

How to regulate shadow banking: Thoughts from the world to China

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Why is shadow banking important?

- Shadow banking can be huge
 - When understood in a broad sense, as big as 20.000 billion USD in the US right before the subprime crisis...
 - Hedge funds are only a small part of it (2-3.000 billion)
- Now shadow banking in US estimated at 16.000 billion USD
 - Banking system amounts to 13.000 USD

Shadow banking still larger than formal banking sector, at least in the US!

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Why is shadow banking important?

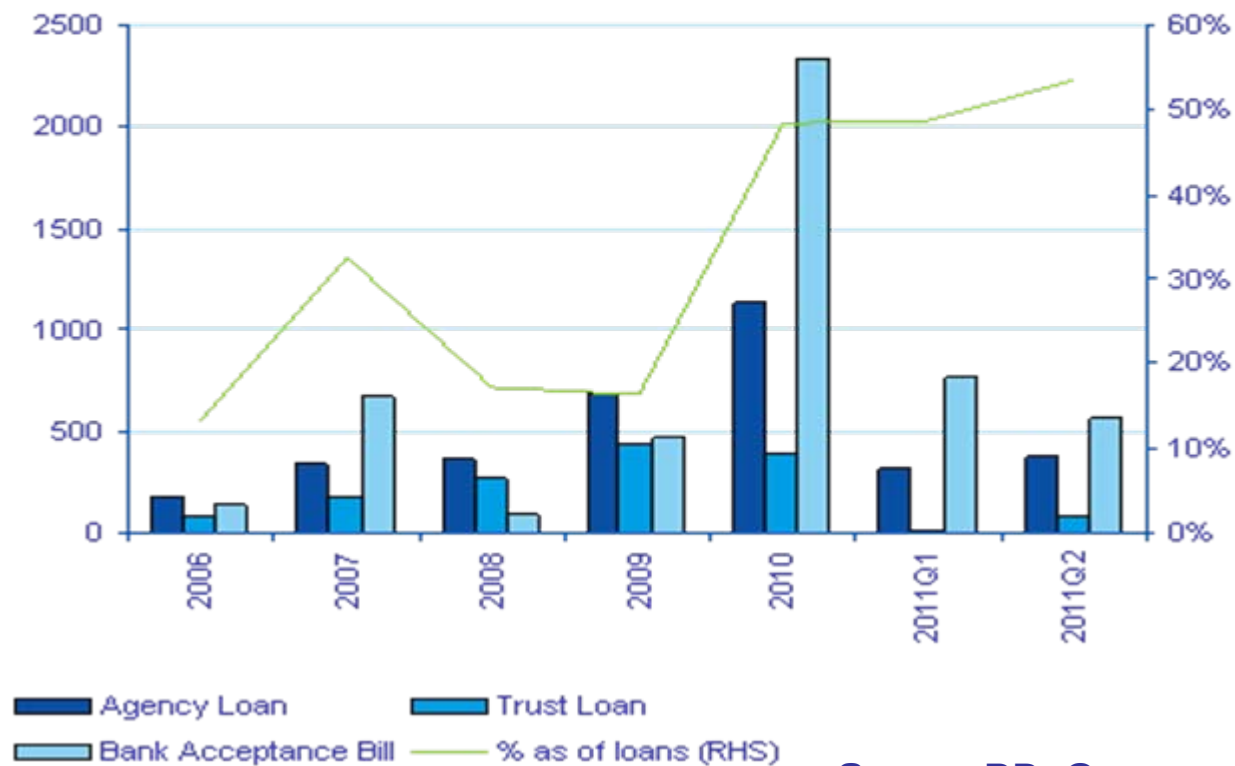
- On the positive side
 - Importance of shadow banking related to innovation capacity
- On the negative one
 - Origin of several episodes of financial instability including the subprime crisis (role of SIVs and other off-balance sheet assets)

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Why shadow banking is an important topic for China

Huge growth since the global crisis both by banks and others

RMB billion



Source: PBoC

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Why is shadow banking important for China?

- At the beginning probably considered like a nice development
China in need of credit during the global crisis
Bank credit was growing fast but not covering all needs
- But becoming a problem in a monetary tightening period!
Shadow banking related credit growing much faster than bank credit one so total credit really exceeding the regulator's targets

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Why is shadow banking important for China?

Why shadow banking growing faster?

Not hard to guess!

- As happens in most of the world, regulatory arbitrage is a key reason

Capital requirements are not existent or much less stringent

- Another specific reason for China is that limits on credit only include official bank credit

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What China can do?

- China is taking action on its own

Obligation to shift off-balance sheet assets on balance sheet (25% per quarter until completed at end 2011)

New capital requirement for trust companies

Although still lower than major banks (10.5% as opposed to 11.5%)

- However, more could come from global developments in regulation

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How global regulation approaches shadow banking?

- Until now, regulation has been focused on traditional banks:
- Not much attention paid to shadow banking ...
 - FSB recommended to strengthen the oversight and regulation of the “shadow banking system” by mid-2011 but not much action

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Global regulation and risks posed by Shadow Banking



Systemic Risk

- Arises from activities that generate maturity and/or liquidity transformation, that involve flawed credit risk transfer
- From the interconnectedness with the regular banking system



Regulatory Arbitrage

Can be used to circumvent banking regulations

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Challenges to regulate shadow banking

A – Precise definition of Shadow Banking

- Lack of consensus on a definition
- Proposed FSB definition
 - “The system of credit intermediation that involves entities and activities outside the regular banking system”
 - ⇒ Focus only on credit intermediation excluding pure equity trading and foreign currency transactions although they are part of the credit intermediation chain
- Need for a flexible forward looking perspective to capture mutations over time

B – Monitoring the Shadow Banking System



Macro perspective

Micro perspective

Purposes:

- Providing a broad picture of **evolution** of shadow banking **over time**
- Alerting authorities to **changes in the system** that may not immediately be picked up from a micro perspective.
- Identifying **funding vulnerabilities**

Purposes:

- Identification of **specific activities or entities** outside of the regulatory scope
- Identification of **potential spill-over risks** from the shadow banking system to the regular banking sector

⇒ ***Focus must be set on types of risks (stemming from the type of instruments) rather than on entities or activities***

C – Challenges

1. **Direct Measures:** Regulation aimed at addressing risks stemming from shadow banking entities or shadow banking instruments
2. **Indirect Measures:** Regulation of the banks' interactions with the shadow banking system or aimed at closing opportunities for regulatory arbitrage
 - Spain treatment of bank off-balance sheet activities is a good example:
 - Everything is consolidated (no off-balance sheet items) and this was the case even before the global crisis
3. **Macroprudential Measures:** Aimed at addressing systemic risk in the shadow banking system including procyclicality, etc
Dynamic provisioning in Spain is in fact applied to in a consolidated basis (not only to pure bank lending)

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In sum

- The fast growth of shadow banking should be a rising concern for China
- While there may be some merits in it in terms of product innovation, etc, there are certainly risks
- Regulation is an important tool to manage that risks and China is already taking action
 - However, mostly direct measures.
 - More could come from indirect measures/macroprudential ones
- Experience elsewhere shows that this may be a moving target but that action can be taken
- Global efforts on regulation are still embryonic but China could play an important role in pushing in that direction