

Assessing the interconnectedness between cross-border shadow banking systems

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February 2018

Summary

This paper provides an overview of shadow banking in numerous economies and investigates their cross-border interconnectedness using a broad measure of shadow banking defined by the Financial Stability Board. We find shadow banking systems are highly interconnected across borders in times of tightening global liquidity conditions, although the cross-border interconnectedness is tenuous during tranquil periods. Their interconnectedness is largely through the economy-specific and global risk factors concerned in this analysis. In particular, investors' search-for-yield behaviour, driven by investment returns, funding support from the banking sector, capital stringency and demand from institutional investors, are key determinants.

Comparing economies' spillover effect, the systems in European and North American economies are the most influential, while those in Asian EMEs are the most responsive. After controlling for the effect of driving factors, the shadow banking system in North American economies remains notably influential worldwide. This reflects that the shadow banking system in these economies is far more complicated than those in other economies, as conventional risk factors can only partially explain their contributions to the risk of spillovers.

Our finding highlights that the spillover risk of shadow banking is not limited by national boundaries, which requires policymakers and regulators to co-ordinate closely with their foreign counterparts. It also draws a possible policy implication for introducing necessary macro-prudential policies, such as monitoring banks' exposures to shadow banking risk and ensuring adequate supply of alternative safe assets, to mitigate the risk of shadow banking being materialised.