

Opinion of the European Economic and Social Committee Communication from the Commission to the Council and the European Parliament — Shadow Banking — Addressing New Sources of Risk in the Financial Sector

COM(2013) 614 final

(2014/C 170/09)

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On 18 April 2013, the European Commission decided to consult the European Economic and Social Committee, under Article 304 of the Treaty on the Functioning of the EU, on the

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The Section for the Single Market, Production and Consumption, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 13 November 2013.

At its 494th plenary session, held on 10 and 11 December 2013 (meeting of 10 December), the European Economic and Social Committee adopted the following opinion by 153 votes to 2 with 5 abstentions.

1. Conclusions and recommendations

1.1 The European Economic and Social Committee (EESC) welcomes the communication as a coherent contribution to on-going efforts to reform financial services with a view to restoring harmony and stability to this key sector and minimising systemic risk.

1.2 The EESC believes that the new financial market regulations will make a positive contribution towards a sound economy and it is profoundly convinced that a stable financial sector and the success of the reforms are preconditions for sustainable economic development, employment and the completion of the EU's internal market.

1.3 The EESC considers that the roadmap setting out measures already taken and those for the future marks a step in the right direction. It recognises the progress already made but would note, nevertheless, the urgent need to accelerate work in a number of areas and to carry through those legislative initiatives that are pending. Following its assessment of the five priority areas for future action ⁽¹⁾, the EESC would make the following remarks:

1.4 The Committee considers that addressing arbitrage is of key importance to financial services reform ⁽²⁾, and therefore welcomes the detailed package of measures ⁽³⁾ and, more specifically, the strengthening of the prudential banking framework for limiting contagion and arbitrage risks.

1.5 The Committee welcomes the efforts to boost transparency and in particular the specific measures aimed at providing a monitoring framework for shadow banking risks in the EU, the development of central repositories for derivatives under EMIR ⁽⁴⁾ (the European Market Infrastructure Regulation), the review of the Markets in Financial Instruments Directive (MiFID) ⁽⁵⁾, the implementation of the Legal Entity Identifier (LEI) and the increased transparency of securities financing transactions.

1.6 The Committee recognises that progress has been made towards establishing a stronger regulatory framework for certain investment funds focusing on improving liquidity and stability particularly for money market funds (MMFs) that are based or sold in Europe.

⁽¹⁾ See point 3.2 of this opinion.

⁽²⁾ OJ C 11, 15.1.2013, p. 39.

⁽³⁾ COM(2013) 614 final, Point 3.4.

⁽⁴⁾ OTC derivatives, central counterparties and trade repositories.

⁽⁵⁾ See: http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm.

1.7 The Committee considers that with regard to the priority area entitled 'reducing the risks associated with securities financing transactions' the communication limits itself to general observations that may reflect a certain reality but omit a number of key circumstances. The EESC recommends stepping up the pace and focusing work on legislation on transferable securities, as securities financing transactions — especially repurchase agreements and securities lending transactions — play a central role when it comes to excessive indebtedness in the financial sector.

1.8 Similarly, it notes delay and recommends intensifying and accelerating action to clarify the crucial issue of strengthening oversight of the shadow banking sector, where mention is simply made of a few issues and the only future measure referred to is the review of the European System of Financial Supervisors (ESFS), to be performed by the Commission in 2013.

1.9 Given that the main unintended victims of the financial and economic crisis are the public as taxpayers, workers, depositors and consumers, the EESC would recommend bolstering the regulatory initiatives regarding the protection of citizens by means of transparency, proper information, social responsibility on the part of the financial sector, and protection for consumers and small investors. It also recalls its own important comments on civil society involvement in the regulation of the financial markets ⁽⁶⁾.

1.10 The Committee considers it important that in its Communication the Commission points out that the shadow banking sector should not be seen solely in terms of the risks that it poses. It also constitutes an additional alternative financing channel that can be useful for the real economy.

2. Definitions, scope and background

2.1 The shadow banking system is defined as 'a system of credit intermediation that involves entities and activities outside the regular banking system' ⁽⁷⁾ composed of two inter-related groups. The first includes entities that are involved mainly in activities such as raising funding with deposit-like characteristics, transforming maturity and/or liquidity, transferring credit risk and using direct or indirect financial leverage. The second includes activities including securitisation, securities lending and repurchase transactions (repos) that are an important potential source of finance for financial non-banking entities.

2.2 Special purpose vehicles are securitisation vehicles such as ABCP conduits, special investment vehicles (SIV) and other special purpose vehicles (SPV), money market funds (MMF) and other types of investment fund/products with deposit-like characteristics, which are susceptible to massive redemptions (runs), investment funds, including Exchange Traded Funds, that provide credit or are leveraged, finance companies and securities entities providing unregulated credit or credit guarantees, or performing liquidity and/or maturity transformation, like banks, and insurance and reinsurance undertakings that issue or guarantee credit products.

2.3 The origins of shadow banking activities lie in the deregulation of the financial system in the 1980s in the United Kingdom, which continued in the US and elsewhere in the 1990s ⁽⁸⁾. The role of the early Basel Accords was important as speculative activities were treated as off-balance sheet while bank balance sheets were subject to strict regulations ⁽⁹⁾.

2.4 The repeal/relaxation of rules and provisions ⁽¹⁰⁾ enabled financial bodies to extend their activities into new areas and complex models, while the promise of high returns had an impact on millions of people around the world with little knowledge of the products and workings of the shadow banking system.

⁽⁶⁾ OJ C 143, 22.5.2013, p. 3.

⁽⁷⁾ COM(2013) 614 final, p. 3.

⁽⁸⁾ Nicholas Gregory Mankiw and Mark Taylor, *Economics: Special Edition with Global Economic Watch* (UK: Cengage Learning EMEA, 2010).

⁽⁹⁾ OJ C 11, 15.1.2013, p. 39 — Green Paper: Shadow Banking.

⁽¹⁰⁾ In the US, the Gramm-Leach-Bliley (1999) law did away with the differences between commercial banks and mortgage banks, insurance and stock broking companies.

2.5 In 2007, the G20 decided to adopt a package of regulatory measures to promote the security and viability of the financial system, while the serious social and economic impact of the 2008 crisis revealed the risks associated with shadow banking activities and the shortcomings, regulatory loopholes, inadequate supervision, lack of transparency in the markets and excessively complex products, emphasising the role of the Financial Stability Board (FSB).

2.6 The European Union is playing a leading role in the international effort within the G20 and the FSB, and has pointed to major progress in implementing the commitments set out in the roadmap for financial sector reform and in establishing new supervisory structures. A number of reforms have already been written into legislation, for instance regarding over-the-counter derivatives, to name just one example.

2.7 The FSB report of October 2011 represents the first comprehensive international endeavour to step up supervision of the shadow banking system and focuses on: a) defining principles for monitoring and regulating the shadow banking system; b) mapping and assessing systemic risks; and c) identifying the scope for regulatory measures within five workstreams⁽¹¹⁾. The European Commission meanwhile issued its green paper, focusing on the potential dangers of the shadow banking system in the EU and on tackling them by means of regulatory provisions.

3. Gist of the communication

3.1 The communication first examines the measures that have already been taken in two areas. The measures for financial entities focus on reinforcing the requirements imposed on banks and on insurance companies in their dealings with the shadow banking system and on designing a harmonised framework for alternative investment fund managers. The market integrity measures focus on risk transfer instruments, stronger provisions to govern securitisation, and a more sturdy framework for rating agencies.

3.2 It also sets out the five priority areas in which the Commission intends to take additional measures:

- 1) increasing transparency in shadow banking,
- 2) providing an enhanced framework for funds, particularly money market funds (MMF),
- 3) developing securities law to limit the risks associated with securities financing transactions,
- 4) strengthening prudential arrangements in the banking sector, and
- 5) improving supervision of shadow banking.

More specific comments follow:

3.2.1 With regard to the transparency of the shadow banking system, efforts regarding the collection and sharing of reliable and complete data are complemented by initiatives to develop a monitoring framework for shadow banking risks and central repositories for derivatives under EMIR⁽¹²⁾ (the European Market Infrastructure Regulation), to review the Markets in Financial Instruments Directive (MiFID)⁽¹³⁾, to implement the Legal Entity Identifier (LEI) and to enhance the transparency of securities financing transactions.

3.2.2 For certain investment funds and principally for money market funds (MMFs) that are established or sold in Europe, new rules have been proposed to improve liquidity and stability alongside reform of the rules for undertakings for collective investment in transferable securities (UCITS).

⁽¹¹⁾ The interaction between banks and shadow banking entities (the Basel Committee on Banking Supervision — BCBS); systemic risks of Money Market Funds (International Organisation of Securities Commissions — IOSCO); securitisation requirements (IOSCO and BCBS); other shadow banking entities (FSB); securities lending and repos (FSB).

⁽¹²⁾ OTC derivatives, central counterparties and trade repositories.

⁽¹³⁾ See: http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm.

3.2.3 When it comes to reducing the risks associated with securities financing transactions reference is made to the in-depth work that has been carried out in order to improve understanding of the problems and learn from them and to the fact that the Commission is considering a legislative proposal regarding securities law with a view to resolving these issues.

3.2.4 Prudential supervision in the banking sector is to be strengthened with a view to reducing the risks of contagion and arbitrage by establishing stiffer rules that step up banks' capital requirements when dealing with unregulated entities, and introduce stricter regulations regarding solvency and new rules on liquidity by means principally of the application as of 1 January 2014 of the Capital Requirements Regulation (CRR) ⁽¹⁴⁾ and Directive (CRD IV) ⁽¹⁵⁾. There are also plans regarding the possible extension of the scope of application of prudential rules to reduce arbitrage risks.

3.2.5 Regarding the need for greater supervision, emphasis is placed on the diffuse, multifaceted and dynamic nature of the shadow banking sector and the challenges inherent in prudential supervision (the cross-border circumventing of rules for instance). At European level, preliminary work is under way in relation to the European Systemic Risk Board (ESRB) and European supervisory authorities. These aspects, the need to address arbitrage and the possible need to clarify the institutional role of each authority, will be tackled by the review of the European System of Financial Supervisors (ESFS), to be performed in 2013.

4. Comments

4.1 Since the onset of the financial crisis, the EESC has expressed the views of civil society in a series of opinions ⁽¹⁶⁾ on a wide range of subjects relating to the functioning of the financial system and has made important comments and recommendations, both of a general nature, and more specifically on the recovery and reform of credit institutions ⁽¹⁷⁾.

4.1.1 The EESC welcomed the green paper on shadow banking ⁽¹⁸⁾, considering it an important step towards dealing with existing problems, emphasising, among other things, that there should be no such thing as 'shadow' activities and that these activities should be subject to the same regulatory and prudential requirements as the financial system as a whole.

4.2 The EESC endorses a world-wide approach to prudential requirements with the aim of extending regulation and oversight to all systemically important financial institutions, instruments and markets ⁽¹⁹⁾. It welcomes the adoption of the recommendations made by the FSB at the recent G20 summit ⁽²⁰⁾, which are fully in line with the present communication.

4.3 It calls on the Commission to specify and lay down a timeframe for increased oversight of the shadow banking system by implementing a cohesive supervisory mechanism, accelerating clarification of the institutional role of the supervisory authorities as part of the review of the European System of Financial Supervisors (ESFS).

⁽¹⁴⁾ 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 (OJ L 176, 27.6.2013, p.1).

⁽¹⁵⁾ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p.338).

⁽¹⁶⁾ These include: OJ C 11, 15.1.2013, p. 59; OJ C 299, 4.10.2012, p. 76; OJ C 191, 29.6.2012, p. 80; OJ C 181, 21.6.2012, p. 64; OJ C 181, 21.6.2012, p. 68. These opinions can be found on the EESC website at the following address: <http://www.eesc.europa.eu/?i=portal.en.financial-markets-opinions>.

⁽¹⁷⁾ OJ C 44, 15.2.2013, p. 68.

⁽¹⁸⁾ OJ C 11, 15.1.2013, p. 39.

⁽¹⁹⁾ See G20 summit communiqué, 2 April 2009, London.

⁽²⁰⁾ 5 and 6 September 2013, Saint Petersburg.

4.4 Given that, depending on the country, certain shadow banking activities and entities may or may not be subject to a regulatory regime, it is especially important that there be a level playing field for competition between countries and between the banking sector and shadow banking system entities, by means of appropriate regulations to prevent regulatory arbitrage, which would lead to distorted regulatory incentives.

4.5 The EESC notes in particular the need for regulatory authorities analysing data to adopt a common global approach, with common frames of reference and open industry standards, to enable the rapid exchange of data and effective and timely action to avert systemic risks and preserve financial stability.

4.6 The EESC believes the scale and rate of growth of the shadow banking system to be another significant factor for systemic risk; according to the FSB (2012) ⁽²¹⁾ it had reached USD 67 trillion in 2011 (up from USD 26 trillion in 2002), equivalent to 111% of cumulative GDP for the countries studied by the FSB.

4.7 The Committee also considers that careful analysis of the issue would be useful regarding activities beyond entities in the shadow banking sector, since supervision and checking of such activities is key to the success of the measures.

4.8 The EESC considers that the issue of scale and of distorted practices is not the sole preserve of the shadow banking system. The oversized banking model, combined with lack of transparency, demonstrably brings with it the risk of economic instability, resulting in the costs of rescuing institutions that are 'too big and interconnected to fail' being passed on to society.

4.9 The EESC holds that in order to boost the competitiveness and stability of the European financial sector while reforming the shadow banking system, it is necessary to address the issue of the size of banks rendering their failure prohibitive, by increasing transparency, rationalising the scale of activity of mega-groups and reducing interdependence within groups.

4.10 Along with the supervisory measures and structural reform, the EESC therefore considers it essential that effective action be taken to combat all distortions of the financial sector, and urges the Commission to speed up procedures for introducing a single reform mechanism, taking account of the recommendations of the Liikanen report and the recent report by the European Parliament's Committee on Economic and Monetary Affairs on structural reform of the EU's banking sector ⁽²²⁾.

4.11 Since the diffuse, multifaceted and adaptable nature of the shadow banking system makes effective supervision complex and difficult, the EESC urges the Commission to act quickly to clarify questions as to whether the relevant national and European supervisory authorities, including the single supervisory mechanism (SSM), are equipped with sufficient resources, supervisory tools and powers.

4.12 The EESC believes that successful oversight must go hand-in-hand with effective, dissuasive and proportionate arrangements for enforcing sanctions, publicising the level of sanctions and information relevant to those who infringe the rules, and points to the issue of non-compliance with European rules on the part of third country natural and legal persons.

4.13 The EESC highlights the need to protect consumers of financial products from unfair practices, misleading and worthless products or services, as well as from any unfair contractual terms. It would also repeat its call for the establishment of a European agency for consumer financial protection, in order to strengthen consumer protection and transparency and ensure disputes are settled effectively.

4.14 User-friendly websites and other up-to-date information tools can enable consumers to compare and choose products and services, while boosting competition and self-regulation on the financial market.

⁽²¹⁾ Financial Stability Board, *Global Shadow Banking Monitoring Report 2012* (FSB, 2012).

⁽²²⁾ 2013/2021(INI).

4.15 The EESC strongly urges the Commission to accelerate the completion of the impact studies so that the new liquidity rules can be finalised and a cost-benefit analysis carried out concerning the efficiency and proportionality of the numerous legislative practices adopted since the beginning of the financial crisis, the purpose being for an overall evaluation to be made of the impact of legislation on the EU financial market.

4.16 The EESC also points to the need for regulatory efforts to be bolstered by advanced expertise and scientific research into questions relating to the collection and exchange of data. There is also a broader need to monitor the on-going development of the shadow banking system more comprehensively and to identify those aspects of benefit to the real economy as well as those that may generate new sources of vulnerability and systemic risk.

Brussels, 10 December 2013

The President
of the European Economic and Social Committee
Henri MALOSSE
