Reply to the European Commission’s Green Paper on Shadow Banking

Introduction

EIOPA welcomes the opportunity to respond to the European Commission’s Green Paper on Shadow Banking. EIOPA believes the Green Paper is a good starting point for preparation on how to apply the global recommendations by the Financial Stability Board in the European Union. Below, EIOPA would like to reply to selected questions more linked to the insurance area.

EIOPA stands ready to further support and advice the European Commission in its future work on shadow banking.

Definition of shadow banking (question a and b)

EIOPA agrees with the European Commission in using the FSB definition of the shadow banking system as a basis of the discussion. However, a definition which takes as a starting point all credit intermediation which involves entities and activities outside the regular banking system seems to be rather general. It therefore risks including entities and activities which are already supervised and regulated and pose little additional risk to overall financial stability. EIOPA concurs with the FSB’s view that traditional insurance business would typically not fall under the definition. As any definition of the shadow banking sector will have consequences for the resource allocation within supervisors and within the European System of Financial Supervision, it is essential that the definition accurately captures activities which are currently not properly regulated or not subject to effective supervision.

In particular, EIOPA believes that it is important to further analyse the potential merit of including certain activities by insurance companies in a definition of shadow banking. In considering these activities, it is important to recognise that they typically constitute a small part of the activity of the insurance sector and do not constitute core insurance business. It is also important to distinguish insurers’ investment activities from credit intermediation. A central part of insurers’ core activity is investments in bonds (e.g. sovereign or corporate bonds), but also investing in other credit related assets. This activity does not constitute credit intermediation, even though it does expose insurers to credit risk. This is not shadow banking as understood by reference to the FSB definition. Against this background, EIOPA has identified some activities for
which it believes further consideration of whether they should fall within the shadow banking definition, is required.

First, there are certain insurance business lines that are directly related to the credit intermediation channel, namely credit insurance and surety business. While these constitute insurance business, they facilitate the operation of the credit channel.

Second, insurance undertakings are engaged in a certain level of credit intermediation in the form of mortgage lending and, in some jurisdictions, direct lending to corporates, and this activity may be relatively widespread in some countries. There are also cases of limited indirect lending following as part of an overall investment strategy.

Third, in some jurisdictions some life companies have, in the past, offered so-called “geared property funds”. Such funds involve the raising of “equity”, which is then combined with borrowing, often from a related bank, to invest in commercial property.

Finally, some insurers engage in limited securities lending and repos. It is not unknown for this activity to include rehypothecation (i.e. reuse of collateral).

In such cases, the activity is outside the banking sector, but is regulated and is part of the supervision of the entities concerned. EIOPA believes that it is essential to acquire a better view of the nature, extent and riskiness of such activities before any indiscriminate definition is applied, also considering the role of unit-linked products. EIOPA at the same time agrees that even if shadow banking activities are carried out by regulated entities, their activities in this area should still be monitored to identify possible systemic risks. This would imply that it might be beneficial for any new regulation to relate to specific shadow banking activities and not immediately to specific types of institutions.

Against this background, EIOPA believes that it would be valuable to analyse how a definition of the shadow banking system could take into consideration the risk posed by the activities and not only the activities themselves. One approach may involve basing a definition on a multiple set of factors, including maturity/liquidity transformation and degrees of leverage. A useful definition of the shadow banking system would appropriately guide the allocation of resources, whereas an indiscriminate definition may prove counterproductive to the aim of financial stability.

**Current measures already taken (question k)**

As noted in the Green Paper, the EU has already adopted measures to regulate shadow banking entities and activities. For the insurance sector in particular, Solvency II addresses a number of concerns by providing consistent economic risk-based solvency requirements across EU/EEA for the first time. Taking a total balance sheet approach, Solvency II will ensure that all entities irrespectively of

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1 It should be noted that the activities (mortgage insurers, trade credit insurers and financial guaranty insurers) falling under this term have very different risk characteristics. The FSB is currently still considering the appropriate degree of differentiation.
the legal structure will be subject to group supervision. Although improved supervision cannot be understood to offer any guarantee against future losses within the sector, especially if insurers are entering into new or unfamiliar activities, Solvency II will enable a better supervision and understanding of the risks run by any particular insurer.

However, it is worth considering if the different regulation in banking (CRD IV) and insurance (Solvency II) creates incentives for shadow banking activities in insurance or in conglomerates. In particular, the assessment of new regulations should take into consideration the possibility that they drive some entities or activities to the shadow banking sector.