Alternative channels to banking: the new challenge for financial stability

In the last few months the international markets for equity, corporate bonds and assets from the emerging countries have gone through a phase of sharp losses and high volatility, triggered by disappointment with China's growth figures and the slump in oil prices. In other words, surprises in variables of a fundamental nature that justify readjusting asset prices. Nevertheless, the intensity and extent of this upset in the financial sphere reached an exaggerated level. Swings between euphoria and depression in the financial markets are not new but the high frequency of such episodes of severe financial instability in recent months invites us to look for causes beyond the usual macroeconomic shocks and the typical ups and downs in investors' appetite for risk. Part of the answer may lie in the mutations undergone by the micro- and institutional structure of the international financial system. What are these changes and which factors have caused them? Are they good news for financial stability? And, ultimately, what are the implications for economic policy?

In the last few years, and in an increasingly globalised and integrated economy, the international financial system has undergone structural changes in the way financial resources are assigned. Historically banks have held a dominant position as intermediaries to channel these resources from those offering them to those wanting them (namely taking deposits and granting loans; activities which, to a certain extent, can simultaneously give banks a additional role to the one of mere intermediary, taking on the parallel task of transforming maturities, guaranteeing liquidity and valuing risk). However, since approximately the end of the 1990s, and very quickly once the financial crisis of 2008-2009 was over, we have witnessed the development of two alternative channels, although in some aspects they are complementary, both to each other and to the bank channel itself. On the one hand shadow banking which, in the broadest sense of the term, refers to all entities involved in financial intermediation without being subject to regulations applicable to entities taking deposits. This group includes investment banks, securitization funds, investment and pension funds, hedge funds, insurers, private equity firms and quite a lot of others. In the last two decades the relative weight of shadow banking has gradually increased, in 2014 accounting for close to one fourth of all assets of financial institutions,[1] in spite of the correction that took place during the devastating crisis of 2008-2009. This growth has been greater in the emerging countries (particularly in China) although shadow banking is still more prevalent in the advanced countries. On the other hand capital markets, which allow resources to be passed on directly between demanders and suppliers, although shadow banking and even traditional banks often intervene in these markets, either by buying or issuing securities. The formidable rise in bonds issued by non-financial firms is particularly relevant in both quantitative and qualitative terms. The annual volume of non-financial corporate bonds issued more than doubled between 2008 and 2015 and has grown at a much faster rate than bank loans. This trend has also been more pronounced in the emerging countries than in the developed.

Various factors have encouraged this trend in the international financial system towards less intermediation by banks. Among the macroeconomic causes, the ultra-expansionary monetary policies adopted by the main central banks after the financial crisis in 2008-2009 have undoubtedly been a key factor. Within an environment of abundant liquidity and low interest rates, the traditional model of banking business has become less attractive compared with that of shadow banking[2] and financing via capital markets, the main beneficiaries of the mechanisms set up to pass on monetary stimuli, especially in the so-called search for yield. In this respect the recent decision by the European Central Bank to include corporate bonds in its asset purchase programme has merely encouraged bank disintermediation even further. Structural factors have also contributed and will presumably continue to contribute to this mutation. These include technological innovations which make it easier to develop alternative means of financing by lowering the cost of transactions and providing new ways to evaluate borrowers and thereby reduce the problem of asymmetric information. And last but by no means least are the tougher regulations for the traditional banking system which have undoubtedly provided a very great incentive both to supply and also to demand financing via alternative channels, increasing their relative appeal.

In principle the development of shadow banking and capital markets seems to be good news for financial stability for several reasons. Firstly because it allows companies to diversify their sources of financing[3] which improves their exposure to risk (in the sense that, if one fails, they can resort to another). Secondly because some shadow banking institutions (for example start-up

1. Excluding central banks.
2. For empirical evidence see IMF, *Global Financial Stability Report*, October 2014, Chapter 2, Annex 2.3.
3. In the case of shadow banking, such diversification benefits are lessened by the sometimes close links maintained by this sector with the traditional banking sector.

funds, venture capital and high yield debt) can provide financing for firms that, given their risk profile, find it more difficult to secure a bank loan. Thirdly because some shadow banking institutions such as securitization funds help to transform maturities and distribute risk towards those investors better prepared to bear and manage such risks.

However, the other side of the coin is that this new paradigm may also jeopardise financial stability. Firstly the greater importance of shadow banking and direct financing via capital markets is closely related to the growing interconnection, complexity and opacity of the international financial system given the nature of the operations carried out and the limited knowledge of the risks assumed by the different parties. This has been identified[4] as a factor that considerably increases the likelihood of contagion. Secondly the shadow banking system is not free from the risks characteristic of traditional banking. Excessive leveraging, the accumulation of illiquid assets and vulnerability to financial panics are not the exclusive property of traditional banks, as became clear with the collapse of firms such as Bear Stearns and Lehman Brothers during the financial crisis of 2008-2009. In fact, unlike the traditional banking system which is supervised and legally required to have demanding capital and liquidity buffers (in parallel with mechanisms such as the deposit insurance scheme and the central bank as a lender of last resort), the weak supervision and regulation of shadow banking makes it more vulnerable to any risk-off episodes. Thirdly the development of direct financing increases exposure to the risk of market illiquidity; i.e. the risk faced by investors of not finding a counterparty to sell their portfolio of bonds or shares under reasonable conditions (unlike in the banking system where, thanks to the presence of the central bank as a lender of last resort, the risk of not being able to withdraw deposits is limited). In fact, one of the most important regulatory reforms over the last few years to reduce risks in the banking sector has increased the risk of illiquidity in capital markets; namely the requirement for banks to limit their operations in capital markets, forcing them to stop acting as market-makers. This means that drops in asset prices that may have been moderate and gradual under conditions of abundant, available liquidity end up being sharp and abrupt when this evaporates.[5] The setback of the last few months mentioned at the beginning of this article is largely due to this kind of phenomenon.

It is therefore clear that this new paradigm of the international financial system has important implications for economic policy. In terms of monetary policy, the channel used to inflate the price of some kinds of assets has become more important, with the risks entailed for financial stability. Related to this area, the impact of monetary policy on the availability of liquidity in the markets is also fundamental, as illustrated by the challenges involved in the US Federal Reserve's normalisation process. Regarding structural policies, the development of a prudential regulatory framework for shadow banking is vital. Similar to the plans to regulate the traditional banking sector, in this case the aim is to find the middle ground between the need to reduce systemic risk but not excessively impair the efficient assignment of financial resources and, ultimately, the efficiency of the economy as a whole. However, both for shadow banking and for capital markets, the progress that has been made is still at the relatively early stage of unifying information and gathering data, according to the Financial Stability Oversight Council itself, the international body in charge of promoting regulatory changes.[6]

In short, in the last few years a lot of attention has been paid to sorting out, restructuring and reforming regulations for the traditional banking system. But given the dynamics of the international financial system as a whole, we cannot say that the risks have disappeared. In a way they have moved from the traditional banking sector to the capital markets and shadow banking. Monitoring and mitigating these new risks to financial stability is a challenge we must face.

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4. See Haldane, A. G. (2015), «On microscopes and telescopes», Bank of England.
5. See IMF, *Global Financial Stability Report*, October 2015, Chapter 2.
6. See FBS, *Global Shadow Banking Monitoring Report 2015, 12 November 2015*.