

Box B

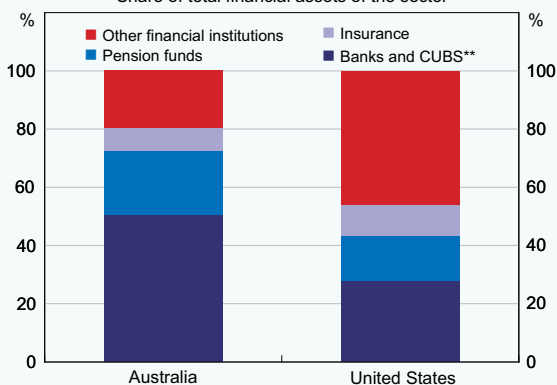
The Shadow Banking System in Australia

The financial crisis in the United States was propagated in part by institutions in the so-called ‘shadow’ banking system. These institutions – including investment banks, structured investment vehicles (SIVs) and money market mutual funds – were typically subject to less regulation than the traditional core of the financial system. Events revealed that a number of these institutions were not holding sufficient capital or liquid assets for the risks that they were taking, and their weakness soon spread more widely throughout the financial system. Other ‘shadow’ institutions, including firms whose activities may not be well-defined (such as hedge funds and commodity trading accounts), were not especially implicated in the recent crisis. Nonetheless, they can be highly leveraged and closely interconnected with the rest of the financial system, and therefore have the potential to amplify and propagate stresses.

Intermediaries outside the core of the financial system also exist in Australia, but they account for a much smaller share of financing. Eighty per cent of the Australian financial sector by assets comprises banks, credit unions and building societies (CUBS), pension funds and insurers, all of which are prudentially regulated by the Australian Prudential Regulation Authority (APRA) (Graph B1).¹ In comparison, these types of institutions account for only around one half of the financial sector in the United States. Institutions that are not prudentially regulated (though they may be subject to market conduct or consumer protection legislation) consequently form a larger part of the financial system in the United States than in Australia. In addition, non-bank intermediaries in Australia do not undertake the same types of activities as those in the United States. In part reflecting these factors, these Australian intermediaries did not transmit the same kinds of shocks to the system during the recent financial crisis as in some other countries.

Data collected by the Australian Bureau of Statistics (ABS) show that the relatively small proportion of financial assets accounted for by the less-regulated sectors has declined since 2007 (Graph B2). Indeed, registered financial corporations’ (RFCs) share of financial system assets – and credit provision – has been declining for the past two decades, as the regulated sectors outpaced their growth. In contrast, sectors such as managed funds and securitisers

Graph B1
Financial Sector Composition*
Share of total financial assets of the sector



* As at 30 June 2010; excludes the central bank and central borrowing authorities

** For the US, these comprise commercial banks, savings institutions and credit unions

Sources: ABS; APRA; Board of Governors of the Federal Reserve System; RBA

¹ For an overview of institutions in the Australian financial system, see RBA (2006), ‘The Structure of the Australian Financial System’, *Financial Stability Review*, March, pp 49–61.

experienced higher growth relative to the financial system for much of the 1990s and early 2000s, but they too have since declined in importance. Securitisers' earlier relative growth was driven by the higher demand for housing finance and the activities of smaller lenders (such as specialist mortgage originators) that are more reliant on securitisation as a source of funding. Their share of the financial system has declined since the onset of the financial crisis, following the strains in securitisation markets globally.

The ABS data also help identify linkages between the regulated and less-regulated parts of the financial system through the exposures between sectors (Table B1). For instance, securitised assets can be redistributed within the financial system when

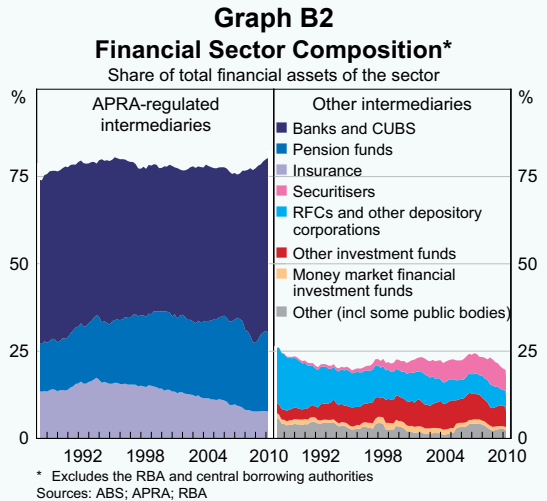


Table B1: Financial Sector Inter-linkages^(a)
Per cent of total exposure to the domestic financial sector as at 30 June 2010

	<i>Exposure of:</i>			Other financial intermediaries ^(c)
	Banks and CUBS ^(b)	APRA-regulated intermediaries Pension funds	Insurance	
<i>Exposure to:</i>				
Banks and CUBS ^(b)	–	46	29	75
Pension funds	0	–	0	1
Insurance	7	28	–	3
RFCs and other depository corporations	26	1	2	4
Money market financial investment funds	0	2	1	0
Other investment funds	8	17	65	8
Securitisers	57	2	2	5
Other financial corporations (including some public sector bodies)	2	3	2	4
<i>Memo item: exposure to the domestic financial sector as per cent of total financial assets</i>	<i>12</i>	<i>58</i>	<i>64</i>	<i>23</i>

(a) Excludes the RBA and central borrowing authorities

(b) Figures for CUBS are estimated from the ABS category of 'other depository corporations', which includes CUBS, RFCs and other depository corporations

(c) Comprising RFCs, other depository corporations, investment funds, securitisers and other financial corporations (including some public sector bodies)

Sources: ABS; APRA; RBA

institutions buy each others' asset-backed securities. This explains most of banks' exposures to securitisers. Managed funds dominate the financial exposure of the insurance sector, while pension funds are exposed mostly to APRA-regulated intermediaries. On the other hand, the less-regulated sectors have limited direct exposures to each other, and are instead predominantly exposed to banks.

Australian regulators have recently increased some of the regulation of these 'shadow' banking institutions. For instance, providers of consumer credit services must now be licensed by the Australian Securities and Investments Commission, which imposes certain obligations on these institutions; the regulatory coverage of credit products under the National Consumer Credit Code has been expanded to include investor-housing mortgages; and the

operation of the *Corporations Act* has been extended to regulate margin lending. In the international context, work is also in progress to expand the 'regulatory perimeter'. Based on recommendations by the G-20 and principles set by the International Organization of Securities Commissions, a number of major economies are working towards increased regulatory oversight of hedge funds and credit rating agencies, and a higher ownership retention requirement for securitisers so that incentives are better aligned. Efforts are also under way to improve cross-border supervision of financial services providers outside the traditional banking system, and to standardise data collection for hedge funds across markets. Australian agencies are following these developments through participation in various international regulatory groupings. ❖