How a simple regulatory approach can reduce the challenges raised by non-bank finance

HIGH LEVEL SEMINAR
BANKING SUPERVISION AND FINANCIAL STABILITY IN EURO-MEDITERRANEAN COUNTRIES
NON-BANK FINANCE AND FINANCIAL INTERMEDIATION

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1. Non-bank finance : an issue for banking supervisors

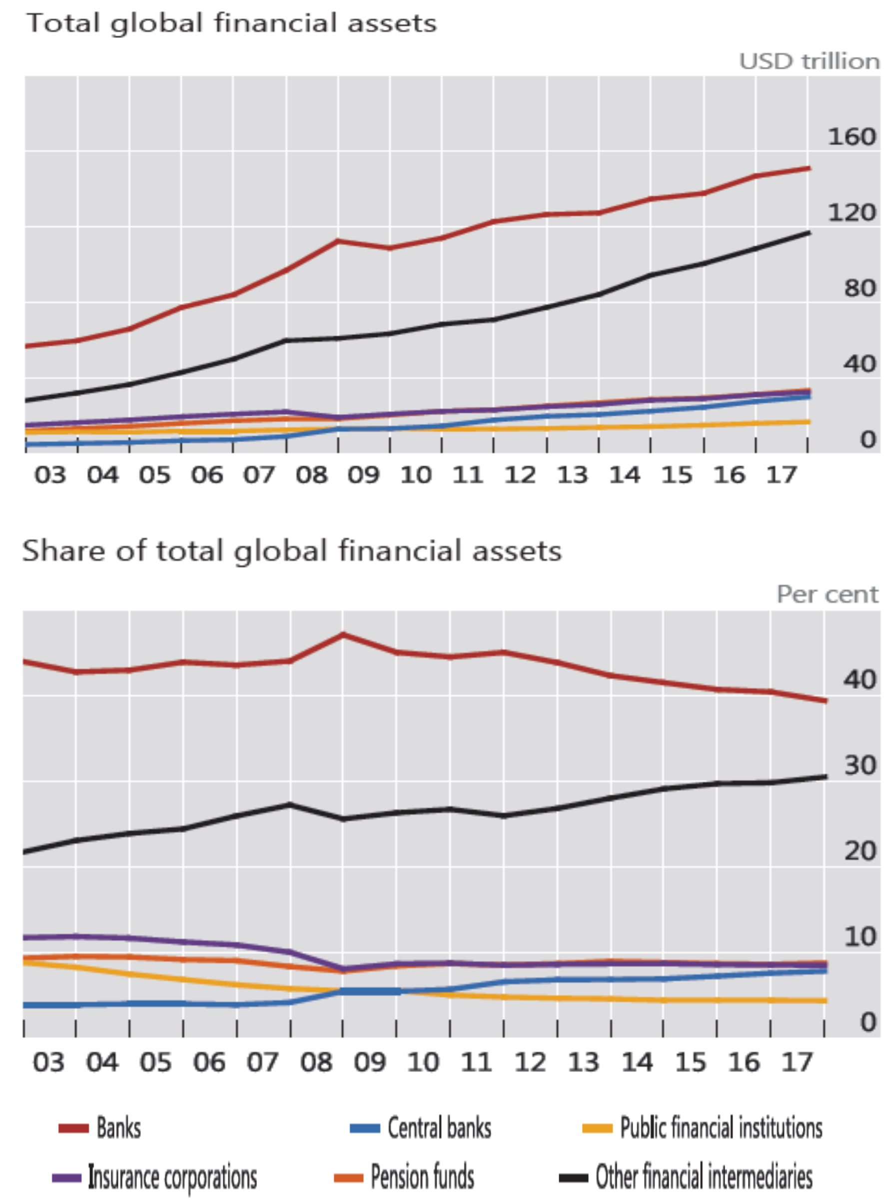
A credit intermediation system that includes **entities:**

? collecting capital with features similar to deposits	Money market funds
? granting loans based on short term- or asset-based finance	Consumer finance, leasing, factoring
	Investment funds
? carrying out maturity or liquidity transformation operations	
? allowing for risk transfers	Securitization vehicles
? using debt leverage	Hedge funds

and **activities:**

- ? Securitization
- ? Security lending/borrowing / repo

An increasing scope :



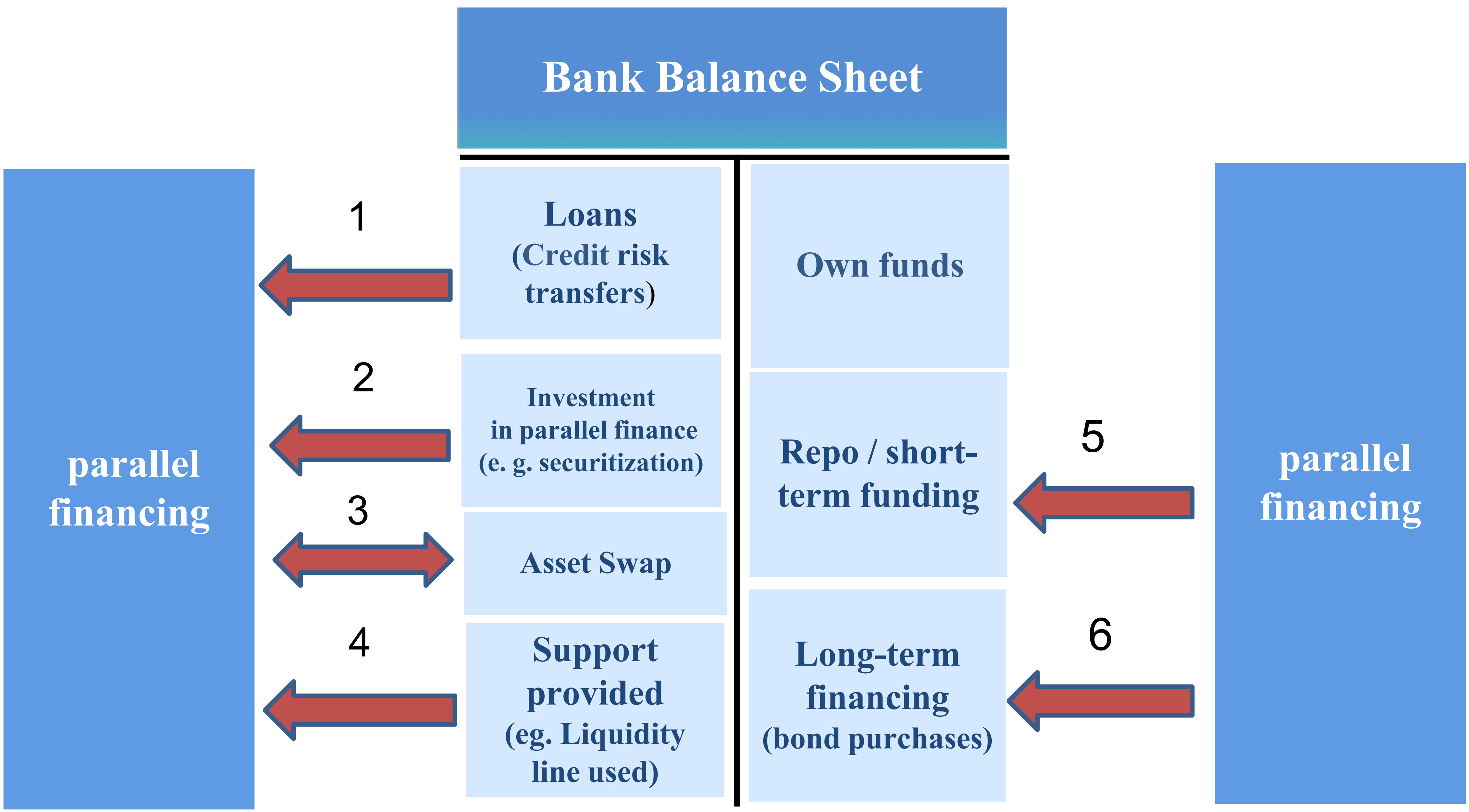
Source : FSB - Global Monitoring Report on Non-Bank Financial Intermediation 2018 - 4 February 2019

2.

Non-bank finance: What are the inherent risks?

Maturity transformation	Liquidity transformation	Resorting to leverage	Imperfect transfer of credit risk
? Financing by debt of long-term assets (corporate bonds) ? Refinancing risk: difference between the maturity of liabilities and that of assets	? Financing of illiquid assets (loans) by liquid liabilities (securities issued by the entity) ? Liquidity risk: Inability to quickly convert illiquid assets to cash to meet a large number of redemption requests	? Use of the differential return between investments and debt to increase the return on equity ? Spreading risk: Amplification of the consequences of mass buyback phenomena	? Credit enhancement of a securitization transaction by providing financial support from the selling bank to the securitization vehicle ? Credit risk: the guarantee granted to the selling bank causes the bank providing the guarantee to bear a credit risk

3. Non-bank finance: risks related to interactions with the banking sector



4. Non-bank finance: the responses from regulators/supervisors (1/6)

From a supervisory point of view, 3 approaches can be used to regulate the risks posed by non-bank finance and interconnections with the banking sector:

- Extending the scope of banking regulation: broadening the definition of credit institutions or applying a regime comparable to non-bank finance ;
- Directly applying measures to non-bank finance, adapted to their features, different from those applied to the banking sector yet regulating risks;
- Implementing regulations on interconnections between the banking sector and non-banking finance, to limit or deter linkages, thus reducing systemic risk within the financial system as a whole.

Regulations

- **Finance companies in France**

- **Money market funds**
- **Securitization**
- **Loans and borrowings**

- **Own funds requirements**
- **Consolidation**
- **Large risk rules**

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Non-bank finance: the responses from regulators/supervisors (2/6)

All credit transactions should be regulated

- Financing the economic activity includes a risk element to financial stability (the best example is the origin of the sub-prime crisis)
- Since 1984 in France, a banking institution = deposits **or** loan
- European texts (CRR/CRD) do not enable such an approach:

  Banking institution = deposits **and** loans
- French decision to maintain institutions that grant loans without deposits in the regulated field

  Restricting the scope of non-bank finance
- Position of "finance companies" for consumer financing, leasing, factoring, etc....

  A regulation similar to the one prescribed for banks

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Non-bank finance: the responses from regulators/supervisors (3/6)

Reducing the risk of massive redemptions of money market fund units

Investment diversification rules

- money market funds may not invest more than 5% in a single type of asset issued by the same issuer. The limit is set to 100%, under certain conditions, when the assets are issued or guaranteed by certain national or supranational sovereigns

Concentration rules

- A money market fund should not hold more than 10% of the money market instruments issued by the same entity (an exception being introduced for sovereign and quasi-sovereign issuers)

Liquidity rules

- At least 10% should be daily maturing assets.
- At least 20% should be held in weekly maturing assets (number reduced to 15% during negotiations)

4 Non-bank finance: the responses from regulators/supervisors (4/6)

Increasing transparency and standardization of information given to investors regarding securitization

Simplicity	Transparency	Standardization
Criteria referring to the homogeneity of the underlying assets with simple characteristics and a transaction structure that is not too complex	Criteria that provide investors with sufficient information on the underlying assets, the structure of the transaction and the participants involved to provide a better understanding of the risks involved	Criteria to help investors understand their investments and allow for a simpler comparison between securitizations of the same asset class

Lower capital requirements in the case of STS securitization

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4 Non-bank finance: the responses from regulators/supervisors (5/6)

Reducing the risks associated with the use of securities and repurchase agreements

- Securities financing transactions must be reported to central data repositories;
- Information on the use of securities financing transactions and swaps must be disclosed
- Framework for the reutilization of financial instruments delivered as collateral with three conditions:
  - information to the counterparty providing the collateral on the risks and consequences of its reutilization;
  - necessary agreement of this counterparty providing the collateral;
  - transfer of reused financial instruments from the account of the counterparty providing the collateral.

4 Non-bank finance: the responses from regulators/supervisors (6/6)

Reducing interactions between banks and non-bank financial entities by limiting the risk induced (step-in) by the support a bank decides to provide to an entity in a difficult position, despite the absence of a legal or capitalistic link:

- Encouraging banks to assess their external links and to quantify, for entities with step-in risk, the potential impact in terms of liquidity and capital for appropriate risk management;
- Being simultaneously followed-up by the supervisor;
- Enforcing a capital surplus measure, when a step-in risk is identified;
- Extending the supervisory framework used to measure and control significant exposures (high-stake risks) to non-bank financial entities

A few words of conclusion

- Non-bank finance responds to investors' will to diversify risks related to the banking system, offering them an alternative to low-interest bank deposits and providing the real economy with alternative financing methods that can meet the specific needs

- The diversity of actors and methods of intervention in non-bank finance calls for appropriate responses

- In terms of credit intermediation, banks maintain objective advantages to assess, manage and hedge risks

Thank you for your attention

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