LUPICINIO
INTERNATIONAL LAW FIRM

ARTICLE

PRACTICE AREA **NOVEMBER 2014**

The Crisis and Momentum of Shadow Banking within the Framework of the Draft Law on Corporate Finance

ANA MUÑOZ
Of Counsel, Lupicinio International Law Firm

1. The Draft Law on Corporate Finance

The recently approved Draft Law on the promotion of corporate finance incites companies within our country to be independent of the need to obtain resources from credit institutions. With the intention to continue seeking solutions for companies, particularly SMEs, and to obtain funding by casting excessive dependence on credit from banking entities aside, last July the legislator presented the Draft Law necessary for the regulation of various aspects with aims to aid corporate financing via alternatives to the banking system. Recently approved by the Congress of Deputies, it is now being passed on to the Senate.

The effects of banking have been certainly been felt by the Spanish economy in recent years. The Preamble notes that the crisis has been exacerbated by restrictions on the volume of credit by financial institutions, along with a parallel increase in its cost. This seems to affect SMEs in particular, mainly due to the lack of information about their solvency, making it both difficult and expensive to carry out the necessary risk assessment prior to financing.

It is hence intended to break the Spanish tradition of being very dependent upon bank financing, in terms of both its investment needs as well as its current operations. SMEs constitute the largest percentage of the Spanish business world and are, as a whole, the country's principal employers, so a restriction on access to bank credit, stemming from problems initially of a strictly financial nature, will of course have a significant impact upon the entire economy. The role of SMEs in a developed economy such as ours is not exhausted by its contribution to the growth of national income, consumption or the generation of employment, but also makes a statement on welfare and the country's social and economic stability. With this objective, the new legal text aims to improve financing channels for companies, especially SMEs. This means making access to credit more flexible, particularly credit which circulates through alternative routes; and channeling savings into investment through more flexible instruments. This set of objectives contributes to the promotion of so-called 'alternative banking'.

2. The Concept of Shadow Banking

Brokerage activity in credit has traditionally been reserved for certain entities. Alongside them, new non-banking intermediaries, characterized by obtaining new resources through alternative routes - not capturing funds through deposit contracts or similar -, performing similar duties with economic advantages and representing a useful means of alternative financing, however also not without risk for the economy.
The term "shadow banking" includes all economic activity characterized by generating additional sources of financing and offering investors alternatives to bank deposits.

These entities achieve similar financial results to bank credit via alternative routes. As the European Community points out, shadow banking activities can play a useful part within the financial system, as they may include any of the following functions: i) offering investors alternatives to bank deposits; ii) channeling resources into specific needs in a more efficient manner, thanks to better specialization; iii) providing alternative funding for the real economy, particularly useful for when traditional banking or market channels or suffer temporary problems; and iv) representing a potential source of risk diversification outside of the banking system.

But the exercise of this activity **could prove to be a potential threat** for long-term financial stability.

Risks can be concentrated within the following factors. Firstly, financing structures similar to deposits can lead to massive withdrawals of funds. They may have a high level of leverage in reusing collaterals several times and thus increasing the fragility of the financial sector and becoming a source of systemic risk. Operations can be performed with the intention to avoid the regulation or monitoring applied to regular banks, fragmenting the traditional credit intermediation process in legally independent structures that negotiate amongst themselves. Regulatory fragmentation generates a race to the bottom on regulatory matters throughout the financial system as a whole, as banks try to imitate the entities of this parallel banking system or move certain operations to entities outside their scope of consolidation. The rupture of the financial system of these entities may affect the banking sector.

It can be confirmed that entities involved in such activity can generate systemic risk, through which a common concern arises for the monitoring of its operation. It wishes to prevent entities from acting which do not correctly internalize the risk that the development of financing functions they assume generates in the market. Traditional financial institutions would not be able to compete with these new activities as the financial liability of the risk requires them to maintain less advantageous conditions from an economic point of view. Through an effective monitoring system it is intended to prevent the actions of regulatory arbitration and close the branches of financial activity to the shadow banking sector on these grounds.

3. Protective Measures

The legislator proposes a series of measures which are sufficiently flexible and adaptable for entities to be able to take into account the continuous innovations and vicissitudes of the financial system.

The first measures are proposed in conjunction with the intention to regulate banking and insurance activity. The novel securitization structures can be monitored by new regulations that prevent banks from evading capital requirements and other legislation in force, such as that which imposes liquidity for entities with special purposes, those in accounting or risk retention requirements. This package of measures includes the proposal to expand new entities and activities in order to gain wider coverage, addressing issues of systemic risks and in the future making regulatory arbitration, under which banking business and banking-related activities are derived, more complicated.
It is also possible to extend to shadow banking entities certain rules of banking discipline itself,

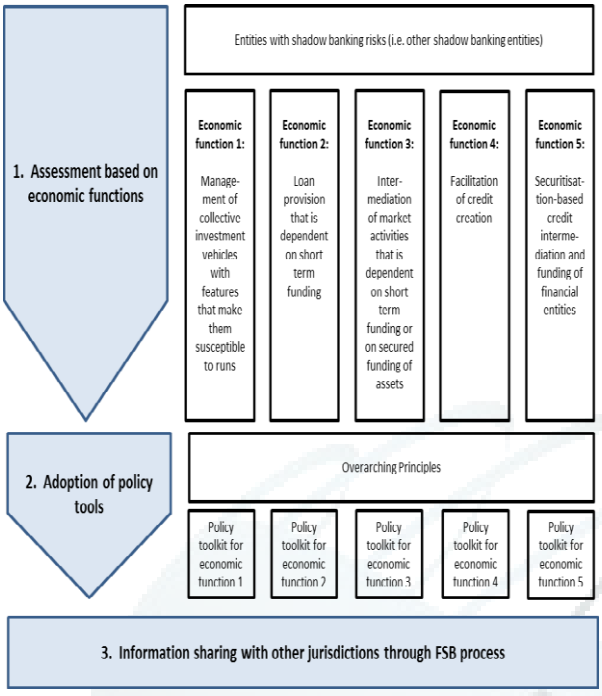
such as issues relating to the *regulation of assets, securities lending and buy-back transactions, securitization* and other entities within the shadow banking system.

As for the matter of *assets*, the regulation affects exhange-traded funds, for which the FSB has detected a possible discrepancy between the liquidity offered to investors in these funds and underlying, less liquid assets. The debate now focuses on the problems of liquidity such as the quality of securities offered in securities lending and derivatives transactions (swaps) between the valued investment funds suppliers and their counterparties; and in the conflicts of interest that arise when the counterparties to these transactions belong to the same group of companies. As far as the regulation of securities lending and buy-back transactions is concerned - activities that lend themselves to the realization of leveraged investments – the legislator is proposing control measures. The Commission's proposal pays attention to the global leverage resulting from securities lending transactions, from the management of securities and buy-back transactions in order to ensure that supervisors have the accurate information to evaluate this leverage and the tools to monitor it and avoid excessive pro-cyclical effects.
The measures should be effective in the field of securitization activity. In this context the committee is exploring ways to take similar measures from other sectors, such as transparency, standardization, retention and accounting requirements.

Regarding other entities, the legislator intends to establish certain steps: on the one hand, to devise a list to determine which entities shall be included to establish supervision and regulation rules for those that exist; on the other hand, it aims to identify loopholes in the regulation, to then ultimately go on to propose additional prudential measures for these entities. Amongst the possible entities that may eventually carry out the activities contemplated within the environment of shadow banking activity are: firstly, the *special purpose entities that perform maturity transformations and / or liquidity*; e.g. securitization vehicles as conduits for asset backed commercial papers (ABCP), structured investment vehicles (SIV) and other special purpose entities; secondly, *money market funds* (MMFs) *and other types of funds or investment products* with similar characteristics to deposits, which make them vulnerable to massive and simultaneous withdrawals of deposits. Thirdly, *investment funds, including exchange traded funds* that provide credit or are leveraged; fourthly, *financial associations and securities firms which provide credit or credit guarantees*, or perform maturity transformations and / or liquidity without being regulated like a bank; and finally, the *insurance and reinsurance companies* that issue or guarantee credit products.

Nevertheless, faced with the difficulty of categorizing the entities widely engaged in this credit intermediation activity, outside of the traditional channels of credit measures, measures proposed on the basis of classifying entities in terms of the economic activity they perform will be adopted.

With this strategy the entities are classified according to the risk generated by the activity they perform:



4. Measures to Encourage and Monitor Alternative Sources of Finance in Spain in the Proposal of the Law on Corporate Finance

4.1 General Considerations

The Draft Law on corporate financing contemplates the adoption of various measures with the aim of facilitating new ways to finance SMEs. Along with measures to boost SMEs' access to bank credit by reforming the legal system of mutual guarantee associations - through which the re-endorsement provided by the Spanish Refinancing Company for these societies is amended -, Title II includes a new legal regime for credit institutions which is motivated by the recent adoption of the Law 10/2014 of 26 June, on the management, supervision and solvency of credit institutions which, in turn, incorporates European regulations in terms of the solvency of Spanish credit institutions.

4.2. Financial Credit Establishments

By adapting to this new regulation, financial establishments lose their status as credit institutions but their inclusion within the scope of strict financial supervision and regulation remains intact. The Preamble clarifies that it aims to promote the development of these financing channels, very important especially for retail consumer financing.

4.3. Securitizations

The context of these regulations favours the growth of financing through securitization. The outbreak of the global financial crisis in 2007 led to the virtual interruption of the use of this instrument and the new legal text is once again proposed to boost its performance.

The securitizations that we already mentioned are bundles of loans that banks group into financial vehicles with the capacity to issue bonds in the financial markets. Traditionally, these loans should have a real estate asset as an underlying guarantee, but now this demand is changing and will allow the *securitization* of loans where the guarantee is a loan for an SME. The Ministry estimated that in Spain there would be some 235,000 million available to be securitized and apparently also available for purchase by the European Central Bank. For this reason, financial institutions will have more incentive to lend to SMEs, as in exchange for these loans may obtain liquidity from the ECB.

With the aim of promoting its use, the legislator defines in the Preamble *securitization* activity as the activity that transforms a set of illiquid financial assets into tradable and liquid instruments that generate cash flow on fixed schedule. The legislator reports that in the period of economic growth, *securitization* grew in Spain at a higher pace than in other neighbouring countries, making our country one of the largest issuers of such securities in Europe. The reform of the *securitization* scheme, contained in Title III, is articulated around three main points in line with international trends, intended to increase transparency, quality and simplicity of *securitization* in Spain.

The Draft Law proposes to combine in a single text the existing regulatory dispersion in the Spanish legal framework on *securitization*, to ensure consistency and systemizing within all the provisions that regulate this area, providing greater clarity and legal certainty to the regulatory framework. Thus the proposal is to unify into a single legal category the hitherto so-called *securitization* funds of assets and mortgage *securitization* funds with a transitory phase of implementation for existing mortgage *securitization* funds at the time of entry into force of the law.

Secondly, the operation of these instruments is made flexible and the obstacles preventing the replication in Spain of certain innovative *securitization* strategies proven to have been successful and useful in neighbouring countries are erased. Finally, the requirements on transparency and investor protection are substantially strengthened in line with the best international practices, and functions to be fulfilled by management companies that, in any case, will

include the administration and management of assets grouped in securitization funds will be established, subject to the impact on the securitization fund of the expenses that apply, according to the articles of association.

4.4. Crowdfunding

With the aim of promoting the efficiently channeled supply of financing to the productive sector and to the real economy, financing mechanisms that favour greater diversification of sources of financing for Spanish companies are created. For this reason, Title V provides for the first time a legal regime for participatory financing platforms, encompassing the activities commonly known as crowdfunding. These platforms, which constitute a novel mechanism of financial disintermediation developed on the basis of new technologies, have grown significantly in recent years. Crowdfunding is a phenomenon with many manifestations, although it is only intended to regulate the figures which prioritize the financial component of the activity or, in other words, those in which the investor expects to receive a cash payment for their participation, therefore leaving crowdfunding which is instrumented through purchases or donations outside the scope of this regulation. Participatory financing platforms put project promoters requiring funds through issuing securities and shares or borrowing in contact with fund investors and bidders seeking a return on their investment.

In this activity two characteristics stand out, which are a) the mass participation of investors that finance small projects with reduced amounts of high potential and b) a risky investment nature. While it might be thought that it is small investors who finance projects on these platforms through accumulation, international experience suggests that professional investors, here called 'accredited investors', are also taking a stake in participatory project financing, providing platforms which lend a useful service for filtering potentially viable projects.

The Draft Law addresses this phenomenon threefold. Firstly, it *establishes the legal regime of entities know as participatory financing platforms*. Secondly, it *regulates and reserves such activity for authorized entities*, in the interest of strengthening the development of this sector and, in time, safeguarding necessary financial stability, coinciding therefore with the principles of necessity and proportionality under the Act 20 / 2013, of December 9th, on the market unity guarantee. Consequently, such a requirement responds to the principles of necessity and proportionality referred to in Article 5 of Law 20/2013, of December 9th.

Thirdly, and finally, it *clarifies the rules applicable to agents using this new financing channel*. The purpose consists, on one hand, of clarifying the regulation which should already be applicable today, as well as, on the other hand, adjusting it for the sake of the delicate balance between a regulation which enhances this activity and one which at the same time guarantees the investor an adequate level of protection. Participatory financing platforms have certain requirements for authorization and registration with the National Securities Market Commission. In terms of operational activity, this regulation is based on the objective of ensuring the neutrality of participatory financing platforms in the relationship between investors and promoters. What should also be emphasized is the prohibition of offering services such as financial advice, which would draw the platforms closer towards other entities already regulated and supervised. In any case, it must be made clear that investment in these projects is inherently risky both because the promoter may be unable to repay or compensate the funds received, and also due to the fact that the platform, in its role as mediator and notwithstanding its due diligence, does not at any point guarantee the solvency or viability of the promoter. However, given that it is not possible to eliminate the risk that investors face with promoters, the regulation provides the former with the tools to at least be able to mitigate and manage these risks. In this regard, measures are established

such as limits on the volume that each project can gain through a participatory financing platform, limits on the maximum investment that a non-accredited investor can make and requirements for the reporting of information so that each investment decision may be duly substantiated. Additionally, as it happens with investment services rendered in relation to complex financial instruments, it will be required, notwithstanding the corresponding signature of the investor, to have a statement by the same confirming that he has been duly warned of the risks. Thus is assured the combination of a conscious and knowledgeable will on the decision to invest funds in assets that are high-risk, yet with high yield potential.

Finally, it should be remembered that participatory financing platforms open a new channel through which the promoters, sometimes considering the consumer, can apply for financing. Considering that part of consumer financing could be channeled through this new phenomenon, it is appropriate to amend and clarify the applicable regulation ensuring an equivalent level of protection, whilst taking into account the singularity that applying for financing from a large number of investors involves. Finally, it must be said that the legislator cannot look back on the certain fact that new technologies allow natural and legal persons residing in one territory invest in another overseas. Therefore, this law does not prevent investors and promoters who are based in Spain from accessing platforms that provide services outside of national territory, but does indeed clarify the terms on which this passive marketing can occur without being subject to the rules of this law.

4.5. New Powers of Supervision for the National Securities Market Commission (CNMV)

The Draft Law includes an amendment in Title VI on the powers of the National Securities Market Commission in order to reinforce their functional independence and strengthen their supervisory powers for the sake of better performance in its duty to ensure transparency of the securities markets, the correct formation of their prices and the protection of investors. For this purpose, it is granted new powers, like the ability to use innovative instruments for monitoring and dictating technical guidelines which although lacking a directly linked nature, are configured as an instrument of great help to guide the industry on how best to comply with increasingly complex and meticulous financial legislation. Moreover it will receive the full powers of authorization and revocation of entities operating in the securities markets and of imposition for very serious offenses, which hitherto belonged to the Ministry of Economy and Competition.

FOR MORE INFORMATION

ANA MUÑOZ
Of Counsel
amunoz@lupicinio.com
+34 91 436 00 90