

„Shadow Banking“ and the Real Economy

Deutsches Aktieninstitut's Position Paper on the FSB's Consultative Documents "Strengthening Oversight und Regulation of Shadow Banking" from 18th of November 2012

14, January 2013

Deutsches Aktieninstitut (DAI)¹ has followed the recent discussions on capital markets regulation with close interest. We therefore also appreciate the opportunity to comment on the Financial Stability Board's consultative documents on "shadow banking activities" which are broadly defined by the FSB as "credit intermediation involving entities and activities fully or partially outside the regular banking system"².

The view presented below is the view of non-financial industrial companies on that issue represented in Deutsches Aktieninstitut's committee on corporate finance and treasury.³

Without doubt FSB and other organisations have improved the understanding of the potential risks as well as the benefits that may result from financial intermediation outside the regular banking system. We also share the view that financial market stability is a pre-condition for growth and prosperity and, thus, potential systemic risks stemming from "shadow banking activities" should be adequately addressed.

However, the term "shadow banking" is vague and may cover a too wide range of activities irrespective of whether they significantly contribute to systemic risks. The vagueness of the issue and the high number of potential regulatory responses brought up in the various discussion papers raise non-financial companies' concerns – at least in two interrelated respects.

- First, non-financial companies have the strong impression that the discussion on "shadow banking" adds to a general political development which we fear will jeopardise the objective of achieving proportionate and high quality regulation: the tendency to launch additional and revisionary regulatory initiatives before previous initiatives have been implemented, granted time to work and have been thoroughly evaluated with regard to their effectiveness.
- Second, non-financial companies have made the experience that numerous well-intended regulatory steps – especially EMIR, MiFID/MiFIR and the European adoption of the Basel III framework (CRD

¹ Deutsches Aktieninstitut e.V. (www.dai.de) is the association of German exchange-listed stock corporations and other companies and institutions which are engaged in the capital markets development.

² See FSB, An Integrated Overview of Policy Recommendations, p. 2

³ The committee is a cooperation project of Deutsches Aktieninstitut, Bundesverband Deutscher Industrie and Verband Deutscher Treasurer under the lead of Deutsches Aktieninstitut.

IV/CRR) – have negative side-effects for them either resulting in increased finance or risk management costs, in severe obstacles for risk management procedures or a tremendous additional administrative burden. Although these regulatory initiatives are not implemented yet we can for example already state that in particular derivatives applied by non-financial companies to mitigate risks related to the commercial and treasury finance activities have become more expensive and their availability decreased for certain instruments.⁴ Against this background we are concerned that further measures that may result from the “shadow banking” initiative could again result in unintended consequences for the real economy, e.g. restrictions on repo transactions which are used by non-financial companies for liquidity management purposes. The documents presented so far have been vague in this regard. Although we feel that the focus of the regulatory initiatives envisaged is not the real economy but other market participants that might add to systemic risk, the real economy has neither been explicitly excluded nor has the potential impact on it been analysed sufficiently.

Negative unintended consequences have to be avoided, because non-bank intermediation often provides valuable alternatives to bank funding for the real economy or alternative investment opportunities for private and/or institutional investors and is in many cases already subject to some kind of financial/banking regulation. The benefits stemming from non-bank intermediation are often very concrete while the risks of “shadow banking” appear to be rather abstract.

Potential direct negative consequences

Potential regulatory initiatives might unintentionally cover activities of non-financial industrial companies themselves (direct negative consequence) – for example with respect to the financing of the real economy or with respect to relations of industrial groups with their customers. In particular, the definition of “shadow banking” is so vague, that even group-internal transactions might unintentionally be included. On a regular basis industrial companies centralise financing and risk management activities in specialised subsidiaries at the group level in order to exploit specialisation advantages as well as centralised internal expertise and to improve the monitoring of the financial status of an industrial group as whole. Examples of those activities are the pooling of cash reserves and the re-allocation of funds in a group treasury centre, the centralisation of derivative transactions with external parties for hedging purposes in a specialised treasury unit or the access to external capital markets through specialised finance subsidiaries. All these activities have in common that transactions are initiated between group subsidiaries and a central unit or a central unit is involved in initiating transactions for its group companies. In both cases no additional risk to the group as a whole or the financial system is created. It is therefore of utmost importance to exclude

⁴ See Deutsches Aktieninstitut/Verband Deutscher Treasurer, Risikomanagement mit Derivaten bei Unternehmen der Realwirtschaft - Verbreitung, Markttendenzen, Regulierungen – (Risk Management with Derivatives in Companies of the Real Sector“, www.dai.de/publikationen

such group internal services from the scope of the “shadow banking definition”. From our point of view a shadow banking activity can only occur in a tripartite relation between an investor/saver, an intermediary and a non-financial company or private household seeking credit. A group-internal transaction of a non-financial company is not a tripartite relation of that kind. Consequently, the existing EU Banking Directive (2006/48/EC, after amendment by 2009/110/EC) states in Art. 4 para. 1 that banks’ business is – in essence – to receive deposits or other repayable funds from the public and to grant credits for its own account. Group-internal transactions lack the link to the public and should therefore be out of scope in general. From the FSB’s comments in the Global Shadow Banking and Monitoring Report 2012 (Annex 5, p. 9) we assume that the FSB also does not see intra-group relationships as falling under the definition of shadow banking. However, an explicit statement to this effect in the FSB’s position papers would be appreciated.⁵

In addition the transformation of maturity or risk does not present the core of the business model of a non-financial company since it may – if any – play a supporting role such as providing corporate finance or facilitate the sale of goods and services. Also, existing financial/banking regulation already sets limits to those activities which we regard as sufficient. Consequently, financial transactions that involve risk or maturity transformation are not significant in size, so that no relevant macroeconomic risks will accumulate in a corporate group.

If non-bank-intermediation activities already play a significant role for a certain part of the business of a non-financial company, these activities are typically centralised in a subsidiary with a suitable licence and/or are ring-fenced for risk management and compliance purposes in the group. This is for example the case in the automotive industry where the sale of cars, trucks or busses is supported by a bank subsidiary. However, this definitely does not mean that the whole group should be regarded as a “shadow bank” for regulatory purposes – the hint to the automotive industry on page 7 of the consultative paper is misleading.

Potential indirect negative consequences

Regulation with respect to “shadow banking“ might also cover (financial) services that are used by non-financial companies (indirect negative consequences).

Though the FSB highlights that the “shadow banking activities” may have benefits for households and businesses⁶, non-financial companies are concerned that these benefits will be disregarded in the political process with the consequence that regulations will not be well-balanced and will have costly negative side effects for non-financial companies. This problem may for example emerge if certain legal structures (e.g. special purpose vehicles) or certain means of finance (e.g. asset backed securities/commercial papers) will be included in the scope of a future regulation without considering the benefits for non-financial companies or their specifics adequately. Making external

⁵ FSB, Global Shadow Banking Monitoring Report 2012.

⁶ FSB, A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities, p. 2.

financing – in particular external capital markets financing – more costly by imposing additional regulation on the respective instruments would impact non-financial companies immediately and significantly, because at the same time the traditional bank credit is also made more costly through the current wave of re-regulation.

Similarly, it should be noted that money market funds with a high credit standing have gained in importance as an alternative to bank deposits in order to diversify cash holdings and to avoid concentrated risks. Any regulation of these entities should therefore maintain these benefits for non-financial companies.

Recommendations

Against the background above, Deutsches Aktieninstitut would like to suggest the following key requirements with respect to any initiative on “shadow banking”:

- We understand the business cases which the FSB intends to cover by the regulation, but currently those business cases are not sufficiently reflected in the definitions of the relevant activities. To list only single specific activities without further clarification has the consequence that the scope of the definition of shadow banking will be much too broad. In particular, the interconnectedness of transactions which gives rise to the systemic risk in the first place has to be reflected more clearly in the definitions of the relevant activities. We do not support the approach to start with a broad scope which then, by implementing exceptions, will be confined. It is our experience that - due to the fact that the real economy is not in the spotlight of the regulation - we often face difficulties how those exemptions are to be construed. Therefore, we support an approach that already limits the definitions before introducing exemptions.
- Exempting internal transactions of non-financial industrial companies' from the scope: It should be made explicitly and unambiguously clear, that it is not intended to classify non-financial industrial companies and/or their group-internal financing or risk management transactions as “shadow banks” or “shadow banking activities”, even if a central specialised unit is involved in centrally initiating transactions for its group companies.
- Studies concerning the impact on the real economy before taking additional steps: Before any additional regulatory step in the sphere of “shadow banking” is taken, impact studies should be performed that substantiate the consequences for the real economy.⁷ Companies of the real economy are increasingly worried that additional regulatory steps are envisaged before amendments to existing regulations currently under negotiation will have come into force and their effects

⁷ The European Parliament shares the view. See European Parliament resolution of 20 November 2012 on Shadow Banking Banking (2012/2155(INI)), Nr. C.34., <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2012-427>

will be analysed. This is also true for regulatory amendments with respect to instruments or practices that are regarded as “shadow banking” by the FSB and others (e.g. securitisation and repos). The lack of experience with existing or newly amended regulations also bears the risk of serious inconsistencies between different regulations. As FSB correctly states that “shadow banking” does not mean that the respective activities are currently un-regulated, there is furthermore the danger that the same activity will be covered by more than one regulation. To increase the regulatory burden although sufficient regulation already exists, should be avoided by such impact studies.

- No excessive data collection: While we basically agree that regulatory steps should be based on reliable data, non-financial companies also have made the experience that regulatory requirements with regard to data provision tend to be overly ambitious and to create additional red tape that is not always justified. For example, according to the European Derivative Regulation (EMIR) also group-internal derivative transactions have to be reported although they do not pose any additional risk for the economy as whole.

Overall, Deutsches Aktieninstitut is concerned that potential future initiatives in the field of “shadow banking” will not adequately reflect the needs and specifics of the companies of the real economy.

These needs are twofold: First, non-financial companies already use entities that may be regarded as “shadow banks”, so that they are interested that current service levels will be maintained in a cost-efficient manner. Second, non-financial companies perform activities that contribute to their business model and are therefore concerned that those activities may unintentionally be regarded as a “shadow banking activity” and may, therefore, be limited or made more costly.

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