

# Assessment of Shadow Banking Situation in Korea

## Through Analysis of Pro-cyclicity

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Shadow banking can broadly be described as credit intermediation involving entities and activities outside of the regular banking system. High levels of leverage and the pro-cyclicity of major countries' financial systems by way of shadow banking have been considered as key causes of the Global Financial Crisis, and concerns have also been repeatedly raised about the shadow banking-related risks from a financial stability perspective since the crisis. In this respect, this paper compares and analyzes the pro-cyclicity of shadow banking in Korea, the US, and Japan, and puts forward elements underlying the differences exhibited among them.

According to our analysis of the pro-cyclicity of shadow banking using a lagged correlation coefficient and the impulse response function of our VAR model, shadow banking in Korea is found to have lower pro-cyclicity than it does in the US and Japan. By type of shadow banking institution, securities firms and collective investment funds are analyzed as being highly procyclical in the US and Japan, but in Korea, the real business cycle is found to have a significant influence on asset size only in the case of credit-specialized financial companies.

The pro-cyclicity of shadow banking in Korea is lower than in the US and Japan, firstly because in Korea its volatility is only slight unlike in the US and Japan where the scale of shadow banking changes rapidly, depending upon conditions at home and abroad. In addition, the fact that the proportion of instruments with relatively high risks in total shadow banking financial instruments and the leverage ratios of major shadow banking institutions are lower in Korea than in the US or Japan also seems to have served as a factor in restraining

pro-cyclicality of domestic shadow banking. Furthermore, securities firms in Korea make relatively little use of RP purchases and re-RP transactions and this characteristic of their way of doing business also seems to have influenced pro-cyclicality of shadow banking.

In light of these analysis results, the risk related to shadow banking in Korea is lower than in the US or Japan. Constant efforts, however, should be made to examine potential risk factors, since the scale of shadow banking in Korea has been continually increasing greatly since the Global Financial Crisis. To this end, the scope of shadow banking should be clearly defined, in reflection of the level of risk by institution and by instrument, and close scrutiny should be given to the interconnectedness of financial institutions through shadow banking. In addition, since the pro-cyclicality of shadow banking will be likely to become higher in Korea due to the increase in both the reuse of collateral assets and collateral transformation transactions, efforts should be made to strengthen the monitoring of these transactions and to improve risk management frameworks.

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