Editors' introduction: the risks and regulatory perimeter for shadow banking

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'Shadow banking' refers to a range of activities that have bank-like character, that is, credit intermediation, liquidity and maturity transformation, and that are undertaken outside the regulated banking system.¹ This can mean activities carried out by non-bank entities that mimic bank-like activities, but can also refer to activities carried out by banks and other regulated firms that do not always operate within the established fabric of regulation they are subject to. Although such activities may be seen as a form of financial innovation, the relationship between innovation and regulatory arbitrage remains uneasy. The former is often viewed more positively than the latter, although it is clear from history that the former has often driven the latter (for example, the emergence of the Eurobond market).

The Financial Stability Board (FSB) has provided leadership in developing international surveys of shadow banking activity around the world² and policy thinking to govern these areas. In 2013,³ the FSB set out in a policy document the need to consider how shadow banking activity affects financial stability, but its focus was inevitably on known areas whose risks have played out in the global financial crisis of 2007–09.⁴ The spotlight on these areas has nevertheless led to regulatory reforms in many parts of the world, discussions of which are canvassed in this volume, but issues remain outstanding in relation to the effectiveness and scope of reforms.

The work of the FSB has been important in underpinning the relevance of financial stability considerations for defining the regulatory perimeter. Since financial stability is a public good, that outcome cannot be expected to evolve from market-based activities. However, the FSB's arguments are not always unchallenged and it continues to face an uphill task persuading regulators around the world to (a) adopt reform measures that substantively move away from market-based governance, for example, in implementing

¹ Klára Bakk-Simon, Stefano Borgioli, Celestino Giron, Hannah Hempell, Angela Maddaloni, Fabio Recine and Simonetta Rosati, 'Shadow Banking in the Euro Area: An Overview' (2012) ECB Occasional Paper, No 133 <www.ecb.europa.eu/pub/pdf/scpops/ecbocp133.pdf?4e7d9b9457759adc96d58dd6dcf1891> accessed 9 June 2017.

² Financial Stability Board (FSB), 'Global Shadow Banking Monitoring Report 2014' (2014) <www.fsb.org/wp-content/uploads/r_141030.pdf> accessed 9 June 2017.

³ FSB, 'Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities' (2013) <www.fsb.org/wp-content/uploads/r_130829c.pdf> accessed 9 June 2017.

⁴ That is repo markets where the cascading needs for collateral top-ups or 'repo runs' played out during the global financial crisis; the securitised assets market which has come under scrutiny for its ability to transform high-risk and illiquid assets into low-risk and liquid assets; and money market funds whose promise to allow investors to redeem at par, therefore providing a product as safe as a deposit, was thrown into question. These issues are all discussed in our volume.

haircuts in reused collateral in the repo markets,⁵ a reform not undertaken by the European Union (EU) in its initial reforms introduced in repo markets;⁶ and (b) to designate reform measures proactively before crises occur, such as addressing the liquidity requirements of asset managers who may face withdrawal crises and can be forced into fire-sales of less liquid assets.⁷ The latter, however, has met with severe lobbying.

In this volume, we bring together a number of contributors to address the broader and more conceptual approaches to shadow banking and the regulatory perimeter, as well as the more granular issues of each area of shadow banking identified. The areas of particular shadow banking activity are based on the work of the FSB and European policy-makers.

Part I of this volume deals with frameworks for understanding shadow banking and the policy choices for governing risks, particularly financial stability risks in shadow banking. Nabilou and Paccès's chapter analyses a range of policy choices from the law and economics approach, and argues that it is neither possible nor welfare-enhancing to ban shadow banking, but suggests that a reduction in the volume of activity may be economically desirable. Hence policy choices should be targeted towards such reduction, such as using taxation devices. Chiu's chapter discusses how policy-makers favour a functional approach to understanding shadow banking, that is, characterising shadow banking activities by their economic functions in order to more clearly discern what characteristics of such activity should be subject to regulatory governance. The functional approach may highlight equivalent or similar functions to already regulated activity but there are often overlaps and underlaps, making policy choices difficult. The chapter suggests a transformational economy–society approach in applying functional characterisation of shadow banking activity in order to develop well-thought and inclusively consulted reforms.

Part II of the volume focuses on shadow banking activity that regulated institutions have undertaken outside their conventional regulatory systems. These continue to pose the most significant dangers to financial stability in most jurisdictions. Cullen's chapter provides an overview of the shadow banking character of the repo market and the financial stability risks it gives rise to. This is complemented by two further chapters on the repo market: de Gioia Carabellese's chapter on the reforms in the EU Securities Financing Transactions Regulations 2015, and their weaknesses and limitations, as well as Johnson's perspective from the US, in particular dealing with the strengths and vulnerabilities of strong clearing banks acting in the tri-party repo market. McVea's chapter highlights hedge funds' activities in the wholesale shadow banking sector and how systemic risks may be augmented. Next, Hsiao's chapter deals with over-the-counter (OTC) derivatives as the global financial crisis highlighted that such instruments, traded in bilateral environ-

⁵ FSB, 'Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions' (2015) <www.fsb.org/wp-content/uploads/SFT_haircuts_framework.pdf> accessed 9 June 2017.

⁶ Regulation (EU) of the European Parliament and of the Council 2365/2015 of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 [2015] OJ L 337/1.

⁷ FSB, 'Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities' (2017) <www.fsb.org/2017/01/policy-recommendations-to-address-structural-vulnerabilities-from-asset-management-activities/> accessed 9 June 2017.

ments with little transparency, obfuscated risks that ultimately culminated in potential systemic risk from American insurer AIG's near failure owing to their excessive exposure to credit default swaps traded in this market. Over-the-counter derivative trading has now been made subject to mandatory central clearing and transparency, and the chapter critically discusses what the EU Regulation on European Markets Infrastructure (EMIR) has achieved. This is complemented by Curtin and Tanega's chapter on the economic benefits and necessity of financial derivative instruments and the continued relevance of market-based governance.

Part III of this volume deals with emerging issues that are not yet the subject of significant reform initiatives. It may be argued that emerging techniques should not be too intensely regulated since the benefits of useful financial innovation may be circumscribed. However the lessons of the global financial crisis may warn regulators to be more proactive in their risk perspectives. Greene et al's chapter provides an overview of emerging issues unified under the theme of 'fin tech' or financial technology, as the digitalisation or online provision of financial services exploding under peer-to-peer lending, equity crowdfunding and so on raise new opportunities and welfare benefits but also issues of concern. The chapter discusses in a comparative manner US, European and UK approaches in providing governance frameworks, albeit skeletal ones at the moment. This is complemented by Lin's and Donovan's chapters on the financial technology theme. Lin's chapter focuses on the technological possibilities and safeguards underlying online peer-to-peer lending and equity crowdfunding, while Donovan's chapter discusses blockchain technology and the use of permissioned ledgers in financial services, how they bring about new efficiencies but also issues of concern in trust and security. Although dealing with a financial product that is well established and not new, Tanega and Baklanova's chapter deals with the fallout for money market funds in the global financial crisis of 2007–09 and reforms that affect the character and regulation of these funds in the US and the EU, as the shadow banking role assumed by these funds are again debated. The chapter provides a comprehensive discussion on the structures and financial stability risks posed by money market funds, and discusses a potential transparency reform that can more effectively address risks than under current reforms. Hanrahan's chapter deals with the investment fund revolution towards exchange traded funds, publicly listed, open-ended investment funds that allow investors to buy and sell whole portfolios of stocks, and usually passively managed at low cost. These funds provide investment liquidity for sometimes opaque and complex financial assets, and we question if these investment products perform shadow banking roles and raise risks in terms of investor protection and systemic stability.

Finally, in Part IV two chapters discuss the experience and lessons from other jurisdictions in relation to shadow banking issues. Shen's chapter discusses the shadow banking boom in China driven by constraints on conventional access to banking products. Noting that there are major hazards in different unregulated or inadequately regulated initiatives, Shen critically discusses what regulatory responses are needed. Contrary to the trend elsewhere, Hofmann's chapter produces the intriguing finding that there is little shadow banking activity in the relatively well-developed financial jurisdiction of Singapore, especially in the retail sector. This could be the result of a proactive and expansive regulatory approach taken to oversee financial activities so that innovation is often governed from the start. The chapter provides some interesting food for thought in considering how the regulatory perimeter should be calibrated.