Shadow Banking in South-East Asia

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Significance

I Shadow banking was responsible for triggering the recent financial crisis in 2007. Since then the growth of shadow banking worldwide, after falling briefly post crisis, has risen to $71 trillion at end of 2012, representing half of global total banking assets and 117% of GDP. Shadow banking is critical because while it represents an alternative source of financing, it also increases systemic risks to the financial system.

While regulators have been busy putting in place more regulations for the formal banking sector, not as much has been done for the shadow banking sector. In fact, one main reason for the increase in shadow banking is regulatory arbitrage, i.e., the more the formal banking sector is regulated, the more incentives for financial institution to operate in the shadow banking universe that is lightly or unregulated.

Analysis

The Financial Stability Board (FSB) defines shadow banking as "credit intermediation involving entities and activities outside the regular banking system". These non-bank financial institutions (NBFIs) range from the sophisticated, such as insurance, private equity, hedge funds, REITs, leasing and finance companies, to the less sophisticated such as financial cooperatives, micro finance and pawn shops. Similarly the financial activities and products offered range from sophisticated derivatives to basic loans.

Drivers of Shadow Banking

The surge in shadow banking is driven by several factors. First, as a response to tighter bank rules, lenders look for alternative sources of funding and channels of lending outside the purview of central bank regulations. A negative real interest rate environment in the last few years served to boost shadow banking as savers and investors reach for higher yields offered by shadow banking institutions. In Vietnam inflation reached 22% in 2011. Though inflation is much lower in Malaysia and Thailand, real interest rates are negative. Difficulties faced by small borrowers to obtain bank loans also create niche markets for shadow banking lenders. Between 1% and 27% of population are not served by the regular banking system.

Negative interest rates have led to double-digit property price increases, fuelling more borrowing and speculation, and further asset price inflation. Property financing remains one of the most lucrative activities for banks and NBFIs. Building societies, finance companies, credit cooperatives are alternative sources of finance for many households in Southeast Asia. In Malaysia, 52% of household loans are for property financing.

Extent of Shadow Banking in Southeast Asia

One of the biggest challenges for regulators is the lack of good data on the extent of shadow banking. Of all the Southeast Asian nations, Malaysia's central bank provides the most information on NBFIs; even this, however, is spotty. In Malaysia, NBFIs accounted for 20% of total credit provided to households but they grew much faster than banks. In 2012, NBFIs approved 600,000 new personal loans worth RM43bil – more than twice (RM19bil) approved by banks. Eighty percent of these personal loans are given to government civil servants who earn less than RM3,000 per month under a scheme where repayment is automatically deducted from their salaries which reduces the risks of default. Personal loan impairment ratio for NBFIs at 1.6% is lower than that for banks at 1.8%. This salary deduction scheme explains the popularity of such loans for both borrowers and lenders.

The wide distribution of these financing packages by NBFIs has encouraged the build up of household leverage causing concerns to authorities. Household debt as percentage of GDP in Malaysia rose from 67% to 87% between 2007 and 2013. The ratio would be higher if loans by informal and illegal credit institutions are included.

According to a World Bank study, NBFIs accounted for 37% of financial assets in the Philippines, 35% in Thailand, and 20% in Indonesia. With the exception of Singapore, shadow banking institutions and products in most Southeast Asian countries tend to be simpler and the inter linkages with other parts of the financial system less complex. The main participants are insurance, finance, leasing and factoring companies, credit cooperatives, micro finance, investment and equity funds, and pawn shops. While some of these NBFIs are supervised by other regulatory agencies, there is a need for more effective regulation and supervision, and better coordination between them and the central bank.

In the Philippines, the central bank is concerned that some banks owned by big conglomerates engage in shadow banking activities between lenders and their affiliates especially in the real estate sector where developers are offering credit facilities to buyers. The government is trying to improve coordination and supervision by setting up the Financial Sector Forum comprising of the central bank, the Securities Exchange Commission and the Ministry of Finance.

Benefits and Risks

Some of the benefits of shadow banks include providing alternatives to bank deposits for large investors, provision of alternative funding for the real economy especially when regular banking channels are interrupted, extension of credit facilities to specialized sectors like agriculture and micro financing.

However, because shadow banks are not subjected to the same degree of regulation and supervision, they pose systemic risks to the financial system. These risks are enhanced through both direct and indirect linkages with the banking system. Funding interdependence is a form of direct link in which banks provide credit facilities to NBFIs, whilst the latter place deposits in banks. In Malaysia, NBFIs deposits account for 10% of total bank deposits while bank lending to NBFIs is 3% of total outstanding loans.

Indirect linkages occur when banks and NBFIs invest in similar assets, lend to same set of clients, or are exposed to same counterparties. A default in one sector can produce contagion and positive feedback effects. Property companies that offer credit to buyers often borrow from banks and shadow banks. A downturn in property market could have serious impact on the financial system.

Many shadow banking institutions, like banks, engage in credit and maturity transformation, borrowing short and investing in high yield, longer maturity assets. Many NFBIs especially REITs are highly leveraged. The use of collateralized borrowing facilities like repos can be used to facilitate several rounds of borrowing amplifying both leverage and pro-cyclicality. The positive feedback loop between collateral and asset price movement amplifies financial instability. Among NBFIs, REITs and hedge funds are most highly leveraged. The dependence on wholesale funding rather than deposits also increases liquidity risks. Because investors or depositors with NBFIs are not protected or insured by regulatory authorities, losses suffered in the event of collapse of NBFIs increases the risks of social protests.

Finally, shadow banking undermines effectiveness of macro-economic management and monetary policies. With so much liquidity sloshing around, central banks find it harder to control their economies by changing interest rates or managing their money supply.

What Next

Cognizant of the growing significance of shadow banks, monetary and fiscal policymakers in the region are looking at measures to better monitor them. Shadow banking in the region was discussed following the fifth meeting of the Financial Stability Board Regional Consultative Group for Asia in 2013.

Some countries, like Malaysia, have introduced new lending rules to apply not only to banks but also extended to NBFIs. In Malaysia, these rules include the reduction of maximum repayment period to 35 years for mortgage loans and 10 years for personal loans; a more prudent debt service ratio for households; a ban on interest capitalization schemes and developers bearing interest programs associated with housing loans; and better coordination with other regulatory agencies. Following these measures, growth of personal and household loans slowed down in second half of 2013 and early 2014.

Conclusion

On the average, shadow banks in Southeast Asia account for between 20% and 40% of total financial assets of the countries. The institutions and activities of shadow banks in Southeast Asia, with the exception of Singapore, are more traditional and involve lesser degree of complex intermediation. The main challenge is bring them under better regulation and to reduce the fragmentation of oversight by different regulatory authorities.