# Between "shadow" banking and an angelic vision of the market: towards a balanced development of non-bank finance

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Non-bank finance is growing rapidly worldwide. According to the Financial Stability Board (FSB), it amounted to USD 160 trillion at end-2016, i.e. 48% of the financial assets held by financial institutions worldwide.[1] Within non-bank finance, certain credit intermediation activities are frequently grouped together under the term "shadow banking". Although it is difficult to clearly determine the scope of shadow banking, two measures provided by the FSB enable us to sketch its outlines. According to the broadest entity-based measure, shadow banking amounted to USD 99 trillion at end-2016.[2] This includes all financial institutions other than central banks, banks, insurers, pension funds, public financial institutions and financial auxiliaries – in other words it covers entities such as investment funds, finance companies and investment firms. However, according to a narrower measure, based exclusively on activities[3] likely to pose a risk for financial stability, it amounted to USD 45 trillion at end-2016.

Beyond the figures, the terms used also count: should we refer to it as "shadow" banking, with its negative connotations, or rather as market-based finance or non-bank credit intermediation? So far, no consensus on the appropriate terminology has been reached. However, these semantic debates should not distract from the real risks associated with the growth of unregulated sources of financing, nor serve as a pretext for questioning the regulatory efforts made since the crisis with the sole purpose of promoting market financing.

While it is essential to complete the regulatory framework to ensure financial stability,[4] the role played by non-bank finance in promoting growth and innovation should not be overlooked. This 2018 edition of the Banque de France's *Financial Stability Review* is therefore timely in that it sheds light on a much discussed – even disputed – topic. As a forum for dialogue and exchange, this review offers leading personalities from diverse backgrounds – academics, institutional and industry representatives – the opportunity of having an open debate.

We should now work towards a balanced development of non-bank finance. European companies need more capital to innovate. It is therefore essential to diversify sources of financing in Europe (1). However, non-bank intermediation can be a source of systemic risk, which must be prevented (2). This is why three priorities should guide regulators' actions: understanding, testing and regulating (3).

## 1| Diversifying financing in Europe: more options and, above all, more equity

The banking system plays a central role in the financing of the real economy in the euro area: bank lending accounted for a little over 80% of the debt of non-financial corporations in 2017. The remaining 20% came from financial markets which, in Europe, are still the preserve of large companies. These proportions are reversed

1 See FSB, March 2018, *Global Shadow Banking Monitoring Report 2017*, data covering 29 jurisdictions accounting for over 80% of global GDP.

2 This scope corresponds to the other financial institutions (OFIs) category as defined by the FSB.

3 Outside the bank consolidation scope.

4 See the FSB's work on mapping, the reform of money market funds, transparency of securitisation, reducing procyclicality in securities financing transactions and the interconnections with the banking sector.

in the United States, where market financing is more widespread and banks provide only 30% of total non-financial corporation debt.[5] Let us first do away with this pointless debate about market-based versus bank-based finance, and the misconception that the US system should be replicated in Europe: the idea is simply to give companies the choice of diversifying their sources of debt financing. However, fundamentally, the real debate lies elsewhere: it is about switching from debt to equity.

Catching-up economies, such as Europe in the post-war era or emerging countries today, finance themselves with debt because it is a well-established method. However, in economies that are close to the "technological frontier", such as the United States and Europe, the key to growth lies in corporate innovation, and therefore in long-term equity financing: since it is riskier to finance innovation, it should indeed offer higher returns. Thus, the purpose of expanding capital markets is not to replace bank financing but to complement it: it must not only serve to diversify companies' financing choices, but also and above all to promote equity financing for all companies, whether they are start-ups or growing businesses. The euro area is lagging far behind in this area: equity only accounted for 73% of GDP in the euro area at end-2017,[6] compared with 123% in the United States.

This welcome diversification of financing can be achieved through the development of sound securitisation in order to free up banks' balance sheets and thus encourage the issuance of new loans, while providing safe assets to investors and offering bond market exposure to borrowers who generally do not have access to this form of financing, such as small and medium-sized enterprises. At the same time, the development of new forms of debt such as microcredit, solidarity-based finance and marketplace lending are filling some gaps, especially for micro-enterprises.

The diversification of financing also and above all requires an ambitious European framework. We need to build a real "Financing Union for Investment and Innovation" to better channel our resources – a savings surplus of EUR 400 billion in the euro area[7] – into equity financing and innovation. This Financing Union must unite and amplify the existing initiatives, first and foremost the Capital Markets Union, but also the Banking Union and the Juncker Investment Plan. It requires making concrete progress in several areas: the revision of accounting rules, taxation and insolvency laws in order to facilitate cross-border investment, mainly in equity; the European-wide development of long-term savings products and investment vehicles such as venture capital funds; the completion of the Banking Union; and finally, the control of financial activities and risks that are of vital importance for the euro area, such as super-systemic central counterparties.

## 2I Preventing risks linked to non-bank intermediation

The extension of market financing in Europe should not, however, be to the detriment of financial stability. Certain activities in non-bank finance are intrinsically risky. The global financial crisis of 2007-08 brought to light the credit, liquidity, leverage and maturity risks associated with shadow banking, as well as the potential for these risks to spread to the rest of the financial system. Within shadow banking, open-end fixed income or money market funds, for example, face a high liquidity risk and are thus susceptible to runs, i.e. massive and sudden outflows of funds in the event of market turmoil.

It is therefore essential to set up a regulatory framework that preserves both the security of the financial system and ensures a level playing field. It is not a question of favouring one sector over another, be it banks or shadow banking. The existence of regulatory arbitrage opportunities could lead to the transfer of capital-intensive activities to less regulated, or even unregulated, entities, which would be counterproductive. Nor is there

5 Sources: European Central Bank (ECB) for the euro area and Federal Reserve for the United States. The share of bank financing is calculated as the ratio of bank loans over total loans and debt securities. Loans are net of resident intragroup loans. Debt securities are expressed at nominal value.

6 As at Q3 2017.

7 12-month current account surplus for the period ending in January 2018. Source: ECB.

any question of imposing banking regulations on shadow banking: since the risks are not the same in banking and shadow banking, capital requirements cannot be the same.

With the completion of the Basel III reform in December 2017, **the priority for financial regulation is no longer bank solvency, but the liquidity of non-banks.** This goal is all the more important as the latter are a growing source of financing for non-financial corporations in some European countries. This is notably the case in France, where the increase in the debt ratios of large non-financial corporations is being fuelled by market debt.

## 3I Priorities: monitoring, testing, regulating

### Monitoring

Regulators' first priority is to gain a better understanding of who the shadow banking players are, in particular through the production of detailed data on this sector. The FSB's annual *Global Shadow Banking Monitoring Report* contributes to this approach by providing a detailed mapping of shadow banking entities. There is great diversity among entities and business models whose characteristics can differ greatly from one country to another. The particularly sophisticated structures of certain major non-bank players pose an even more complex challenge, as they render their operation opaque and call for an in-depth analysis. The priority now is to acquire a more precise knowledge of shadow banking data, in order to better understand the numerous interconnections between this sphere and the traditional players in banking and insurance, be they capital links or cross-holdings.

### Testing

The second priority is to deepen, through the use of specific tools, the analysis of these interconnections, which are of a systemic nature. In particular, the development of the non-bank sector raises the need for contagion models that extend to the entire financial system. It is also necessary to set up a framework for macro stress testing liquidity risk in order to measure the overall impact of shocks. This exercise would primarily cover investment funds, which are potentially susceptible to runs if they are open-end funds. These ambitious and complex models should be developed in a concerted manner at the international level in order to pave the way for a harmonised systemic stress testing framework: the FSB endorsed this principle in 2017; but there is a real risk that this will remain in the realm of wishful thinking and that no action will be taken.

### Regulating

Lastly, the third priority is to develop a proportionate and consistent regulatory framework at the international level. The non-bank sector must be provided with micro-prudential and macro-prudential regulations tailored to its business model and risks, without strictly replicating the tools already in place for banks and insurance companies. At the macro-prudential level, extending the scope of risk assessment and prevention to the entire financial system is particularly important. However, our experience of macro-prudential measures outside the banking sector is still very limited: France is a pioneer in this area with its decision to introduce, as of 1 July 2018, a measure for large enterprises that also takes into account their market debt. Developing liquidity management tools for investment funds, as well as refining the measurement of their leverage is also one of the key projects being conducted by the FSB. It is also necessary to improve the transparency of shadow banking activities. In this respect, the entry into force in spring 2018 of two European regulations, the European Market Infrastructure Regulation (EMIR II) and the Securities Financing Transactions Regulation (SFTR), will provide a more detailed picture of derivatives and securities financing transactions in Europe, two market segments at the heart of financial interconnections.

## 4| Conclusion

After the considerable regulatory progress that has been achieved with the completion of Basel III, it is now time to look beyond banking. Market financing should not give rise to irrational fears, but nor should it be over-idealised. Rather, it should be seen as an essential addition to bank financing for the efficient financing of the economy, including equity. The challenge now is to strike a balance between the development of long-term market financing and the management of financial risks; here too, closer international cooperation is essential, in order to take full measure of the interactions that exist between the different national financial systems.