The European Commission's Communication on Shadow Banking: A Coordinated Effort to Avoid Contagion of Regulated Markets

By Orestis Omran, Nora Wouters on September 11, 2013

On September 4,2013 the European Commission (“ the Commission”) issued a Communication to the Council and the European Parliament on shadow banking with a view to address new sources of risk in the Financial Sector. The Communications sets out the roadmap which aims at limiting the emergence of risks in the unregulated systems with a focus on risks of a systematic nature and is an additional step, following the 2012 Commission’s Green Paper, towards the adoption of unified EU wide legislation in order strengthen market integrity and transparency and increase the confidence of savers and consumers.

US investors and market participants that have frequently resorted to the different segments of the shadow banking sector need to monitor closely the developments in the European Union and become aware of the new regime which will include enhanced supervision in order to avoid regulatory arbitrage.

I. DEFINITION OF SHADOW BANKING

The Communication follows the definition adopted by regulators in both sides of the Atlantic, who define shadow banking as a system of credit intermediation that involves entities and activities outside the regular banking system, including but not limited to entities that:

(i) raise funding with deposit-like characteristics;

(ii) perform maturity and/or liquidity transformation;

(iii) allow credit risk transfer;

(iv) use direct or indirect leverage, including securitization vehicles or conduits, money market funds, investment funds that provide credit or are leveraged and financial entities that provide credit or credit guarantees.

II. MEASURES FOR FINANCIAL ENTITIES

The most important measures that aim at tackling the risks to which financial entities such as banks, insurance companies and investment funds, are subject include: (i) the strengthening of requirements imposed on banks in expectation of the Basel Committee’s review of prudential consolidation practices in the end of 2014; (ii) the reinforcement of requirements imposed on insurance companies, including the risk based approach adopted by the Solvency II Directive; and (iii) new rules for all hedge funds, private equity and real-estate funds with a focus on the new Alternative Investment Fund Managers Directive.

III. MEASURES FOR MARKET INTEGRITY

Suggested measures to secure market stability and reliability are also provided in the Communication. They include: (i) regularization of risk transfer instruments to prevent contagion of regulated markets by shadow banking activities especially with regard to OTC derivatives, central counterparties and trade repositories where applicable legislation provides for central clearing of all standardized derivative contracts, as well as margin calls for non standardized contracts; (ii) more robust securitization arrangements especially with a view toward increasing transparency and reinforcing the standardization of disclosure; and (iii) rationalization of credit rating agencies’ role in the financial system in order to avoid overreliance on such rating, improve their reliability and increase their liabilities under applicable legislation.

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The Communication sets out a number of additional measures that are deemed necessary to minimize the risks posed by shadow banking for the stability of the financial system. Enhanced transparency via central repositories or the implementation of the Legal Entity Identifier (LEI) (the new standard ensuring a unique identifier for each legal entity that is party to a financial transaction) is particularly worth mentioning while the Commission stresses its attention in the need to reconsider the risks posed by money market funds formerly considered as a relatively stable form of investment and UCITS. Securities financing transactions are also targeted as a potential source of arbitrage and thus the Commission also calls for special attention to such transactions via the establishment of a central repository to collect detailed data on repurchase transactions in the EU, as recently proposed by the European Central Bank ("ECB").

V. ASSESSMENT

The Commission's Communication on shadow banking is a multi-level plan that operates in different regulatory stages and aims at tackling the risks posed by the shadow banking sector which, although remaining heavily unregulated, accounted for EUR 51,000 billion of asset worth worldwide. The strong connections between the shadow banking system and the rest of the financial sector create severe risks of contagion and market failures that need to be avoided. Prudent foreign investors operating in the EU need to become familiar with the Commission's initiatives and be ready to adapt to a new regulatory era.

Topics: **Commercial Lending**, **European Commission**, **European Union**, **Financing & Lending**

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