Chapter 3
Can Consolidated Supervision Deter Shadow Banking?

Rituparna Das
Centre of Risk Management and Derivatives, National Law University Jodhpur, India

Harish C. Chandan
Argosy University, USA

ABSTRACT

This chapter analyzes the business of shadow banking practiced by non-banking financial companies that are subsidiaries of bank-groups or conglomerates across the continents. The central banks want to stop shadow banking because it has hidden regulatory arbitrage in it that can create distortions and additional risks to the financial systems. Three countries - one each from Belgium in Europe, Canada in North America and China in Asia in addition to USA and UK along with India are taken as cases in this chapter. This chapter inquires into whether consolidated supervision can work as a way out of the problem of shadow banking.

CONCEPT OF SHADOW BANKING

Kodres (2013) succinctly delineated the concept of shadow banking. Shadow banks are non-bank financial companies or institutions that perform a number of functions, which the banks also perform but these institutions are outside bank regulation. These are called ‘shadow’ because although like banks they raise short term funds from money market in USA (or short term deposit from the public in India) on the one hand and on the other hand use the short term funds and/or deposits in acquiring long term debt instruments and/or lending for long term, but unlike banks neither can they borrow from the central bank as the ‘last resort lender’ nor are the deposits they raise from public are covered by deposit insurance.

INTRODUCTION

A consensus emerged worldwide that 2007-08 crisis stemmed from shadow banking activities. The first regulatory concern over conglomerate supervision arose out of the Joint Forum established in 1996 under DOI: 10.4018/978-1-4666-9758-4.ch003
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the aegis of Basel Committee on Banking Supervision (BCBS). The objective of the Joint Forum was to plug the holes between the supervisors on banking, insurance and security in order to prevent systemic risk and regulatory arbitrage. In order to prevent systemic risk, the Joint Forum decided

1. To examine the different purposes of and approaches to capital requirements in the banking, securities and insurance sectors including the different definitions of capital,
2. To study financial conglomerate structures that may impair effective supervision,
3. To follow the risk based aggregation approach via considering only the capital externally generated by parents and Group entities as regulatory capital or via comparing the Group capital with the sum of capital requirements of the regulated entities and notional capital amounts of unregulated entities, or to follow the risk-based deduction method via adding (or deducting) the dependant’s capital surplus (or deficit) to (or from) the book value of each participation in a dependant company after deduction of the parent’s investment in the dependant from the balance sheet of the parent, where any direct or indirect reciprocal interest, of a dependant company in a participating company is assumed to have zero value and to be eliminated from the calculation,
4. To follow building block prudential approach by comparing the fully consolidated capital of the financial conglomerate to the sum of the regulatory capital requirements for each Group member,
5. To deduct fully of the book value of all investments made by the parent in dependants based on the implicit assumption that no regulatory capital surpluses within dependants of the Group would be available to support the parent’s capital or debt service and that there is no regulatory capital deficit in face of
   a. Double and multiple gearing by parent, subsidiary and second subsidiary and unregulated affiliates,
   b. Issuing debt and using as equity in subsidiary by parent,
   c. Unregulated subsidiaries carrying business of regulated entities like factoring, leasing, reinsurance,
   d. Strong participation in entities within the conglomerate, and
   e. Double counting of capital.

This chapter throws light on the scenarios, emerging needs and common problems of bank-Groups or conglomerates in three countries - one each from Belgium in Europe, Canada in North America and China in Asia in addition to USA and UK along with India. The countries are selected based on ease of availability of online financial information in English language. In each case a real life case of a bank conglomerate has been referred to.

ABOUT USA

Sanches (2014) portrayed the shadow banking crisis in USA against the backdrop of sub prime crisis. In USA, the financial crisis of 2007-08, the assets of the shadow banking system were at least as large as the assets of commercial banks. Shadow banking grew outside the oversight of regulators largely to avoid the costs associated with regulation. The market for repurchase agreements (or repos) became