Intelligence MEMOS

From: Jeremy Kronick and Wendy Wu

To: Canada's Financial Regulators

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Re: **Shadow Banking Is Growing up and Needs Adult Attention**

Canada's financial services sector weathered the 2007-08 credit crunch better than those in many other developed countries.

One explanation was the smaller size of our shadow banking sector, formally the "non-bank financial intermediation" (NBFI) sector.

Now, however, rapid shadow banking growth suggests this resilience might be under threat. What does that mean for monetary policy, financial stability and regulation?

As it turns out, a lot.

Broadly speaking, the shadow sector includes investment funds, private lenders like mortgage finance companies, companies that offer private-label securitization like asset-backed securities, and more. Unlike conventional banks, they don't take deposits and make loans.

They instead split their operations into different entities. An NBFI might operate a money market mutual fund, for instance, selling shares to investors and using the proceeds to buy money market securities issued by lenders (also part of NBFI) that in turn use the money to make various investments, including lending to Canadians.

These institutions managed $1.5 trillion – about 10 percent of total financial assets and 34 percent of total assets of all deposit-taking institutions – at the end of 2017 according to a recent Bank of Canada report. The sector's share of overall financial activity hasn't actually grown. But in absolute terms its assets have doubled since 2005, growing 30 percent between 2015 and 2017 alone. It's now too big to ignore.

These financial institutions provide much-needed competitive alternatives for both depositors and borrowers. But both because they aren't as closely regulated as banks and because deposit insurance doesn't cover their liabilities they might increase overall risk in the financial system. If an NBFI goes down, the damage to the system may well be greater than it was when the shadow institutions were smaller.

In some recent research we tried to determine whether the shadow sector might hinder the Bank of Canada in hitting its 2 percent inflation target, and if so, why and how that might in turn affect financial stability.

The story of how monetary policy affects the real economy goes something like this: the Bank of Canada surprises markets with a hike in the overnight rate, causing an increase in the cost to banks of providing loans, which lowers the supply of credit available in the broader economy, which in turn slows spending, investment, and the economy at large.

That's the traditional bank story. How might the shadow sector change the story?

In fact, growth in NBFIs makes a real difference to the effectiveness of monetary policy. Though hikes in the overnight rate do still slow down credit growth, some of that credit now shifts away from traditional banks and toward NBFIs. As funding costs increase for banks, households and businesses move to the shadow sector instead.

The upshot is that both the traditional monetary policy tool of hiking the overnight rate, and the more recent addition of tightening mortgage underwriting standards, may have the unintended side effect of encouraging NBFI growth and reducing the effectiveness of monetary policy.

These results matter both for the Bank of Canada's conduct of monetary policy and for regulating the overall system to ensure financial stability. In trying to judge the likely effects of a given interest rate hike, the Bank therefore needs to take the shadow sector into account.

For financial regulators, this points to several options. They could require NBFIs deemed systemically important to hold a similar percentage of capital on their balance sheets as traditional banks must. That might moderate the flight of credit to the shadow sector. Another option would be closer regulatory scrutiny. Canada does not have a single prudential regulator in charge of systemic risk. It does, however, have four co-ordinating bodies that involve key regulators, including the Bank of Canada, OSFI (the Office of the Superintendent of Financial Institutions), the Department of Finance, and provincial securities regulators. Shadow banking should be an important part of discussions among these co-ordinating bodies.

Though NBFIs do constitute a shadow sector, they are not actually shadowy financial institutions. They operate in the open and provide much-needed choice and competition in Canada's financial system. But the bigger they are, the bigger the harm they can do if they fail. It's our fault, not theirs, if we don't keep that in mind and act accordingly.

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