Taking shadow banking out of the shadows to create sustainable market-based finance

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As progress has been made in reforming the global banking system and as risk appetite returns to financial markets, wider attention has begun to focus on shadow banking.

That focus is not new for policy makers. Reform of shadow banking – the extension of credit from entities and activities outside the regular banking system – has been a core part of the Group of 20's agenda to overhaul the global financial system since the 2009 Pittsburgh summit, when, in response to the crisis, leaders established the Financial Stability Board. The aim has been to deliver a transparent, resilient, sustainable source of market-based financing for real economies.

In the run-up to the crisis, opacity in shadow banking fed an increase in leverage and a reliance on short-term wholesale funding. Misaligned incentives in complex and opaque securitisation structures weakened lending standards. Securities financing markets fed boom-bust cycles of liquidity and leverage. Ample liquidity and low volatility drove increasing availability of secured borrowing. That created a self-reinforcing dynamic of more leverage, even greater liquidity, lower volatility and even greater access to secured borrowing. When confidence evaporated, that process went sharply into reverse. Markets seized up, investment vehicles – the size of which had tripled in the three years before 2007 – failed, and money market funds experienced runs.

The banking system was not immune. The problems found their way back to the core of the system causing a sharp deterioration in capital and liquidity buffers, threatening the viability of major banks. The supply of credit to real economies was drastically restricted.

Authorities recognise that as the banking system is reformed to become more resilient, activity can be pushed into the shadows. New regulatory requirements on banks create incentives to move activities to other parts of the financial system where they are not subject to the same prudential standards.

The approach to reform recognises that an effective financial system needs intermediation outside the traditional banking sector. When conducted appropriately, it can be a valuable alternative to, and provide competition for, banks in funding the real economy. Diversifying sources of finance makes the provision of the credit that is essential for growth more plentiful and more resilient.

But shadow banking can perform those roles only if it is a sustainable source of market-based finance. The reform programme to deliver that has three elements. First, new standards to limit large exposures of traditional banks to shadow banks are being implemented, installing a firebreak between the sectors.

Second, reforms are in train to make the institutions and markets at the heart of the shadow banking system more resilient. Money market funds are being made less susceptible to runs through minimum liquid asset requirements and by establishing an ability for funds to use, for example, temporary suspensions of withdrawals and redemptions in kind. The misalignment of incentives created by unsound securitisation structures is being corrected. And minimum margin requirements are being developed to reduce the cycle of excessive borrowing in economic booms that cannot be sustained when liquidity dissipates in core fixed income markets.

This approach to reform is tailored and, because it is focused on activities that are material to the wider financial system, proportionate. By establishing common policy standards and arrangements for co-operation, the reforms will help to avoid a fragmentation of the global financial system.

The third reform is to build a mature framework for monitoring and addressing financial stability risks arising from shadow banking. Unlike the first two elements, this will be an ongoing process.

Oversight and regulation of shadow banking is being strengthened so that authorities can be alerted to the excessive growth of leverage and liquidity risks. System-wide oversight is being established and a global monitoring exercise is under way.

Moreover, authorities are aware of the need for regulation to keep pace with the constant innovation and arbitrage that has been a hallmark of shadow banking. To that end, the scope of regulation will not be fixed to particular types of institutions. It will be dictated by what institutions do rather than how they are labelled.

Regulation will evolve as shadow banking evolves. There will be a co-ordinated approach to extending regulation where that becomes necessary. Where reforms have unintended consequences or where regulation can be improved we will not hesitate to make adjustments. Of particular concern is the need to examine the extent to which reforms could be impeding a resumption of sound securitisation activity.

The goal is to replace a shadow banking system prone to excess and collapse with one that contributes to strong, sustainable balanced growth of the world economy. While much has already been achieved, because the G20 has been alert to these risks since the crisis, the job is not yet complete. As the G20 completes work on the core of the financial system, reforms to shadow banking must, and will, progress. Now is the time to take shadow banking out of the shadows and to create sustainable market-based finance.