even nonfinancial corporations can become too big and too interconnected to fail, and hence systemically important. The FSB should therefore consider the proposals to mandate minimum capital-adequacy ratios for big nonfinancial entities. Furthermore, leverage from acquisitions should be constrained (Sukhdev, p. 157 f).

There will of course be resistance from the financial sector, as decreasing leverage means decreasing return on equity. Yet real economy and society need sustainable wealth, not permanent fragility and financial pressure. This real need has to be the priority.

1.3 The need for preventive policies: testing of financial innovations (finance TÜV[1])

The FSB policy recommendations have been guided by general and obvious principles such as “forward-looking” and “effectiveness”. These principles and their corresponding measures require a preventive testing of financial innovations (finance TÜV), in order to become feasible (Reiners).

How will one be able to anticipate the future and overcome regulatory arbitrage, if financial innovations enter the market more quickly than can be recognised and regulated? How will one be able to act forward looking and effective, if financial innovations continue to increase opacity?

One can neither monitor nor regulate financial markets effectively without a preventive testing for financial innovations, including financial techniques. The result of market-wide surveys in opaque markets will be opacity again. Institutions for macro-prudential supervision like the European System of Financial Supervision (ESFS) or the Financial Stability Oversight Council (FSOC) in the USA will remain unable to operate effectively. This is particularly true for shadow banking with its extreme opacity and highly interconnected linkages. Notably, the International Monetary Fund (IMF) has already called for simpler financial instruments (IMF, pp. 63, 75ff). The key drivers of financial

1 Abbreviation of road-safety test in Germany.

innovations are overcoming the cost of regulation and avoiding taxes. With some derivatives, for example, companies can shift profits to earlier or later time periods.

Consequently, a finance TÜV is a core prerequisite to addressing systemic risks and regulatory arbitrage including tax avoidance. Financial institutions will have to prove that the financial instrument is beneficial to the real economy and is the most welfare enhancing option (positive list). Special attention should be given to highly leveraged financial instruments. - The same purpose can often be fulfilled by a variety of financial instruments, which can be more or less useful or harmful to the real economy and to society. The alternatives of collateralised debt obligations (CDO) vis-à-vis simple covered bonds backed by real assets is a good example (Judge, p. 716f). Some financial innovations should be bound by specific conditions, e.g. position limits.

Financial instruments not on the positive list would either be legally unenforceable or prohibited. In countries such as Austria, Germany, and Switzerland financial bets on future prices were previously classified as financial gambling and legally unenforceable. This "financial gambling reservation" law was abolished due to pressures from the financial markets ten years ago.

Re-securitisation (securitisation squared, cubed etc.) is currently only bound by weak conditions such as capital requirements, and the requirement that banks have to hold a certain percentage on their own balance sheets. The FSB suggestions of standardisation and disclosure templates are similarly ineffective. Re-securitisation is not needed for the real economy and should thus be prohibited. Otherwise, the establishment and more prolific use of central clearing risks creating a new systemically important and hence risky entity.

2 Answers to questionnaire: A policy framework for oversight and regulation of shadow banking entities (consultative document 2)

Q1 and ***Q5*** are answered together:

Q1. *Do you agree that the high-level policy framework effectively addresses shadow banking risks (maturity/liquidity transformation, leverage and/or imperfect credit risk transfer) posed by non-bank financial entities other than MMFs? Does the framework address the risk of regulatory arbitrage?*

Q5. *Are there any costs or unintended consequences from implementing the high-level policy framework in the jurisdiction(s) on which you would like to comment?*

The FSB mentions key risks and provides meaningful measures. Thereby the main concern should not be unintended consequences from implementing the framework, but unintended consequences from setting the standards too low (see 1.1). The focus must be on the sound functioning of the whole economy, not individual business interests. The real economy does not need over-leveraging and over-financialisation through opaque credit intermediation chains. It needs a solid basis of private and public finance. The financial system, economy and society will benefit from reliable standards which reduce the risk-enhancing profit pressure inherent in shadow banking. The result may reduce profit for financial institutions, but might not be a credit crunch. – The volatility of credit creation will be diminished; and as the FSB notes, procyclical effects on credit availability can also be avoided by requirements calibrated to be countercyclical.

Q2. *Do the five economic functions set out in Section 2 capture all non-bank financial activities that may pose shadow banking risks in the non-bank financial space? Are there additional economic function(s) that authorities should consider? If so, please provide details, including the kinds of shadow banking entities/activities that would be covered by the additional economic function(s).*

The five economic functions – management of client cash pools, loan provision, intermediation of market activities, facilitation of credit creation as well as securitisation and funding of financial entities – provide a comprehensive framework. In addition, at the level of entities, hedge funds should be prohibited and not only be registered, as it is presently the case. They have been part of the complex network of financial intermediaries that was instrumental to the growth of shadow banking, either through

their involvement in securitisation activities or in the repo market (FSA, pp. 48-50). Some (lobbyists) argue that hedge funds are also useful for the real economy, because they are willing to take risk and can provide a countercyclical alternative to banks. Yet they are risk-generating, risk-accelerating and exert pressure on the real economy: Their risk-reward profile is definitely negative as hedge fund driven downward and upward spirals of asset values (e.g. governments bonds and commodity prices) show every day.

Q3. *Are the suggested information items listed in the Annex for assessing the extent of shadow banking risks appropriate in capturing the shadow banking risk factors? Are there additional items authorities could consider? Would collecting or providing any of the information items listed in the Annex present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.*

The information items constitute a complex list, which requires a preventive finance TÜV in place of opacity to become realizable (see 1.3). Additionally, we recommend considering the suggestion of Finance Watch, to fully consolidate the "internal shadow banking sub-system" in banks' balance sheets; since it exists in most cases for regulatory arbitrage purposes. Just as banks have desks dedicated to "balance sheet advisory", regulators should dedicate professionals to this task (Finance Watch, p. 11). More highly qualified and paid regulators and supervisors are necessary.

Q4. *Do you agree with the policy toolkit for each economic function to mitigate systemic risks associated with that function? Are there additional policy tool(s) authorities should consider?*

It is a complex toolkit, which also requires a finance TÜV to become manageable (see 1.3). Moreover, maturity mismatches and links between banks and other groups (e.g. ownership, loans, debt securities holdings) should not only be monitored, but preventively limited by binding rules, in order to avoid systemic risks.

3 Comment on: A policy framework for addressing shadow banking risks in securities lending (consultative document 3)

A main function of securities lending and repos is to provide securities for short sellers. However, short selling – if uncovered or only covered by cash or borrowed securities – has proven to increase opacity and volatility without benefiting the real economy. Consequently, these kinds of short selling should be prohibited. This would also be a crucial step to bring the re-use of collateral to a manageable level. It would contribute to protecting exchange traded funds from posing systemic risk, too. These retail investor friendly funds have meanwhile become the primary vehicle for institutions to short markets, because it is easier to trade in one index fund than to borrow many different securities (Gapper).

Shadow banking does not only enhance systemic risks; it also has significant influence on monetary transmission and the conduct of monetary policy (Poschmann, p. 4). Furthermore, financial stability depends on close coordination between monetary policy objectives and regulatory policies (de Rezende, p. 38). These essential facts have still been excluded from the framework of the FSB and must be addressed. Gorton and Metrick suggest, for example, that central banks should act as "securities lender of last resort" on a regular basis (Gorton and Metrick, p. 290). The idea behind this is: If the volume of treasury securities outstanding is insufficient for use as collateral, the private sector might use riskier substitutes. They also propose to rethink open market operations, because the re-use of collateral can mean that open market operations simply exchange one kind of money for another. The FSB should include these proposals.

4 Conclusion: Don't be afraid to downsize shadow banking and the financial sector

Today, private finance is mainly driven by its own dynamics like proprietary trading. Immense leverage, increased securitisation and re-pledging of collateral has made both shadow banking and regular banking more and more based on fragility. The liquidity illusion is everywhere (Moe, p. 67). Shadow banking and the entire financial sector have grown out of proportion. So why should we fear downsizing this financial sector? Without implementing courageous measures the shift from regular banking toward shadow banking will not stop; and the risk-loaded profit-seeking competition between regular banking and shadow banking will not be halted. In addition to this, the increase in

complex financial instruments has led to a decline in credit business and securities emissions (Dullien, p. 16), which means a complete misallocation of resources.

Shadow banking also heavily influences monetary transmission and the conduct of monetary policy. Hence this must also be addressed. Quantitative easing as part of regular monetary policy is acceptable as long as it serves the real economy and does not feed liquidity illusions and fuel financial bubbles. Thus the downsizing of illusory private liquidity should be accompanied by the creation of new central bank money. New money given against real economic performance is not inflationary. It can, for example, contribute to fund investments in climate protection, for instance in cooperation with development banks. As a result, money for necessary investments would be available without depending on unmanageable private money creation.

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