Chapter 6

Shadow Banking: A Practical Approach

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ABSTRACT

Shadow banking has gained prominence in recent years, and especially after the world financial and economic crisis because, on the one hand, it favours the funding of firms that have difficulty accessing the tradicional banking system, and, on the other hand, it offers to investors alternatives to the traditional bank deposits. However, shadow banking involves risks because it is subject to a lower level of regulation than the traditional system and it is clearly pro-cyclical, contributing to worsening the economic climate in times of recession. The chapter shows in detail how the shadow banking works and what the advantages and disadvantages of this alternative system are. In addition, reference is made to the debate about the possibility of reinforcing the regulation of this sector, although so far, the supervisory authorities prefer maintaining a vigilant attitude while not imposing strict requirements, which would lead to limit the role played by shadow banking.

INTRODUCTION

The Financial Stability Board (FSB) defines shadow banking as “a credit intermediation system made up of entities and activities that are outside the traditional banking system” (FSB, 2018). In other words, it is a banking system parallel to the

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traditional system in which financial intermediaries perform the same activities of liquidity, maturity, and credit transformation than in the traditional system but in a different way (Bakk-Simon et al., 2011; Kessler & Wilhelm, 2013; Parramón Jiménez, 2014; Guttmann, 2016; Adrian & Ashcraft, 2016). While in banks everything arises from bank deposits, here everything arises from the issuance of financial assets. It is important to highlight that these entities and activities can be totally or partially outside the traditional banking circuit, that is, shadow banking is not a world independent of traditional banking, but the border between them is not clearly defined and is absolutely permeable, both in activities and in actors (Bengtsson, 2013; Harutyunyan et al., 2015; Plantin, 2015; Judge, 2017).

The growth of shadow banking over the last decade has been spectacular (Pozsar et al., 2010; Nersisyan & Wray, 2010; Ordóñez, 2018). According to data from the EU Shadow Banking Monitor (European Systemic Risk Board, 2018), shadow banking represented 40% of the total European financial system at the end of 2017, with a business volume of 42.3 trillion euros, that is very similar to the one reported at the end of 2016. This report is part of a periodic series that analyzes the risk that shadow banking can pose on the financial system as a whole. In these series risks are classified into four groups:

1. Liquidity risk and risks associated with indebtedness in some types of investment funds.
2. Interconnectivity and risk of contagion between sectors and within the shadow financial system itself.
3. Procyclicality, indebtedness and liquidity risk created by using derivatives.
4. Vulnerabilities in some parts of the financial system due to the scarcity of information about the transactions carried out.

Before entering into an analysis of the different types of risks generated by the shadow banking activity, it is necessary to deepen the concept of shadow banking and its way of acting.

BACKGROUND

Shadow banking is a credit intermediation system made up of entities and activities that are outside the traditional banking system.

In the traditional system, banks receive deposits from clients and they use these deposits to give loans. Banks receive a liquid asset, usually in the short term and without risk, and they transform it into a long-term asset, illiquid until maturity and with risk of default. In shadow banking, agents receive liquidity by issuing financial
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