How shadow banks in emerging markets have become the global economy's greatest threat.

Flying Blind

BY NICHOLAS BORST

In the wake of the global financial crisis, financial regulators worldwide have struggled to adequately address the risks inherent in shadow banking. In the advanced economies, post-crisis regulatory efforts have tamed some of the previous excesses and slowed the growth of shadow banking. Despite these efforts, the shadow banking systems in Europe and the United States remain large and under-regulated. In emerging markets, shadow banking systems have continued to grow rapidly and risks are accumulating. Perhaps this is why Financial Stability Board Chairman (and Bank of England Governor) Mark Carney recently described shadow banking excesses in emerging markets as posing the biggest threat to the global economy. The threat centers around China, which is now the world's second-largest economy and has the largest shadow banking system among the emerging market countries.

For all its expressed concern about the dangers of shadow banking in emerging markets, the Financial Stability Board's approach to addressing the problem is surprisingly ineffective. Its effort to monitor shadow banking in the world's largest emerging market is marred by a lack of transparency and a methodology designed for Anglo-American financial systems rather than those in emerging markets. These deficiencies result in a significant underestimate of the size of the shadow banking system in China

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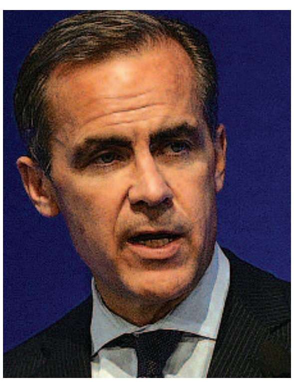
and give cover to those who wish to prevent regulatory action.

The international focus on shadow banking is recent. This is understandable given that the concept of shadow banking itself is relatively new. The first usage of the term is ascribed to former PIMCO economist Paul McCulley in 2007. Awareness of shadow banking grew during the global financial crisis, when many bank-linked special purpose vehicles went bad and brought down the banks with them. In subsequent years, the label of shadow banking has been applied to a variety of financial structures, ranging from relatively common financial products such as money market mutual funds and real estate investment trusts to the more exotic, such as hedge funds and structured finance vehicles.

The approach to addressing the problem is surprisingly ineffective.

In the wake of the crisis, there was a general consensus that there needed to be a comprehensive and internationally coordinated response to shadow banking. The Group of 20, an international grouping of the twenty largest economies, decided during the November 2010 Seoul summit to strengthen the regulation and supervision of shadow banking. The newly formed Financial Stability Board was given the task of formulating new policies to improve the oversight of shadow banking. The Financial Stability Board set out to clarify the term shadow banking, develop approaches for monitoring, and explore measures to address regulatory arbitrage and systemic risk.

The Financial Stability Board now publishes the annual Global Shadow Banking Monitoring Report. This report attempts to measure the scope and growth of the global shadow banking system, helping give national regulators a more accurate picture of the entire financial system. The approach adopted by the Financial Stability Board to accomplish this task is seemingly sensible. Shadow banking is broadly defined in the report as all credit intermediation involving entities or activities outside the regular banking system. The scope of coverage is similarly broad, with the most recent report covering 86 percent of global GDP and 90 percent of financial system assets.



Financial Stability Board Chairman **Mark Carney** *recently described shadow banking excesses in emerging markets as posing the biggest threat to the global economy.*

The main problem with the report is that while claiming to cover both entities and activities outside of the regular banking system, the focus of the report is decidedly on entities and not activities. The financial assets of "other financial entities" are used as a proxy for the size of the shadow banking system. The categories for these non-bank institutions are drawn from the Anglo-American financial structure, that is, financial systems with significant direct financing channels. Many of the largest categories are tailored towards the U.S. financial system, including U.S. funding corporations, U.S. financial holding companies, bond and equity funds, broker dealers, and money market mutual funds.

In bank-dominated financial systems, which include China and most emerging markets, the share of financial assets held outside of banks is vanishingly small. Chinese non-bank financial institutions, as defined by Chinese authorities, account for 2.4 percent of total financial assets in 2012. This leads to extremely low estimates of shadow banking if only nonbank entities are counted.

The problem is compounded by the lack of transparency.

If instead the "activities" approach is adopted, a different picture emerges. In 2012, $2.5 trillion in new credit was extended by Chinese financial institutions. Of this credit, 42 percent was not in the form of traditional loans, but rather in one of the rapidly growing alternative financing channels, including trust loans, company-to-company entrusted loans, corporate bonds, and bankers' acceptances.

This is a marked change from most of the 2000s when traditional loans accounted for the vast majority of

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new credit. While the role of loans has declined, banks are closely linked to many of these other activities. For example, banks arrange entrusted loans, issue acceptances, and buy trust products and corporate bonds. The rapid growth of these non-loan financial activities is in large part driven by regulatory arbitrage. Faced with strict prudential requirements and loan quotas, banks have become experts at devising ways to avoid regulations and extend more credit. According to the People's Bank of China, these off-balance-sheet activities reached \$7.9 trillion in 2012, growing 19.7 percent year-on-year and equivalent to 36.4 percent of on-balance-sheet assets.

Against this backdrop, the Financial Stability Board's estimate that the entirety of the Chinese shadow banking system is \$2.1 trillion is not credible. The situation is even worse if wealth management products, China's large informal loan market, rapidly growing internet lenders, and guarantee companies are included in the estimate. If the Financial Stability Board stuck true to its own definition of measuring both activities and entities outside the normal banking system, the size of the shadow banking system would be much larger, perhaps two to three times the reported size.

The problem is compounded by the lack of transparency surrounding the exercise. The data for the report is submitted by national authorities who are under no obligation to reveal the subcomponents of their country estimate. This makes evaluating the data difficult because the scope of coverage is not available. Over the past three years there have been significant yearly adjustments to the report's methodology with little accompanying explanation. For example, the estimate for China's shadow banking system in 2011 was retroactively increased by 345 percent, from \$400 billion to \$1.5 trillion, in the most recent report.

The negative consequences of this failure to accurately measure shadow banking are potentially significant. The data for the Financial Stability Board report is provided by the Ministry of Finance, which is generally skeptical of shadow banking. The low estimates produced by the Financial Stability Board's methodology provide a false sense of comfort and give cover to the parts of the financial bureaucracy that oppose regulatory action. In its 2013 Financial Stability Report, the People's Bank of China states that compared internationally, the scale and risks of the Chinese shadow banking system are small. The China Banking Regulatory Commission goes even further, denying that most

The concept of shadow banking itself is relatively new.

non-bank financial institutions constitute shadow banking. If one were to adopt the China Banking Regulatory Commission's viewpoint, the already-low estimate of China's shadow banking system would shrink to almost nothing.

One of the lessons derived from the global financial crisis is that it is critically important for regulators to have accurate data on the entire financial system, spanning the whole range of bank, quasi-bank, and nonbank financial activities. Monitoring the health of bank balance sheets is only part of the picture as off-balance-sheet and non-bank financial activities can directly impact banks during periods of financial distress. The essence of the Financial Stability Board's mission is to track all of these activities that fall outside of the deposit and loan business of the banks. With respect to China, the Financial Stability Board's Global Shadow Banking Monitoring Report is not up to the task.

To correct these problems, the Financial Stability Board must embrace its own wider definition of shadow banking and demand openness from national authorities compiling these statistics. Much of the resistance among Chinese regulators stems from the negative implications of the term shadow banking. Use of a more innocuous term, such as "market-based financing" as suggested by some in the Financial Stability Board, would help reduce some of the stigma associated with having a large shadow banking system.

Though the amount of the underestimate in China is likely the largest due to its size, these same problems exist for other emerging markets. Most emerging markets have bank-dominated financial systems and therefore approaches focused narrowly on nonbank entities will fall short. An accurate measurement of shadow banking must include all forms of credit intermediation outside of the banking channels, regardless of whether the entity is a bank, nonbank, or bank-linked entity. If, as Chairman Carney suggests, shadow banking in emerging markets is truly the greatest threat facing the global economy, then financial regulators are currently flying blind. ◆