Finance Group
German Savings Banks Association

FOCUS PAPER

Shadow banks – Mitigating risk comes before sharing risk

Non-Bank Financial Intermediaries (NBFIs), also known as "shadow banks", are booming. They are financial institutions outside the traditional banking sector that provide bank-like services. They are less regulated than banks but they also provide financing. While this stimulates growth, it also creates risks. Commercial banks and their customers should therefore not be held liable for these new risks.

Risks outside commercial banks are growing

Since the financial crisis 15 years ago, the banking sector has been extensively regulated. This prompted much of the lending business to move to the less regulated NBFI sector. In 2022, the NBFI's global financial assets amounted to approx. USD 218 trillion, and that of the banks amounted to USD 183 trillion. This pattern is especially pronounced in the euro area.[1]

Source: DSGV, FSB 2023

This not only provides opportunities but it also generates risks in the overall markets, as leading figures in the financial sector have noted.

> **"I think the next crisis – when it happens – will be in that sector."**
>
> (Colm Kelleher, UBS President)

The supervisory authorities have also begun examining this problem. According to Marc Branson, the head of Germany's BaFin, it is important to keep an eye on risks outside the banking system that are driven by the capital markets if the leverage is significant and complex.

And just recently, the Federal Reserve Bank of New York stated that it has observed how, in times of heightened market-wide stress, liquidity demand from NBFIs piles up at banks. The interdependencies between banks and NBFIs thus would become vectors for the transmission and amplification of shocks, forcing the authorities to intervene on a large scale, the Fed of New York says.

Reconciling risk and liability

While the financing provided by NBFIs is needed to tackle growth and transformation, NBFI transactions are frequently hedged via the banking sector. And the chain of commitments ends with the guaranteed customer deposits which banks in the EU are legally obliged to protect. Growing risks in the unregulated NBFI sector can infect banks via domino effects, thus giving access to deposit protection schemes.

The banks' customer protection schemes must be shielded from the risk appetite of the shadow sector

However, different banking risks – impaired loans, public debt or regulatory framework conditions in the event of insolvency – make it difficult to assign liability and control. The largely unregulated risk appetite of NBFIs adds another risk, and one that is rapidly growing. Savings Banks should on no account be made liable for these risks by drawing on the preventive resources which they have accumulated and manage for their depositors.

! *Mitigating risk comes before sharing risk*

- → When regulating financial transactions, the objective should always be a level playing field.
- → Commercial banks and their deposit protection schemes must not be held liable for NBFI risks.
- → EU-wide risk sharing should not be considered until risks have been effectively mitigated. As far as the NBFI sector is concerned, this is only just beginning.

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[1] *End-of-2022 data for 29 countries accounting for 85 percent of global GDP. Source: Financial Stability Board (FSB): Global monitoring report on non-bank financial intermediation 2023.*