SOUTH INDIAN Bank
Experience Next Generation Banking

STUDENTS' ECONOMIC FORUM

To kindle interest in economic affairs...
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SHADOW BANKING SYSTEM (SBS)

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Theme No. 270 : SHADOW BANKING SYSTEM (SBS)

A well informed customer will make the policy makers as well as organisations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organisations and improve the quality of goods and services produced.

The "SIB Students' Economic Forum" is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the "Forum". A recent report released by FSB (Financial Stability Board), Switzerland says, the global shadow banking system, grew rapidly from $26 trillion in 2002 to $62 trillion in 2007.The size of the total system declined slightly in 2008 but increased subsequently to reach $67 trillion in 2012. We discuss this month about the shadow banking system.

What is the concept of Shadow Banking?

The shadow banking system is the collection of non-bank financial intermediaries that provide services similar to traditional commercial banks. It includes entities such as hedge funds, money market funds and structured investment vehicles (SIV). These institutions may conduct much of their business in the shadow banking system (SBS), but are not generally classed as shadow banking institutions. The core activities of these types of investment banks are subject to regulation and monitored by central banks and other government institutions - but it has been a common practice for them to conduct many of their transactions in ways that do not show up on their conventional balance sheet accounting and so are not visible to regulators. Prior to the financial crisis, many of the investment banks were engaged in mortgage finance through off-balance sheet securitization and hedged the risk through off-balance sheet credit default swaps. In short, shadow banking involves 1.Accepting short term funds with deposit-like characteristics, 2 Performing maturity and/or liquidity transformation, 3.Undergoing credit risk transfer; and, 4.Using direct or indirect financial leverage.

What is the size of SBS?

The volume of transactions in the shadow banking system grew dramatically after the year 2000. Its growth was checked by the 2008 crisis and for a short while it declined in size, both in the US and in the rest of the world. In 2007 the Financial Stability Board estimated the size of the SBS in the U.S. to be around $25 trillion, but by 2011 estimates indicated a decrease to $24 trillion. Globally, a study of the 11 largest national shadow banking systems found that they totalled to $50 trillion in 2007, fell to $47 trillion in 2008 but by late 2011 had climbed to $51 trillion, just over its estimated size before the

crisis. Overall, the world wide SBS totalled to about $60 trillion as of late 2011. In November 2012 Bloomberg reported an unexpected increase of the SBS to about $67 trillion. Shadow banking business in India is estimated at nearly Rs. 37 lakh crore, which accounts about one percent of the worldwide total.

Briefly describe the history and origin of SBS?

The term "Shadow Banking System" refers to credit intermediation that supervenes outside the traditional banking system and entails maturity or liquidity transformation. It is a system in which non-financial institutions borrow money in the short term and take that money to invest in long term assets outside the regular banking system. As per a report released by Bank of International Settlement (BIS) large banks which are closely inter-wined with the regulated system, typically draw substantial income from shadow banking activities and retain both direct and indirect credit and operational exposures to them through business lines such as loan origination, credit enhancements, back up liquidity lines, brokerage services warehousing and credit insurance. The full extent of the shadow banking system was not widely recognised until the paper was published in 2010 by Manmohan Singh and James Aitken of the International Monetary Fund. The work showed that when the role of re-hypothecation was considered, in the U.S. the SBS had grown to over $10 trillion, about twice as much as previous estimates. During 1998, the highly leveraged and unregulated business failed and was bailed out by several major banks at the request of the government, which was concerned about possible damage to the broader financial system. In the years leading up to the crisis, the top four U.S. depository banks moved an estimated $5.2 trillion in assets and liabilities off their balance sheets into special purpose vehicles (SPVs) or similar entities. This enabled them to bypass regulatory requirements for minimum capital adequacy ratios, thereby increasing leverage and profits during the boom but increasing losses during the crisis.

What is the role played by Shadow banks in the financial system?

Like regular banks, shadow banks provide credit and generally increase the liquidity of the financial sector. Yet unlike their more regulated competitors, they lack access to central bank funding or safety nets such as deposit insurance. In contrast to traditional banks, shadow banks do not take deposits. Instead, they rely on short-term funding provided either by asset-backed commercial paper or by the repo market, through the mechanism of selling the security to a lender and agreeing to repurchase it at an agreed time in the future for an agreed price. Shadow banks can be involved in the provision of long-term loans like mortgages, facilitating credit across the financial system by matching investors and borrowers individually or by becoming part of a chain involving numerous entities, some of which may be mainstream banks. Due to their specialized structure, shadow banks can sometimes provide credit more cost-efficiently than traditional banks. In the US, prior to the 2008 financial crisis, the shadow banking system had overtaken the regular banking system.

What are the risks associated with shadow banking?

As shadow banks do not take deposits, they are subject to less regulation than traditional

banks. They can therefore increase the rewards they get from investments by leveraging up much more than their mainstream counterparts and this can lead to risks mounting in the financial system. Unregulated shadow institutions can be used to circumvent the strictly regulated mainstream banking system and therefore avoid rules designed to prevent financial crises. As shadow banks use a lot of short-term deposit-like funding but do not have deposit insurance like mainstream banks, a loss of confidence can lead to "runs" on these unregulated institutions. Shadow banks' collateralised funding is also considered a risk because it can lead to high levels of financial leverage. By transforming the maturity of credit—such as from long-term to short term—shadow banks fuelled real estate bubbles in the mid 2000s that caused the global financial crisis when they burst. Shadow banks can also cause a build-up of systemic risk indirectly because they are inter related with the traditional banking system via credit intermediation chains, which means the problems in this unregulated system, can easily spread to the traditional banking system. Economist Paul Krugman said a run on shadow banks was "the core of what happened" to bring about the global financial crisis of the late 2000s.

Which are the major areas of risks identified by FSB (Financial Stability Board)?

Not withstanding the complementary role played by shadow banks to the banking system, their activities, on the flip side, create risks which can assume a systemic dimension, due to their complexity, cross jurisdictional nature, as well as their interconnectedness with the banking system. The risks emanating from shadow banking could be primarily of four types viz., (i) liquidity risk, (ii) leverage risk, (iii) regulatory arbitrage and (iv) contagion risk.

- ***Liquidity risk*** – This is one of the most common risks faced by shadow banks, as these entities undertake maturity transformation i.e., funding long term assets with short term liabilities. The risk of ALM mismatch leading to liquidity problems is quite high. In India, we had a situation during the height of global crisis in 2008 when some NBFCs ran into severe liquidity problems as they were using short term liabilities such as CPs (commercial paper) and NCDs (Non-Convertible Debentures) to fund their long term lending or investment. I will be discussing this issue in detail a little later.
- ***Leverage risk*** – As shadow banks do not usually have prudential limits on borrowings, they can become highly leveraged. High leverage exacerbates the stress in the financial system and the real economy during the downturn adversely affecting financial stability.
- ***Regulatory arbitrage*** – Credit intermediation is, traditionally, a banking activity. Regulations applied to banks in this regard can be circumvented by transferring components of the credit intermediation function to shadow banks which are subject to less stringent regulation. Transfer of risks outside the purview of banking supervision played an important role in the build-up to the global financial crisis.
- ***Contagion risk -*** Shadow banking entities have close inter-linkages with the banking sector both from the asset as well as the liabilities side, and also with other segments of the financial system, which can lead to contagion risk in times of loss of confidence and uncertainty.

Which are the guiding principles for a regulatory framework to contain the risks in the context of overall financial stability?

The recommendation of G20 leaders on regulating shadow banks emphasises the need to increase regulation in areas like securitisation and money market funds and use registration requirements to ensure more transparency in others. The working group recommends to ensure the resilience of the NBFC sector and also to contain risks emanating from the sector for overall financial stability in India.

The guiding principles are

- Appreciating the contribution of the NBFC sector to the financial system and the economy and rationalising regulations to preserve the innovativeness of the sector.
- Recognising the need to address systemic risk arising out of concentration and exposure of NBFCs to sensitive sectors.
- Recognising that the NBFCs have the ability to leverage on the RBI registration and therefore, rationalising the scope of regulation to address risks appropriately.
- Conserving regulatory resources and directing them where required.
- Dealing with regulatory arbitrage while not recommending completely bank-like policies and regulation for NBFCs and
- Giving adequate transition period to the industry so as to cause minimum dislocation to the sector.

What are the positive aspects of shadow banking?

The shadow banking system offers credit and also provides liquidity and funding in addition to that provided by the mainstream banking system. Given the specialized nature of some shadow banks, they can often provide credit more cost-efficiently than traditional banks. The shadow banking system is very important for the economy because it provides funding to traditional banks and without this funding, traditional banks would not lend money, which would then slow growth in the economy. Shadow banking institutions like hedge funds often take on risks that mainstream banks are either unwilling or not allowed to take. This means shadow banks can provide credit to people or entities, which might not otherwise have such access.

What will be the effect of Basel III norms on SBS?

Basel III may also be adding momentum to the rise of the shadow banking system. Hedge funds, buy-out firms, unregulated investment funds and insurance companies are all providers of credit and transactions services provided by banks, but are not included under Basel III. There are very important signs to indicate that they have been fast in spotting the opportunity to step in. Acting as "shadow banks," these entities are free to use their investors' money and seek wholesale funding to engage in direct lending and other banking services without being subject to Basel III rules on capital and liquidity. Shadow banks are also reportedly targeting smaller businesses that "are too large to visit their local bank but too small to attract the attention of the bond market".

Growth in Total Assets of Banks vis-à-vis NBFCs

Item	As at end					
	2007	2008	2009	2010	2011	2012
Banks	3459961	4326486	5241330	6025141	1835227	8299400
Growth (Y-o-Y)		*25*	*21.1*	*15*	*19.2*	*15.5*
NBFCs	366452	478997	560035	657185	866713.7	1038189
Growth (Y-o-Y)		*30.7*	*16.9*	*17.3*	*31.9*	*19.8*

Source: Trend and Progress of Banking in India, various issues

Note: NBFCs include all deposit taking NBFCs and NBFCs-ND-SI

Proposals for reducing systemic risks in Shadow Banking

- ***To mitigate the spill-over effect between the regular banking system and the shadow banking system***
- ***To reduce the susceptibility of money market funds (MMFs) to "runs"***
- ***Recognising the need to address systemic risk arising out of concentration and exposure of NBFCs to sensitive sectors.***
- ***To assess and mitigate systemic risks posed by other shadow banking entities.***
- ***To assess and align the incentives associated with securitisation.***

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in

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