Shadow Banking Demystified

With banks facing tighter supervision and a wave of new regulation, more financial activity is expected to move out of the regulated banking industry and into the shadow banking system. **Jeremy Estabrooks** and **Kristin Fisher** of **Practical Law Company** explain what is meant by "shadow banking" and explore how this parallel banking system is likely to be affected by recent financial reforms.

The unregulated sphere of banking-like activity known as shadow banking has become an increasing source of concern for banks and their regulators. In the years leading up to the financial crisis, the shadow banking system grew rapidly in size and influence. Research by the Federal Reserve Bank of New York indicates that, by the height of the crisis, the shadow banking system was nearly twice as large as the traditional banking system. Although it has since contracted, shadow banking remains an important source of credit activity, financing roughly 30% of total financial assets in the US, according to Standard & Poor's.

The shadow banking system has been identified as a source of potential systemic risk, both directly and through its relationship with the traditional banking system. The run on "shadow banks" in 2008 is cited as a key contributor to the scale of the financial crisis. In addition, there is concern that these less-regulated entities can exploit regulatory arbitrage opportunities which may undermine the more stringent bank regulation mandated under recent financial reforms including the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) and Basel III.

"Almost invariably there is a significant correlation between an increase in regulation in a particular sector of the banking industry and the ability of non-bank players to find ways to perform substantially similar services," says Greg Lyons, a partner and co-chair of the Financial Institutions Group at Debevoise & Plimpton LLP. "A lot of activities traditionally associated with banking and necessary for business in the modern economy, including lending, securities trading and derivatives trading, could move outside of regulated institutions if the final rules under Dodd-Frank and Basel III are not moderated."

Against this background, this article explores:

- What is meant by shadow banking and how it differs from traditional banking.
- The benefits and risks associated with shadow banking activities.
- How regulatory reforms under the Dodd-Frank Act and Basel III may impact the shadow banking industry.
- Ongoing national and global initiatives to strengthen the oversight and regulation of the shadow banking system.

WHAT IS SHADOW BANKING?

Shadow banking broadly refers to bank-like activities (primarily the creation and intermediation of credit), which take place outside of the traditional retail deposit-funded banking system, where these activities are subject to no or significantly less regulation and supervisory oversight. Examples of institutions that make up the shadow banking system include money market funds (MMFs), hedge funds, private equity funds, consumer finance companies, structured investments vehicles (SIVs) and asset-backed commercial paper (ABCP) conduits.

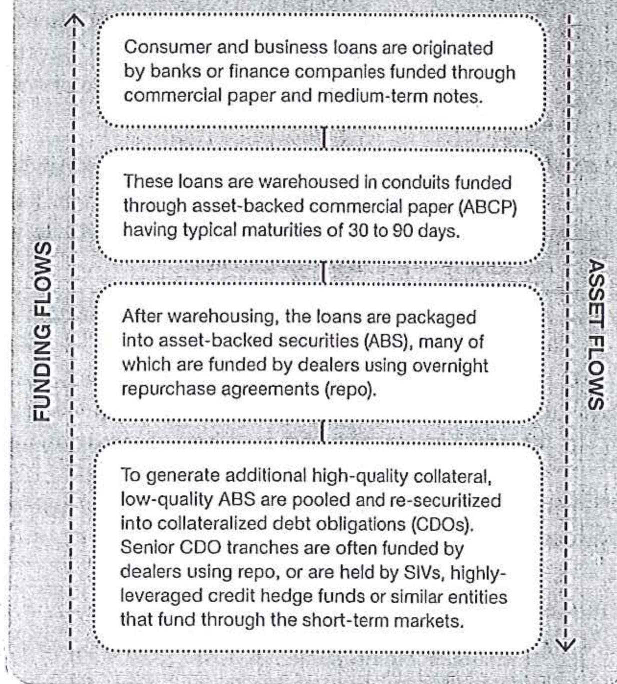
Like traditional banks, shadow banking entities typically borrow in short-term debt markets and invest in longer-term, illiquid assets (see *Box, Shadow Banking: Credit Intermediation Process*). But unlike traditional banks, they lack access to public sources of capital and liquidity support, such as the FDIC-insured deposit market and the Federal Reserve System's discount window.

POTENTIAL BENEFITS OF SHADOW BANKING

Shadow banking arose primarily as a result of financial innovation and regulatory changes affecting the traditional banking model. Although there is some concern about the risks it creates, policymakers and regulators do not necessarily view shadow banking as a bad thing, according to Ernie Patrikis, a partner at White & Case LLP and former First Vice President of the Federal Reserve Bank of New York. Today, shadow banks provide essential credit intermediation services that can offer various advantages over traditional banking.

ALTERNATIVE AND CHEAPER SOURCES OF FUNDING

Shadow banks offer alternative sources of funding and liquidity to businesses and consumers. The freedom to structure



financial transactions without the regulatory safety and soundness concerns surrounding traditional banking products can provide shadow banks with a competitive advantage, which will likely be heightened following recent reforms strengthening the regulation of banks.

"A principal goal of the regulators is to make banks less complex, less interrelated and more focused on historical core banking activities," explains Lyons. "So it's a good thing there are non-bank vehicles that can take on aspects of that business."

Further, because they are subject to less capital and other regulatory constraints, shadow banks can often provide lower-cost financing.

LESS MORAL HAZARD

The lack of regulation of shadow banking activities does not make them fundamentally riskier than traditional banking activities. In fact, an argument can be made that, because shadow banks do not have the benefit of explicit government support or guarantees, or access to cheap sources of funding through the deposit market, they may be less prone to excessive risk-taking.

"On the one hand, hedge funds and private equity funds will take risks to make money," says Patrikis. "On the other hand, they don't want their business to collapse from excessive risks. Because one, they'll lose investors, and two, it's their own money."

SPECIALIZED PRODUCTS

Shadow banks may also be driven by gains from specialization, making them more efficient in providing some products and services than traditional banks. They can achieve economies of scale in the origination, servicing, structuring, trading and funding of loans. For example, shadow banks have traditionally served subprime credit card or auto loan customers, as well as companies with low-rated credit like commercial airlines, which are generally not served by depository institutions.

RISK DIVERSIFICATION

Although the financial crisis has called into question the riskiness of the securitization structure, the securitization-based shadow credit intermediation process can potentially reduce volatility in the financial system by:

- Mitigating and spreading out credit risks.
- Allowing lenders to increase and diversify their sources of funding.
- Involving the market in the supervision of banks, by providing third-party discipline and market pricing of assets that would be opaque if left on the banks' balance sheets.

POTENTIAL RISKS OF SHADOW BANKING

As the shadow banking system continues to develop, regulators are turning their focus to those shadow banking activities that can give rise to systemic risk or significant regulatory arbitrage.

SYSTEMIC RISK CONCERNS

The shadow banking system can become a source of systemic risk if, for example:

- There is a large-scale run on shadow banks.
- The build-up of leverage in the shadow banking system magnifies market fluctuations.
- The traditional banking system is negatively affected by developments in the shadow banking system.

Modern Bank Runs

While federal protection schemes such as FDIC deposit insurance have proven to effectively prevent bank runs created by periods of temporary illiquidity in the market, there is

no comparable public safety net for shadow banks. Shadow banks are vulnerable to runs if their sources of funding are short term and can be withdrawn at any time and their assets are long term and difficult to liquidate. For example, during the collapse of Lehman Brothers, investors rushed to draw their cash out of MMFs, fearful of their level of exposure to the failing bank (see below *Money Market Fund Reform*). If these runs become widespread, they can destabilize the broader financial system.

However, it should be noted that not all shadow banks are subject to this short-term liquidity risk. For instance, private equity funds operate on an opposite model, requiring investments in the fund to be locked in for a substantial period of time (typically ten years), while the fund itself may invest in more liquid investments. In addition, hedge funds have redemption suspension and restriction clauses that can be activated by the fund manager in times of financial distress.

High Leverage and Procyclicality

Because shadow banks are not subject to the same capital restrictions as traditional banks, they can employ higher leverage to generate greater returns on their assets.

The build-up of leverage in the shadow banking system can promote the procyclical effects of risk being underestimated in good times and overestimated in bad times. The volume of funding and leverage tends to be high during strong economic cycles when asset prices are high and margins on secured financing are low. However, as seen during the financial crisis, a drop in the value of collateral and an increase in margins can quickly create a loss of confidence in the market, resulting in rapid deleveraging and fire sales of assets.

Banking System Exposure to Shadow Banking

The shadow banking system and the traditional banking system are closely linked, with banks often comprising part of the shadow banking chain (such as through loan warehousing). Banks can also be exposed to the shadow banking system by:

- Providing financing or contingent credit lines to shadow banks.
- Investing in financial products issued by shadow banks or relying on shadow banks for funding.
- Holding assets or derivative positions that are connected to shadow banks.

Regulators are concerned that the close relationship between the systems can exacerbate the procyclical build-up of leverage and increase the risks of asset price bubbles. It can also amplify market reactions when liquidity is scarce.

These concerns are partly dealt with by the increase of certain activities restrictions and capital requirements that banks are facing under recent reforms (see below *Regulatory Reforms*). "What Dodd-Frank is really trying to address is the enormous interdependencies of this incredibly complex financial system," says Robin Maxwell, a partner and head of the Financial Regulation Group at Linklaters LLP.

REGULATORY ARBITRAGE CONCERNS

As the regulatory environment for banks becomes more challenging, they may seek new ways to use shadow banking activities to circumvent their capital and liquidity requirements or business activities restrictions. "Innovation will always continue," says Maxwell. "The name of the game for financial services is to figure out the most efficient way to structure and book their business," she adds. "But there is a gap between the sophistication of the regulatory response and that of the financial markets."

Regulatory arbitrage concerns are to some extent linked to systemic risk concerns. The migration of certain bank functions to the shadow banking sector may shift risk to where it faces lower standards and constraints.

However, it remains to be seen whether regulators will (or should) address regulatory arbitrage in those circumstances where it does not involve systemic risk. There is a long-held belief that healthy, thriving communities depend in part on the strong and active presence of banks in those communities. This may factor into the decision making of policymakers and regulators if they determine that shadow banks have gained a substantial advantage.

REGULATORY REFORMS

According to Lyons, while there has been a lot of focus on heightened regulation of banks, and financial institutions more generally, regulators have not yet paid significant attention to the shadow banking system. However, regulators have expressed their intent to focus more directly on shadow banking in the future.

Still, the sweeping regulatory reforms under the Dodd-Frank Act and Basel III will considerably affect the shadow banking industry.

THE DODD-FRANK ACT

The Dodd-Frank Act includes many provisions that will be relevant to the shadow banking sector, particularly in relation to aspects of shadow banking where there is a close connection between banks and non-banking entities. For example:

- Non-bank financial companies deemed systemically significant by the Financial Stability Oversight Council (FSOC) will be subject to supervision and regulation by the Federal Reserve Board (for more information, search Summary of the Dodd-Frank Act: Regulation of Systemically Significant Financial Institutions on our website).

- With certain exceptions yet to be clarified, banking organizations will be prohibited from engaging in proprietary trading and from acquiring or retaining any ownership interest in, or sponsoring, a hedge fund or private equity fund (for more information, search Summary of the Dodd-Frank Act: The Volcker Rule on our website).
- ABS sponsors or their affiliates will generally be required to retain 5% of the credit risk of a securitized asset pool and to increase their levels of disclosure and reporting. Also, firms underwriting ABS will be restricted from betting against (shorting) those securities within a year of issuance (for more information, search Summary of the Dodd-Frank Act: Securitization on our website).
- Much of the over-the-counter derivatives trading will be moved to exchanges and clearinghouses (for more information, search Summary of the Dodd-Frank Act: Swaps and Derivatives on our website).
- Hedge funds and private equity advisors will be required to register with the Securities and Exchange Commission (SEC) and must provide certain information about their trades and portfolios (for more information, search Summary of the Dodd-Frank Act: Private Equity and Hedge Funds on our website).
- Retail lenders will be subject to federal regulation by the new Consumer Financial Protection Bureau (CFPB) (for more information, search Summary of the Dodd-Frank Act: Regulatory Structure on our website).

>> For a Practice Note that tracks the rules and regulations which implement the Dodd-Frank Act, search Road Map to the Dodd-Frank Act on our website.

BASEL III

The new global regulatory standards on bank capital adequacy and liquidity (Basel III) proposed by the Basel Committee on Banking Supervision will also affect the shadow banking industry. The principal prescriptive themes of Basel III revolve around the three main requirements that:

- Banks maintain more and better quality capital.
- Banks be subject to specific liquidity requirements.
- Systemically significant financial institutions have heightened loss absorbency capacity.

>> For an overview of Basel III, search Basel III: An Overview on our website.

>> For more information on the impact of Basel III on US banks, search Basel III: Overview and Implementation in the US on our website.

IMPACT OF THE DODD-FRANK ACT AND BASEL III

The regulatory changes to be effected under the Dodd-Frank Act and Basel III raise several issues in relation to the shadow banking industry, including:

- Which institutions may be deemed systemically significant by the FSOC.
- Which business lines will be unloaded by banks and picked up by the shadow banking sector.
- Whether inconsistent global standards and regulations will push certain financial activities overseas.

SSFI DESIGNATION

One of the most important reforms under the Dodd-Frank Act is the creation of a regime to supervise and regulate banks and other financial companies whose failure would threaten the stability of the US financial system. Under this regime, the FSOC, after a two-thirds vote of its members, may designate a US non-bank financial company as a systemically significant financial institution (SSFI), subjecting it to enhanced regulation by the Federal Reserve Board.

According to Patrikis, SSFI designation is the first step that regulators will take toward tackling shadow banking issues. However, regulators must clear up much of the uncertainty around the SSFI criteria. "The interesting question is how many organizations are going to be defined as SSFIs and then subject to enhanced supervision," comments Patrikis. "Is it insurers, hedge funds, private equity funds, mutual funds? And what does it mean to 'pose a threat to the financial stability of the United States'?"

Regulators are expected to release more detailed criteria for determining SSFIs later this summer, with SSFI determinations expected to come sometime in 2012. While it may be too soon to tell what the implications of the SSFI regulations will be, according to Maxwell, there will likely be a lower number of institutions on that list than many initially feared.

Some financial companies at risk of being designated systemically significant may consider altering their business model or operations to avoid being subject to additional oversight. For example, over the past six months, two large insurance companies unloaded thrift subsidiaries in part to avoid heightened regulation through potential SSFI designation. "These institutions have to weigh the advantages and disadvantages of being under Fed prudential supervision," says Patrikis. "Ultimately, what Congress has done by imposing these new regulations on the banking organizations is bolster the shadow banking system."

>> For more information on the regulation of SSFIs, search Summary of the Dodd-Frank Act: Regulation of Systemically Significant Financial Institutions on our website.

SHIFTING BUSINESS LINES

According to Lyons, the capital charges and liquidity requirements under the Dodd-Frank Act and Basel III, coupled with absolute prohibitions on activities such as the proprietary trading

restrictions under the Volcker Rule, are prompting banks to consider limiting or shutting down certain business lines.

As rulemaking gets underway, banks will have to reevaluate which business lines are too expensive or challenging to continue. "Dodd-Frank will be difficult for the banks to deal with, and Basel III may in certain respects be even worse over time. But the real wild card is how these two legal frameworks will integrate," says Lyons.

Proprietary and Counterparty-based Trading Activities

"We are already seeing hedge funds and private equity funds buying some of the proprietary trading businesses that banks may be forced to spin off in 2013," says Lyons. "And as new rules become more certain, banks will need to assess the sustainability of their operations. There may be ever more opportunities for non-highly regulated vehicles to provide similar services."

Counterparty-based activities, principally derivatives trading, securities trading and securitizations, are a particular focus of Basel III and will likely be picked up by shadow banks. "On the supply side, these activities could carry much higher capital charges for banks," explains Lyons. "On the demand side, there is some level of certainty around the regulatory framework, and many non-bank players already engage in these activities."

General Lending Activities

Since the financial crisis, bank lending activity has remained at low levels, which will likely continue due to the heightened liquidity and capital requirements imposed under Basel III. Although most funds do not historically have a credit market-focused strategy or structure to engage in extensive lending activities, some funds may be tempted to enter or expand into this area given the current opportunities and competitive advantages they may enjoy.

Consumer Financial Services

At this point, shadow banks are more hesitant to take on activities in the consumer financial services area. "The core issue is the uncertainty of how much more regulation and oversight there might be by virtue of the CFPB," says Lyons. "They seem to have a broad range of authority to regulate not just banks, but anybody who is involved in the chain of providing these kinds of products to consumers. And there is some question as to how much they will exercise that authority."

Recent pronouncements by the CFPB have indicated its intention to cast its oversight powers widely to include non-bank consumer lenders and other entities engaged in consumer credit-related businesses.

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INCONSISTENT GLOBAL REGULATIONS

According to Maxwell, "The real shadow banking threat for US institutions is overseas. There are serious limitations on the ability of regulators in different countries to come up with rules that are truly identical."

Although there have been significant international efforts to create a more level global playing field (most notably Basel III), specific rules and regulations must be formulated and implemented by each relevant jurisdiction. This makes global harmonization difficult to achieve and creates more opportunities for regulatory arbitrage.

Maxwell points to the G-20 agreement on derivatives regulation as an example, saying that many fear proposals of the Commodity Futures Trading Commission (CFTC) would put US banks at a serious disadvantage to foreign banks. "Dodd-Frank has something that, on its face, looks similar to the EMIR (the EU's derivatives reform). Yet there are serious concerns about competitive inequalities between these regimes," she says. "These concerns have the potential to affect very dramatically where business ends up being conducted."

If shadow banking centers develop outside the US, US banks may confront not only competitive concerns but the threat of increased systemic risk arising from the lack of uniform global supervision and an uncoordinated regulatory framework. "Systemic risk, by its nature, does not have national borders," says Maxwell. "So it is subject to question whether or not national regulators each purporting separately to limit and contain systemic risk can really do the job."

ONGOING REGULATORY INITIATIVES

While the Dodd-Frank Act and Basel III take some meaningful steps toward the regulation of shadow banking, there are still noticeable gaps in the legislation. However, there are continuing efforts in the US and internationally to monitor and regulate the shadow banking system. For example:

- The SEC and the President's Working Group on Financial Markets (PWG) are considering measures to enact stronger MMF reform in the US.
- The Financial Stability Board (FSB) is working to develop global recommendations to strengthen the oversight and regulation of the shadow banking system.

MONEY MARKET FUND REFORM

MMFs came under scrutiny after the failure of Lehman Brothers, which was a substantial issuer of commercial paper held by MMFs. As commercial paper and other short-term instruments became highly illiquid, one large MMF, Reserve Primary Fund, "broke the buck" when its share price fell below the stable $1 net asset value (NAV) that MMFs traditionally maintain. The illiquid commercial paper market, along with significant redemptions of MMF shares by institutional investors, raised concerns about the systemic importance of MMFs. Ultimately, the government stepped in to temporarily guarantee these funds.

Despite these events, "money market funds are not treated as systemically significant as banks by Dodd-Frank," explains Lyons. "There was some concern that they would be regulated more like banking institutions because they historically have been viewed by customers as an alternative to the bank deposit-taking function. But so far that has not occurred."

In early 2010, the SEC responded to concerns about MMFs by amending the rules under the Investment Company Act of 1940 that govern them. Under the new rules, among other requirements, MMFs must:

- Restrict their investments to the highest-quality securities.
- Reduce the average maturity of their holdings.
- Maintain substantial liquidity cushions.
- Provide monthly holdings reports.

Still, regulators, academics and fund industry professionals continue to debate over whether further measures should be taken to protect MMF accounts. In October 2010, the PWG released a report assessing additional reforms needed to reduce the industry's susceptibility to runs and risk to the financial system.

The report provides several options for MMF reform, including:

- Floating NAVs instead of stable NAVs.
- Industry-funded, private emergency liquidity facilities.
- Regulating stable NAV MMFs as special purpose banks and/or imposing an FDIC-like deposit insurance system.

In May 2011, the SEC held a roundtable to discuss the reform proposals. One of the principal topics of debate was whether MMFs should be viewed as shadow banks primarily designed to circumvent banking regulation. Regulators and industry stakeholders remain divided on this issue and to date the SEC staff has not supported any specific reform option.

FSB RECOMMENDATIONS

At the meeting of the G-20 leaders in Seoul, South Korea in November 2010, the FSB was mandated to develop recommendations to strengthen the oversight and regulation of the shadow banking system. In April 2011, the FSB published a background note, *Shadow Banking: Scoping the Issues* (available at *www.financialstabilityboard.org*), setting out the initial views of a task force formed by it to:

- Clarify what is meant by shadow banking.
- Present potential approaches for monitoring the shadow banking system.
- Explore regulatory measures to address systemic risks and arbitrage concerns arising from shadow banking.

The FSB's task force will explore possible regulatory options within the following four broad categories:

- Regulation of bank interactions with shadow banking entities.
- Direct regulation of shadow banking entities.
- Regulation of shadow banking activities, markets or instruments.
- Macro-prudential policy measures to mitigate risks such as procyclicality and contagion across markets.

The FSB will consider initial recommendations at its plenary meeting in July 2011 and submit recommendations to the G-20 in time for its meeting in Cannes, France in November 2011.

THE ROAD AHEAD

The broad architecture of the Dodd-Frank Act and Basel III is more or less fixed, leaving the remaining issues to be worked out by the regulators. According to Maxwell, "The regulators are not more hawkish than Congress. They do not seem disposed to make things tougher than they need to be."

Lyons adds that if the regulators decide to extensively regulate the shadow banking system, they would be caught in a conundrum in relation to the traditional banking system. "If they take shadow banking regulation to the fullest extent possible," he says, "the banks would not be able to restructure or spin off the activities the regulators apparently want them to discontinue. They can't have it both ways."

With long implementation and transition periods ahead, there remains a lot of uncertainty as to how the new rules and regulations will play out. "These issues must be approached very cautiously so as not to foreclose the non-bank intermediation activities that will be critical to the resurgence of the US and global economies," says Lyons. "As with all things in this regulatory environment, much is to be written."