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Shadow banking's rapid growth poses risks that need addressing, ECB and BOE officials warn

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By Abhishek Kumar

The shadow banking industry's almost unchecked growth over the past 15 years poses significant risks to the financial system, a European Central Bank supervisory board member has warned. Officials from the ECB, Bank of England and the Central Bank of Ireland discussed concerns including regulation of non-bank financial institutions, or NBFIs, and counterparty risk at a London banking conference.

The shadow banking industry's almost unchecked growth over the past 15 years poses significant risks to the financial system, a European Central Bank supervisory board member has warned.

Elizabeth McCaul's remarks came at a conference in London* yesterday where officials from the ECB, Bank of England and the Central Bank of Ireland discussed concerns including regulation of non-bank financial institutions, or NBFIs, and counterparty risk.

"We have seen an absolute explosion, the numbers are staggering, from $15 trillion in 2008, we are at $31 trillion today," McCaul said, warning that the rise has created a correlation risk over exposures to the banking and the NBFI sectors toward levels that notoriously saw hedge fund Long-Term Capital Management collapse in 1998s.

On expanding the regulatory perimeter to include the shadow banking sector — providers of financial services such as hedge funds, insurers, pawn shops, payday lenders and microloan businesses — McCaul said she would instead prefer to focus on ushering in more transparency over NBFI activities.

Gerry Cross, director of financial regulation and policy risk at the Central Bank of Ireland, stressed a need to ensure early completion of the EU's Banking Union to help address risks to the financial system.

He called for an integrated approach for supervising the NBFI sector, adding that significant progress had been made internationally after the Financial Stability Board and the International Organization of Securities Commissions, or Iosco, finalized new recommendations to address systemic risk stemming from the sector.

A key example he gave of the integrated supervision approach was the establishment of real-time coordination groups by the European Banking Authority and European Supervisory Markets Authority to jointly regulate cryptocurrency companies.

For regulating shadow banking, standards would need to be carefully calibrated to avoid putting the international system at risk, he said.

David Bailey, the Bank of England's executive director for UK deposit takers supervision, called for setting of global standards for supervising the non-bank space adding that international efforts need to be made through the Financial Stability Board and Iosco.

The BOE's systemwide exploratory stress tests enable it to understand the interconnectedness between the different parts of the financial sector, he said, especially between banks and non-banks and the flow of risks through them.

— Counterparty risk, tech actors —

On counterparty risk, Bailey urged supervisors to monitor the robustness of controls and risk management in regulated entities.

McCaul stressed that the ECB is not using banks as a proxy to regulate shadow banking, saying the central bank is well within its ambit to look at counterparty credit risk exposures and the nature of derivative arrangements between banks and non-banks.

"It is rather good supervision to understand where there is a build-up of risk in the banking sector and making sure that we are all about improving the risk management and credit processes," she said, giving an example of commercial real estate as a market where exposures are building up in the lending arrangements between banks and NBFIs.

On the benefits of having a supervisor housed within a central bank, McCaul said it ensures a good flow of information between the central banking and supervision functions and supports financial stability.

Cross discussed systemic risks posed to financial institutions by non-bank, non-financial actors such as large cloud service providers, saying: "We will create an oversized regime which allows us to collectively engage with these entities and see whether there is resilience in the services they are providing to the system."

He added that the EU's proposed Digital Operation Resilience Act would allow regulators to learn about specific types of risks associated with the deep integration of big technology companies into the financial system.

"We are getting to grips with them, but once again in a way that I think is quite nuanced and sophisticated, and it is a real step forward," Cross said. "It is a very cross-border business, it is not just a financial services business, so how we do it is still to be fully worked out."

**Financial Times Global Banking Summit, London, Nov. 27-29, 2023.*

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