

CENTRAL BANKING

Shadow banking links leave EU banks vulnerable – ESRB paper

European banks are largely exposed to three types of shadow financial entity, study finds



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European Union banks' exposures to the shadow banking sector may leave them vulnerable in times of financial stress, says a working paper published by the European Systemic Risk Board (ESRB) published today (March 15).

In ***Mapping the interconnectedness between EU banks and shadow banking entities***, Jorge Abad *et al* use data gathered by the European Banking Authority (EBA) in 2015. When it was developing guidelines for banks' large

exposures, the EBA asked European banks to calculate their exposures to some kinds of “lightly regulated” financial entity.

These were defined as institutions that carried out one or more kinds of credit intermediation and that were not regulated under the Capital Requirements Regulation and Capital Requirements Directive or by a similar regime. The banks surveyed account for 56% of the total assets of the EU financial sector, the authors say.

EU banks have “significant exposures to shadow banking entities”, the study finds, although EU banks have only “low levels of individual concentration towards shadow banking entities”.

“This diversification leads to high overlap where different banks are commonly exposed to the same types of shadow banking entity,” the authors argue.

Approximately 65% of EU banks’ shadow banking exposures are to three types of “shadow” financial activity, the study finds. These are securitisations, finance companies, and entities classified as “non-money market funds”. The authors call this a “high but shared diversification”, which could lead to “common sources of vulnerability in times of stress”.

The banks’ exposure is also highly regionally concentrated, with 27% of EU banks’ total shadow banking exposures being to companies based in the US.

Furthermore, while only 13% of the banks in the sample are based in the UK, those banks account for 39% of the total assets, against 11% for German-based banks and 2% for French-based banks. EU banks also have “significant” shadow sector exposures to entities based in Ireland, France, the UK and the offshore UK dependency Jersey.

The authors argue that their dataset is “a unique insight into the geography of the exposure of EU banks to shadow banking entities”, but admit it has several limitations. The data they use is based on the domicile of the shadow banking entity, but this may not reflect the location of the “ultimate risk bearers”.

The authors note that their research is based on the asset side of banks’ balance sheets, and that future research would need to look at liabilities, specifically examining how shadow entities fund banks. Researchers should also look at the relationships and “potential contagion paths” among different non-bank financial entities, they recommend.

The authors go on to call for more work on the supervision and regulation of non-bank financial entities, looking at “which entities lie fully outside of the regulatory perimeter”.