Structural changes in banking have paved the way for shadow banks

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Structural changes in banking have created space for new players on the financial markets. Weak economic growth, regulation, search for yield and technical innovations have facilitated growth in shadow banking. Even though the diversification of funding channels is to be welcomed, the growth of shadow banking entails risks that must be monitored. In Finland, the volume of shadow banking is small by international comparison.

Shadow banks play an important role

The term 'shadow bank' often evokes negative connotations. The importance of shadow banks on the financial markets is in many ways hard to understand. The negative connotations are heightened by the general idea that shadow banks played a significant role in the events leading to the financial crisis in 2008 and the onset of the crisis itself.

However, shadow banks are important for the financial markets. They increase competition and channel funds from savers to investors The shadow banking sector provides more extensive sources of funding and supports market liquidity, and it is also involved in risk transfer. Moreover, shadow banks can be significant entities in certain small and specialised markets where the traditional banking sector is not willing or able to operate. Shadow banks have also been significant sources of various financial innovations.

The Finnish shadow banking sector is small by international comparison, and the risks involved are currently low. Developments in the sector must nevertheless be monitored.

What are shadow banks?

There is no fully unambiguous definition of the term 'shadow banking sector', and the meaning of the concept may vary significantly between studies. The shadow banking sector consists of a diversity of entities, and, from the perspective of financial stability, their role may differ significantly. In its broadest sense, shadow banking refers to financial intermediation that takes place fully or partially outside the traditional banking sector.

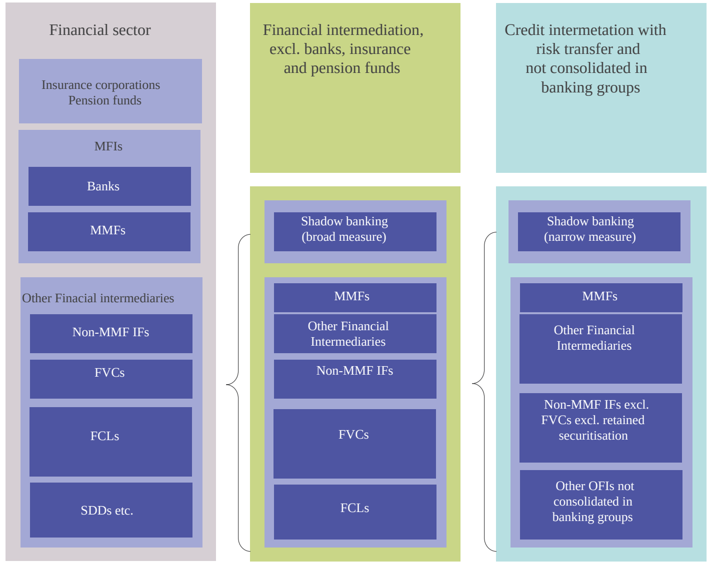
Shadow banks are not deposit banks, i.e. they do not accept deposits, but use other sources to fund their activities. As a rule, they are not covered by banking regulation, but are not necessarily weakly regulated. For example, the Financial Supervisory Authority supervises and regulates not only banks and insurance companies, but also investment funds and investment activities that are generally considered part of the shadow banking sector. Shadow banks do not have a public safety net (deposit guarantee and central bank liquidity) similar to that of the banking sector.

Like traditional banks, however, shadow banks can be a potential source of systemic risk, which is due to the large size of some of the entities and their strong interconnectedness with banks, other financial market entities and the real economy. Moreover, some shadow banks operate on the financial markets in the same way as banks: they convert short-term debt to long-term loans, and illiquid assets to liquid investment instruments, or transfer or diversify credit risks. Shadow banks are also again increasingly using leverage to finance their activities.

Several factors have increased the probability of the realisation of market and liquidity risk for shadow banks: the increase in illiquid investments such as loan portfolio investments, the growing popularity of exhange-traded funds (ETF), the general search for yield, correlation of investment strategies and the decrease in market-making. Particularly sensitive to changes in securities prices are those money market and investment funds from which assets can be drawn within a very short time. An abrupt and strong increase in redemptions may force funds to realise their investments rapidly which, in a crisis situation, could amplify price fluctuations further.

Chart 1

The Financial Stability Board’s definition of the shadow banking sector



Source: Financial Stability Board.

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Sector's role growing

The financial crisis, and the debt crisis that followed, have shaped the financial markets significantly. The banking sector, in particular, has for several years been undergoing major changes. The prolonged difficulties in the operating environment, regulatory changes, the search for yield resulting from the low level of interest rates, and technical innovation have changed the competitive landscape on the financial markets in recent years.

The decline in banks' business has seen some of the banking and payment business taken over by the other financial sectors. The growing volume of market finance is being channelled, via the shadow banking sector, to e.g. the consumer credit market, corporate bond and loan markets, real estate markets or stock markets. According to estimates by Goldman Sachs, the US banking sector is at risk of losing 7% of its annual profit to the shadow banking sector in the next 5–10 years.[1] According to the Financial Stability Board (FSB), the assets of the global shadow banking system in 2013 totalled USD 75 trillion, i.e. approximately 50% of the total assets of the global banking system.[2]

Volume of activity in Finland still small

Because there is no unambiguous international definition for the concept 'shadow bank',

1. Goldman Sachs (3 March 2015) The Future of Finance, part 1: The rise of the new shadow banking.
2. Financial Stability Board (30 November 2014) Global Shadow Banking Monitor Report 2014.

estimates on the size of the Finnish shadow banking sector differ considerably, depending on the entities covered. At its broadest, the definition of 'shadow banking' comprises the entire sector 'Other Financial Intermediaries'.[3] This sector includes entities that differ considerably and are outside the traditional banking sector, such as investment funds and alternative investment funds, peer-to-peer lending and asset management companies. This definition often also covers money market funds, which are part of the MFI sector; their inclusions is due to their nature as undertakings for collective investment in transferable securities (UCITS).

Not all the entities in the OFI sector are subject to regular statistical reporting, and it is therefore difficult to obtain comprehensive statistical data on the Finnish shadow banking system. Calculations of the scale of Finnish shadow banking exclude at least some real estate funds as well as entities involved in crowd funding and peer-to-peer lending.

According to the statistics, in December 2014 the assets of the Finnish shadow banking sector totalled EUR 132 billion. This is less than a quarter of the size of the banking system. Even though the OFI sector is small relative to the traditional banking sector, its pace of growth has in recent years exceeded that of the banking sector. Growth in banking sector assets in 2014 was mainly due to the higher book values for derivatives, whereas in the OFI sector, growth in assets was due particularly to the positive developments in share prices.

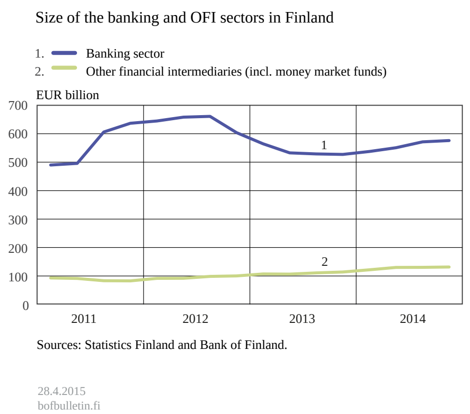

Chart 2

In Finland, the OFI sector is relatively small by international comparison, at approximately 65% of GDP. According to the Financial Stability Board, shadow banking sector assets globally represent approximately 120% of global GDP. Compared with Sweden, too, the volume of Finnish shadow banking is smaller: the scale of Swedish shadow banking is estimated at 90% of GDP.[4]

Entities included in the OFI sector are not always considered as being part of the shadow banking sector. Such entities include equity funds. In Finland, UCITS account for 70% of the OFI sector. Of this, over 35% is accounted for by equity funds. Investment funds are,

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3. The so-called OFI sector. Statistics Finland's Classification of Sectors 2012: S.124–S.127.

4. Sveriges Riksbank (2014) Sveriges Riksbank economic review 2014: 3.

however, not necessarily engaged in credit intermediation or other similar activities, as referred to in the definition of shadow banking.

The Finnish shadow banking sector is small, and the risks involved are currently low. This is partly due to the fact that in Finland, as in the Nordic countries generally, the banking sector accounts for the majority of activities that in other countries are taken care of by shadow banks. Nevertheless, developments in the shadow banking sector must be monitored closely both in Finland and internationally. Monitoring is important to ensure financial market stability, the transmission of monetary policy and the avoidance of regulatory arbitrage.

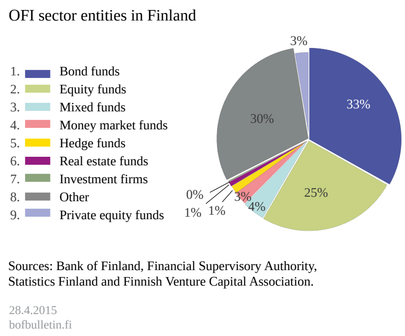

Chart 3

Tags

financial intermediation, shadow banks