What is Shadow Banking?
Why is it Important?

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The Shadow Banking System.

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In the last decade, the architecture of our financial system has changed hugely due to the emergence of new intermediaries. If it is true that nowadays we still rely on traditional intermediaries such as banks and financial markets, new players have been rapidly emerging. Some of these players are the so-called Shadow Banks, institutions positioned between the traditional intermediaries mentioned above that are generally not well understood by the general public. In this article we will try to shed some light on this topic to better understandwhat these institutions are and why they are important today.

Although for most of the people the Shadow Banking institutions fall within the category of banks, they are completely different financial institutions. In a general way, Shadow Banks can be defined as financial institutions performing core banking functions without having the same funding, backstops and regulations than commercial banks. In this regard, Shadow Banks differ from commercial banks in four important aspects: their activities are not funded by deposits, they do not have direct access to the liquidity of a central bank, they aresubject to lighter regulations and they are not backstopped by any deposit guarantee. According to the Financial Stability Board, the institutions that can be included under the category of Shadow Banks are: insurance companies, pension funds, "pure" investment banks, collective investment vehicles susceptible to runs (such as fixed income funds or money market funds), lending companies dependent on short term funding (finance companies), companies in charge of market intermediation dependent on short-term funding (broker-dealers), financial guarantors facilitating credit intermediation and companies facilitating the securitisation-based credit intermediation (such as securitisation vehicles or structured finance vehicles).

Shadow Banks are key important players in our financial system mainly because of their size, interconnexionwith other banking and non-banking institutions and the possible negative spillovers that they can have on the financial system. Probably, one of the best examples of the problems associated with Shadow Banks was showed at the beginning of the Great Recession with Lehman Brothers collapse in 2008 and the subsequent liquidity drain in several markets. These events showed that they were under the radar of the regulatory bodies around the world. After 2008, the new financial regulation introduced some important changes in regard to the non-banking financial institutions, creating several supranational organisms in order to monitor these intermediaries and their possible effects on the system. Despite this, the degree of complexity of their operations, their interconnections, the lack of available data concerning their activities, the new financial innovations and the inclusion of bank-like activities in the business models of some fintech and big tech, makes difficult to have a clear picture of the real extension of the Shadow Banking sector.

From the positive side and, as it happens with other financial institutions, the existence of Shadow Banks provides some dynamisms to the financial markets, increasing the level of competition and allowing market participants to diversify their funding sources and portfolios. Despite this, in periods of economic stress or financial turmoil, Shadow Banks can be a source of concern as they can be the origin of systemic[1] and financial stability risk. This is mainly due to their level of interconnection and, sometimes, the performance of key functions for the financial markets.

To better understand Shadow Banking, it is useful to know how commercial banks work. Commercial banks, as any other financial intermediary, are institutions that channel funding between economic agents in need of financing and economic agents with spare financial resources. To do this, they get financing from their clients through deposits and extend loans to their clients. With this channeling of funding, commercial banks are involved in credit intermediation, a process that includes maturity and liquidity transformation[2]. These two activities can be risky since banks, institutions with long terms illiquid investments, are obliged to meet the withdrawals of money from their depositors. Even though banks can intermediate the risk arising from these activities, the banking business has shown through history that it is prone to sudden confidence crises and banks runs than can be only solved through the provision of liquidity, coming from a central bank or a private institution, and the existence of public deposit backstop. In addition to this, other regulations such as reserve coefficients and minimum liquidity and capital requirements have been enforced in order to minimize the effects of the maturity and liquidity mismatch.

Concerning Shadow Banking institutions, apart fromother activities, they are also engaged in maturity and liquidity transformation. The difference with commercial banks is that they do not have any of the external safety nets of a commercial banks. The volatile short-term funding of Shadow Banks, mainly coming from wholesale money markets[3], their lack of access to the liquidity coming from the central bank and their lower (if any) liquidity cushion, make them to be more prone to suffer liquidity crisis and, at thesame time, to be ill-prepared to withstand them.

In case one of this liquidity crises take place, Shadow Banks, in order to get cash to meet redemptions, dump a lot of assets all together in the market. This process, known as fire sales, if followed by several sizeable institutions, depresses hugely the valuationof the assets. Through this decrease in valuation, the actions of Shadow Banks can impair the balance sheets of other financial institutions holding the same assets thus, forcing them to reduce their assets (contributing to more price decreases) or to absorb the losses coming from those assets. Furthermore, the decrease in prices is accelerated by the use of leverage strategies and the necessity to get cash to repay the debts contracted. A recent example of this took place in March 2021 and involved the fire sale of Archegos Capital Management shares. The event did not have systemic consequences but implied billions of dollars in losses for Nomura and Credit Suisse and showed that there are hidden cracks under the surface of ourfinancial system.

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In the case of banks, the depreciation of assets and the absorption of losses, forces them to reduce their funding capacity and, as a consequence of the credit reduction, the first negative effects on the real economy start appearing. Furthermore, the existence of commercial banks participating through Special Purpose Vehicles in some of the activities of Shadow Banks, makes them to be directly exposed to the risk of this activities. One of the main examples of this were the activities involving credit risk transformation, whose major exponent was the securitization chain, a process that transforms illiquid assets in cash-like securities. During the Great Recession, some big commercial banks[4] had to offer support to the Special Purpose Vehicles they created to participate in the subprime mortgage market.

The fast balance sheet contagion among several financial institutions makes it easy for reductions of liquidity in some parts of the market to be amplified thus, having big effects on the overall liquidity of the market and the level of losses arising from asset depreciations. It is because of this that the Shadow Banking entities can pose a risk to financial stability affecting the financial system as a whole.

Concerning the growth of Shadow Banks, they have been outperforming the growth of other financial intermediaries in the last decades and more specifically, since the Great Recession. The reasons of this, taking into account the differences among jurisdictions, have to do with the search-for-yield, the general level of liquidity in the system, the growth of insurance and pension funds, the complementarities with the banking sector, the increased demand of the products offered by Shadow Banking institutions and the increase in the level of regulation of banks. When it comes to the increased demand of products, the necessities of international investors to park their savings in safe assets encouraged Shadow Banks to offer securitised products, deemed safe by market participants. Regarding the banking regulations, these have created an uneven playing field for banks and, as a consequence, the non-banking financial institutions are in better position to offer more attractive terms for the financing they provide and, at the same time, higher yields to investors. Because of this, it is possible to say that, to some extent, banking regulation has been somehow counterproductive as it has encouraged the migration of risks from the banking sector to the non-banking financial sector.

In brief, the existence of non-banking financial intermediaries is highly positive since they can complement other sources of funding while, at the same time, introducing new opportunities for investors. Although, because of the possible negative effects they can have on the financial system, they should be properly monitorised and have mechanisms to weather periods of market stress. Some possible ways to achieve this is through the access to central bank liquidity or through well designed regulations related with liquidity cushion or redemptions.

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1- According to the Bank of International Settlements systemic risk can be defined as “a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy”.

2- Maturity transformation because they invest in long term assets (loans) obtaining funding with short term liabilities (deposits). Liquidity transformation because cash-like liabilities are used to fund illiquid assets.

3- Money markets include all those markets in which it is possible to obtain sort term financing (normally with a maturity lower than 180 days). In the case of financial institutions, the instruments that are normally used include repurchase agreements (REPOs) and asset backed commercial paper.

4- Some examples of commercial banks directly involved in the process of securitization were Bank of America and Citibank.

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