Andreas Dombret: Systemic risks of shadow banking

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Salzburg Global Seminar "Out of the shadows: should non-banking financial institutions be regulated?", Salzburg, 20 August 2013.

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When talking about shadow banking we should be clear what we mean. I subscribe to the FSB's definition of "credit intermediation involving entities and activities outside the regular banking system". What I deem to be relevant from my financial stability perspective is that such entities create bank-like risk without being subject to banking regulation. Obviously, the non-banking financial sector is composed of a very heterogeneous set of agents. Some of them – such as insurance corporations and pension funds – usually have very long-term investment horizons and can therefore potentially serve as a stabilising element for the financial system. To be clear on this point: I firmly believe that insurance corporations can be systemically important institutions, too. Thus, effective resolution regimes for Global Systemically Important Insurance corporations need to be developed and implemented.

The overall effects of the so-called shadow banking system and its activities on financial stability are ambiguous. Theoretically, non-banking financial institutions that perform bank-like activities are associated with diversification and specialization benefits. Therefore, it could be assumed that they contribute to efficiency gains and greater financial system resilience. However, empirical evidence from the financial crisis suggests that the activities of shadow banking entities might often be driven by the motive of exploiting regulatory arbitrage. Altogether, the economically beneficial attributes and systemically stabilising effects of entities and activities of the shadow banking system are not always that obvious. In particular, developments prior to the financial crisis revealed that the activities and entities of the shadow banking system can also pose a threat to the stability of the financial system as a whole.

The risks inherent in the shadow banking system pertain to both dimensions of systemic risk: the cross-sectional (interconnectedness) dimension as well as the time-serial (procyclicality) dimension. I see these potential threats as being caused mostly by maturity and liquidity transformation, the build-up of leverage and credit risk transfer conducted by the shadow banking system. All of those activities are not evil per se, but the ensuing systemic risks need to be contained. All activities must be made transparent, in particular vis-à-vis supervisory authorities, and they must be adequately regulated. In that regard, I welcome the global regulatory initiative on shadow banking – under the leadership of the FSB – and I am closely following initiatives at the regional and national level.

I want to comment on three specific aspects of the systemic risk posed by shadow banking: first, the risk of runs on money market funds (MMFs); second, the potential procyclicality of securities financing transactions; and third, the linkages between banks and shadow banking entities.

Regarding money market funds' liquidity risk: due to their perceived deposit-likeliness, constant net asset value MMFs face a relatively high risk of investor "runs" in times of crisis. Thus, the mandatory move to variable net asset value MMFs might be the single most important regulatory action to make the MMF segment more stable. I expect the European Commission to implement that move in Europe soon – in line with the ESRB's recommendation of December 2012. It was with keen interest that I also observed the recent proposal by the US Securities and Exchange Commission to adopt similar measures.

Regarding securities financing transactions: In an environment of ample liquidity, securities financing transactions can obviously contribute to a procyclical build-up of leverage in the financial system. Going one step further in a typical chain of transactions, the practice of collateral re-hypothecation intensifies interconnections in the financial system, while at the same time lacking the necessary transparency for clients and supervisors. Therefore, I support the recommendations envisaged at global level to increase regulatory reporting and public disclosure requirements for financial institutions' securities financing activities. With the results of thoroughly conducted impact assessments at hand, the imposition of somewhat tougher regulatory measures, such as minimum standards for calculating collateral haircuts, can be considered.

The last issue I want to cover are the interconnections between banks and entities of the shadow banking system. With the global implementation of Basel III capital and liquidity requirements for the banking sector, there are increasing incentives to shift risky activities to shadow banking entities, where regulation is less stringent. However, such regulatory arbitrage poses risks to the stability of the entire financial system. To effectively regulate the direct ownership links between banks and shadow banking institutions, the scope of regulatory consolidation needs to be internationally harmonised. Also, minority participations of banks, such as investments in the equity of funds belonging to the shadow banking system, require an internationally consistent, risk-sensitive application of Basel capital standards.

And, last but not least, large exposures of banks vis-à-vis counterparties of the shadow banking system need to be adequately measured and controlled by looking through complex investment structures. Finally, the effectiveness of regulatory requirements with regard to shadow banking must be constantly assessed and their implementation should be peer reviewed at the global level. As outlined, addressing the liquidity risk of money market funds, procyclical credit expansion via securitised financing, and interconnections between banks and shadow banks are key regulatory reforms. Adequately regulated, it should be possible to effectively mitigate systemic risks posed by such non-banking financial institutions and enable them to affect financial stability more positively.