Shadow Banking and Financial Stability

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Sinaia
November 2012

Outline

- **International focus on regulating the shadow banking system**
  - Reasons
  - Regulatory challenges
- **Shadow Banking in Romania**
  - Overall perspective
  - NBFI focus
  - Conclusions

Reasons for regulating the SB

Shadow banking has been placed high on the agenda for regulating bodies including the Financial Stability Board (FSB) and the European Commission (EC) as:

- The risks of the shadow banking system became apparent during the financial crisis, making it clear that this segment of the financial system requires greater attention.

- Since then, there has been a growing recognition that shadow banking system may pose even greater systemic risk than traditional banking, because its activities are exposed to similar financial risks but are not subject to the same degree of oversight and regulation.

- Moreover, the Basel III implementation may provide further incentives for banks to shift part of their activities outside the regulated environment → <u>activity will always flow to the less regulated sector</u>

What are the risks?

From a financial stability perspective the main risks of shadow banking are:

- the potential for excess leverage;
- amplification of procyclicality;
- the vulnerability to bank-like runs - without having liquidity requirements nor access to safety net, deposit guarantee schemes or to CB as lender of last resort;
- transmission of systemic risks - contagion effects due to market dynamics
  - interlinkages (ownership, financial rel.);
- regulatory arbitrage – SB activities may be used to circumvent the tighter regulation imposed on banking institutions;
- the reputational risk that shadow banking may entail for regular banks.

Does this mean shadow banking is bad?

It is widely agreed that financial intermediation outside the regular banking offers some benefits, and hence can represent a valuable part of the financial system as:

- Provides substitutes to bank deposits for large investors;
- Its specialized expertise enables to channel resources toward specific needs more efficiently;
- Represents an alternative source of funding for the real economy and contributes to economic growth;
- Also, provides funding and risk diversification through:
    - credit extension to certain sectors that might otherwise not have access to credit
    - a range of tools for liquidity, maturity and credit risk management

<u>Therefore the challenge for regulators is to maximize its efficiencies while minimizing its risks</u>

Defining shadow banking

- FSB (October 2011) broad definition: "*a system of **credit intermediation** involving **entities** and **activities** outside the regular banking system*".

- EC (*Green Paper, March 2012*): entities that "*operate outside of the banking system and engage in one of the following: accepting funding with deposit-like characteristics, performing maturity and/or liquidity transformation, undergoing credit risk transfer and using direct or indirect financial leverage*" and/or engage in activities that "*could act as important sources of funds for non-bank entities*", including "*securitisation, securities lending and repurchase transactions (repos)*" .

EU recent regulatory developments on shadow banking

❑ Direct regulation

- Alternative Investment Fund Manager Directive

❑ Indirect regulation

- Credit Rating Agencies (CRAs) regulation and reducing reliance on CRAs
- CRD IV and Solvency II

❑ Enlarging the scope of current prudential regulation

- MiFID review

Next steps towards strengthening the regulatory framework

- Based on the initial recommendations set out in the October 2011 Report, five workstreams have been launched by the FSB to develop policy recommendations in the following five areas:

  (i) Banks' interactions with shadow banking entities;

  (ii) Money market funds (MMFs);

  (iii) Other shadow banking entities;

  (iv) Securitization;

  (v) Securities lending and repos.

- Apart from this, the European Union is also working on legislative proposals that are expected to be presented till the end of 2012.

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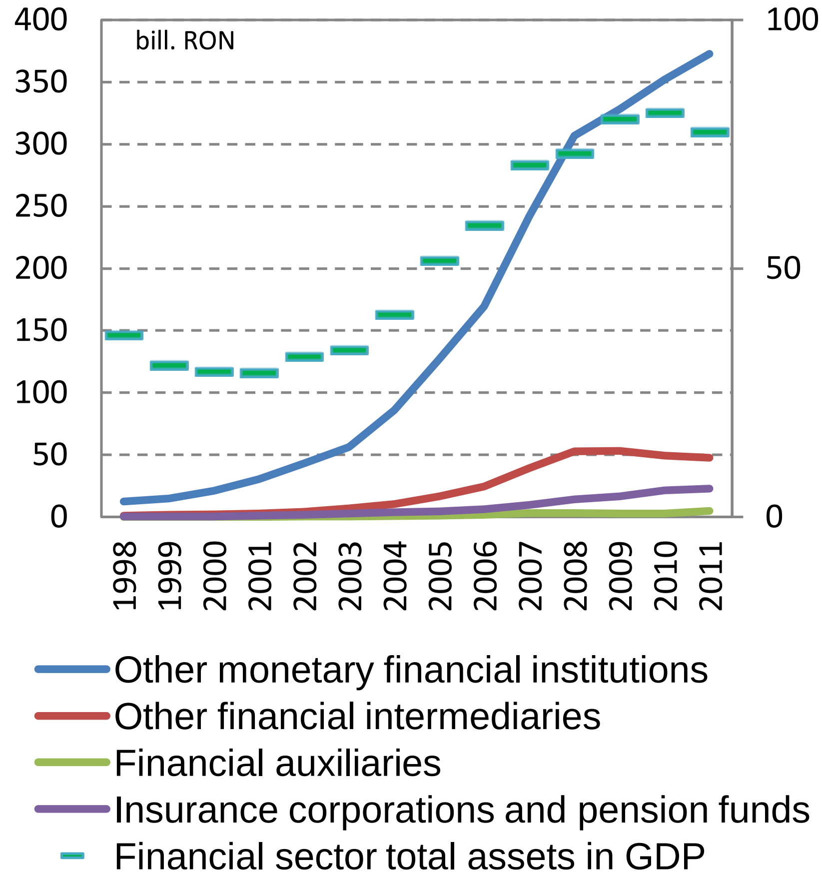
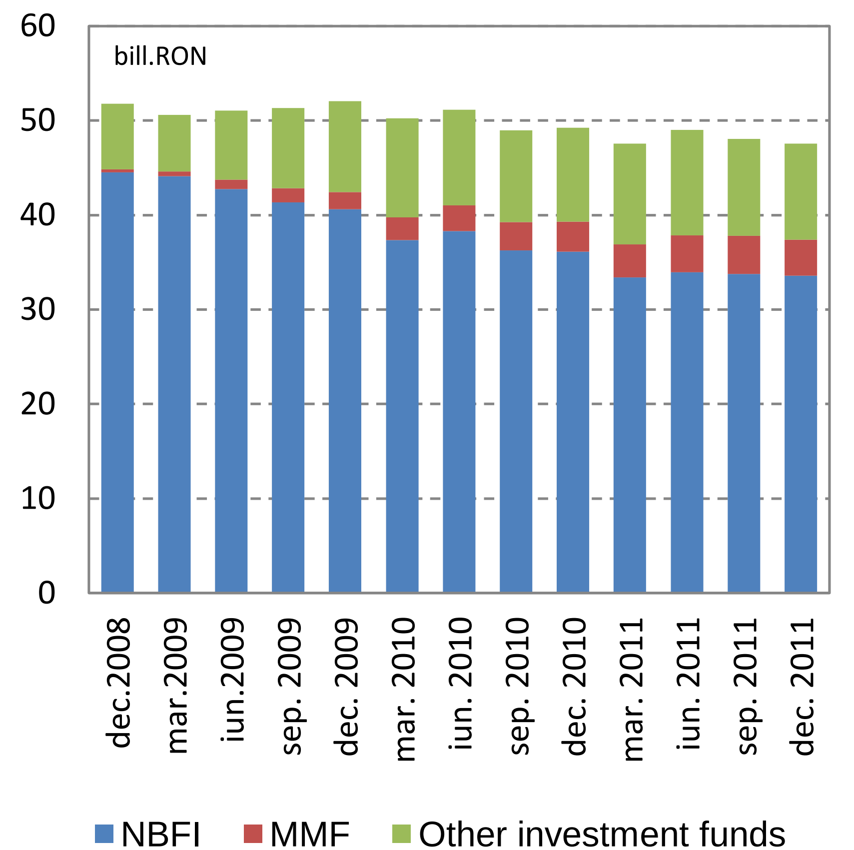
How large is the shadow banking system in Romania?

Chart 1. Overview of developments in the Romanian financial sector total assets



Source: NBR, Flow of Funds

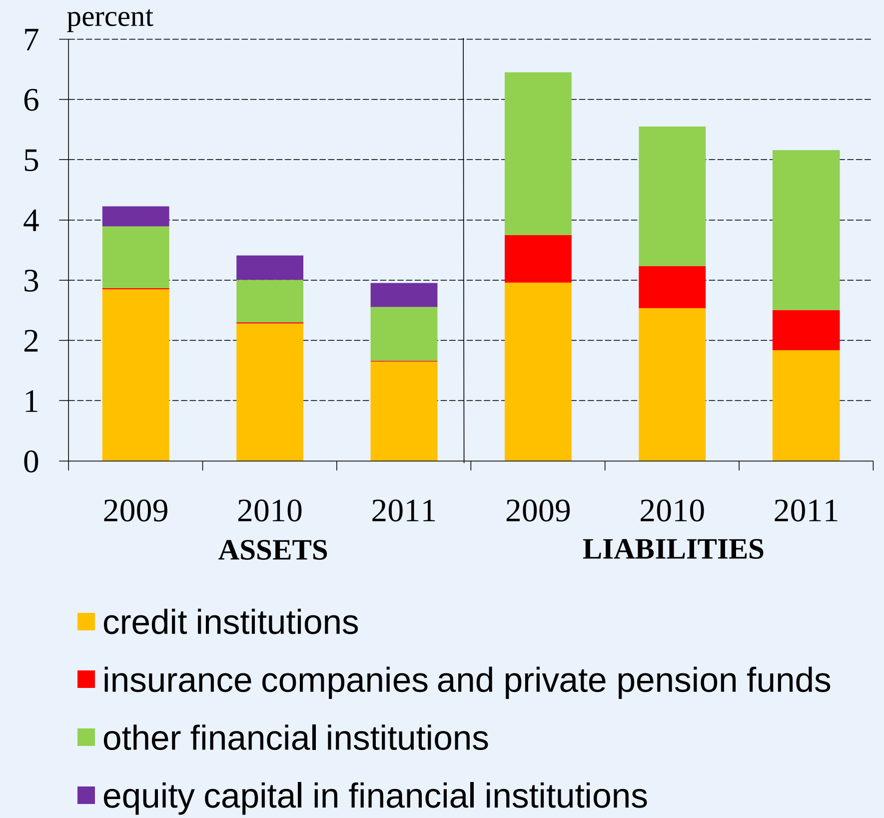
Chart 2. Developments in the non bank financial intermediaries sector (total assets)



Source: NBR, Monetary statistics

What are its interlinkages with the banking system?

Chart 3. Share of exposures and funds raised from domestic financial institutions in the balance sheet of credit institutions



Source: NBR

- Of particular importance from a financial stability view is were shadow banking intersects with regulated banking system.
- The small share of exposures to and funds raised from the domestic financial institutions in the aggregate balance sheet of the banking system points to a relatively low contagion risk threatening the financial stability.

Main components of the Romanian SB

Shadow banking in Romania is relatively simple. It does not involve long, complex or opaque chains of intermediation as it is often seen in advanced economies.

Mapping the shadow banking system:

- *Entities:*

  - Non-bank Financial Institutions (NBFI) – i.e. leasing, finance, factoring companies, guarantees granting funds
  - Money Market Funds

- *Activities:*

  - Repo – end of 2011 outstanding position 450 mil. EUR, most in the interbank markets
  - Securities lending - 53,2 mil. EUR between banks, 75 mil. EUR with OFI

NBR's monitoring of shadow banking

- **Direct Monitoring / Supervision and Regulation of NBFI**

- **Indirect Monitoring**

  The exposures and the funds raised by credit institutions from domestic financial institutions is aimed at identifying risk concentration that may have systemic effects considering the banking sector's importance to the Romanian financial system.

- **Macro-prudential Assessment**

  Financial Stability Report (FSR) assesses the stability of the overall financial system, including shadow banking.

Money market funds

- At the end of 2011, there were 14 MMFs, more than half of them being part of banking groups.

Asset structure of MMF		Holders of MMF units/shares	
Fixed income securities	54%	Households	73%
Term deposits	43%	Non-fin. companies	20%
		Institutional investors	7%

- Starting with February 2012 the MMF were reclassified to other investment funds categories.

NBFI: regulation and supervision

❑ Starting with 2006 the NBFI are regulated and supervised by the NBR with the aims to promote a sound credit growth in economy, increase transparency and strengthen financial stability.

❑ The oversight of NBFI are tailored according to the size and complexity of carried out activities:

- General Register
- Special Register
- Entry Register

❑ The current regulatory provisions require the NBFI to observe:

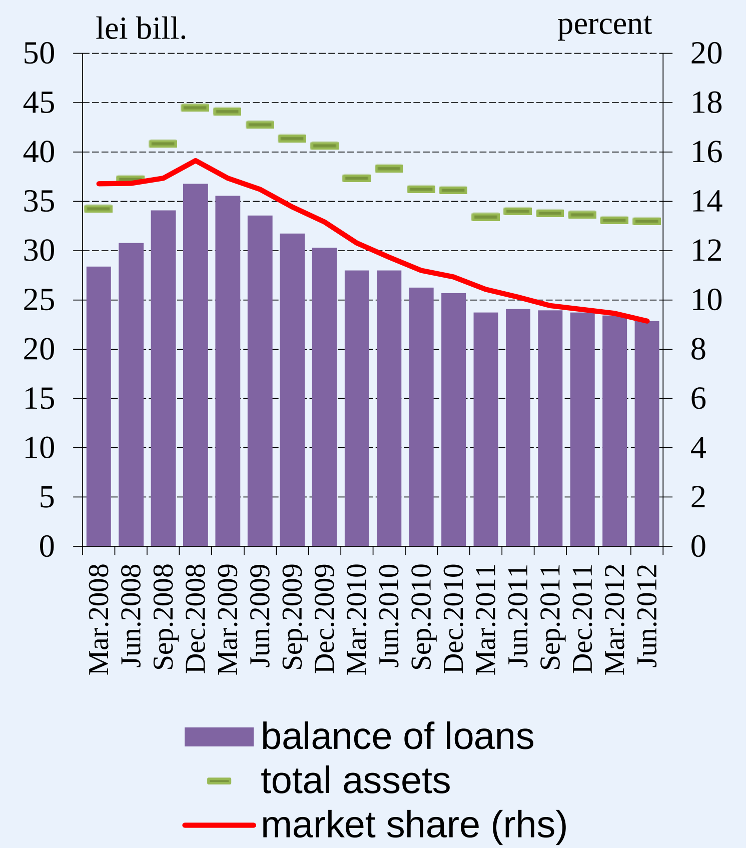
- Qualitative requirements (e.g. governance standards)
- Quantitative requirements (e.g. large exposure, provisioning, capital adequacy ratio)
- Credit granting rules – also applicable to credit institutions

NBFI: financial stability analysis

- In order to assess the soundness of the NBFI sector from a financial stability standpoint the following issues are considered:
- Developments: size, growth, concentration;
- Exposures: debtors, currencies, loan type;
- Risks and vulnerabilities: credit risk, currency and maturity mismatches;
- Leverage and funding structure;
- Financial results;
- Interlinkages with domestic credit institutions and systemic risks.

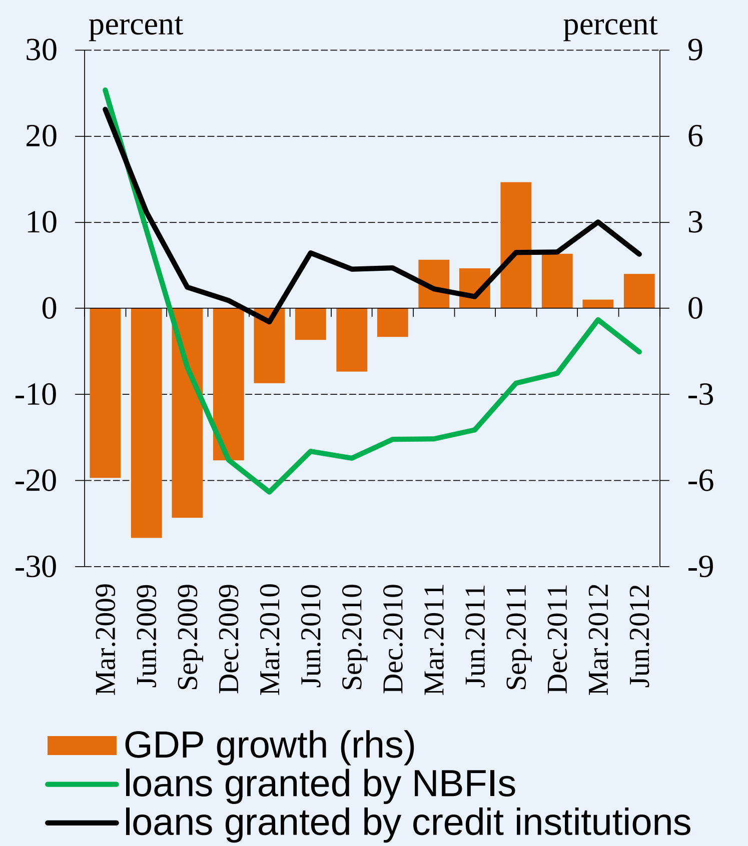
Credit intermediation outside the banking system

Chart 4. Developments in the NBFI sector



Source: NBR

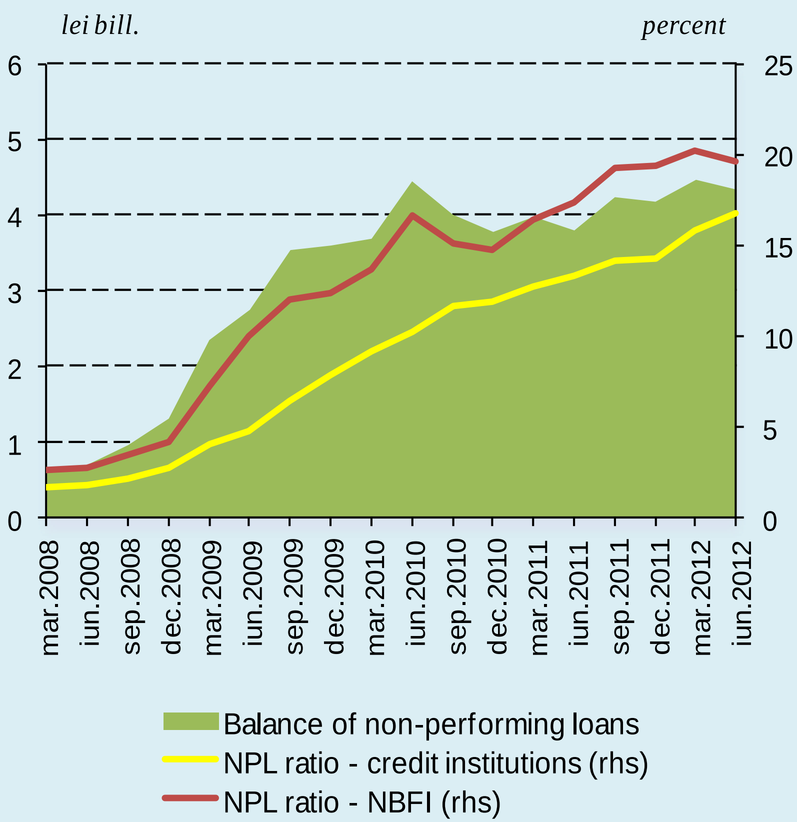
Chart 5. Loans and GDP dynamics (annual growth)



Source: NBR, NIS

Risks and vulnerabilities of NBFI

Chart 6. Non-performing loans



Source: NBR

- Credit risk is the main challenge for the entities in this sector. Loan portfolio quality continues to deteriorate, the NPL ratio rising above the level reported by the banking sector.

NBFI's funding structure

Chart 7. Breakdown of borrowings by country of origin

Source: NBR

- While domestic capital accounts for 56 percent of NBFIs' share capital, the liabilities breakdown points towards the marginal role played by local credit institutions in the sector's financing and the weight of resources raised from European markets.

Conclusions: Does SB in Romania pose systemic risks?

- Considering that shadow banking system in Romania is relatively small, potential risks emerging from this segment of financial sector are not posing systemic disruptions to the banking sector, neither to the real economy.

Focusing on NBFIs (the main component of SB):

- Although NBFIs conduct their activity especially with the entities affiliated to credit institutions, their financing resources are drawn particularly from external markets: from the parent credit/financial institution, as well as from other institutions outside the group.

- Domestic credit institutions' exposure to the NBFIs is low, standing at approximately 1.5 percent of total non-government loans.

- Nevertheless, worsening of NBFIs' financial conditions could have a detrimental effect on the entire group via the indirect channel, following the emergence of *reputational risk*.

- On the other hand, increased reliance of both credit institutions and the NBFIs on the external financing is a vulnerability of the domestic financial system in the event of external liquidity shocks, which could weigh on the Romanian economy's financing costs and availability.

Thank you!

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