Box D

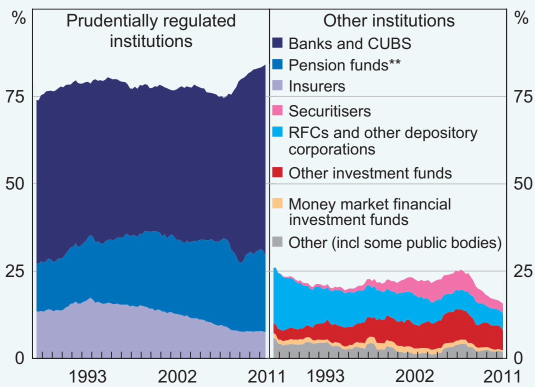
A Closer Look at the Shadow Banking System in Australia

Since the 2008–2009 crisis, there has been growing interest internationally in monitoring and assessing the risks posed by the so-called 'shadow' banking system. In a recent report, the Financial Stability Board (FSB) defined the shadow banking system broadly as 'credit intermediation involving entities and activities outside the regular banking system'. The global shadow banking system grew rapidly in the years leading up to the crisis, and some of the entities within it directly contributed to the spread of the crisis.

To strengthen the monitoring of shadow banking systems, the FSB has recommended that jurisdictions adopt a two-step monitoring framework. It recommended that authorities first examine the broad scale and trends in non-bank credit intermediation in the financial system. Based on this assessment, the FSB recommended that jurisdictions then narrow their focus to the subset of shadow banking entities that have the potential to pose systemic risks from factors such as maturity transformation, liquidity transformation and leverage, or those that give rise to regulatory arbitrage concerns.

Because it can be difficult to identify non-bank credit intermediation activities directly, one approach is to first examine all financial institutions outside the perimeter of prudential regulation. In Australia, non-prudentially regulated institutions include registered financial corporations (RFCs), securitisation vehicles, money market funds and other investment funds. Together, these institutions account for a relatively small and declining share of financial system assets: currently around 15 per cent, down from 25 per cent in 2007 (Graph D1). This is a much smaller share than in Canada, the Netherlands and the United States, but similar to France, Italy, Germany and Spain. Not all non-prudentially regulated financial institutions engage in bank-like activities, however, and they do not necessarily pose systemic risks that warrant closer monitoring or stronger regulation. The remainder of this box examines the main types of non-prudentially regulated financial institutions in Australia and the key risks they pose to the financial system.

Graph D1
Financial Sector Composition*
Share of total financial assets



* Excludes the RBA and central borrowing authorities; adjusted for self-securitisations
** Includes self-managed superannuation funds regulated by the ATO rather than APRA
Sources: ABS; APRA; RBA

Registered Financial Corporations

In Australia, RFCs are most readily considered shadow banking entities, as they intermediate between lenders and borrowers, and some of them engage in investment banking activities. While RFCs are not prudentially regulated by the Australian Prudential Regulation Authority (APRA), they are required to meet disclosure, licensing and conduct requirements that the Australian Securities and Investments Commission (ASIC) administers in respect of all financial companies. RFCs with assets exceeding $50 million are also subject to certain reporting requirements with APRA.

There are currently over 300 RFCs in Australia, accounting for around 5 per cent of financial system assets as at September 2011. Around 120 RFCs report data to APRA, of which 20 are money market corporations (MMCs) – accounting for nearly 40 per cent of reporting RFCs' assets – and the remainder are finance companies. The sizes of reporting RFCs vary widely: the largest has assets of around $15 billion (less than half the size of the smallest regional bank in Australia), while 30 or so have assets less than $100 million.

The assets of the RFC sector have been declining over the past few years, from around $250 billion in mid 2008 to $160 billion as at December 2011. This partly reflects the more difficult funding environment that has existed since the onset of the 2008–2009 crisis, which has caused some RFCs to scale back their operations. Much of the fall has been in the assets of MMCs, consistent with many of them being more exposed to shifts in wholesale funding market conditions, although the assets of finance companies also decreased over this period.

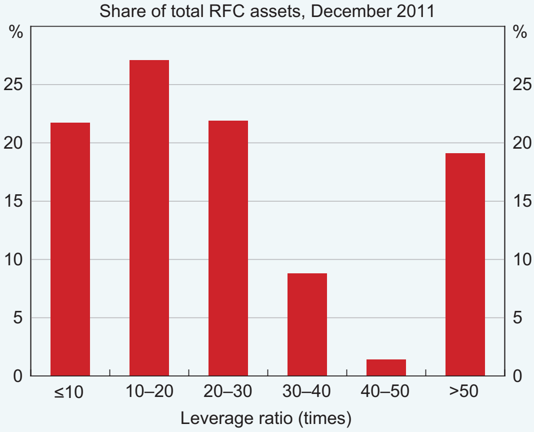
Most MMCs are owned by banks or securities firms and they are typically involved in similar activities to investment banks in other countries. Their asset mix tends to be skewed towards commercial loans and trading securities, while they obtain a relatively large share of their funding from short-term wholesale markets – including repurchase agreements (repos) – and, in some cases, from related parties. Finance companies are typically smaller than MMCs and are generally involved in the provision of motor vehicle, consumer or business finance. A few of the larger ones are the financing arms of large car manufacturers. Some of the finance companies focusing on consumer and business finance are owned by Australian banks, and are therefore considered as part of APRA's consolidated approach to supervising banks. Funding for finance companies varies: some source a large share of their funding from domestic banks, while others make use of long-term loans and other forms of wholesale funding. In many cases, finance companies' funding is concentrated in a particular type of funding.

The leverage of reporting RFCs varies quite widely, with the highest leverage ratio (total assets to equity) well over 50 but the majority having leverage ratios of less than 30 (Graph D2). The RFCs with higher leverage include some of the larger institutions, with their repo books contributing to their leverage. As an indicator of risk, leverage ratios have shortcomings, however, as they do not take into account the composition of assets and liabilities. An institution with higher leverage but safer assets and more long-term liabilities may be less risky than an institution with lower leverage but weaker assets and more short-term liabilities.

Even though RFCs are relatively small, they have linkages with the regulated banking system that could in principle be a source of risk. As at September 2011, RFCs accounted for about one-half of the exposure of Australian authorised deposit-taking institutions (ADIs) to other non-ADI domestic

Graph D2
Distribution of RFCs' Leverage Ratios*

Share of total RFC assets, December 2011



* Ratio of assets to equity; excludes some small institutions
Source: APRA

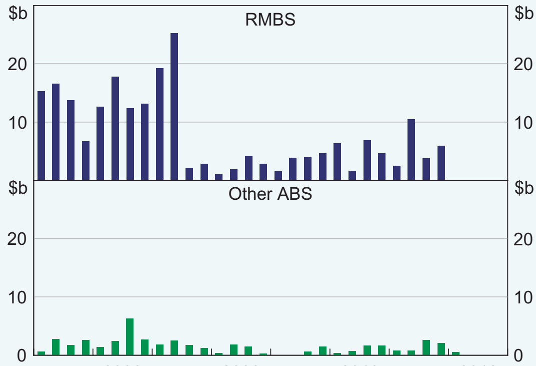
financial institutions. However, ADIs' overall exposure to RFCs is relatively small as over 90 per cent of ADIs' financial assets are with the non-financial sector, mainly in the form of loans. Where an RFC is owned by an Australian ADI, APRA's approach to consolidated supervision ensures that the risks associated with intragroup exposures are carefully managed. APRA also enforces a range of other prudential standards aimed at ensuring ADIs manage the risks associated with their exposures to related and unrelated RFCs.

Securitisation Vehicles

Securitisation vehicles accounted for around 3 per cent of financial system assets in Australia as at September 2011, a share that has declined since 2007 due to the problems that emerged in securitisation markets globally during the crisis. These vehicles are closely interconnected with ADIs, as securitisation has been an important source of funding for housing lending, particularly for smaller ADIs, and institutions often buy each other's asset-backed securities to meet their demand for liquid assets. Though it is not counted as part of the assets of securitisation vehicles, ADIs also undertake 'self-securitisation', which they retain on their balance sheets and which can be used to obtain liquidity from the RBA in exceptional circumstances.

In Australia, securitisation has not posed the same risks as in some overseas markets because most of the underlying assets were high-quality, prime mortgages, and there were very few securitisations involving the more complex structures that caused problems overseas. Around 90 per cent of the outstanding securities issued by securitisation vehicles are residential mortgage-backed securities (RMBS) for which the underlying collateral has continued to perform strongly. Despite this, Australian RMBS still suffered reputational damage as a result of the problems that emerged in the US RMBS markets in 2007, and RMBS issuance in Australia has not been as strong in recent years as in the years leading up to the crisis (Graph D3).

Graph D3
Issuance of Asset-backed Securities*



* March quarter 2012 is quarter-to-date; excludes self-securitisations
Source: RBA

The RBA has for some years collected market-based data on securitisation structures so as to understand and monitor the growing importance of securitisation as a funding source for ADIs and any risks arising from this activity. APRA also has prudential requirements requiring ADIs to manage the risks associated with their securitisation exposures prudently, and to hold sufficient regulatory capital against any residual credit risk ADIs retain in respect of those exposures.

Investment Funds

Investment funds, including money market funds and hedge funds, accounted for around 6 per cent of financial system assets as at September 2011. The majority of investment funds in Australia are equity funds, that invest entirely or predominantly in domestic or foreign equity markets, and would therefore not be considered shadow banks. Money market funds, which mainly invest in short-term debt instruments, are relatively uncommon in Australia, currently accounting for ½ per cent of financial system assets. Although they engage in some bank-like activities (intermediation), they typically do not engage in maturity transformation and are too small a part of the system to pose systemic risks. This contrasts with the situation in some other jurisdictions, like the United States and Europe, where money market funds are a much larger share of the financial system and are an important source of financing for governments, businesses and financial institutions. Market-based surveys indicate that there are relatively few hedge funds in Australia and they account for a small proportion of the assets of investment funds. The investment strategies of hedge funds can vary widely, but few of them are engaged in credit intermediation. All investment funds in Australia, including hedge funds, must meet certain duties towards their investors, and comply with disclosure and competency requirements administered by ASIC.