Classifying the Shadow Banking in Commercial Banks of Vietnam

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***Abstract*—**This paper present the overview of the shadow banking: definition of the shadow banking, features of the shadow banking and benefits and risks of shadow banking activities. Shadow banking system can bring huge benefits for the development of the financial system and the entire economy but also created serious risks which tear down the entire system. The paper specially divides negative impacts of these banking system into 4 key groups. Due to the important role of the commercial banks in Vietnam banking system, this paper would determine whether there are shadow banking activities in commercial banks of Vietnam or not. To classify the shadow banking in commercial banks of Vietnam, banking operations are divided into shadow banking include: mobilization group, the issuance of valuable papers with creditors - other financial intermediaries and capital group.

***Keywords*—**shadow banking, mobilization, capital, credit institution.

I. Introduction

ACCORDING to FSB, up to 31/12/2014, the total asset value of financial institutions operating in the form of shadow banking was about 36 trillion dollars, increased 1.1 trillion compared to 2013, accounting for 90% of the financial system total assets. Especially, while the total asset value of global banking system tends to decrease in 2014, the scale of the shadow banking increases in recent years from 55% of GDP in 2012 to 59% in 2014.

Traditional banking system of Vietnam now includes three main groups: State banks, commercial banks and foreign banks. There are also joint stock banks and representative of foreign credit institutions. In the reform and innovation, the commercial banks in Vietnam keep on an important fund channel for the economy, while contributing to stabilize the purchasing currency market. Therefore, determining whether there are shadow banking activities in commercial banks of Vietnam or not is an important issue.

This paper aims to classify the shadow banking in commercial banks of Vietnam. The activities are classified into shadow banking include: mobilization group, the issuance of valuable papers with creditors - other financial intermediaries and capital group.

II. Overview of the Shadow Banking

A. Definition of the shadow banking

The phrase "shadow banking" was first introduced by Paul McCulley - PIMCO Chief Investment Officer – The world-class fund of investment in bond – launched in 2007 at the Economic Forum held by United State Central Bank at Jack Hole Wyoming. The later research of Gorton and Metrick (2012); Mehrling (2013); and Claessens & Ratnovski (2014) agreed that operation of the shadow banking is a segment of financial market, operating similar to commercial banks (except for accepting deposits), but then again it is made by non-bank financial institutions through lending services in form of derivatives in Over-The-Counter market (OTC). The lending services exist in parallel (shadow) with credit operations of commercial banks, but outside of the Central Bank's supervision.

B. Features of the shadow banking

Shadow banking report of Fed (2010) studied specifically and formatted operation of shadow banking under different angles, starting from the identification of the non-bank financial institutions engaged in operation of shadow banking to manners (procedures) and instruments that those institutions used in operation of shadow banking. This is particular features of the shadow banking.

- Firstly, shadow banking is associated with wholesale funding in financial market. Traditional banking system depends on deposits mobilization from the public and businesses through a network of credit institutions in order to fund lending activities. Meanwhile, funding activities of the shadow banking system depends on the mobilization through releasing money market instruments (CP, ABCP, repo) for investors such as money market mutual funds market money; or through releasing medium and long-term instruments for pension funds, securities firms, insurance companies ...
- Secondly, shadow banks and traditional commercial banks both active in the transfer of excess funds from people with capital surplus to people with capital shortage in the economy. However, the implementation of two systems have certain differences, which leads to differences in capital rotation mechanism as well as risk transfer mechanism, and supervision of activities.

(1) Traditional commercial banks system (CBs) is established as a credit intermediation, in which commercial banks' key role is to mobilize capital in the form of taking deposits (current accounts, savings, term deposits) and loaning to the economy through the credit products. Via its credibility, CBs will link capital flows from savers to borrowers, so banks also incur credit risk of people lack of capital and liquidity risk when customers withdraw money massively. Meanwhile, the shadow banking system operates based on the credit intermediation chain. With the same principles as CBs are attracting cash flow in and making loans to the economy (cash comes in, loan goes out). However, shadow banking activities according to Diagram 1.2 will be started when the financial company with a special purpose vehicle (SPV) acquired debt portfolio from commercial banks and ended with the release of the tool like ABS in the capital market. These tools are mainly purchased by the money market fund, bond funds, and other financial institutions such as insurance, financial companies... It is also the main channel for capital mobilization of the shadow banking system in order to finance the acquisition of debt portfolio from the commercial banks.

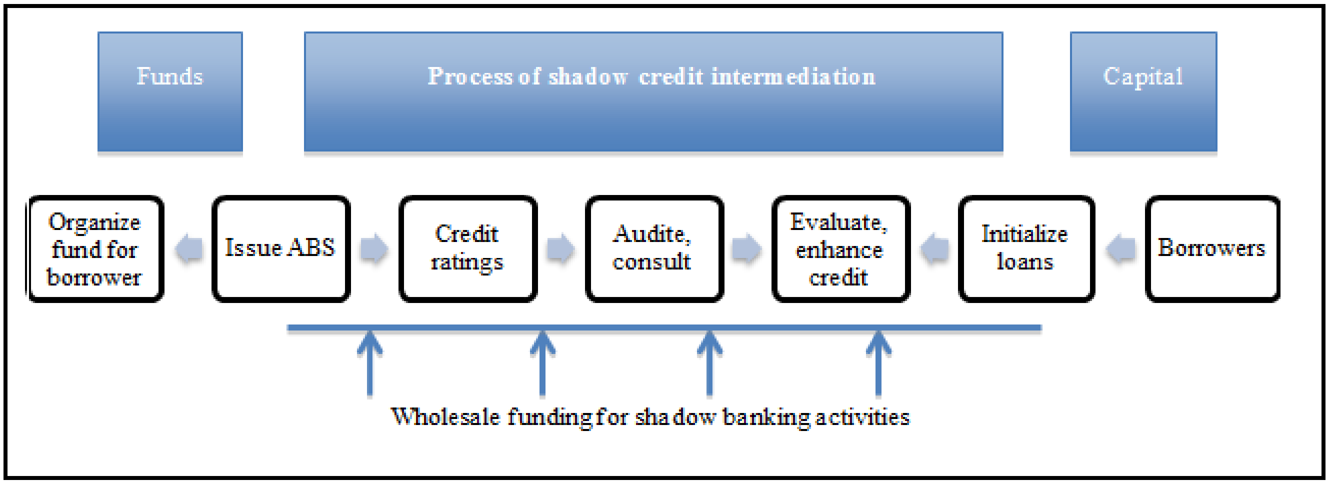

Diagram 1: The Shadow Credit Intermediation Process

Source: Luttrell et all (2012), Staff Papers

Thirdly, in 2011, according to the report of the Financial Crisis Inquiry Commission (FCIC), shadow banking activities include financial transactions having a lot of similarities to the conventional banking. Nevertheless, shadow banking activities are done outside the system of traditional commercial banks and not or less subjected to the law, especially the central bank.

In fact, shadow banks are less regulated by law than traditional banks, it means that at a certain angle, the legal loophole has created the demand for shadow banking activities. Therefore, enhancing the adjustment of law on traditional banking activities will definitely increase the shadow banking activities demand.

C. Benefits and risks of shadow banking activities

Through many researches that has been done, organizations which specializes in banking activities management in the world or at regional level such as Bank for International Settlements (BIS) or European Council (EC) have acknowledged that shadow banking activities have a major impact on the financial system as well as the entire economy. Shadow banking system can bring huge benefits for the development of the financial system and the entire economy but also created serious risks which tear down the entire system.

2.3.1 Benefits of shadow banking activities

Shadow banking activities have existed long time ago and have brought many benefits for the finance system. Green Paper on shadow banking activities of European Commission has summed up positive effects of the shadow banking system to the economy in general and the finance system in particular as follows: (1) provide investment methods for investors to replace the common banking saving; (2) allocate resources more efficiently due to more professionalization; (3) is an effective donation to replace traditional donation channels for the economy in case where these channels are temporarily damaged and (4) is a source which help diversify risk prevention for the commercial bank system.

2.3.2 Risks of shadow banking activities

Besides the benefits, shadow banking activities always have potential huge risks for the financial system which not only in one country. Green Paper on shadow banking activities of ECB has grouped negative impacts of these banking system into 4 key risk groups:

<u>Group 1 – Banking disorders risk – Financial contagion risk</u>

Shadow banking activities are usually subject to the same kinds of financial risks to commercial banking system but not tightly controlled. Gandhi (2014) also showed that, while commercial banks are protected from "bank panic" by the financial safety net, of which the most important is deposit insurance and lender of last resort, or other legal regulations relating to the government guarantee, etc ..., the shadow banking system has absolutely no such mechanism. Many shadow banking activities are financed by short-term funds and will take huge risks when customers rushed to withdraw money massively.

Group 2 - default risk

The shadow banking activities always use high level of financial leverage, which promote high default risk making the financial sector more fragile. This happens because the shadow banking activities are not controlled and set limits by the relevant authorities. Moreira & Savov (2013) also pointed out, in good economic conditions, the shadow banking activities increase the liquidity of the economy; however, they use up scarce resources and create more useless securities in the crisis period making the financial situation become more unstable.

In addition to the widespread use of financial leverage, shadow banking system also makes the economy become unstable by putting it into the state of co-cycle fluctuations. This was asserted by some researchers such as Stanley (2014), Gandhi (2014) and Labes (2014). Because the liquidity of financial instruments of the shadow banking depends heavily on the fluctuations of market price, the financial system will fluctuate with the co-cycle, meaning the financial system is sensitive and vulnerable to the impacts of extreme volatility like sudden growth or sudden recession.

Group 3 - violation risk, abuse, reduction of efficiency of law provisions

Shadow banking system is not really regarded as a "bank", the legal provisions relating to the banking system such as statutory capital requirements, capital adequacy ratio, the financial safety indicators assurance, mandatory participation in deposit insurance, and restriction on risky investment and business activities are not applied to this system. On a larger scale, the violation of law or abuse of law provisions can occur across the countries and regions. Gandhi (2014) pointed out that, while the banking operations expanded at global level, different legal systems make the shadow banking more difficult to manage.

Group 4 - Cross risks to the operation of commercial banking system

The shadow banking activities often have links with the operation of commercial banks. Therefore, the crisis in the shadow banks would cause panic spread to the activities of commercial banks. Maeno, Nishiguchi, Morinaga and Matsushima (2014) used the model Network Asset systemic risk - ANSWER shows that while the proportion of shadow banks in the economy accounts for between 10% and 50%, the collapse of the shadow banks would cause a series of bankruptcies in the commercial banking system.

Besides the mentioned main-risk groups , some studies also showed that the operation of shadow banks can hinder and reduce the effectiveness of monetary policy leads transmitted through commercial banking system. Due to the less transparent in structure construction, operation and scale as well as the relationship between banks and shadow banking, trade, information from the monetary policy indicator may be affected and, therefore, the effect of monetary policy significantly reduced. Gandhi (2014) pointed out shadow banks impede the transmission of monetary policy commercial banking system through the credit channel, Labes (2014) warned that when the operation of shadow banks is superior, that would lead ineffective rate interest channel. Research by Deutsche Bundes bank (2014) concluded that the increase in the operation of shadow banks weaken the credit channel and the interest rate and its monetary policy transmission through the commercial banking system, but increased effectiveness of asset price channel.

III. Classifying the Shadow Banking in Commercial Banks of Vietnam

A. *Classifying the shadow banking activities in Vietnam*

Traditional banking system of Vietnam now includes 3 major banks group state banks, commercial banks and foreign banks. There are also joint stock banks and representative of foreign credit institutions . In the reform and innovation, the commercial banks in Vietnam keep on an important fund channel for the economy , while contributing to stabilize the purchasing currency market. The existence or not of shadow banking system is a Vietnam's matter because of the risks and more importantly, it directly affects the safety of the traditional banking system Vietnam.

It shows generally the scale of capital supply for the economy of Vietnam financial institutions (06/2014) reached 4.57 million billion VND(approximately 152% of GDP), in which the banking system accounted for 80.5%, 18.5% the stock market, insurance market 0.5%, 1% social security; total outstanding loans was about 3.5 million billion VND (100% of GDP), the size of the stock market (bond markets) over 1 million billion VND (28.6% of GDP), insurance market size about 70 thousand billion VND (2% of GDP). Therefore, we can see that funds used to serve the economic development of Vietnam is still largely based on borrowing from the banking system. In other words, the main actors perform credit activities in Vietnam is commercial banks.

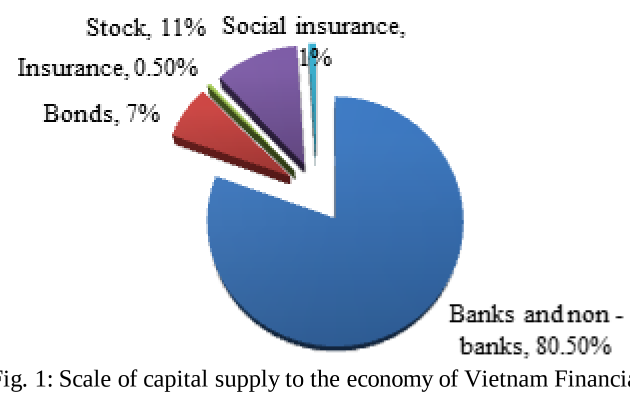

Fig. 1: Scale of capital supply to the economy of Vietnam Financial Institutions (6/2014)

Source: Luc Van Can (2014)

B. Classifying the shadow banking activities in Vietnam commercial banks

The implementation of banking operations as mobilizing deposits from financial institutions, issuing valuable papers to buyers that are other banks or lending to other banks or deposit activities at other financial institutions, purchasing derivative financial instruments and other financial assets (which the borrower's other credit institutions) are regarded as the specific activity array of shadow banking activities. Four prerequisites used to assess whether an activity (the capital or asset side) is shadow banking activities or not includes: 1/ activity has brought credit nature, 2/ activity is not belong to group of mobilization or using traditional capital (core) of commercial banks, 3/ activity is not formally guaranteed from public funds and 4/ activity is less regulated by the central bank; can see the activities are classified into shadow banking activities performed by commercial banks include

- Mobilization group : receive deposit from other credit institutions, issue valuable paper for other financial intermediaries

According to IMF, the core liabilities, deposits and loans from other financial institutions cause shadow banking activities in commercial bank. Researchers say that deposits and loans take a significant proportion of the total debt mobilization. In 2009, the share of deposit and loan in total liabilities was 13% in average, increased to 20% in 2011, reduced gradually and was 15% in 2014.

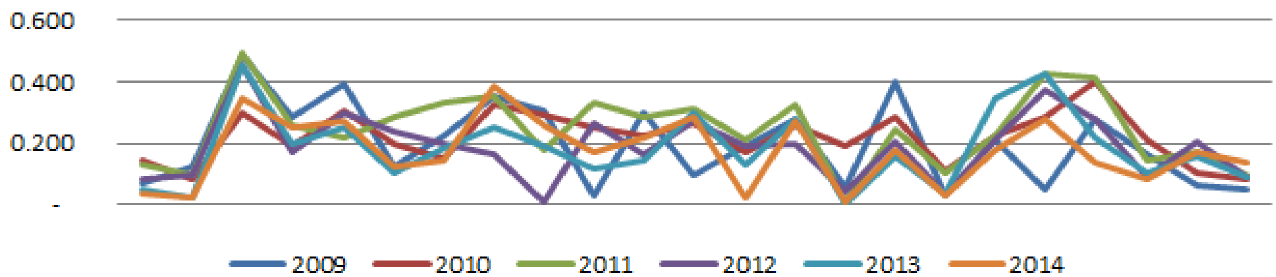

Fig. 2: Share of deposits and loans from financial institutions over total liabilities in commercial banks from 2009 to 2014.
Soure: Data and analyses from financialstatements of commercial bank

In general, the average share of deposit and loan from credit institutions over total liabilities from 2009 to 2014 is not high, about 13% - 20%. Nevertheless, having overview from figure 2.8, this proportion is not stable, even outliers. For example, in 2009, while Southeast Asia Joint Stock Commercial Bank (SeaBank) took the highest share of deposit and loan over total liabilities with 49%, Vietnam Prosperity Bank was in the lowest position with 2,9%. Inspite of gradual reducing share of deposits and loans over total liabilities after 2011, in 2013, SeaBank got the highest number (about 49,5%) and SaiGon Bank had the lowest with 0.2%. In the inter- bank , being in temporary surplus, a bank may lend to other banks with very short period, like one week even one night. The common values for specific proportion over the years at commercial banks is 20-30%. Even though the debt mobilization is very short and risky, commercial banks still utilize such as a significant source of deposits from other banks or the loan agreement between them.

- The issuance of valuable papers with creditors - other financial intermediaries, are also considered shadow banking by commercial bank.

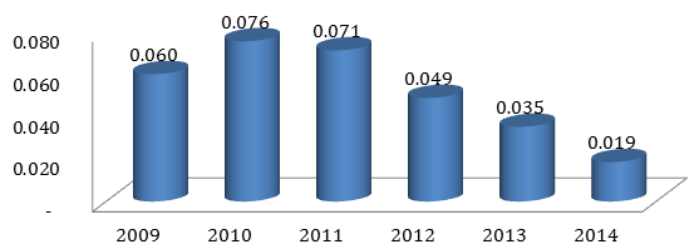

Fig. 3 : The share of valuable papers issued over total liabilities
Soure: Data and analyses from financial statements of commercial bank

Funds from the bond issue are not adjusted by the reserve requirement. Therefore, it is highly stable source than the deposits and loans to other banks. However, the issuance of valuable papers proportion is smaller than the mobilization deposit from other credit institutions in commercial bank. According to figure 2.9, average density of valuable papers issued over total liabilities reached only 6% in 2011, increased to 7.6% in 2012 and decreased over the years. In 2009, it was about 2,9% in the total debt mobilization.

The average density of valuable papers issued over total liabilities is not stable. On the other hand, in 2011, there was great disparity between the smallest proportion (under 5% with Vietnam International Bank) and the largest proportion (over 30% with Viet Capital Bank).

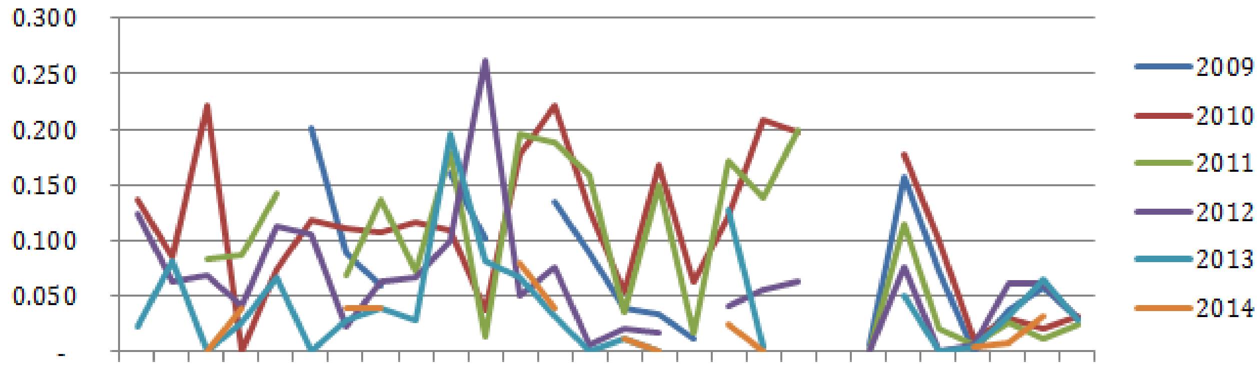

Fig. 4: The share of valuable papers issued over total liabilities in commercial bank from 2009- 2014

Soure: Data and analyses from financial statements of commercial bank

- Capital group: lend other credit institutions, operate deposits in other credit institutions, purchase derivative financial instruments and other financial assets.

Purchasing derivative financial instruments and other financial assets activities (the borrower is another financial institution) account for a very insignificant percentage in the total assets or plan for capital of commercial banks. In 2009, the average proportion of derivative financial instruments and other financial assets over total assets accounted for 0.035%. In 2014, this figure fell to less than 0.003%, almost negligible. In conclusion, this activities mainly is not in investment assets of commercial banks.

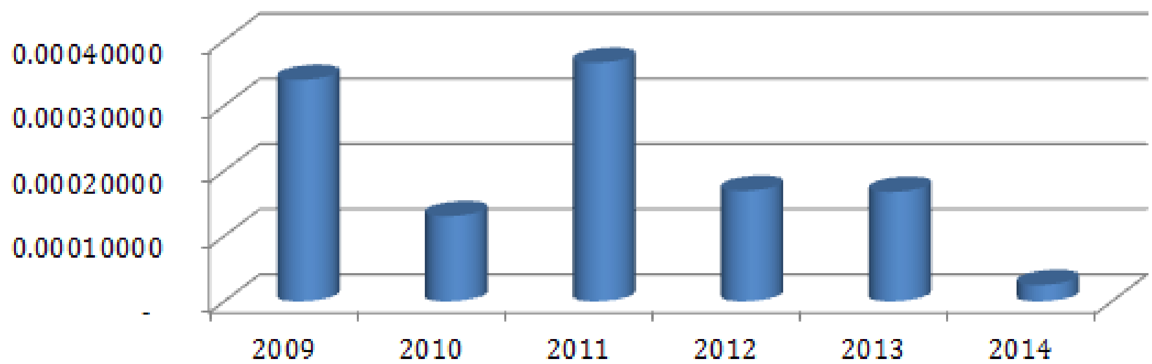

Fig. 5: Average share of derivative financial instruments and other financial assets / Total assets

Soure: Data and analyses from financial statements of commercial bank

Taking deposits and loans for other credit institution is opposite to deposits and loans activities for them in term of capital. The average proportion of deposits and loans for other financial institution to total assets ranged from 15% to 20%. In the end, deposits and loans for other credit institution activities account for a significant proportion in investment assets of commercial banks.

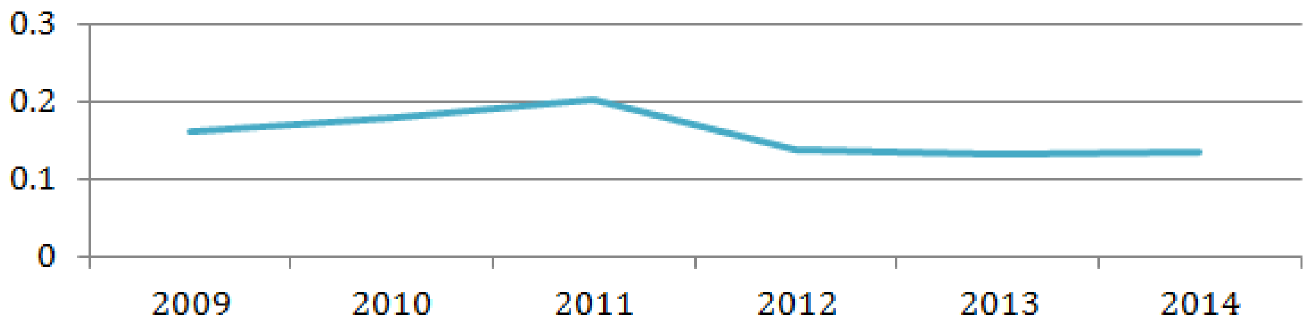

Fig. 6: Average proportion of deposits and loans / Total assets.

Soure: Data and analyses from financial statements of commercial bank

In general, many people warn about the black credit and seem it as a shadow banking activity. Nevertheless, according to the concept and criteria of IMF (2014), this is not true. Black credit is the form of mobilization credit through the banking system. There is no business registration as well as unlicensed and out of official management by government.

A common form of black credit is usury in which one organization mobilizes and lends with high interest rates. However, the procedure is much more simply than the credit operations of usual banks. The size of this market is not calculated but at the end of 2011, this figure could reach to 22% of banking system credit scale (Alan Phan, 2011). According to some researchers, total black credit of Vietnam accounts for 30% of total credit provided by commercial banks, about $ 50 billion. Considering the international standards, this figure is really high.

In conclusion, black credit is out of shadow banking category. To prevent black credit, it is essential to raise the awareness of residents about black credit and the law to protect themselves. In order to solve the credit, we need analyze the reason to the increase of black credit in the economy. That is the difficulty of economy in creating opportunities for people to access formal credit from the commercial banking system. Raise the awareness combined to improve the life of residents to gradually eliminate black credit out of social.

IV. CONCLUSION

In conclusion, based on four prerequisites used to assess whether an activity (the capital or asset side) is shadow banking activity or not, the activities are classified into shadow banking performed by commercial banks includes :

- Mobilization group : receive deposit from other credit institutions, issue valuable paper for other financial intermediaries
- The issuance of valuable papers with creditors - other financial intermediaries, are also considered shadow banking by commercial bank
- Capital group: lend other credit institutions, operate deposits in other credit institutions, purchase derivative financial instruments and other financial assets

According to the concept and criteria of IMF (2014), black credit is not a shadow banking activity. However, the government should facilitate for the resident to prevent and protect themselves from the increase of black credit market.

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