What is Shadow Banking?

16th Annual International Banking Conference

"Shadow Banking: Inside and Across National Borders"

November 7-8, FRB Chicago

Stijn Claessens
Research Department, IMF

Based on work joint with Lev Ratnovski
see: http://www.voxeu.org/article/what-shadow-banking

Disclaimer! The views presented here are those of the author and do NOT necessarily reflect the views of the IMF or IMF policy

How to Define Shadow Banking?

- **Existing definitions**
  - FSB (2012): “credit intermediation involving entities and activities outside the regular banking system”
  - NY Fed (2010): Securitization; Singh (2011,12): Collateral services; CPRS (2012): Safety and Collateral
- **Our take here**
  - “All financial activities, except traditional banking, which require a private or public backstop to operate”

Focus is on backstop and systemic risk

- Backstop is what SB activities fundamentally need
- And this backstop relates to systemic risk

Spectrum of Financial Activities

"Traditional " intermediation by institutions	Activities commonly referred to as forms of "shadow banking"	"Traditional " intermediation by market entities
Traditional banking (deposit taking and lending) Traditional insurance	***Securitization***, including: tranching of claims, maturity transformation, liquidity "puts" from banks to SIVs, support to par value money funds. ***Collateral services***, primarily through dealer banks, including: supporting the efficient re-use of collateral in repo transactions, for OTC derivatives and in prime brokerage; securities lending. ***Bank wholesale funding arrangement,*** including the use of collateral in repos and the operations of the tri-party repo market ***Deposit-taking and/or lending by non-banks***, including that by insurance companies (e.g., France) and bank-affiliated companies (e.g., India and China).	***In capital markets:*** Hedge funds Investment companies Underwriters Market-makers Custodians Brokers ***In non-bank sector:*** Leasing and finance companies Corporate tax vehicles

Classifications remain ad-hoc, unsatisfactory

- **FSB**: Covers entities that are not commonly thought of as SB; and describes SB activities as operating primarily outside banks, but in practice, many operate within banks

- **Functional** ("a collection of specific intermediation services"): Stresses demand (and less supply/arbitrage), but does not tell what essential characteristics are; nor works across countries (e.g., EU, China, India)

A new way: all activities (but not banking) that need a backstop

- SB, just like *traditional banking*, involves risk – credit, liquidity, maturity – transformation
- Differs from banking though in that SB uses many *capital markets'* type tools

- Yet also differs from capital market activities in that SB needs a *backstop:*
  - While most risks can be distributed away, some rare and systemic ones ("tail risks") always remain
  - SB needs to show it can absorb these risks to minimize the potential exposure of the ultimate claimholders who do not wish to bear them

Shadow banking activities look for deep backstop externally

- SB cannot generate the needed ultimate risk absorption capacity internally
  - Too low margins – as services are contestable
- Yet backstop needs to be sufficiently deep
  - Scale is large and residual, “tail” risks significant
- Two ways to obtain such a backstop:
  - Private – franchise value of existing institutions ⇒ therefore operate **within** banks
  - Public – explicit or implicit ⇒ thus seek government guarantees, too-big-to-fail; bankruptcy “stay” exemptions for repos; implicit guarantees on bank-affiliated products (“WMP”), NBFI liabilities; etc.

The need for a backstop as a "Litmus test" gives policy clues

1. **Where to look for new SB risks.** Among activities needing franchise value or guarantees
2. **Why SB poses regulatory challenges.** Backstops reduce market discipline, enable (systemic) risks
3. **Yet, often within regulatory reach**. Can affect whether regulated entities use franchise value or guarantees to support SB activities
4. **Less migration of risks from regulated to SB**. A lesser problem than many fear: cannot migrate on a large scale w/o access to franchise value or guarantees. Makes spotting SB a narrower task