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Taking the Shadow Banks out of the Shadows

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The Sylvia Ostry Lecture, Presented to the C.D. Howe Institute

Thank you for inviting me to deliver this year's Sylvia Ostry Lecture. I was involved in the early years of this event when Bernard Ostry asked me to chair the foundation which he endowed for this purpose. My job then was to seek out as speakers, former colleagues and great admirers of Sylvia. This was an easy job for me and we attracted a prestigious group of presenters, reflecting the status that Sylvia had earned over the years. I feel very honoured to be in their company and am delighted that Sylvia is here today.

I chose as my topic, Shadow Banking, since for many it is a misunderstood banking sector of the financial services industry, in large part because of its name. It connotes shady people, doing shady things in the shadow of the highly regulated commercial banking sector.

In fact, it is nothing of the kind. In large part, it plays a positive role complementing the activities of the regulated banks and supporting many useful activities and players in the economy. Indeed, the Bank of Canada refers to shadow banking as "market-based finance" to avoid the pejorative connotation.[1]

What is Shadow Banking?

Simply speaking, the Financial Stability Board (FSB)[2] defines shadow banking as the extension of credit from entities or activities which are outside the regulation perimeter for banks. Others are a little more expansive. The C.D. Howe Institute's Finn Poschmann, for example, defines it as "financial intermediation, credit and

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1 I have drawn information for my comments from recent work by the International Monetary Fund, the Financial Stability Board (FSB) and an article in the Bank of Canada Financial System Review by Toni Gravelle, Timothy Grieder and Stéphane Lavoie.

2 The FSB is an international body that monitors and makes recommendations about the global financial system. Its members are the G20 central banks and Departments of Finance, and major public international financial institutions and regulators.

liquidity provision and maturity transformation undertaken outside the regulated banking sector or on its fringes." The latter definition suggests, correctly, that in practice, there is a bit of a symbiotic relationship between the shadow banking sector and the regulated banks. Because of the increased regulatory burden on the banks, they have grown to be less flexible and innovative in meeting the credit demands of changing economies. And at the same time, the shadow banking sector is responding to these demands and the regulated banks are playing a strong supportive role to the shadow banking sector by providing funding to a wide range of participants in the banking sector and in some cases, distributing their securities.

At this point it might be useful to draw some comparisons with the traditional banking sector. For their part:

- Banks draw much of their funding from their deposit base which tends to be more passive in times of stress and is protected in part through deposit insurance.
- Banks have mandated capital and leverage requirements.
- Banks have access to the lender-of-last-resort facility of the central bank.
- Banks are subject to ongoing supervisory guidance and stricter regulation.

Moreover, much has changed to strengthen the traditional banking sector since the 2008 global financial crisis so it is fair to conclude the overall financial system is much safer today than it was at the time.

The shadow banking system hasn't been subject to these same regulatory and system changes. But let me make the obvious point that a safer traditional banking sector is of great benefit to the shadow banking sector.

Who Does this Business?

There is not a straightforward answer to that question, since as the FSB suggests, the definition of shadow banking can involve entities or activities. Some participants are entities like money market funds, hedge funds, private equity funds, pension funds or financial services companies that do bank-like business. The common thread through all of these entities is that they fall outside the formal prudentially regulated banking sector.

Another approach to the definition relates to certain credit intermediation activities that may be carried out by banks or non-banks like mortgage-backed securities and other securitized vehicles, commercial paper, repurchase agreements (repos), money market funds or plain mutual funds. These activities fall outside what might be considered traditional deposit and loan-based banking and, in large measure, these have not had the safety net of the formal system nor the formal prudential requirements that accompany it.

So by either an entity or activity definition, it is clear that shadow banks do many good things that are quite complementary to the regulated system and enhance the credit intermediation and provision of other financial products needed for a healthy economy. But by definition, they carry a higher risk profile.

In today's economic and financial conditions there are a number of opportunities for shadow banks to continue to grow, although not necessarily in those areas which led to trouble during the crisis. Interest rates are historically at very low levels. This provides favourable funding opportunities for shadow banks but also for shadow banking activities, particularly securitized investments and various bond funds. These low rates also encourage investors to "reach for yield" which the formal banking sector is more constrained in providing. Greater regulation, higher capital requirements and leverage constraints are also pushing some activities, which banks would otherwise be keen to do but no longer find attractive, into the shadow bank sector.

Traditional banks have also become more risk averse since the crisis, resulting in weaknesses in credit availability in certain banking sectors. Corporations are taking advantage of attractive debt and equity market performance to obtain long-term or permanent capital from non-bank entities.

This combination of factors has provided the shadow banking sector with good opportunities for growth on favourable terms.

How Big is the Shadow Banking Sector and What is the Recent Growth Profile?

The banking sector globally, according to the Financial Stability Board (FSB) constitutes about one-quarter of total financial intermediation. So it is big enough to disrupt the financial system as we saw in the crisis. The shadow banking sector is also significant in size, but rather than throw a lot of figures at you let me put this into perspective.

The relative size of the shadow banking sector varies considerably in different regions of the world. Shadow banking as a percent of GDP is 160 percent in the US, 190 percent in Europe, 360 percent in the UK, 85 percent in other advanced economies, and 30 percent in emerging market economies. These numbers have been fairly stable over the past few years with the exception of the UK, where the percent of the GDP has grown from slightly in excess of 200 percent in 2006 and 2007 to the current figure.

Shadow banking as a percent of banking assets also shows a relatively stable picture in recent years but, notably, the figure for the United States, ranging from 170 percent to 200 percent in recent years, is considerably higher than for other countries, whose figures range from about 30 percent to 60 percent. Since the overall financial sector has grown considerably, the absolute size of the shadow banking sector is large and forms an increasing portion of systemic risk.

What these broad numbers do not show is the changing composition of the assets. In Canada, the growth period leading up to the 2008 crisis was driven by fairly uniform patterns in the major banking sectors. However, this balanced pattern changed significantly going into the crisis. Since 2007, asset-backed commercial paper (ABCP) not surprisingly has fallen sharply, as have money market funds. Mortgage-backed securities have generated almost all of the growth since, rising from about 20 percent of total assets to 60 percent, while other components have held roughly constant or declined, although not proportionately as much as ABCP and money market funds.

I am not going to take you through the performance of the banking subsectors in other regions. I will simply make the point that for better understanding of the financial sector, awareness of the dynamics within these subsectors is important. The macro data may well appear benign from a risk standpoint while a fast-growing subsector may be demonstrating higher risk symptoms.

What is more difficult to obtain are numbers reflecting the liability side of the balance sheet. Anecdotal evidence would suggest that leverage has built up in recent years and that, in some cases, the asset/liability mismatch has increased.

Obviously this is not an issue with pension funds and insurance companies because their liabilities, for the most part, are very long term. But asset and fund managers who are exposed to the possibility of withdrawals or redemptions and have illiquid assets are in a potentially difficult position in times of capital market volatility or crisis as we saw in 2007-08. Indeed, in the US, runs related to money market mutual funds and the tri-party repo market, in which post-trade processing is outsourced by the parties to a third-party agent, were at the epicentre of some of the difficulties. There is the further question of the credit quality of the assets acquired by shadow banks, which can vary considerably depending on the business model.

I mention these factors since they are all components of the risk profile of the shadow banking sector. In addition, the data are not as timely or as granular, either on an entity or activity basis as in the case with the regulated banks. And for the most part, the sector is not subject to the continuing supervisory or regulatory oversight similar to the traditional banks. So risks can build without warning.

Let me make a brief observation here. The size of the Canadian shadow banking sector is not as large in relation to our economy or the regulated banking sector as in other countries. The assets involved are subject to less credit risk. For example, for most of the securitized banking sector, largely involving *National Housing Act* (NHA) mortgage-backed securities and Canada Mortgage bonds, there is a federal government backstop. And the entities active in the banking sector are typically more conservative in management style than is the case in other countries.

Having said that, our banking sector is not immune to risk. The risk factors in shadow banking are no different than those which have precipitated financial crunches in the past. These same risks are also faced by prudentially regulated banks but to differing degrees.

1. First, credit quality. There is a now a tendency for traditional banks to improve the quality of their balance sheets in the wake of the crisis, moving away from lower quality assets, which in turn are being taken up by the shadow banks sector.
2. Second, leverage. The shadow banking sector business model is not dissimilar to that of traditional banks. They must have an element of leverage to support their profitability. This will normally lead to a maturity mismatch: a combination of short-dated liabilities and longer term illiquid assets. This is not a problem in normal times when interest rates are low and funding is readily available. Indeed, the current very low rates may encourage an increase in leverage.
3. Third, concentration of players. There has been a consolidation of entities in the shadow banking sector on the one hand and natural organic growth of these larger units on the other. These larger entities benefit from their capability to gather assets on a more efficient basis than their smaller competitors.
4. Fourth, concentration of decision-making. This concentration in the banking sector can lead to less diversity in decision-making as market expectations in these larger entities transcend an array of asset classes.
5. Fifth, potential of runs. There is a growing tendency of individual investors to reach for yield in the current low interest-rate environment. This can reverse quickly when credit or market circumstances change as these investors tend to follow the crowd.

The combination of these factors, which tend to feed on one another, leads to a higher risk environment as we move to more challenging markets.

Government authorities must watch for a trend towards a combination of lower quality, less liquid assets and increasing leverage. These factors can lead to runs as investors, both institutional and retail, change their investing patterns as financial markets tighten – a flight to quality similar to situations we have seen in the past.

So what is the role of regulators in the shadow banking sector?

The recent IMF report covering shadow banking makes the point that "policy makers must strike the right balance between containing systemic vulnerabilities to risks while preserving the benefits of shadow banks." A key factor in this consideration is the interconnectedness of the shadows to the traditional banking sector.

The FSB has also devoted a significant amount of attention to shadow banking in recent years. It has developed five general principles for regulatory measures, as follows:

- **FOCUS:** regulatory measures should be carefully designed to target the externalities and risks the shadow banking system creates.
- **PROPORTIONALITY:** regulatory measures should be proportionate to the risks shadow banking poses to the financial system.
- **FORWARD-LOOKING AND ADAPTABLE:** regulatory measures should be forward-looking and adaptable to emerging risks.
- **EFFECTIVENESS:** regulatory measures should be designed and implemented in an effective manner, balancing the need for international consistency to address common risks and to avoid creating cross-border arbitrage opportunities against the need to take due account of differences between financial structures and systems across jurisdictions.
- **ASSESSMENT AND REVIEW:** regulators should regularly assess the effectiveness of the regulatory measures after implementation and make adjustments to improve them as necessary in the light of experience.

A common theme running through these principles is the importance of comprehensive and granular data to be collected and disseminated both domestically and internationally. A good deal of data is available on a timely basis through regular reporting by publicly listed companies. In addition, the discipline of rating agency reporting is equally important. But this could be augmented by reporting from others in the banking sector.

These data could be analyzed and the changing nature of the risk profile of the banking sector could be assessed and publicly disclosed in a regular report by authorities. This would inform market participants of the environment they are facing or are expected to face.

At this stage, there is no established authority in Canada to perform this function.

I suggest this is something that the Bank of Canada could take the lead on as part of its responsibility for a sound financial system. It has the skill set to understand the changing risk profile. For some time, the Bank has been collecting very current economic data on a voluntary basis from the non-financial sector in order to identify early signals of change in economic activity. Extending this to the non-regulated financial banking sector is in the interests of both the Bank in its management of the system at large, as well as the shadow banking sector in so far as it gives management a broad overview of their sector.

This might well be done by the securities regulators but since there is no national body, the data and the analysis might not be consistent. In addition, they do not immediately have the capabilities necessary to do this work.

My conclusion is that the Bank of Canada is best suited to take the lead, collaborating with the Office of the Superintendent of Financial Institutions, the securities regulators and the Department of Finance. Obviously, the participants in the shadow banking sector would need to cooperate in this voluntary approach. With an explanation of what is proposed, including the public discussion that would build awareness of shadow banking activity, this should generate the necessary cooperation.

The FSB has also developed a policy toolkit on shadow banking that individual country regulators might draw upon to address any build-up in system risks or risks limited to particular activities or individual entities.

The components of this toolkit are in some cases quite intrusive. Some examples are:

- Limits on illiquid assets and asset concentration.
- Imposing restrictions on redemptions.
- Suspension of redemptions.
- Limits on liquidity and leverage.
- Increased retention of assets by originators of securitized products.

This is only a selection from the list, but I think that you will see that it could lead to regulating the non-regulated banking sector. This raises the question of proportionality. Following this FSB approach appears to me to run counter to the IMF principle of striking the right balance between containing system vulnerabilities to risks while preserving the benefits of the shadow banks.

The Canadian shadow banking sector currently does not pose any meaningful risk to the stability of the financial system. So let me draw on my observations to propose an approach Canada might follow, which is less intrusive and I believe quite compatible with the FSB recommendation:

- Collect data on entities and activities and fill gaps in existing data in order to give authorities a better understanding of the risk profile of the shadow banking sector and to identify the risk exposure of entities – for example through leverage build-up, asset/liability mismatch, credit quality deterioration – and shift to a greater reliance on funding from individual investors.
- Publish the data on a quarterly basis with a commentary on the degree of risk in various categories.
- Establish a more current dialogue with key large shadow banking entities in order to develop a better awareness of the activities of these players, convey to them concerns on any risk build-up in various segments of the banking sector and their own operations, and provide appropriate guidance.
- Share this information with key global counterparts, including the FSB.
- And, where appropriate, draw selectively from the the FSB toolbox those elements of guidance to advise the shadow banking sector where risk profiles have reached a worrisome stage and, in that way, help them manage their businesses.

Let me expand on this approach with some comments on two sub-sectors.

First, mortgage-backed securities (MBS). Since the assets that are securitized are NHA mortgages there is no credit risk. But there could be a maturity mismatch, leading to a potential liquidity concern. If this were the case, the degree of leverage could also be a meaningful risk factor. This could be a greater concern if the investors in the MBS vehicle were largely individual investors or if government reduced its support of the underlying security.

Second, commercial paper financing automobile receivables. The credit profile of the portfolio should be regularly monitored for deteriorating performance. There is likely to be a maturity mismatch with 30 to 90 day notes financing illiquid receivables of up to 5 years. Leverage levels must be monitored as well as the degree and source of liquidity support.

These two examples demonstrate the importance of monitoring both the activity and the entity. Since circumstances can change quickly, the data, particularly for the larger entities, must be current to be of use in guiding participants in the banking sector. Let me emphasize that I am not recommending new regulation for the shadow banking sector. I am recommending increased oversight including improved data collection compilation and publicly available analysis, together with the use of moral suasion or guidance to address signs of potential stress. The key objective is to avoid a crisis in the banking sector.

In conclusion, we must recognize that care must be taken to find the right balance between managing the stability of the overall financial system and providing the shadow banking sector with the flexibility to deliver their products and services in competition with the regulated banks.

Canada does not at this stage have a problem with its shadow banking sector. However, other jurisdictions, such as the US, and Europe, are in a more advanced stage of development of their shadow banking sectors. As a result, problems in these countries, with the likely contagion, would affect us. So we must be vigilant of the impact of this on our banking sector. And it is in our interest to support the FSB in its efforts to identify and contain risks in other jurisdictions by practicing policies in Canada which are compatible with its global efforts.

I believe that this would be a useful and responsible step forward to managing the shadow banking sector in Canada. It would help both the authorities and the banking sector in carrying out their responsibilities, and in so doing, it would contribute to taking shadow banking out of the shadows.