

## **Transcription of the shadow banking lecture delivered by Olivier Klein at the Economic Summit held in Aix-en-Provence on 9 July 2011**

### **Philippe MABILLE**

Olivier Klein, you're both Board Member and CEO of the BPCE Group, responsible for Commercial Banking and Insurance. You're thus in a great position to offer an opinion on shadow banking as well as on the regulatory framework that will soon be applicable to banks. I'm speaking obviously of Basel III, its advantages and disadvantages.

### **Olivier KLEIN**

I'll also address my comments as an economics professor, which will allow taking a certain distance from my line of work so as not to be accused of defending bankers!

My feeling is that when discussing the topic of shadow banking, in reality we're focusing on the relationship between regulations and circumventing regulations. Let me propose two very summary approaches. From my point of view, regulation is necessary since markets are incapable of practicing self-regulation under all circumstances. As such, we've been experiencing repeated speculative bubbles in the financial markets, along with the risks of runaway credit. Since both these trends tend to reinforce and maintain each other, the result is systemic risks that must be contained, especially preventively, through regulation.

Yet at the same time, once this statement has been accepted as fundamentally important, once the recurrence of market failure has been recognised, we're still not able to justify all regulations as being good, and by that I mean relevant, appropriate and effective in all situations. Regulations can also fail. Let's frame this assessment in the following dialectic: regulation vs. circumvention of regulation, and excessive regulation vs. inadequate regulation. From this perspective, what is the right dose of regulation?

As regards shadow banking more specifically, this sphere is basically defined as those entities or activities operating outside the traditional banking system and beyond the scope of prudential regulation, yet which nonetheless still act like banks. It goes without saying that we're targeting here the special vehicles created for purposes of securitisation in whatever form (conduits, SPV and the rest) as well as hedge funds. Put concisely, this is what falls under the heading of 'shadow banking'.

These hedge funds and special vehicles operate like unregulated credit brokers, non-banks so to speak, which generate potential systemic risks by transforming fund maturities outside of a regulatory framework (medium- or long-term loans via short-term financial resources) or as a result of assuming credit risk through the use of uncontrolled levers. Moreover, a regulation arbitrage may be conducted, which winds up facilitating, for example, the appearance of offshore centres.

As part of this race between regulation and deregulation, Basel I and Basel II gave rise to the need for securitisation in order to develop banking activities while optimising the quantity of required capital. This process however had not been controlled in any serious way, which, within the financial system, typically led to the possibility of creating (and bursting) bubbles or else assuming credit risks that normally would not have been absorbed inside banks, had they not been eligible for outsourcing by banks and then resold in the market via securitisation.

In France and throughout continental Europe, we have not been confronted with a run of deposits. The financial crisis has its roots mainly in securitisation; so much complexity was introduced with the CDOs, the CDOs squared and then cubed. When it all blew up and the risk assumed was considered poor, no one knew how this risk could be measured or, for that matter, who was actually holding it. Moreover, securitisation as it was conceived (all too often without much in the way of control) introduced a significant moral hazard in the behaviour of banks or at least certain banks. Since the securitisation process involved absolving the lending banks of all risk, the criteria for awarding loans were considerably weakened, particularly among U.S. banks. European banks on the continent securitised their loans to a much lesser extent and preserved their loan award criteria, based on clients' income stream or future cash flows and not on a subsequent evolution in the price of assets being financed. Monitoring, which constitutes a normal banking function of tracking and supervising client activity in order to avoid excessive indebtedness, has also slackened tremendously since the risk had been removed from balance sheets and was no longer on the books of the issuing bank. This effect would make it possible for banks to maximise their profitability within the scope of regulations imposed by Basel I or Basel II.

Along the same lines, with securitisation, the leverage effects could be raised to infinity, with for some special vehicles absolutely none of the institution's capital being placed at risk. Furthermore, these same vehicles did not have to abide by any rules governing liquidity risk management, thanks in particular to issues of ABCP (Asset-Backed Commercial Paper). Assets were being financed by very short-term refinancing operations, and this was applicable to loans that could be written for very long terms. The liquidity crisis spawned from

the fact that the asset base of these vehicles remained unknown. Since they carried long positions and for some were being refinanced over the very short term, investors abruptly stopped lending, causing the liquidity crisis to become severe. Given that many banks had granted refinancing back-up lines to these vehicles, all of a sudden the liquidity risk and risk of overvalued assets, both of which had been taken off banks' balance sheets, re-emerged. Banks had to generate liquidity from these SPV (Special Purpose Vehicles), meaning reincorporate them into their balance sheets. All of this was thrust back onto the banks like a boomerang with massive destabilising effects that regulators had not at all anticipated.

A word on hedge funds. For them, the risk is of the same type, meaning that they have not raised the regulatory amount of capital to conduct market transactions. Since Basel II, banks must be sufficiently capitalised in order to limit the associated risks. Hedge funds thus engender a concentration of market risks with leverage effects capable of reaching colossal proportions. Yet banks were lending heavily to hedge funds, leading once again to a systemic banking risk due to the relations between hedge funds and banks.

LTCM, that was back in the 1990's. As a matter of fact, during 2008-2009, hedge funds on the whole were well managed and only experienced very slight bankruptcy activity. It cannot be stated therefore that the crisis originated with hedge funds, even though the potential for systemic risk remains present via the closed-loop relationships I described previously.

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Basel III offers responses to these phenomena. The new regulation seeks to account for past failures, but in my opinion with a highly ineffectual approach. Moreover, Basel III introduces even more possibilities for engaging in shadow banking and likely creates the need for it.

The new obligations relative to offshore centres and hedge funds found in Basel III strike me as falling short. For nearly all offshore centres, tax information transmission agreements now have to be signed. For hedge funds, recording requirements are now in place, yet still no regulation has been adopted on capital holdings or liquidity transformation. It would be necessary to verify in practice whether these recording obligations actually provide regulators with control authority.

On the other hand, I feel that these regulations offer a stronger response in avoiding the moral hazard tied to securitisation in Europe and in an unforeseeable future in the United States, banks will be required to hold 5% of the RWA (Risk-Weighted Assets) of their securitised assets. You're aware that this value reflects the amounts of assets held and

weighted with respect to their risk. Once banks have securitised assets or loans, they'll be required to keep 5% in RWA terms, which means retaining capital holdings that correspond to these risks. I find 5% to be on the low side, but at least it's a start to overcoming the moral hazard, since banks engaged in securitisation operations will be required to consider that they're holding a portion of the risk stemming from the assets they've securitised.

The liquidity ratio is another modification introduced by Basel III, inasmuch as all lines of credit granted to special vehicles by banks will have to be integrated at 100% within these ratios. This condition will serve to improve recognition of the boomerang effect on bank balance sheets. Basel III also insists on better monitoring of the lines granted to hedge funds.

Furthermore, though the new regulation is able to correct some of these points, I still feel that Basel III will wind up increasing the development potential of shadow banking. Why is this so? It can't be assumed that Basel III will have an effect of simply reducing bank profitability and that the financing of economies will continue, notwithstanding, along this course without modification. In reality, the cost of bank credit activities is increasing, as a result of the requirement for greater capitalisation. The new liquidity ratios adopted will, in one way or another, interfere with lending. When these two phenomena are coupled, banks will be more heavily constrained in their lending activity. In many instances, Basel III, like for the insurance industry, tends to favour financing States rather than financing companies or individuals. If we continue along this path, we'll be subjected to severe restrictions in financing the actual economy. This prospect will no doubt lead to further increases in securitisation since for a bank one of the best responses to Basel III will be to move towards greater securitisation. Here we're left with a somewhat paradoxical situation since securitisation, while admittedly misguided, was one of the causes of the 2007 financial crisis.

Private equity carried by banks and insurance companies will be reduced to the suitable proportion, given that it has been so heavily penalised in the solvency ratios of banks and insurers. This change will provide room and opportunity to other market actors.

The economic functions, even of banks, are being affected, given that the reality of a bank's economic utility is to act as the intermediary between those agents with financing capacity and those seeking financing (especially small and medium firms, professionals and individuals), with the banks assuming the credit risk themselves instead of the lending agents. These new ground rules address a problem of information asymmetry between lenders and borrowers that the financial markets are only able to solve for large borrowers. The bank's other purpose is to oversee this transformation since the economic agents involved in investments prefer short-term investments while agents who borrow, when

building (companies for their productive investments, households for their residences, etc.), prefer to borrow long. If banks are forcibly prevented from behaving in this way, which is the way banks are supposed to behave and thus fulfil their economic function, then apparently other actors will step in.

I'd like to conclude with just a couple of words. Regulation is beneficial, and even essential. Yet a dialectic exists with regulation and regulation avoidance. Then comes the problem of how best to dose regulation: too much vs. not enough. Excessive regulation can suppress risk appetite and favour circumvention because, under all circumstances, risk is helpful to the economy. It would be preferable for these risks to be assumed by professionals under regulatory control. As regards this specific issue, I feel that regulators must exhibit a strategic behaviour when implementing regulations, with fewer details and more strategy. A healthy dose of strategy is in fact needed to counter the temperamental behaviour of actors subjected to regulation and of those trying to outmanoeuvre the regulator. With such a framework, which calls for introducing a macro-prudential regulation in addition to its micro-prudential counterpart along with a strategic behaviour adopted by regulators, we may just reach long-term efficiency and enhanced security in the banking and financial system.