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What is shadow banking?

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Shadow banking refers to all credit intermediation activities that take place outside the regulated banking system. Although shadow finance plays a valuable role, it is not without risk. Certain activities – estimated by the Financial Stability Board at $51,600 billion in 2017 – are liable to present systemic risks to financial stability.

Shadow banking is a series of **financial institutions performing credit intermediation activities** – i.e., linking fund providers and applicants – **outside the regulated banking system and thus on the fringes of existing bank guarantees** (deposit guarantee mechanisms, emergency liquidity assistance, etc.).

Like traditional banks, these institutions **raise funds from the public** and perform **maturity** (using short-term funds to finance long-term loans) and **liquidity** (using liquid instruments to finance illiquid assets) **transformation activities**.

Shadow banking involves numerous activities (securitisation, repo and re-use transactions, securities lending, crowdfunding, inter-company loans, etc.), and **its players are involved in a wide range of sectors** (money market funds, general purpose investment funds, securitisation vehicles, private equity funds, hedge funds, credit guarantee companies, factoring companies (inter-company loans), consumer or micro credit or car loan institutions, crowdfunding sites, virtual currency (such as bitcoin) platforms, etc.).

The sector is hard to get a grip on due to the extremely broad spectrum of activities and players involved, the complexity of certain structures and the (long) list of components, which vary in accordance with the definitions employed. Due in part to a lack of transparent information, current regulations approach shadow banking in a piecemeal – as opposed to overall – fashion (per type of activity or player) –, while some of its elements remain unregulated or poorly regulated.

Shadow banking plays a valuable role by offering:

- An alternative to bank financing, increasing the financing capacity of the economy and thus contributing to supporting economic growth
- Higher returns than those offered by the traditional banking system

But it also entails risks:

- By causing arbitrage opportunities that impair the scope of banking regulations
- By distorting competition to the detriment of traditional banks, which are subject to strict regulations
- By involving systematic risk, both directly, due to the potential vulnerability of some of its components to investor runs, and through its links with the traditional banking system (via financing transactions, credit or liquidity lines or cross investments, or by being subsidiaries or banks)

Shadow banking, which emerged in the 1980s with market liberalisation and the development of information systems, has experienced **significant growth since 2010** as a result of:

- Persistently low interest rates, which prompt investors to seek higher returns outside the traditional banking system
- Tighter prudential regulations, which spur the banks to encourage various shadow banking activities such as asset securitisation in order to offload activities that are deemed risky and therefore capital intensive (Basel III requires banks to hold more capital against risk-weighted assets)

Today, shadow banking assets have reached huge levels: $116,600 billion worth of assets in 2017 – i.e., more than 30% of global financial assets – according to the Financial Stability Board (FSB), an organisation that brings together central banks and standard-setting bodies, which was set up in 2009 by the G20 to monitor the stability of the financial system.

Within this overall context, **the FSB estimated activities liable to cause systematic risk** – because they use leverage or are exposed to credit, liquidity or maturity risk, – **at $51,600 billion worth of assets in 2017**, i.e., 14% of global financial assets, up 8.5% year-on-year. These activities represented 75% of the GDP of countries studied in 2017.

The main activities liable to pose systematic risk are collective investment vehicles (71.2% of the total), whose volumes grew by 9.1% in 2017 (compared with average annual growth of 13.2% over the 2011-2016 period). These are mainly monetary, bond, mixed and hedge funds, as well as certain property funds, funds of funds, ETFs and mutual funds. The second-largest category of systematic players is **securitisation vehicles** (9.6% of the total), up 9.1% year-on-year, followed by **securities brokers** (8.2%), with a 5.2% year-on-year increase.

Almost three quarters of these potentially more risky activities are concentrated in six countries: the **United States** (29%), **China** (16%), **the Cayman Islands** (10%), **Luxembourg** (7%), **Japan** (6%) and **Ireland** (5%).

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