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Shadow banking: thoughts for a possible policy agenda

Speaking at the European High Level Conference in Brussels today, Paul Tucker – the Bank's Deputy Governor for Financial Stability and a member of both the Financial Policy Committee (FPC) and the Monetary Policy Committee (MPC) – outlines his views on specific policies to address the risks to financial stability posed by shadow banking. In doing so, he explains that his aim is to "help nudge this work into its next stage", following the publication of a consultative paper by the EU Commission on shadow banking.

Paul Tucker propounds ten specific policy recommendations. First, that "shadow banking vehicles or funds that are sponsored or operated by banks should be consolidated on to bank balance sheets". While he notes that such a policy might require changes in accounting rules, which might take time, he says the vehicles and funds should in the meantime be treated as consolidated in the application of Basel 3 regulatory capital requirements; "if necessary, Pillar 2 should be used to achieve that".

Second, Paul Tucker recommends that "the draw-down rate assumed in the Basel 3 Liquidity Coverage Ratio should be higher for committed lines to financial companies than for lines to non-financial companies. That is, banks should hold more liquid assets against such exposures." Noting that some shadow banks, while not part of a banking group, are fundamentally dependent on banks through committed lines of credit, he says that "without a policy of that kind, there will be a strong incentive for maturity-transformation to be undertaken off bank balance sheets but with an umbilical cord back to the banking system."

Third, Paul Tucker recommends that "Money Market Funds should be required to choose between being Variable Net Asset Value (NAV) funds or Constant NAV funds; that any remaining CNAV funds should be subject to capital requirements of some kind; and that all should be subject to 'gates' or other measures that can be used to delay withdrawals, to make runs less likely". In the event that a globally consistent approach to money funds is not forthcoming, one possibility would, he says, "be for bank supervisors to limit the extent to which banks could fund themselves short-term from US money funds and from other fragile/flighty sources, including CNAV money funds domiciled elsewhere" (his fourth recommendation). He emphasises that such a policy need not be targeted at US funds per se. "It could be cast in terms of the liability structure and sources of funding of the banking system. The Basel 3 Net Stable Funding Ratio may help a bit with this." He also notes that on some fronts, notably transparency, "Europe should aim to catch up with the progress the US has already made."

Fifth, in respect of non-bank financial intermediaries which finance themselves externally in the market, Paul Tucker recommends that “if they are financed materially by short-term debt, they should be subject to bank-type regulation and supervision of the resilience of their balance sheets”. The policy would, he notes, apply to some kinds of finance company and might apply to securities dealers too.

Sixth, Paul Tucker recommends that “only banks should be able to use client moneys and unencumbered assets to finance their own business to a material extent; and that should be a clear principal relationship. Legal form should come into line with economic substance. For non-banks, any client moneys and unencumbered assets should be segregated and should not be used to finance the business to a material extent. It should, however, remain permissible for non-banks to lend to such clients on a collateralised basis to finance their holdings of securities (‘margin lending’).” He notes that regimes in this area vary enormously around the world or are non-existent; “we need a global discussion”.

Paul Tucker then turns to the markets that firms and vehicles can use to develop a de facto banking business, in particular securities lending and repo markets. Notwithstanding the “vital” role which collateralised borrowing markets play in ensuring efficient capital markets, he makes four further recommendations in this area. First, “there should be greater market transparency, perhaps ideally via a Trade Repository with open access to aggregate data, so that the world can see what is happening in these very important but opaque financing markets”. Second, “financial firms and funds should not be able to lend against securities that they are not permitted or proficient to hold outright”. Third, “non-bank financial firms should be regulated in how they employ cash collateral”. And finally, “the authorities should be able to step in and set minimum haircut or margin levels for the collateralised financing markets (or segments of them)”. That, he says, would need to be pursued at international level. Noting that the resilience of the system is impaired when a bout of exuberance drives down haircuts, he says “the authorities need to be ready to place constraints on that – through minima that either apply continuously or are specially introduced when conditions are overheating”.

In conclusion, Paul Tucker notes that “it would be foolhardy to imagine that we can frame policies today that will stand the test of time. The financial system will evolve, and we need to permit innovation. A policy framework on shadow banking therefore needs to be adaptive. And it mustn’t try to shut everything down ... non-bank finance is not intrinsically a bad thing. We will need effective surveillance of what is going on and what concentrations of risk are emerging ... and we will have to make discerning policy judgments that are explained and consulted upon. That is exactly what the EU, alongside the FSB, is now embarked upon”.

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