Commentary

Shadow Banking Poses Challenges for Global Financial Markets in Coronavirus Crisis

Introduction

Ongoing disruptions in the global financial markets have refocused attention on nonbank financial intermediaries (FIs) and shadow banking. These nonbank FIs are important, especially now. Shadow banking assets now represent more than a third of the global assets held by banking organizations. The financial authorities globally have been concerned with the risks posed by these FIs. In a stressed environment, withdrawals, funding difficulties and other disruptions at these nonbank FIs can have a widespread impact on the financial markets. With the heightened uncertainty surrounding the spread of the Coronavirus Disease (COVID-19), that stressed environment is here and the stress on these FIs is having an impact.

Investors may be surprised to hear that their investment in a fixed income fund is a part of shadow banking. These funds are bank like in supplying financing to the market, but also in allowing investors to withdraw their funds. It’s not just about hedge funds and exotic funding vehicles. The consequences for the markets are the same, if investors draw down their holdings and the fund has to sell bonds or other assets, which can amplify market declines.

That is what is happening now, with more withdrawals leading to more selling. Declines in fund values can exacerbate investors’ concerns and lead to further withdrawals. There are other consequences. Credit may become less available, as some of these nonbank FIs struggle to roll their funding in more stressed markets. Some nonbank FIs may also reduce the funding that they provide to other participants in the financial markets. Bond funds may choose to stay more liquid, rather than buying new bonds.

Given the high level of current uncertainty around cashflows, many businesses, nonbank FIs and individuals are seeking to have more cash on hand. Credit lines are being tapped and cash conserved, rather than being put to work. Banks are also facing stress as businesses draw on their credit lines.

The resulting disruptions are likely to present greater challenges to shadow banking FIs. The business mix at shadow banks are generally more monoline and less diversified than banking groups. Many have less resources and capacity to manage deteriorating credits in a stressed environment. Moreover, they generally don’t have direct access to borrowing from central banks, unlike banking groups.

The current stresses are now evident in widening spreads and falling prices for both high yield, as well as investment grade corporate bonds. In the face of this liquidity squeeze, central banks globally have...
been taking various actions to inject liquidity into the financial markets. For more details see *Sovereigns Taking Action to Mitigate Impact of Coronavirus*, March 2020.

**The Global Scale of “Shadow Banking” and Other Financial Intermediaries**

The scale of global shadow banking is substantial. In 2018, there were $51 trillion in assets in these nonbank FIs that are not covered by prudential regulators (see Exhibit 1). This is just over a third of the $145 trillion in assets in banks. Growth in 2018 was modest, up only marginally from $50 trillion in 2017. Although shadow banking assets likely grew in 2019, the ongoing market turmoil could result in a decline in 2020.

**Exhibit 1** Global Assets of Different FI Segments (USD Trillions)

[Graph showing assets of different financial intermediaries from 2002 to 2018.]

Shadow banks are a significant subset of Other Financial Intermediaries (OFIs). These OFIs are defined as all financial intermediaries that are NOT banks, central banks, insurance companies, pension funds, public financial institutions or financial auxiliaries. Various types of funds are the predominant component of OFIs. Shadow banking assets accounted for approximately 45% of the $114 trillion in assets in OFIs in 2018. Assets in OFIs were down moderately from 2017 due to the market dislocation experienced in 4Q18, especially in equity funds, which are not included in shadow banking assets, as discussed below.

A global perspective on the scale of assets across various types of FIs is provided in the Financial Stability Board (FSB)'s recently released Global Monitoring Report on Non-Bank Financial Intermediation (the FSB Report). Providing data through 2018, this report updates the FSB’s evaluation of risk from what
it has called shadow banking. The FSB now refers to this sector as the “narrow measure”. It encompasses those nonbank FIs that are involved in extending credit and other financial intermediation. These nonbank FIs are engaged in banking activities, but are operating outside the prudential regulation of banking authorities or other prudential regulators, such as insurance regulators.

**Shadow Banking Growth Moderated in 2018**

Growth in global shadow banking moderated in 2018, with only a 2% growth rate for 2018 to $51 trillion, up from $50 trillion in 2017. This moderation followed seven consecutive years of continued expansion of global shadow banking, primarily driven by collective investment vehicles (CIVs), which are predominantly a wide range of funds. For the first time since 2011, growth in global assets in banks outpaced growth in global shadow banking assets (see Exhibit 2). In 2018, global banking assets totaled $145 trillion, compared to $141 trillion in 2017. Meanwhile, CIVs were largely unchanged at $37 trillion for 2018.

DBRS Morningstar anticipates growth in global shadow banking for 2019 to be similar to the modest growth experienced in 2018. Given the expected impact of the coronavirus, shadow banking assets are likely to decline in 2020, as occurred during the Financial Crisis. Shadow banking assets have generally grown faster than the assets of banks in stable, expanding markets, but this pattern has reversed in volatile, weaker markets. Due to the market turmoil, we expect this pattern to be repeated in 2020.

**Exhibit 2  Shadow Banks vs. Banking Sector Growth Rates**

![Chart showing Shadow Banking vs. Banking Sector Growth Rates from 2007 to 2018.](source: DBRS Morningstar, FSB.)
U.S. Still Has Largest Share of Shadow Banking, But Others Are Expanding

The U.S. still has the largest global share of shadow banking assets with 30%, or $15 trillion in 2018, although this share is well down over the last decade (see Exhibit 3). The Euro area has the next largest share with 24%, but it is seeing little change. The role of offshore centers is evident in the share of the Cayman Islands. The most noticeable change from ten years ago is in China, which now has a 15% share. Some of the changes in regional shares relative to ten years ago also reflect changes in reporting. Going forward, this is likely to be a much smaller factor.

Exhibit 3  Geographic Distribution of Shadow Banking

<table>
<thead>
<tr>
<th>Year</th>
<th>United States</th>
<th>Euro area</th>
<th>China</th>
<th>Cayman Islands</th>
<th>Japan</th>
<th>Other</th>
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<tr>
<td>2006</td>
<td>62%</td>
<td>10%</td>
<td>7%</td>
<td>12%</td>
<td>6%</td>
<td>10%</td>
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<tr>
<td>2007</td>
<td>60%</td>
<td>11%</td>
<td>8%</td>
<td>12%</td>
<td>7%</td>
<td>10%</td>
</tr>
<tr>
<td>2008</td>
<td>57%</td>
<td>9%</td>
<td>8%</td>
<td>12%</td>
<td>7%</td>
<td>10%</td>
</tr>
<tr>
<td>2009</td>
<td>54%</td>
<td>9%</td>
<td>8%</td>
<td>12%</td>
<td>7%</td>
<td>10%</td>
</tr>
<tr>
<td>2010</td>
<td>45%</td>
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<td>2011</td>
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<td>7%</td>
<td>10%</td>
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<tr>
<td>2012</td>
<td>43%</td>
<td>11%</td>
<td>12%</td>
<td>12%</td>
<td>7%</td>
<td>10%</td>
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<tr>
<td>2013</td>
<td>39%</td>
<td>11%</td>
<td>11%</td>
<td>12%</td>
<td>7%</td>
<td>10%</td>
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<tr>
<td>2014</td>
<td>36%</td>
<td>13%</td>
<td>10%</td>
<td>12%</td>
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<td>2015</td>
<td>30%</td>
<td>16%</td>
<td>11%</td>
<td>12%</td>
<td>11%</td>
<td>10%</td>
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<tr>
<td>2016</td>
<td>30%</td>
<td>15%</td>
<td>11%</td>
<td>12%</td>
<td>11%</td>
<td>10%</td>
</tr>
<tr>
<td>2017</td>
<td>30%</td>
<td>14%</td>
<td>11%</td>
<td>12%</td>
<td>11%</td>
<td>10%</td>
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<tr>
<td>2018</td>
<td>30%</td>
<td>14%</td>
<td>11%</td>
<td>12%</td>
<td>11%</td>
<td>10%</td>
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Source: DBRS Morningstar, FSB.

Trends in Components of OFIs

The FSB tracks data for a broad set of financial institutions across 29 jurisdictions globally that includes banks, central banks, public financial institutions, and other nonbank FIs for combined total assets of $374 trillion. Reversing a trend of sustained global growth, assets of nonbank FIs were slightly lower YoY. This decrease reflected a modest decline in assets of OFIs, as well as generally stable assets in insurance companies and pension funds.

While there is a diverse mix of financial institutions categorized as OFIs (see Exhibit 4), other investment funds represented the largest proportion of OFIs with 37%. These include equity funds, fixed income funds and other funds. The next largest component is captive financial institutions and money lenders (CFIML) with 22% at YE18. Special purpose entities are the predominant form of these FIs, often as subsidiaries of multinational companies that are used to pass through capital, with 80% being located in four jurisdictions (Canada, Luxembourg, the Netherlands and the UK).
For the first time since the Financial Crisis in 2008, assets of OFIs were moderately lower at $114 trillion in 2018. The decline in OFIs was primarily due to the market dislocation in December 2018, which negatively impacted asset valuations. Equity funds, which represented 50% of OFIs, were especially impacted with a decline of 8% YoY globally. Net outflows in CFIML also contributed to lower OFI assets. Nevertheless, the market largely recovered in 1Q19 from the volatile environment in 4Q18. While the data are not available for 2019, we expect that assets of OFIs would have recovered to normalized levels in 1Q19 and the growth rate would have continued in 2Q19-4Q19, in line with prior years. The outcome for 2020 is likely to be a decline.

**Global Shadow Banking or the "Narrow Measure" Components**

Assets of insurance corporations, pension funds, financial auxiliaries, and certain OFIs for a combined $121 trillion were excluded from the narrow measure. Examples of OFIs that are excluded include CFIMLs totaling $22 trillion and equity funds totaling $20 trillion.

Even though there was a decline in OFIs, shadow banking assets are still at a high of $51 trillion. When examining the five economic functions (EF) of shadow banking assets, EF1, the CIV segment, still represents the largest segment, but growth has slowed in fixed income funds and money market funds (see Exhibit 5).
Fixed income funds, totaling $10 trillion, are one of the entities in the EF1 segment that pose greater risks of disrupting financial markets when considering the level of credit intermediation, as well as exposures to liquidity and maturity transformations. For credit intermediation, fixed income funds hold a majority of credit assets relative to assets under management (AUM). However, these funds do not hold loans on balance sheet, indicating that there is very limited direct lending. Fixed income funds could be vulnerable to periods of diminished market liquidity due to their exposure to liquidity and maturity transformations. These funds often have funding mismatches. By their nature, they are investing in longer maturity fixed income securities, while giving investors the right to withdraw their funds. These withdrawals may be subject to some constraints, but imposing such constraints can adversely affect the reputation of the fund manager and possibly lead to withdrawals from their other funds. In meeting investors' withdrawals, funds may be forced to sell securities in disrupted markets, exacerbating liquidity pressures and market volatility. These liquidity and liquidation issues can apply even to funds with much shorter maturities, such as money market funds, as investors view these as stable value and a source of liquidity.

EF2 entities provide loan provision that is dependent on short-term funding, generally specializing in either consumer or commercial lending. Finance companies continue to dominate the EF2 segment, with 79% of EF2 assets. The EF3 segment, involves market activity intermediation with short-term funding and secured client asset funding, grew the most, with broker-dealers remaining the majority of the segment. The FSB provided more color this year on EF3, clarifying that custodial accounts and securities finance companies belonging to this category.
Meanwhile, the facilitation of credit creation through guarantees and credit insurance, or EF4, remains modest in size. While the EF5 segment, securitization vehicles, structured finance and trusts, was largely unchanged at $5 trillion, the mix in EF5 has slightly changed. Structured finance vehicles experienced strong growth due to increased levels of CLOs, offset by a decline in trust companies in China.

The Appendix provides a more extensive breakout of the economic functions for 2018.

Appendix: 2018 Global Shadow Banking: Breakout of Economic Functions

EF1

- Fixed income funds: 29%
- Mixed funds: 11%
- Money market funds: 14%
- Consigned financial planning: 17%
- Other funds: 19%

EF2

- Finance companies: 79%
- Real estate finance companies: 9%
- Leasing companies: 7%
- Non-bank credit providers: 5%
- Credit card companies: 2%

EF3

- Broker-dealers: 84%
- Custodial accounts: 15%
- Securities finance companies: 3%

EF4

- Investment funds: 49%
- Mortgage insurers: 16%
- Insurance corporations: 17%
- Financial guarantors: 2%

EF5

- Structured finance vehicles: 24%
- Trust companies: 76%

Source: DBRS Morningstar, FSB.
About DBRS Morningstar

DBRS Morningstar is a global credit ratings business with approximately 700 employees in eight offices globally.

On July 2, 2019, Morningstar, Inc. completed its acquisition of DBRS. Combining DBRS’ strong market presence in Canada, Europe, and the U.S. with Morningstar Credit Ratings’ U.S. footprint has expanded global asset class coverage and provided investors with an enhanced platform featuring thought leadership, analysis, and research. DBRS and Morningstar Credit Ratings are committed to empowering investor success, serving the market through leading-edge technology and raising the bar for the industry.

Together as DBRS Morningstar, we are the world’s fourth largest credit ratings agency and a market leader in Canada, the U.S., and Europe in multiple asset classes. We rate more than 2,600 issuers and 54,000 securities worldwide and are driven to bring more clarity, diversity, and responsiveness to the ratings process. Our approach and size provide the agility to respond to customers’ needs, while being large enough to provide the necessary expertise and resources.