Shadow Banking
- Japan’s experiences and the BoJ’s approaches

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1. Introduction

— “Shadow banking” - Japan’s experiences
Backgrounds of Recent “Shadow Banking” Debates

- Economic Boom and Financial Crisis
  - Real estate bubbles (during “Great Moderation”) and their burst
  - Risks associated with securitization and bad market practices

- Tighter Bank Regulation (Basel III, G-SIFI framework) under Easy Monetary Conditions
  - Strengthened bank regulation might stimulate shadow banking.

- Heightened Attention to “Macro-prudence”

These concerns are similar to those in Japan’s asset price bubbles and financial crisis in late 1980s and 1990s.
Japan’s Asset Price Bubble in late 1980s

We can see many “common factors”...

➢ **Asset price inflation with credit expansion**
  - Real estate bubbles were partially accelerated by non-bank lending.
  - Monetary easing continued until 1989.
  - Optimistic views on asset prices and productivity growth led to under-estimation of risks.

➢ **Scheduled Introduction of Basel I**
  - Announced in July 1988

➢ **Destabilization of financial system and the economy**
  - Non-banks’ fund intermediation and herding behavior of market participants seemed to amplify credit cycles.
  - During the bubble period, the regulatory authority introduced direct ceiling on banks’ lending to several sectors. Nonetheless, it did not sufficiently contribute to financial stability.
Credit Expansion during Japan’s Asset Price Bubbles
- Contribution of Non-banks (from flow of funds data)

Amount Outstanding of Financial Assets

Note: 1) “Other financial Intermediaries” include Financial dealer/brokers, Public Financial Institutions, Nonbanks and Securities investment trusts.

2) Other financial institutions, classified as "Financial auxiliaries" (Stock Exchanges, FX brokers, etc.) have been excluded from above, because their financial assets are marginal (Share in 10/1Q: 0.4%).

Source: Flow of Funds Accounts, Bank of Japan
But, there are also some differences...

- Differences in the structure of financial systems
  - As in most Asian countries, loans have continuously occupied a dominant share in financial intermediation in Japan.
  - “Originate-to-Distribute (O-t-D)” business models have never been widespread.

Thus, regarding “shadow banking”, our primary focus has been on the risks associated with non-bank lending to real estate-related sectors. (These non-banks often relied on banks as funding sources).

On the other hand, securitized products (and related rating issues) have not been a major source of risks, mainly due to their limited roles in financial intermediation.
2. Addressing Risks of Shadow Banking

- Need for flexible approaches
Characteristics of Shadow Banking

✓ Difficult to define!
   - The risk of “regulatory arbitrage” is significant. (Any inflexible definition of shadow banking can easily be circumvented.)
   
   Rather, shadow banking might be a “mirror” of any distortion in regulatory and supervisory frameworks.

✓ Continuously evolve!
   - Today’s regulatory and supervisory framework for shadow banking might soon become obsolete.
   - Some SB might be sources of financial innovation that enhance welfare or risk management/sharing techniques.

✓ Market-oriented!
   - Market-based information is extremely important.
Two “Extreme” Options...

(Option 1) Extending the scope of bank regulation to cover all shadow banking

- Applying bank regulation to shadow banking

(Option 2) Insulating banking sector from shadow banking

- Bank regulation focuses on banks. Only banks are allowed to access to central bank liquidity.
So, we need flexible approaches.

✓ Need to be open-minded and forward-looking

- At the initial stage, we need to cast a broad net.

  ‘The “shadow banking system”…can broadly be described as “credit intermediation involving entities and activities outside the regular banking system.’ (FSB, “Shadow Banking : Scoping the issues“< April 2011>)

✓ Need to think about each issue or problem in a flexible manner

- Then, we need to carefully examine the characteristics of each risk or problem stemming from shadow banking, and to apply the most suitable tools to address it.

- We need to avoid “one-size-fits-all” approaches.
In viewing the diversity of risks and the variety of measures, we need to strike the right balance between these two extremes.

**How to address each issue of shadow banking?**
- Need to select the most suitable measures

<table>
<thead>
<tr>
<th>Risks, Problems</th>
<th>Appropriate toolkit</th>
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| ✓ Insufficient disclosure  
✓ Lack of transparency (esp. structured products) | ✓ Enhanced disclosure  
✓ Consumer protection |
| ✓ Spill-over to banking systems | ✓ Close and continuous monitoring of banks’ exposure and commitments to shadow banking |
| ✓ Excessive credit expansion  
✓ Distorted incentives  
✓ Destabilization of financial system and the real economy | ✓ Macro-prudential assessment  
✓ Market intelligence |
3. BOJ’s Framework for Shadow Banking
BoJ’s Monitoring of Shadow Banking

- BoJ makes full use of a wide-ranging toolkit to assess and tackle risks associated with shadow banking.

**Monitoring of Shadow Banking through Banks**
- On-site examination and off-site monitoring of banks and securities firms. (BoJ assesses banks’ and securities firms’ exposure and commitment to shadow banking systems <eg. non-banks, SPVs> in detail.)

**Direct Monitoring of Non-banks**
- Bilateral dialogues with major non-banks (e.g., insurance firms, consumer finance companies, fund managers, etc.)
- Utilization of various data, including those published by private entities.

**Macro-prudential Assessment**
- Financial System Report (FSR, semi-annually) assesses the stability of the overall financial system, including various shadow banking activities.
- The Financial System and Bank Examination Dept. assesses the overall financial stability, and reports to the Policy Board on a monthly basis.

**Utilizing Market Intelligence**
<table>
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<th>Shadow Banking Entity</th>
<th>Central Bank Counterparties’ exposure to and risks from their relation with shadow banking entities</th>
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<tbody>
<tr>
<td><strong>Size (Amount Outstanding, Volume)</strong></td>
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<tr>
<td><strong>Risks (Credit Risk, Market Risk, Liquidity Risk)</strong></td>
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**Macro Perspective** (eg: Flow of Funds data)

- $\triangle$: Some information obtainable,
- $\triangledown$: Close to no information

**Micro Perspective** (Primary statistics, confidential data collected through CB counterparties)

- $\triangle$: Some information obtainable,
- $\circ$: More or less obtainable

**Market Intelligence** (Qualitative information with focus on potential future risks)

- $\circ$: More or less obtainable

Note: $\circ$: More or less obtainable, $\triangle$: Some information obtainable, $\triangledown$: Close to no information

BoJ makes full use of available data and information.
Monitoring of Shadow Banking in Real Estate Finance
-- from a Macro-perspective (Flow of Funds statistics)

Issues: Although we have aggregate data on financial institution lending towards housing loans, it is not easy to single out commercial real estate loans from the data.

Issues: Other than size, we have only limited information regarding the liability side of the SPCs (maturity of liabilities, source of liquidity, etc.)
Monitoring of Shadow Banking in Real Estate Finance
- Assessment based on various data

Commercial Land Price Index (00/3=100)
(% change over previous date)

Source: CB Real Estate Institute

Issuance of CMBSs (per half year)
(trillion yen)

Source: Japan Securities Dealers Association

CB Counterparties’ exposure to CMBS

Source: Bank of Japan

CB counterparties’ exposure to CMBS by credit rating

Source: Bank of Japan
Feedback process in BoJ’s framework

- SB Monitoring should be a regular and continuous process, as SB may emerge in any form and may evolve rapidly.

Identify signs of inappropriate SBs through regular surveillance

Share and exchange views among authorities/with financial industry, such as through publication of FSR

Collect quantitative and qualitative information

Assess risks of SBs

1) Current risk of SBs
2) Spillover to financial system
3) Future developments of risks

Market Intelligence

Supervisory and/or macro-prudential considerations, if necessary
**Related Issues**

- Considerations on cost-benefit of policy actions

- One of the concerns behind the recent debates on regulatory reform, including that for SB, is to minimize social costs including taxpayers’ losses.

- In Japan, the losses stemming from credit crunch and recession was much larger than taxpayers’ direct losses associated with public fund injection.

- Most of the injected public money has already been repaid, owing to the recovery in the financial sector and stock prices.

### (Repayment of the injected public funds)

![Graph showing repayment of public funds](image)

Notes: 1. The sum of public funds injected pursuant to the Early Strengthening Law, the Financial Function Stabilization Law, the Deposit Insurance Law, the Financial Reorganization Promotion Law, and the Financial Functions Strengthening Law.

2. At face value.
**Related Issues**

- Costs and benefits of financial intermediation outside banking systems

- In order to avoid credit crunch and promote the **sound development of market-based financial intermediation**, the BoJ has taken various measures, such as the purchases of ABS and ABCP.
  - These measures seemed to contribute to mitigating the negative impacts of credit crunch caused by impaired risk-taking capacity of the banking sector.

- BoJ tries to **maximize the benefits of financial innovation**, while carefully **avoiding the risks associated with SB**, such as those stemming from lack of transparency and undue market practices.

“**Purchases of Asset-Backed Securities**” (June 11, 2003) – excerpt –

“ABSs are expected to contribute to promoting smooth corporate financing by reducing credit risks through their diversification as well as by reallocating credit risks to investors with various risk preferences. The Bank judged that it can play an important role in encouraging the development of the ABS market by directly taking credit risks through purchases of ABSs as a temporary measure. By encouraging the development of the ABS market through this unprecedented scheme for a central bank, the Bank could strengthen the transmission mechanism of monetary easing against the background of bank’s weak financial intermediary function. “

“In designing the scheme, due attention was paid so that the Bank’s purchase would contribute to the **sound development of the ABS market**, without distorting market mechanism.”
Thank you for your attention!