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## **DECLARATION**

I hereby declare that that work has been written solely by me and it has not been submitted, in whole or in part for the fulfillment of any other degree. Except where stated otherwise with references, the work is entirely my own.

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## ABSTRACT

Under the shadow banking system is understood as a set of financial institutions that carry out banking operations, but do not have a bank license. This system began to develop actively in the early 2000s, and to date, the volume of its operations has approached 100% of world GDP.

The term "shadow bank" was introduced by the American economist Paul McCully in 2007. According to the definition of the Financial Stability Board (FSB), the shadow banking system includes any credit relations with the participation of structures outside the official banking system. Shadow banking participants include structural investment companies, hedge funds, investment banks and brokers-dealers, who carry out activities through the attraction of repo-loans. The main features of the activities of shadow banks are that they do not serve the real sector of the economy and the population (their clients are traditional banks), but help group the capital received by banks in the form of derivative securities and alternative financial instruments, as they borrow short-term funds in money markets and use them to purchase more long-term assets.

Shadow banks for the first time attracted the attention of many experts due to their growing role in the transformation of housing mortgages into securities (securitization) before the beginning of the global financial and economic crisis of 2008. This mechanism began with the provision of a mortgage, which was then bought and resold by one or more financial institutions, until it was included in the mortgage loan package used to provide the security that was sold to investors. The value of this security was related to the cost of mortgage loans in the package, and interest on the mortgage-backed securities was paid out of borrowers' payments on the loan. Thus, practically the whole mechanism passed beyond the zone of direct visibility of the financial regulation bodies.

To date, the United States, Ireland, the Netherlands and Luxembourg are the largest shares of shadow banking. Most researchers note that in the case of the

rapid development of the shadow banking system in the future, this may entail a significant risk of global systemic instability.

# SHADOW BANKING AND FINANCIAL CRISIS

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## INTRODUCTION

**Actuality of the study.** Shadow banking, as an economic phenomenon of recent years, should be considered primarily in the context of changing macroeconomic conditions. Today, a new global macro position is a post-crisis suspension of the rapid growth of the world economy, which results in a situation of general uncertainty in the economy fixed for a long time. Specific signs of the modern qualities of the world economy, in our view, are as follows:

- inhibition of economic growth (the growth potential due to the loading of capacities and labor reserves is almost exhausted) and the balancing of the global economy on the verge of zero or weakly positive growth while preserving objective country differences. Thus, the growth of world GDP in 2012 amounted to 2.2%, the consensus of expectations for the growth of this indicator for 2013 is 2.5-3%, including GDP growth of the BRIC countries will be 6.5%, the USA - 2% , and Europe will experience a recession (according to S & P, the fall in the euro area in 2013 will be 0.1%).

- non-cyclic chaotic changes in the markets, not brought under the notion of "crisis phase". This was foreseen by J. Schumpeter in the dynamic concept of cycles as the patterns of economic growth. He criticized the authors (in particular K. Marx) who viewed crises only as a phase in a fundamental undulating movement, and grounded the cycles with innovations - technological, political, social. The financial innovations that broke into this family at the end of the 20th century pushed other changes and transformed the modern economy qualitatively, giving its dynamics an unstable and risky look, inducing serious risks.

In general, the modification of the manifestation of economic laws does not refute, but only confirms the basic postulates of the theory of cycles;

- the exhaustion of the effectiveness of traditional instruments of state regulation and supervision in the financial sphere, the search for tools for "fine-tuning";

- de-autonomization of the solution of problems in the financial sector, connection to the actions of monetary authorities of macroeconomic regulators, an increasingly frequent appeal to nation-wide measures;

- finally, the irreversibility of all these manifestations.

Thus, the new macroeconomic background from the position of the theory of economic cycles in our understanding is not only a certain combination of macro indicators, but also obvious chaotic, unpredictable capital flows, the difficulty of objective forecasts of economic growth, the state of public finances, investment processes. It is interesting that this concept of a kind of suspension of the world economy in the state of enduring crises; reality, perhaps, confirms it. Under the new conditions, the effectiveness of the old instruments of stimulating demand, traditional methods of monetary and fiscal policy, is gradually becoming unobserved, and non-standard, non-classical regulatory and supervisory decisions, including those of an unpopular nature, are increasingly being resorted to.

The positive or negative consequences of Shadow Banking and the Azerbaijan Employee's shadow banking sector on their existence in Azerbaijan will be of great significance in terms of finance in Azerbaijan. At the same time, the first findings of the shadow banking sector on Azerbaijan are being discussed. The study is thought to be a pioneering work in terms of defining shadow banking in Azerbaijan in this respect and it is aimed to become a starting point for a new discussion point in the literature. Therefore, it is thought that the research can be a pioneering work that can open the way of scientific studies to be done in this subject.

**Purpose of the study** is to examine the impact of shadow banking to financial crisis. The objectives of the study are following:

1. Analyse of concept of shadow banking;
2. To discuss shadow banking as as institutional and functional regulation;
3. To explore shadow banking role in financial intermediation;
4. Analysis of the state of the Azerbaijan banking system and the problems of shadow banking;



5. To find ways fighting against the shadow banking system as a mechanism to ensure the economic security of the country;

6. Development directions for improving the mechanisms of counteraction to shadow banking.

**Object of the study** is Azerbaijan banking system.

**Subject of the study** is analyse the role of shadow banking in development financial crisis.

**Scope of the Study:** The scope of the study is to investigate the existence of a shadow banking system in developing countries such as Azerbaijan, where the banking sector plays an important role, and whether the shadow banking sector is accompanied by Azerbaijan's financial characteristics. It is aimed to determine whether the non-interest and off-balance transactions in the banking sector, which has a more rigid rules and a new audit mechanism (BRSA) after the 2001 crisis, are an alternative source of income in the banking sector and a hidden risk source.

**Methodology of the study.** The methodological basis of the study was the main provisions of modern economic theory, the works of domestic and foreign scientists in the field of the world economy and international activity of banks, the evolution of the world banking system and the implementation of banking supervision. To substantiate the propositions put forward in the thesis, the system analysis, abstract-logical estimation methods, groupings and generalizations, comparative analysis, graphical method, statistical methods of information processing, expert assessments, etc. were used.

**Practical importance of the study.** The practical significance of the study is to expand and supplement the methods and mechanisms for improving the international activity of banks in the conditions of shadow banking in the financial crisis.

**Scientific novelty of the study.** The scientific novelty of the work is to develop and justify the author's position of improving the international activity of banks in a shadow banking environment.

## **CHAPTER I: THEORETICAL BASIS OF SHADOW BANKING**

### **1.1. Concept of shadow banking**

The heyday of shadow banking or the shadow banking system is in the first half of the 1990s, the time of rapid growth of structured finance, which actually formed its *modus operandi*, or the mechanism of functioning. The basis of structured finance was an attempt to bring credit risk beyond the banking sphere and the desire to create new forms of liquidity or sources of financing for credit markets by transferring banking assets to the balance sheet for the purpose of their subsequent resale.

The result of the development of structured finance was a change in the way the banking industry operates. The traditional banking model of generating and financing loans, called "generate and retain," was replaced by a different "generate and distribute." In the framework of this new model, the bank, instead of maintaining loans on its balance sheet before full repayment, began to withdraw them beyond its limits. Namely, to sell or transfer to off-balance structures - the so-called Special Purpose Vehicles (SPV), as a rule, created by the same bank. Off-balance-sheet loans issued by the bank (SPV) were pooled, underwritten and sold as Asset-Backed Securities (ABS). The "generate and distribute" model allowed banks to transfer, share and sell related risks (for example, the default risk, the risk of default on interest, the risk of changing loan interest, etc.). In addition, the new model provided banks with ample opportunities to free up their own capital and reuse it to generate more and more new loans without any serious limitations on its reservation. As a result, the emission of, for example, the so-called ABS and MBS - asset-backed securities or CDOs - Collateralized Bond Obligations, as well as credit derivatives designed to transfer risks beyond the banking sphere, began to grow with great force, creating the foundation of a "shadow banking system".

The growth of the shadow banking system was due not only to the internal needs of banks seeking to expand their credit opportunities through the use of a new business model, but also the needs of credit markets. The fact is that in the last

quarter of the last century in the financial industry there was a significant redistribution of the population's resources from banks to various mutual funds, whose activities were aimed at obtaining higher interest rates from invested capital compared to deposits offered by banks. The total volume of assets managed by various funds in the world has been growing rapidly over the past twenty years and amounted to more than \$ 117 trillion.

These funds have become the main consumers of innovative loan products represented by securitization and credit derivatives. Institutional investors in the form of professionally managed funds should also be supplemented by non-financial companies and state organizations that have significant amounts of cash on their accounts. For the shadow banking system, all these structures began to act as depositors, and their free cash is that for traditional bank deposits are.

The need for institutional investors in structured financial products was due to the need for a temporary "absorption" of free cash that would yield a return comparable to traditional bank deposits, with the same liquidity and reliability of capital preservation as the latter have for individual investors in commercial banks. Why for institutional investors is shadow banks the object of temporary investment of capital? The fact is that the deposit insurance in the banking sector covers only a small amount in comparison with the volume of cash that is temporarily on the accounts of institutional investors in anticipation of long-term investments. So, for example, in the US, the FDIC insurance - of the Federal Deposit Insurance Corporation - covers only 250,000 dollars of a depositor in a bank of capital. The shadow banking system, through the use of structured financial instruments, allowed institutional investors to solve the problem of temporary and reliable placement of huge free cash volumes for a very attractive interest. The mechanism for solving this problem was the repo market. Repo - is a simultaneous agreement on the sale and repurchase at a specified price and on a fixed date of any securities acting as collateral. In other words, the repo agreement is a short-term loan secured by securities. In the case we are considering, structured finance products - all kinds of asset-backed securities in the form of ABS, MBS or CDOs - began to act as

collateral, and institutional investors as lenders provide the shadow banks with their free capital for liquid security, which serves as a guarantee for the preservation of assets like the one that is FDIC insurance in a traditional American bank.

So, the growing demand for quality liquidity in the form of all sorts of structured financial products on the part of their main consumer - institutional investors with huge amounts of temporarily free cash, along with a change in the banking business model - became the main reasons for the rapid growth of the shadow banking system, in one of its main constituent parts. In the works of various Western researchers - both academic and state-sponsored - the size and size of the shadow banking system are assessed in different ways. We take as a basis the data of the Financial Stability Board (FSB), the Financial Stability Committee, established in 2009 by a group of twenty leading economies in the world (G20) for the supervision of credit markets. So, according to the estimations of this Committee for 2012, the size of the assets of the shadow banking system of the world exceeded \$ 60 trillion, and according to Bloomberg estimates - 75 trillion dollars<sup>3</sup>. This, according to the English analytical company The City UK Partnering Prosperity, accounts for almost 60% of the assets of the world's 1000 largest banks. At the same time, 40%, or 24 trillion dollars, of the total volume of assets of the shadow banking system falls on the US; 37%, or 22 trillion dollars for Europe. According to Michel Barnier, the Commissioner of the European Union for the Supervision of Financial Markets, "the shadow banking system represents 25-30% of the global financial sector." In the US, the share of the shadow banking system in the financial sector is even higher - according to experts' estimates it is 35-40%.

In the broadest sense, the shadow banking system can be defined as a credit intermediation carried out by organizations outside the regular banking system. Being a credit intermediary, the shadow banking system performs three basic functions, similar to the traditional banking business. Namely, it carries out the transformation of the loan, debt obligations and liquidity. Credit transformation

means the improvement of the credit quality of a debt issued by a credit intermediary based on the use of the priority mechanism for claims or subordination, the attraction of guarantees and letters of credit, and so on. Transformation of debt obligations is the use of short-term deposits to secure long-term loans, thanks to which the credit intermediary creates the necessary liquidity to finance the borrower's needs. Transformation of liquidity means the use of liquid instruments or liabilities to fund illiquid assets. A characteristic feature of the shadow banking system as a credit intermediary is its active use of financial leverage or leverage. The financial lever here is analogous to the principle of partial bank reservation of traditional banking. A distinctive feature of leveraging the shadow banking system from the principle of partial reservation of banking is that the former is applied by the shadow banking system with even greater scope and uncontrolledness.

The shadow banking system has three features that fundamentally distinguish it from traditional banking. First, the shadow banking system is unregulated. In other words, there are no rules and a supervisory authority that would ration and regulate its actions. A serious attempt to streamline the activities of shadow banks was the instruction of the leaders of the G-20 countries to the Financial Stability Committee (FSB) to draft a rule for their regulation. The second most important feature of the shadow banking system is that, unlike the traditional banking system, it does not have access to the source of liquidity provided by the last Central Banks in the event of cash problems. So, for example, American banks that do not have enough reserves can freely borrow the necessary funds from the Fed, which, in turn, has the right to create money *ex nihilo*, i.e. from nothing. Another important feature of the shadow banking system is that, unlike the traditional banking system, it is also deprived of access to guarantees of deposits provided by the state to private individuals.

So, like traditional banks, the subject of shadow banks is mediation between borrowers and lenders of financial resources. Shadow banks function in parallel to the banking system and similarly the latter are provided with loans and

liquidity, and also generate various financial instruments that act in the form of money. However, unlike the banking system, shadow banks are deprived of access to the resources of central banks, and also do not have state guarantees for the preservation of capital. In addition, unlike the banking system, where each bank in itself under one roof is able to implement all the stages of intermediation between borrowers and lenders, in the shadow banking system such intermediation is broken down into a chain, although internally interconnected, but nevertheless legally separate structures, each of which fulfills its specific role, without which the whole system of credit intermediation simply ceases to work.

The *modus operandi* of the shadow banking system is a wide range of different types of innovative tools, techniques, procedures and forms of financing covered by the notion of securitization, such as asset-backed securities (ABS-Asset-Backed Securities), asset-backed commercial paper (ABCP-Asset-Backed Commercial Paper), collateralized debt obligations (CDOs - Collateralized Debt Obligations) and repo agreements, as well as various derivative products of a higher level based on them, such as credit derivatives.

The multi-stage structure of credit intermediation of the shadow banking system can be reduced to three main parts:

- 1) the emergence or generation of a loan;
- 2) the process of securitization or structuring of loan-based securities (consolidation of loans, ABS issue, credit transformation of ABS through CDS, etc.);
- 3) funding or investing in structured finance instruments.

The starting stage of the functioning of the shadow banking system are various types of loans (student loans, loans for the purchase of motor vehicles, mortgage loans, corporate loans, corporate bonds, etc.) issued or organized by depository institutions, broker-dealer and financial companies.

In the US banking system, depository institutions include commercial banks, savings institutions and credit unions. At the same time, 90% of all assets of depository institutions belong to commercial banks. Therefore, when talking about

depository institutions in the US, one should keep in mind only commercial banks. In the euro area to depository or credit institutions - Monetary financial institutions - include lending institutions, central banks, money market funds and financial institutions falling under the definition of MFI (Monetary Financial Institutions).

Broker-dealer companies are investment banks. The balance of these organizations is seriously different from the balance of traditional depository institutions, because, unlike the latter, investment banks do not accept deposits as their main sources of funding. The role of broker-dealer companies in the field of lending has been increasing as securitization in the financial system grows. In the course of its development, the area of structured finance has become the main source of competition between broker-dealer companies and commercial banks.

Financial companies are either independent financial companies or financial companies that are subsidiaries of an industrial firm. In the United States, financial companies are the second largest source of lending to businesses and individual consumers, following depository institutions. However, unlike banks, financial companies do not accept deposits. Not being depository institutions, they are not subject to banking regulation and therefore do not have access to the liquidity of the central bank, as well as deposit guarantees. To finance loans, financial companies mobilize capital by issuing commercial paper and other short- and medium-term debt instruments.

So, the loans of depository institutions, investment banks and financial companies constitute the first or the starting stage of the functioning of the shadow banking system.

The emergence of structured finance has formed the path of transition from traditional finance to the shadow banking system. The essence of structured finance was the pooling of economic assets or financial resources (for example, loans, bonds, mortgage bonds) into pools with the subsequent emission on their basis of securities for further resale in order to attract financing.

Securitization allowed illiquid banking assets (loans and receivables) to be turned into liquid financial instruments, and credit derivatives to provide a risk-free

character and a guarantee of reliability. In addition, structured finance has allowed a new way of credit intermediation to reduce the cost of borrowed capital in comparison with traditional banking, and to facilitate its accessibility. But this is not all - the shadow banking system, which arose on the basis of structured finance, gradually turned into a significant source of funding for the most traditional banking system, finally closing in a single circle, both.

Securitization process - the central stage of the functioning of the traditional banking system follows a certain, strictly sequential order, each stage of which corresponds to a specific type of shadow banking organization, financed by a specific class of obligations. In the process of securitization of assets, the number of these organizations or shadow banks can vary significantly from three to seven or even more, depending on the type and quality of the loan initially received, as well as the complexity of the structured financial product being created. All types of organizations or shadow banks implementing the securitization process can be characterized as conduits or special purpose funds (SPV) and structured investment vehicles (SIV). SIV and SPV are the entities created to transform assets (loans) from the balances of the banks and financial institutions that generated them.

In the simplest form, the securitization process, as well as the corresponding types of shadow banking structures, can be represented as follows:

1. Consolidation or "warehousing" of loans (Loan Warehousing), received from the organizers of the loan. The procedure for combining loans deals with a specially established structure, called a conduit or SPV. In some cases, it is the same legal entity as the bank - the organizer of the loan. Financing of this structure, as a rule, occurs at the expense of the bank - the organizer of the loan.

2. Sale of pooled or pooled SIV loans, a trusted person or administrator of which is usually a large commercial or investment bank. SIV issues securities secured by loans in its investment portfolio. At the same time, depending on the volume of emissions, SIV can be divided into single Purpose Standpoint Issuers and Multiple Issuance Structures. Financing of the activities of the SIV is carried out through remuneration or commissions received for their services.



3. Sale of securities created by SIV. In most cases, the issued securities are not directly sold by the founder administrator of SIV. As a rule, the administrator sells them to the underwriter. Such guarantor-guarantor is usually the investment bank, which assumes the responsibility to sell the acquired securities to the ultimate investor. It is noteworthy that sometimes the underwriter leaves part of these purchased securities in his portfolio.

Speaking about the securitization process as the central stage of functioning of the shadow banking system, it should be noted that it can be implemented in two ways - traditional and synthetic. Traditional securitization means that the originator of this process - a bank or a financial company - directly sells and transfers its assets (loans) to off-balance structures - SPV and SIV - for their subsequent "transformation" into structured financial products. This transaction allows the originator to turn illiquid assets into liquid assets to acquire free capital and thereby reduce the regulator's requirements to the level of its own funds. Moreover, the originator can use the received capital to issue new loans. Synthetic securitization means the process of combining traditional securitization with credit derivatives. So, with synthetic securitization, the originator, through the application of credit derivatives, transfers only the credit risk to the shadow banks of SPV and SIV, keeping the entire portfolio of loans issued on its balance sheet. The very meaning of the term "synthetic" just implies that the risks from one person to another are transferred artificial, that is, in a synthetic way - without the sale of a basic obligation. Transferred by the originator to shadow banks, credit risk is transformed by them through the mechanism of credit derivatives into various types of complex structured products. It should be emphasized that synthetic securitization, i.e. securitization using credit derivatives is the fastest growing segment of the structured finance market used by the shadow banking system. Distinguishing between traditional and synthetic securitization, we can conclude that the first goal is to obtain cheaper sources of funding, and the second is to hedge credit risks.

Concluding the consideration of the securitization process as the middle stage of the functioning of the shadow banking system, it should be noted that the term "asset-backed securities" - ABS - is mainly used in the broad sense due to specific research tasks. Those this term is understood as all products of securitization, both traditional and synthetic. If to specify the concept of ABS, then it includes two main classes, more precisely, the level of structured financial products: 1) the primary or classical level, which includes traditional ABS (securities secured by loans for training and buying transport), MBS, consisting of RMBS and CMBS (securities secured by mortgage mortgages for housing and commercial buildings) and, finally, ABCP (securities secured by enterprise receivables and credit cards); 2) secondary level - the level of synthetic securitization and resecuritization. Products or tools of this level include: CDO (secured debt obligations) consisting of CLO (secured loan obligations) and CBO (secured bond obligations); all kinds of synthetic CDO - CDO hybrids provided by CDO, ABS, RMBS and CMBS and other structured products; CDOs provided with specific CDO tranches and the like.

Shadow and traditional banking systems are closely intertwined with each other. Moreover, they simply cannot exist without each other, because they represent two sides of the same medal - the modern credit market, the modern financial system as a whole. It is worth recalling that the emergence and development of the shadow banking system in itself was due to the urgent needs of just the traditional banks, seeking to withdraw credit risks from their balances, and through this, through the creation and application of structured financial instruments, to increase their profitability. Unsurprisingly, commercial banks often became part of the chain of shadow banks, as well as explicitly or implicitly support shadow banking structures in the process of transforming their liquidity and the maturity of debt obligations. In addition, traditional banks were one of the most active investors in structured financial products emitted by the shadow banking system. Moreover, for traditional banks, the shadow banking system in the

last decade has become one of the main sources, along with households and corporations of its own funding or lending.

Such interdependence and interconnectedness of traditional and shadow banking systems means their extreme sensitivity to each other's problems. So, the fall or collapse of an institution in the structure of the shadow banking system can lead to a domino effect that will jeopardize the stability of the entire financial system as a whole. Examples of this development over the past two decades are more than enough. The close interconnectedness of these two systems of the credit market, actively using leverage and structured financial products, representing different levels of concentration, usually of unsecured obligations, inevitably leads to increased cyclicalities and increases the possibility of generating price bubbles, especially when the structures of both these systems are invested in the same assets in the form of securitized products or derivatives.

### **1.2. Shadow Banking as institutional and functional regulation**

Shadow banking, as an economic phenomenon of recent years, should be considered primarily in the context of changing macroeconomic conditions. Today, a new global macro position is a post-crisis suspension of the rapid growth of the world economy, which results in a situation of general uncertainty in the economy fixed for a long time. Specific signs of the modern qualities of the world economy, in our opinion, are the following: - the slowdown of economic growth (the opportunities for growth due to loading of capacities and labor reserves are almost exhausted) and the balancing of the global economy on the verge of zero or weakly positive growth while preserving objective country differences. Thus, the growth of world GDP in 2012 amounted to 2.2%, the consensus of expectations for the growth of this indicator for 2013 is 2.5-3%, including GDP growth of the BRIC countries will be 6.5%, the USA - 2% , and Europe will experience a recession (according to S & P, the fall in the euro area in 2013 will be 0.1%).

In Azerbaijan, according to forecasts, growth is expected to be 3.5-4%, which is significantly lower than pre-crisis rates of development. The slowdown in

economic growth in Azerbaijan is taking place against a background of slightly reduced inflation;

The financial innovations that broke into this family at the end of the 20th century pushed other changes and transformed the modern economy qualitatively, giving its dynamics an unstable and risky look, inducing serious risks. In general, the modification of the manifestation of economic laws does not refute, but only confirms the basic postulates of the theory of cycles;

- the exhaustion of the effectiveness of traditional instruments of state regulation and supervision in the financial sphere, the search for tools for "fine-tuning";

- de-automatization of the solution of problems in the financial sector, connection to the actions of monetary authorities of macroeconomic regulators, more and more frequent appeals to nation-wide measures;

- finally, the irreversibility of all these manifestations.

Thus, the new macroeconomic background from the viewpoint of the theory of economic cycles in our understanding is not only a certain combination of macro indicators, but also obvious chaotic, unpredictable capital flows, the difficulty of objective forecasts of economic growth, the state of public finances, investment processes. It is interesting that this concept of a kind of suspension of the world economy in the state of enduring crises; reality, perhaps, confirms it. In the new conditions, the effectiveness of the old instruments of stimulating demand, traditional methods of monetary and fiscal policy, is gradually becoming unobvious, more and more often one has to resort to non-standard, non-classical decisions in the field of regulation and supervision, including an unpopular one.

In the conditions of the changed global macroeconomic situation, the problem of shadow banking and its regulation is actualized. The topic deserves close attention from the position of scientific and practical understanding of this phenomenon. In the already well-established interpretation, shadow banking is a segment of the financial market that functions outside the control and supervision of official banking regulators, including central banks. The term itself appeared in

the US and initially designated any unregulated or completely uncontrolled FRS organization.

Operators of the para bank alternative market are hedge funds, private equity funds, investment divisions of traditional banks, money market funds, brokers and stock market dealers, including conduit companies, securities issuers for securitized assets, special legal entities (SPV), insurers and reinsurers . The banking sector includes not only the investment industry, but also other specialized financial intermediaries of the non-banking type, including insurance companies and pension funds. The instrumental structure of operations of shadow entities is mainly represented by credit default swaps CDS, CDO, OTC derivatives, repo transactions and other complex structured financial products. It should be noted that the term "shadow" does not mean the unofficial and, especially, the illegal status of entities in this sector of the financial market; it is only a statement of the alternative nature of their functioning in comparison with a more tightly controlled banking segment.

Thus, the shadow and investment segments of the financial market can be considered structurally practically the same. But, nevertheless, there are differences - both formal and essential. The term "investment banking" focuses on the objective specificity of its facilities - these are mainly instruments of the stock market. In the interpretation of "shadow banking", the leading sign is an institutional moment, that is, a feature of its regulation that is not determined independently, but from the opposite - this is "non-banking" regulation. In addition, from the point of view of the actors, shadow banking is broader than the investment segment proper - it also includes large institutional investors - private pension and insurance structures.

In the scientific plan, the allocation of shadow banking as an independent segment of the financial sphere does not rely on some fundamentally new positions, is not accompanied by the nomination of new postulates, the identification and study of new trends and patterns - by and large, does not produce an increase in scientific knowledge in the field of finance and money. One can say

that, being concentrated in the field of financial investments, the capital of shadow banking entities is a modification of fictitious capital under modified conditions - the conditions of financial globalization, integration, increasing volatility and uncertainty, imbalances in the development of the real and financial sectors.

The need for terminological isolation in the conventional shadow segment of a certain part of the financial market was born solely as a reaction to the destructive nature of the actions of the unregulated market actors, if not provoked, then deepened the global financial crisis of 2008-2009. Accordingly, the designation of the framework of this segment was necessary in a pragmatic sense - to build a new system of regulation and supervision of market entities, more clear and structured, more stringent and demanding, that is, approaching the concept of banking segment regulation.

Relative youth and a certain quasi-scientific, uncomfortable term "shadow banking" allow to interpret it in different national jurisdictions in different ways. More precisely, the interpretation of this term is expanding. So, there is a point of view that in developing countries, state guarantees for loans of government-affiliated financial structures, other operations of large oligarchic financial groups are included in the shadow tools. In Azerbaijan, due to the relatively weak development of the investment sector, in the context of shadow banking, in our opinion, the actions of market agents are also leading to a semi-legal and unidentifiable export of capital; transactions in a cluster of captive banks, operations in the segment of microfinance and microcredit. This requires a separate study. At the same time, following the formed interpretation, we do not consider it expedient to include corruption schemes of money laundering and the withdrawal of capital, the movement of criminal incomes, etc., into shadow banking. [2, p.67]

The report of the Financial Stability Board (FSB) "Global Shadow Banking Monitoring Report, 2012" reveals colossal and increasing sizes of the shadow segment of the financial system. Its volume at the beginning of 2012 amounted to 67 trillion dol. Which corresponds to 86% of world GDP, 25-30% of the entire financial system and about half of the official banking system.

The highest activity in the growth of this segment was demonstrated by the USA. According to the Federal Reserve Bank of New York, in 1995 the volume of obligations of "ordinary" and "shadow" banking in the US equaled about \$ 5 trillion. At the peak of activity, in 2007, shadow banking was estimated at \$ 16 trillion. (in the world was about \$ 50 trillion) against \$ 10 trillion. in the banking system.

The report also examines three financial structural paradigms that have emerged in the modern world: the American "shadow banking system", German "lending from bank deposits," and Arab "central planning". The criterion of division is the share of banks and their correlation with non-bank financial institutions and central banks in different countries. The conditionally "German" structure is inherent in developed countries with a share of non-banks not exceeding 20% (Australia, Canada, France, Germany, Japan and Spain). The shadow banking system is a system of the United States, Great Britain, the Netherlands, where the share of non-banking financial institutions is above 20%, and in some cases exceeds the share of banks.

Experts note that in Europe there was a dramatic confrontation between countries aimed at developing the informal sector, and Germany, which does not want this. This difference in financial systems within the zone also hampers, in particular, the formation of a pan-European new financial architecture, which includes the uniform and coordinated behavior of central banks. Finally, a centralized system has developed in developing countries with a high proportion of state-owned banks, central banks and a low proportion of non-bank financial intermediaries (Argentina, China, Indonesia, Azerbaijan , Saudi Arabia).

Individual character is carried by shadow banking in China. Before the crisis, the banking system had the form of a traditional and adequately regulated one. The rapid growth of the economy led to increased lending, including on-lending, against inflation and inflation of the "bubble" in the real estate market. The need for capital (especially for small and medium-sized businesses) has led to the emergence of the shadow sector, while maintaining the key positions of

traditional players, in fact, controlling the young shadow segment. It was decided to reform the shadow sector by authoritative efforts through the legalization of informal financial intermediaries, their licensing and the designation of a clear status - private credit organizations or local banks. The problem lies in the balance between the desire of the shadow intermediaries to legitimately interact with the state (including assistance from it) and the desire to maximize profits through highly risky operations.

Analysts of the Financial Stability Board believe that a "well organized cartel of central banks" operates in the conditional third zone of developing countries. The strength of central banks of some developing countries is based, among other things, on significant sovereign funds and foreign exchange reserves due to a strong balance of payments. In this paradigm, the greatest danger to the world is seen. It is related to the activity of central banks as centers for issuing bad money and the only sources of credit resources, as the core of mass monetization and the source of inflation due to the "infinite zero interest rate policy." It should be noted that similar claims can be made against the central banks of the leading countries of the world as sources of global inflation (despite the difference between developing and developed countries in the state of balance of payments and in the quality of emitted money). Three rounds of aggressive quantitative easing in the US, soft monetary policy in Europe and Japan laid the foundations for rising inflation and inflation of bubbles in asset markets. Partially, the situation is mixed only by freezing liquidity in bank accounts of enterprises (for all the world, 1.7 trillion dollars have been accumulated).

In principle, the described division of financial structures into three types ("investment", "credit" and "centralized") is very close to the already well-established interpretation of the national financial sectors, primarily bank (bank based financial system) or predominantly market based on the securities market market based financial system). The banking system symbolizes financial markets based on a close relationship (relationship-based), and the market system means direct, without intermediaries, access to resources (arm's length). The expansion of



this division and the designation as a separate type of centrally planned financial sectors has been generated by the objective strengthening of the tandem of the state-central bank in a number of countries in recent years. In the Azerbaijan banking sector, there is still a conflict of interest in the form of preserving the participation of the Central Bank itself as a regulator in the capital of the largest bank, Capital bank of Azerbaijan

The central link in the formation of the shadow banking regulation system, in our view, is the consideration of the specific nature and scope of its risks.

Traditional banks are burdened with partial reservations, constantly under threat of inflation risks associated with regulation by the central bank, are afraid of outflow of deposits, loss of assets, decapitalization. The investment sector was initially free from all these threats and shackles, but often carried out para bank operations. Shadow banking operators are not bound by many regulatory norms and restrictions, like traditional banks, are not regulated by capital and risks, are not directly related to individuals - the most demanding and sensitive resource segment.

The opacity of the operations of investment banks and the lack of information from regulators allowed investors to manipulate investors' opinions for a while (example of Lehman Brothers bank temporarily shifting a number of problem assets worth \$ 50 billion from the balance using the mechanism of REPO transactions). This could not happen in a traditional bank, whose control operations are initially much more stringent.

The abandonment of traditional bank credit channels by broadcasting funds and replacing them with channels of non-bank intermediaries in the form of unsecured loans was based on a lack of "good" resources for issuing secured bank loans. If before the crisis the shadow sector received guaranteed private liquidity transfers, issuing non-guaranteed bills, then with the fall of the creditworthiness of the private sector, shadow banking faced a liquidity crisis, it had to refinance, borrowing from traditional banks, from the state or selling assets, which did not always ensure success. The financial situation of investment banks has seriously

worsened. This is confirmed by a fairly strong (by 7%) decrease in their commission income over the past year and a drop in their minimum level since 2009. These are revenues from financing mergers and acquisitions, underwriting. The reason for the fall in demand for investment services is a sharp drop in the issuing activity of companies both in the form of IPOs and in the form of additional floatations. According to Freeman Consulting, almost a third of all transactions in the US and Europe in 2012 were carried out by the companies themselves, in a state of strong uncertainty and forced, therefore, to seriously save. On the other hand, objective restrictions on organic growth of business will force real business again to return to the mechanisms of mergers and acquisitions, and therefore, to appeal to investment intermediaries. Large consolidation deals have already been announced. Nevertheless, the revival of M & A is a matter of uncertain future. At the present time, some banking holdings, now consolidating traditional and investment operations in their business, are thinking about abandoning the investment division in principle. This is how the British RBS, Japanese Nomura began to operate, gradually winding down mergers, deals with debt instruments.

Problems are observed not only in the actual investment banks. Great risks were assumed by other "shadow" institutions - for example, insurance companies, which in many countries acquired a fundamental backbone value, like banks. Many of them transferred banking and investment risks to their business, went beyond the framework of their statutory activities, directly by lending or financing large projects, not being satisfied with the traditional rate of return. As a result, the loss of financial stability was provoked not by insurance, but by unconventional operations (example AIG).

In general, the Para bank world financial segment has evolved in recent years largely uncontrolled. This generates significant risks, relative to the level of which the business community and financial regulators, in fact, were deceived, for the risks were largely camouflaged. The crisis to a certain extent was the product of a culture of thoughtless risks. The report of Global Shadow Banking Monitoring

Report 2012 noted: "The unprecedented volume of the shadow banking system in itself can become a source of systemic risks for the world economy and cause an exaggerated reaction from global markets in the event of a sharp drop in liquidity. We believe that it is necessary to conduct adequate monitoring and create a form of certain regulation of the shadow banking system. These actions should help at least partially reduce the risks against the background of the huge volume of the shadow banking system that continues to grow ".

Experts note a decrease in the protection of clients of the informal sector, poorly predicted and destructive influence on the monetary policy of the leading countries, growth of inefficient mergers and acquisitions, shortfall in budget taxes and some other negative effects. In contrast, in a more strictly regulated banking sector, the formation of adequate anti-crisis mechanisms is easier. This is the implementation of the Basel requirements, reasonable self-regulation in response to the pressure of investors and owners. In the US, companies with assets in excess of \$ 10 billion must create a Risk Committee, develop and agree with the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC), special plans for the resolution with comprehensive information on the financial condition and risks.

Priority in preventive anti-recessionary measures - recapitalization of financial institutions, consolidation, including mergers and acquisitions. This is important against the backdrop of a capital deficit. According to The Boston Consulting Group (BCG), in a sample of 145 banks in the United States, Europe and Asia, which concentrated 75% of all banking assets in the region, the capital deficit is 474 billion euros (17% of their capital), including Europe 256 billion euros, which is twice the need for capitalization of US and Asian banks. The economic added value of banks went negative (minus 89 billion euros in 2011), which also affected the negative dynamics of market capitalization, which fell by 50-80%.

The market is also de-globalized due to the exodus of banks from foreign jurisdictions. We believe that the return of capital to national borders is a manifestation of the phenomenon of "home bias" and a similarly interpreted

paradox of Feldstein-Horioki adapted to the banking sector: investors, in contrast to the expected increase in the diversification of the international financial portfolio, prefer internal financial instruments. This effect, by the way, partially refutes the absolutization of financial globalization.

Thus, in the regulatory sense, the banking segment is built more clearly, and the risks are monitored and regulated better. The absence of many restrictions in the investment business, like banking, means understating the risk assessment and, accordingly, an inadequate set of regulatory measures. By and large, there was no system regulation in the shadow banking. And at the same time, paradoxically, in some moments it was superfluous, but inadequate. That is why today the creation of a coherent and effective system of its regulation, both at the global and national levels, is actualized. The key report says: "We believe that it is necessary ... to create a certain regulation of the shadow banking system. These actions should help at least partially reduce the risks against the background of the huge volume of the shadow banking system that continues to grow".

Regulation is not only economically, but also a politically relevant topic. Azerbaijan, which presides in the G20 in 2013, proposed effective regulation of shadow banking for discussion at the summit in September.

We consider this important in two ways. First, In terms of limiting the hypertrophied and, as a rule, the negative impact of fictitious capital, as a basis for shadow banking, on the real sector and financial stability. Secondly, the potential of non-banking operations stimulating economic activity is also evident. In other words, regulation should be extremely flexible and should not be reduced solely to "twisting nuts". The positive potential of the financial market should not be rejected. The same derivatives in non-crisis periods effectively insure the financial risks of creditor banks of the real sector.

Next, we will assess the institutional and content aspects of shadow banking regulation. The reform of the world financial institutional architecture actually began already during the crisis. At the end of the crisis, more than 30 boards of regulators were created with system-forming global financial institutions,

including the Financial Stability Oversight Council (FSB). It was created in April 2009 by the countries of the Group of 20 and the European Commission on the basis of the Financial Stability Forum. Its purpose is to identify and monitor the systemic risk of significant companies - banks and large non-bank financial companies (with assets in excess of \$ 50 billion). While the Council has the shape of a discussion club and its decisions are purely recommendatory, not mandatory, for national jurisdictions. It should become an independent and authoritative international management institution, which is ensured, in particular, by the composition of its members, including regulators, central banks and ministries of finance. In the United States, under the Securities and Exchange Commission (SEC), a new supervisory body, the Office of Credit Ratings, was created. He is declared the controller of the activities of credit agencies NRSRO - recognized by the Commission rating agencies. The purpose of creating a new structure is mitigation of the conflict of interests and, in particular, the restoration of the reputation status of credit and rating agencies, investment advisers. An important step is the institutionalization of consumer and investor protection in the form of the Bureau of Consumer Financial Protection. Its function is to protect consumers from unscrupulous financial products and services.

We support the view that in the crisis, the faults are not markets, not participants, and especially not tools, and not ready for a sharply increased risk regulatory system and its infrastructure. It is the weakened control of regulators and rating agencies, the opacity and non-unification of trade outside the stock exchange, which accounted for the vast majority of the derivatives market, was a source of particularly devastating risks. Many important financial personalities in the West warned about this, but the crisis, as always, burst unexpectedly. Thus, the identification of potentially dangerous segments and sub-segments of the financial market and tightening of their regulation is the key to a more peaceful implementation of negative scenarios objectively unavoidable in modern complex markets.

So, immediately after the crisis, trading in derivatives and swaps was expected to be regulated more severely. The US has banned the provision of government assistance to swap dealers (including through the discount window of the Fed), which is a very reasonable and responsible measure. In accordance with Chapter 7 of the Dodd-Frank Act, derivatives trades presume mandatory centralized clearing at stock exchanges with provision of collateral for transactions. This means that the risks will be identified much more fully. But at the same time, new risks arise that undermine this theoretically impeccable measure. For example, problems with the inaccessibility of collateral items (highly reliable government securities) for operators on derivatives have already appeared. The lack of bonds has become an excuse for other banks to "make money" on this - exchanging reliable securities for a commission for less quality ones. This service of large banks (JP Morgan Chase, Bank of America, Barclays, Deutsche Bank Goldman Sachs) is referred to as "security collateral transformation". Clearly, such an exchange of assets raises risks, which, in turn, should also be monitored. The option of reducing these risks is mitigating the requirements for collateral, which the largest US clearing houses started to do. In general, financial regulation and supervision in the most vulnerable financial sector of the global economy - shadow banking - is moving towards limiting risks through consolidated prudential and economic measures to market operators.

## **CHAPTER 2. ANALYSIS OF THE IMPACT OF THE SHADOW BANKING ON THE BANKING SYSTEM OF THE COUNTRY**

### **2.1. Shadow banking: the place and role in financial intermediation**

In recent years, in the foreign financial literature, speeches of representatives of the banking community and supervisory bodies, much attention has been paid to the shadow banking system (hereinafter TBS). This term is commonly referred to as a network of specialized non-bank financial institutions that perform intermediary functions in the sphere of lending to households and enterprises in the real economy. They use alternative financing channels and apply innovative

financial instruments and technologies, outside of the sphere of direct control and regulation by the official supervisory bodies.

Particular attention was paid to the activities of the institutions of this parallel sector in the midst of the global financial crisis of 2007-2009, when a sharp deterioration in the positions of shadow banking participants contributed to undermining the stability of the money and stock markets and deepening the economic recession. In the future, interest in this topic has not decreased, on the contrary, a large number of analytical studies on the nature of TBS and the forms of its participation in the system of financial intermediation.

At the meeting of the leaders of the Group of 20 in 2010, the task was to strengthen regulation and supervision over the activities of shadow banking. The Financial Stability Board (FSB) and other international organizations to develop financial standards were instructed to submit recommendations on monitoring the activities of TBS and developing measures to regulate it. At the Group of 20 summit in November 2011, the directions of analytical work in the field of shadow technologies were determined, and in particular, the identification of the scale of TBS, its features and risks.

The FSB report "Shadow Banking: Strengthening Regulation and Regulation", based on the financial statistics of 25 country jurisdictions (including the euro area as a single entity), demonstrated the global nature of the distribution of TBS, the variety of methods used in this area, and re-emphasized the need for adoption of effective measures to control the operations of TBS and reduce the associated systemic risk.

Economists have repeatedly stressed the complexity and lack of transparency of operations and relationships in the sphere of shadow banking, its "changing, subtle nature." This to a certain extent makes it difficult to determine the boundaries of the TBS and to assess the scale of its activities.

In the work of the International Monetary Fund's research department devoted to the problems of TBS, it is noted that there are great disagreements on the question of what shadow banking is. Some authors identify him with

securitization, others with non-traditional banking operations, and others with non-traditional methods of lending.

The extensive network of non-banking financial institutions, which represent the shadow banking system, has taken an active part in financial intermediation processes over the past decades. An important role in the formation and accelerated development of this sector is played by the intensification of competition in the financial services market, the desire to avoid restrictions imposed by the regulatory bodies on traditional banks, and the rapid growth of financial innovations that have led to the emergence of new tools and effective forms of organizing banking.

At the same time, performing some functions of traditional banks (for example, the function of converting and "matched" the timing and liquidity of various articles of assets and liabilities - maturity and liquidity transformation function), shadow institutions apply specific methods of lending and special sources of financing operations.

Unlike deposit banks that provide loans and keep them on balance until maturity, in shadow banking, this single lending process breaks down into a series of phases or phases that form distinctive "chains" and are serviced by various types of non-bank financial institutions. At the same time, commercial banks and other institutions of the traditional sector that sponsor shadow structures and use them as a source of replenishment of liquidity can participate in operations in certain sections of the chain.

The structure and functions of this form of intermediation can be considered on the example of securitization of mortgage debt.

The first stage of the operation is issuance of mortgage loans by banks or financial companies. The credit debt that arises in this case can later be used to issue market mortgage obligations and sell them to the co-investors.

The second stage is the consolidation ("warehousing") of mortgage debt. Individual loans are pooled (taking into account their terms, as well as qualitative and risk characteristics), are "packaged" and prepared for issuing securitized securities as collateral. These functions are carried out by special purpose vehicles



(special purpose vehicles) 3 or conduits created by banks for this purpose. The latter finance their operations through the issuance of short-term commercial paper (ABCP), secured by a "stored-in" debt and placed on the wholesale money market (REPO, swaps).

**Table 1**

**The scheme is simplified, since it does not reflect the stages of creation of more complex types of structured securities (for example, SRO).**

Stages	Participants in the intermediary "chain"
1. Loan origination	Commercial Banks, Mortgage financial companies, Consumer financial companies
2. Loan warehousing	ABCP conduits, Special legal entities (SPV)
3. Securitisation	Structured invest. institutions (SIVs) Special legal entities (SPV)
4. Distribution /Wholesale funding	Mutual money market funds (MMMF) Hedge funds Banks

The third stage - securitization, issuance of debt securities (mortgage bonds), secured by a pool of mortgages. This operation is carried out by structured investment vehicles (SIVs) or special legal entities (SPV).

The fourth stage is the sale (sale) of mortgage bonds. The operation involves brokers and stock market dealers who sell these securities to institutional investors (money market funds, hedge funds, commercial banks and other institutions) for their own portfolio or for further resale. At the same time, they can store part of the portfolio of securities, financing them by obtaining short-term loans in the money market through repo transactions and other types of loans secured by securities.

Thus, with the help of a multi-step process and intensive use of money market funds, TBS structures transform a non-liquid and risky debt for medium- and long-term loans into externally risk-free short-term obligations that are easily realized on the wholesale money market (REPO and commercial paper). These transactions are the source of their income on the basis of the spread between

higher interest rates on assets and lower for liabilities.

In the process of securitization with each stage of the current "chain", it is increasingly difficult to control the genuine quality of collateral used for the issue of structured securities (in this case, mortgage bonds). As the financial crisis showed, a significant part of the mortgage pools providing mortgage securities included subprime mortgages, which was masked by unreasonably high ratings assigned to these securities by credit agencies. The collapse of the debt superstructure led to a sharp reduction in operations for wholesale financing of shadow intermediary structures, a massive sale of securitized securities, a drop in their market value and bankruptcies for financial institutions that had large packages of these liabilities in their portfolios.

Another peculiarity of TBS is that its institutions are in most cases not under the direct control of official supervisory authorities and do not have access to sources of official financial support in the form of discount loans from the central bank or programs for guaranteeing bank deposits that are used by banks of the traditional sector. This increases the instability of shadow structures, increases their risk profile and leads to an increase in dependence on changes in conditions in the money market. And although they have informal sources of support from private financial institutions (including banks and insurance companies), this is inadequate in the face of the financial crisis.

Shadow structures (in contrast to depository institutions) use on a large scale short-term borrowings on the wholesale money market for investing funds in assets with a long maturity. Due to this practice, TBS is often called a "market-based system". American economists G. Gorton and A. Metric believe that the wholesale financing system and related securitization operations were an important factor that ensured the rapid growth of the shadow banking sector at the end of the 19th century. and early 2000's.

In addition, a number of TBS participants, especially brokers and stock market dealers, are actively applying the procedure for reusing collateral secured in collateral, which leads to an increase in leverage. Excessive dependence on market

sources of resources and high debt burden are the Achilles' heel of shadow banks that weaken their stability during periods of financial turmoil.

The evaluation of the place and role of TBS in the system of financial intermediation is ambiguous and contradictory.

Many authors give a positive assessment of some aspects of TBS. Shadow structures create alternative channels of lending in financial markets, provide access to credit for small and medium enterprises and some categories of the population. For example, in developed countries, investment funds act as intermediaries of insurance companies and pension funds in operations of long-term financing of enterprises in the real sector.

In developing countries, non-bank institutions (financial companies, microfinance institutions) have expanded the possibilities of obtaining credit for small businesses in places with a poorly developed network of banking institutions and for people with low incomes.

On the other hand, the rapid development of TBS in a scale comparable to the level of the traditional banking sector has created a new source of system risks, which threatens the stability of the financial system. The intensive use of short-term financing instruments by the shadow structures, such as REPO operations, credit and interest rate swaps, commercial paper, shares of mutual funds of the money market, etc., creates prerequisites for a mass demand for funds under these obligations, which in its consequences likewise a raid of depositors to deposit banks. Because of the high share of illiquid assets in the portfolios of shadow (parallel) structures and the lack of financial support from official authorities, their activities can contribute to the emergence of acute liquidity crises in the money market, and the existence of close operational ties with traditional banking institutions pro-cyclical nature of its activities.

Thus, the development of TBS contributed to the improvement of the effectiveness of financial intermediation in various segments of the money market and mitigation of the negative impact of prudential requirements on the profitability of operations in the traditional banking system. However,

redistributing risks and creating the appearance of safe investment of funds, shadow banking increases systemic risks and contributes to the development of crisis recessions. This testifies to the need to strengthen regulation and control of this sphere of financial activity by the official supervisory bodies.

In the country aspect, the US and euro zone countries have the highest share of shadow banking in the global OFIs - 33% and 34%, respectively. Another 12% of the assets of shadow institutions are in the UK. In total, 80% of the world's shadow banking is concentrated in these countries for a total of \$ 69.3 trillion. USA.

It is of interest to break up the shadow sector by types of non-banking financial institutions entering into it. According to 2013, the first place in terms of assets was occupied by "other investment funds" - \$ 24 trillion, or 34% of all OFI assets. At the second stage, brokerage and dealer firms for trading valuable securities (\$ 9.3 trillion). Next come: institutions for structural financing, financial companies, mutual money market funds, hedge funds for investing in real estate.

Each group of institutions has its own special place in the system of shadow financing, which reflects in the structure of their assets and methods of attracting resources. Below is a brief description of some popular types of institutions from the groups listed above.

Mutual funds of the money market (Money Market Mutual Funds, MMMF) are very popular in the US (total assets of 2.7 trillion dollars in 2013) and European countries (1.1 trillion euros), where 90% such institutions. They appeared in the late 70's in the US as competitors of traditional banks, for which there were legislative restrictions on the payment of interest rates on deposits. MMMF offered clients a higher return on shares and other services similar to banking ones. This led to their rapid growth: in 1979, their assets grew by \$ 2 billion.per month.

MMMF invests in short-term debt obligations (government securities, certificates of deposit, commercial banks). Their activity is connected with deposit banks, as they are large holders of commercial papers issued by banks.

MMMF finances its operations through the sale of shares. Two methods of valuation of shares are used: at market value, which varies depending on market quotes (VNAV - variable net asset value), and according to the initial estimate (CNAV - constant net asset value), which is set in advance and subsequently does not change.

Since the shares of the fund can be bought out by the owner on demand, CNAV creates problems of "mismatching" the timing and liquidity of its assets and liabilities. In addition, with funds with this system, the change in the market value of the portfolio of assets does not affect the value of the shares, which entails great difficulties in meeting the requirements of investors for redemption of shares during the periods of financial stress. In the absence of a system of guarantees and the possibility of using a central bank loan, these institutions are highly dependent on market conditions and are a source of systemic risk. In the USA, most MMMF traditionally use the CNAV assessment system, and in Europe both systems are equally applied.

Hedge Funds. These investment institutions use different strategies to generate income and are most often created as partnerships with a limited number of accredited investors. Among them, an important place is occupied by corporate and pension funds and trust-departments of banks. Investors make a large initial deposit without the right to withdraw money quickly.

Hedge funds invest in low-medium medium and long-term securities and often use loans from the interbank market to finance operations. They work closely with brokers of the stock market, providing them with cash and securities for current operations. The amount of hedge fund assets in the US is estimated at \$ 2.5 trillion.

Another type of institution of the same group is the investment funds in private securities (private equity funds). They buy shares of medium-sized non-financial companies and provide them with loans secured by securities or without collateral. At the same time, they are the object of investing funds for insurance companies and pension funds, interested in obtaining a stable income.

Brokers and dealers of the stock market (Brokers / Dealers) are also engaged in mediation in the current sector. They take an active part in repo transactions, receiving on

credit cash on security of securities from non-bank financial institutions (for example, mutual funds of the money market) and using them for trading on the stock market and for conducting securitization of financial assets.

Real Estate Investment Trusts (REITs) invest in residential and commercial real estate, mortgage securities, derivatives, and receive resources through the issuance of shares and debt. In particular, trusts specializing on mortgages (mortgage REITs), use short-term loans for investing in long-term and low-liquid assets. They attract MMMF funds with the help of stock market dealers, participating in repo transactions. For institutions of this type, a high level of leverage is characteristic. A brief overview of a number of investment institutions that form the basis of shadow banking shows that the associated threat to overall financial stability is generated by the risks caused by the imbalance in the timing and liquidity of the items in their balance sheet and the special nature of funding operations.

As you know, in the early 2000's. in the US and a number of other countries, a boom in the field of mortgage lending. Strong competition in this segment of the financial market has led to a weakening of control over risks and a decrease in the quality of collateral for mortgage-backed securities. Investors' confidence in all types of structured liabilities fell sharply, which led to a drop in their market value. Large investment institutions of the United States, Great Britain and other countries, which had large packs of mortgage bonds, suffered huge losses, which was a factor in deepening the financial crisis.

Central banks and treasuries of a number of countries, primarily the US Federal Reserve and the European Central Bank, were forced to take urgent programs to help banks and TBS institutions to prevent further development of the crisis.

At present, the volume of the issue of structured securities in the US has declined significantly compared to the peak reached in 2007: according to ABB papers - a decline from \$ 375 billion up to 150 billion dollars in 2010 and then rising to \$ 275 billion in 2014; on IMO-equity securities MBE - a decrease from \$ 2750 billion in 2005 to the current level of 1300 billion dollars.

Large spread in the money markets of developed countries received repo transactions. Repo is a credit transaction whereby the borrower receives money in exchange for securities that provide collateral for the transaction, and after a specified period (from one day to several weeks), the borrower is obliged to buy back the collateral at a negotiated price that includes a commission and interest for use credit. The security is valued at a discount to its market value, and the discount depends on the type of collateral and the degree of liquidity.

Both TBS institutions and banks from the regulated banking sector participate in REPO operations. Creditors are institutions with large amounts of excess cash (MMMF, pension funds, insurance companies), and borrowers - those market participants who need replenishment of liquidity (commercial banks, brokers and dealers, hedge funds and others investment companies).

There are bilateral and tripartite repurchases. In a bilateral repo transaction, two counterparties participate, usually brokers and dealers who use this transaction to regulate their position on low-liquid securities.

In tri-party repo (tri-party repo) there is a intermediary that performs the functions of a clearing agent. He controls the transfer of funds against securities and determines discounts from the market value of collateral, depending on its reliability and marketability. The role of clearing agents is usually performed by large banks (for example, in the US JP Morgan Chase and Bank of New York Mellon) or central depositories. The terms of tripartite REPO are subject to strict rules, are conducted on an overnight basis and are settled by electronic payment systems.

In general, repo represent an important source of highly liquid and standardized financing. These operations are called "the main component that ensures smooth functioning of the financial system". But they also increase the risks and lead to an increase in leverage in TBS.

In the United States, the MMMF is governed by the Investment Companies Act of 1940, as amended and supplemented by the Dodd-Frank Act of the Securities Act of 2010. These documents provide for a number of rules: the

minimum amount of the fund's capital prior to the commencement of its operations (\$ 100,000), the diversification and restriction of the share of illiquid assets in the fund's portfolio (15%), the limitation of leverage, etc. Currently The US has limits on the average weighted terms of financial instruments and portfolio.

At the international level, the FSB and IOSCO (International Organization of Securities Commissions) initiated the introduction of the category of "non-bank systemically important financial institutions" for investment funds (SIFI). The set of criteria for the reference of funds to this group includes an assessment of the risk of portfel, credit risk against world systemically important banks and insurers, the specific weight of operations with derivatives, the proportion of collateral, the ratio of the weighted average liquid portfolio to liquid shares of the Fund.

Important reforms were carried out in the area of asset securitization, which has defects, primarily related to the processes of redistribution of credit risk. There is a mismatch between the interests of originators of operations and investors. By transferring debts on loans to SPV, the originator transfers the risk to the ultimate investor (buyer of securities), improving the performance of its profitability. This practice stimulates credit expansion of banks and simultaneously reduces incentives for the selection of reliable customers.

At the summit of 20 countries in 2009 in Pittsburgh, a proposal was made to impose on the originator the obligation to take part of the risk for a securitization transaction. This rule is expressed in the legislation of several countries. So, in the EU, according to the Capital Requirement Regulation and Directive (CCR / CRD IV), the originator must notify the financial regulator of accepting 5% of the possible material losses in the operation of issuing structured bugs (for each tranche or for a tranche, which will be the first to suffer losses). In the United States, according to the Dodd-Frank Act, the sponsor of the TBS structures, like in Europe, is subject to a risk retention of 5%.

In addition, the Basel Committee on Banking Supervision in December 2014 revised the minimum requirements for bank capital in respect of investments in securitized securities. The new rule, which will come into effect in January 2018,



provides for the weighing of risk assets based on internal ratings and the establishment of the required capital against securitized assets at a level of at least 15%. Basel III also prescribes banks to have an adequate supply of high-quality assets to maintain the liquidity of ABCP conduits. The rules allow national regulators when calculating the liquid coverage factor to include in the liquidity stock some types of high-quality securitized securities.

In the United States, it was suggested not to apply the rule of 5% compensation for losses when issuing certain types of "quality securitized securities" secured by commercial real estate loans, loans to commercial firms, auto loans and ABS for high-quality residential real estate. These initiatives testify to the desire of official authorities to preserve more reliable forms of securitization as a useful tool for credit intermediation.

In conclusion, it should be emphasized that, according to the acknowledgment of many specialists, shadow banking has become an important element of the modern financial system. It relies on the use of the latest tools and financial technologies and contributes to the improvement of the effectiveness of financial intermediation processes. The tightening of regulatory requirements for the work of shadow structures conducted by national and international organizations in recent years is aimed at substantially improving the business climate in this area, reducing systemic risks and increasing the contribution of TBS to the financial servicing of the production and consumer sectors of the economy.

## **2.2. Analysis of the state of the banking system and the problems of shadow banking (an example Azerbaijan)**

Almost all the countries of the world face the problem of the shadowing of economic processes. According to IMF experts, a large volume of shadow banking turnover is growing at the early stages of the transition to the market, but then decreases with the progress of reforms and the reduction of the corruption component in government bodies.

It is known that the size of the shadow economy affects the amount of money laundering risk in banks (most shadow schemes in the economy of Azerbaijan are impossible without the involvement and direct participation of commercial banks).

Today, the following stages of the process of money laundering in banks:

1. Accommodation. In the banking sector, this stage manifests itself in actions that are aimed at identifying customers. The main forms of "laundering" of funds in the first stage are as follows:

- fraud using fictitious individuals or legal entities;
  - exchange of banknotes of small nominal value for banknotes of high denominations;
  - Bribery of bank employees;
  - for the purpose of concealing the true source of origin of money or their location - actions aimed at forging documents;
  - Smerfing - transfer of funds to bank checks, bonds, bearer securities, etc.
- At the same time, the purchase is carried out for a smaller amount than the one for which it is necessary to identify the client;
- structuring of payments in small amounts to the same bank account;
  - use of enterprises with significant cash turnover, to the legal proceeds of which "dirty" funds are added;
  - the organization of fictitious structures that declare "dirty" funds as legal proceeds.

2. Stratification. At this stage, the process of separating criminal proceeds from sources of their origin (financial transactions in the second stage are usually of an international nature). In addition, a characteristic financial operation at the stage of "stratification" is the purchase of securities in the secondary market (in order to hide the original source of funds, their purchase and sale occurs with the involvement of brokers or dealers).

3. Integration. At this stage, money is acquired legally and invested in the economy. One of the elements of the "clean" activities of banks is the mandatory identification of bank customers.

So, as international experience shows, the fight against legalization is impossible without the introduction of an effective system of financial control, which should inform the authorized body about all questionable transactions. In addition, to reduce the level of risk of money laundering in the banking sector, it is necessary:

- ensure timely provision by the government of financial monitoring of information to domestic banking institutions regarding new types of criminal activity (securities fraud, fictitious bankruptcy schemes, illegal withdrawal of funds from accounts, etc.);
- create a single analytical system for tracking dubious financial transactions and expand the list of transactions to be monitored (for example, the circulation of valuable metals, real estate trading);
- increase criminal liability for fraud and economic crimes in the banking sector and the like.

The development of the banking sector provides for continuous improvement of banking supervision, the main objective of which is to ensure the stable development of banking institutions, to protect the interests of bank customers.

The problems of improving the system of regulation and supervision of the financial market are reflected in the works of domestic and foreign scientists. Most of the authors' works are devoted to understanding the concept, functions and main components of banking supervision. At the same time, supervision is considered as a mechanism for monitoring compliance with certain requirements in the banking sector. We suggest considering banking supervision as a control based on an assessment of the risk management system of banking institutions.

In the process of risk management, there are often certain components that neither the bank nor the relevant supervisory authorities can resolve. With the

development of banking products, most risks will be all latent in nature and will only manifest themselves when environmental factors change in an unfavorable direction. So, supervision cannot completely eliminate the probability of bankruptcy of individual banks and fully insure against various losses of shareholders and depositors.

Banking supervision, depending on the life cycle of the bank, is divided into three stages:

1. The stage of "origin". At this stage, it is monitored that the bank, in terms of capital and other indicators, is in compliance with the current legislation on the registration and licensing of banking institutions. Instrumentation of supervision at the first stage are:

- analysis of the bank's charter;
- analysis of the business plan;
- verification of information about bank participants and customers;
- verification of information on the management bodies of the bank's client (for legal entities);
- verification of information on the competence and business reputation of the client's superior persons (legal entity);
- control over the minimum amount of the authorized capital;
  - checking the availability of material and technical facilities and the like.

2. The stage of "formation" (growth of the bank's assets, financial indicators, etc.). At the second stage, banking supervision should focus on preventing crisis situations in the work of a banking institution, on complying with mandatory economic standards of the bank.

The instrument of supervision at this stage is:

- control of financial, management and statistical reporting;
- carrying out inspections, analyzing the findings of internal and external auditors;
- application of certain measures of influence.

3. The stage of "extinction". At the third stage, banking supervision should supervise the process of reorganization of a banking institution, that is, removing from the state of a financial crisis, or the process of liquidating a bank.

The practice of supervising the activities of banks in different countries differs not only in the form of its organization, but also in the bodies that conduct it. In countries such as the Netherlands, Greece, Spain, New Zealand, Brazil, Bulgaria, Croatia, India, Israel, Romania, Russia, the Czech Republic, the body responsible for banking supervision is the national / federal bank of the state.

In some countries, banks are supervised by an independent monitoring body, a commission or an agency (for example, in China, it is a bank regulation commission of China).

However, in many countries banking supervision is carried out by a mega-regulator, that is, a body that regulates not only banking activities, but also the entire financial sector (the work of insurance companies, credit unions, investment funds and other non-banking financial institutions). The mega-regulator is formed in countries such as Austria, Denmark, Luxembourg, Malta, Norway, etc.

When choosing a supervisory system, it is necessary to take into account the strategic goals of developing the entire financial sector of the economy.

The threat of economic security is the effect of factors, as well as the situations and conditions that result from these actions. Threats to economic security are closely related to the economic interests of the state, as well as with interests outside its territory. Depending on the type of source of danger, internal and external threats differ. The threat operates mainly in the relevant sphere of economic interests, but its negative impact extends to other economic interests. Although it is possible to identify threats that act simultaneously on a significant number of economic interests. The most important threat to the country's economic security is the presence or further rapid development of shadow economic activity, a significant increase in its volumes, complications in its activities, and the like. Therefore, the issue of determining the directions of the influence of factors of shadow activity on indicators of economic security. [26, p.79]

The shadow economy is quite an ancient phenomenon that arose with the development of business entities. Today, this phenomenon reigns in all countries of the world, covering all spheres of society. The shadow economy breaks up into components. The components of the shadow economy are various sectors.

Having investigated the mechanisms of interaction of the shadow economy with a legal economy, one can confidently implement the policy of detenization.

Various structural elements of the shadow economy have different effects on the life activity of society. The most dangerous underground (criminal) economy, has antisocial, criminal, and then, exclusively destructive character. The danger of its development is as follows:

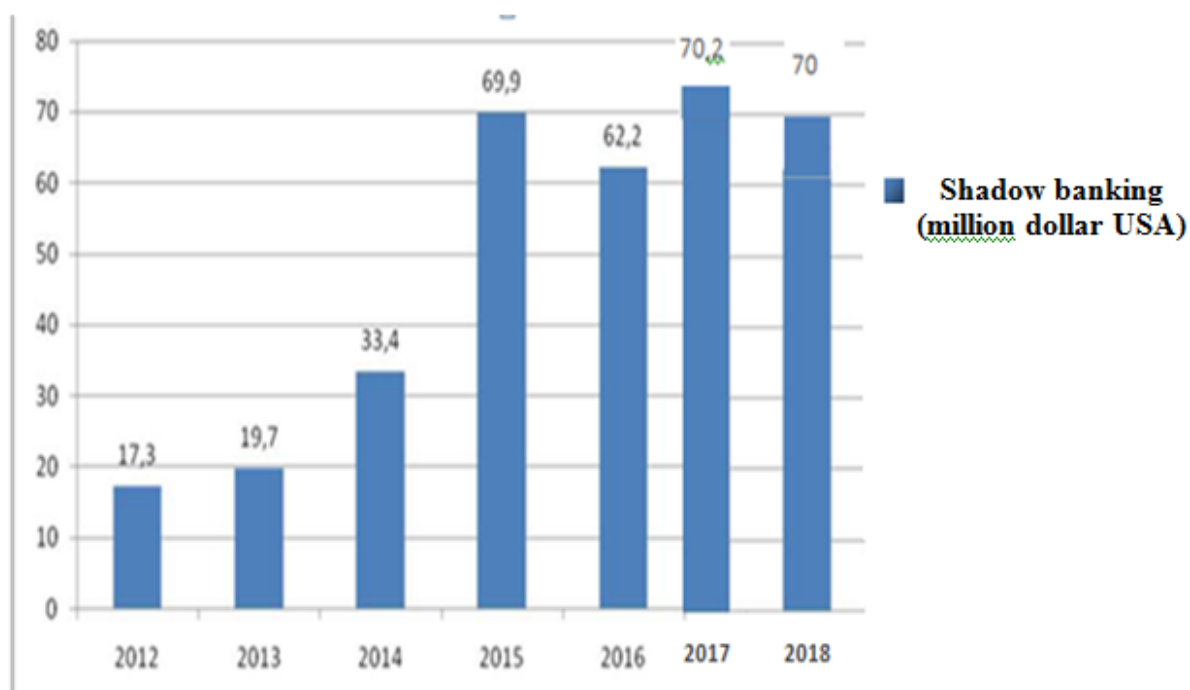
- Narrowed by the official sector of the economy, which is expressed in bankruptcy;
- Parasitic consumption due to the redistribution of the national income of the state.
- Uncontrolled spread beyond legal relations, as well as corruption; the formation of an oligarchic circle in the state, which is accompanied by an increase in socio-political tensions in society;
- The collapse of the budgetary system, as well as the debt of the debt;
- Uncontrolled leakage of capital abroad.
- Loss of public confidence in the state establishment (power, ruling circles, political elite).

The shadow banking system can, in general, be described as a credit intermediation involving companies and activities outside the usual banking system. Interim loans through non-banking channels can have important advantages and contribute to the financing of the real economy, but such channels can also become a source of systemic risk, especially when they are structured to perform banking functions (for example, maturity transformation and leverage) and when their relationship to the conventional banking system is strong.

Proper monitoring of shadow banking and the application of appropriate policy measures, when necessary, help to mitigate the growth of different systemic risks.

Comprehensive monitoring of the size, trends, risks and adaptation of shadow banking across the state is an important element in strengthening supervision of this sector and, ultimately, transforming shadow banking into sustainable market financing. To this end, federal and international bodies (for example, the Financial Stability Board) coordinate the annual collection, aggregation and analysis of global trends and risks in the shadow banking system

Shadow banking in the state creates risks for financial stability. And its name conveys a sense of turbidity. "Shadow Banking" is a comprehensive phrase that includes risky investment products, pawnshop and loan operations and so-called peer-to-peer lending between individuals and businesses. Even art dealers, such as Sotheby's, have turned into shadow banks, making millions of dollars of loans to customers who buy masterpieces. The common denominator is that these products and practices thrive beyond the ordinary banking system and are often inaccessible to regulators. The most devastating waste of the financial crisis of 2008 was not due to bank deposits, as happened during the Great Depression, but on shadow banks such as Lehman Brothers (broker-dealer) and money market funds.



**Figure 1. Shadow banking value in Azerbaijan from 2012 to 2018 (in billions of US dollars)**

As show the figure shadow banking volume was high in 2015 and in 2017 than other years. The reason for this is the first in 2015 and the second devaluation in 2017.

High rates of development of the Azerbaijani financial market by foreign banks require in-depth study of issues related to the presence and possible directions of the influence of these banks on the development of the domestic banking system and the economy as a whole, the impact of their entry into the Azerbaijani financial services market. Taking into account foreign experience, the presence of foreign investment in the form of foreign banking organizations in Azerbaijan can be viewed as an effect of such economic processes.

The processes mentioned above began at the end of the 20th century, and their influence on the national economy becomes more and more noticeable. Even today, we can assume that no country in the world can escape from it. The question to be answered is: what is the result of such influence?

Globalization is a phenomenon that is crucial for all aspects of the life of society. Azerbaijan actively integrates into the world financial markets. The consequences of globalization processes, both positive and negative, are becoming relevant for the Azerbaijani financial system. Priority tasks for the development of Azerbaijan are: increasing the capacity of the banking system, creating groups of powerful banks, reducing the tax burden, structural changes in the banking system.

For the first time the term "globalization" was used by J. MacLane in the 80s, later by the American sociologist R. Robertson. Scientists define globalization either as an interrelated development of the economy of different countries, or as a new level of internationalization of resource markets, labor markets, financial and information markets.



Globalization is understood as an objective process of integrating most of the capital of different countries, increasing their interdependence.

British scientist T. Lewitt points out that globalization is a process of expanding and deepening the interdependence of the countries of the world in all spheres of modern life. This definition of globalization was suggested by other experts who believe that globalization is the growth of dependence of individual countries and their economies.

Supporters of the new theory of globalization argue that globalization began at the end of the 20th century and was associated with a more general process - internationalization. Supporters of the new theory argue that globalization is manifested not only in the quantitative measurement of the level of intensity of relations between economies, but also in qualitative terms - the formation of a global level of economic organization.

Because of globalization, world markets are becoming more interdependent in virtually all spheres of activity. Therefore, one can observe the constant growth of international integration, turning into a multi-channel process.

Globalization as a new phenomenon characterizes a new stage in the internationalization of economic life, which is accompanied by the liberalization of foreign economic relations, the elimination or reduction of various barriers between countries regarding the movement of capital, goods and services, which creates the prerequisites for the formation of a society without borders.

One of the key areas of globalization is financial globalization, which should be understood as the free and efficient movement of capital between countries and regions, the functioning of the global market, the formation of a system of supranational regulation of world finance.

The integration structure of markets allows you to benefit from the features of business cycles, economic policies, tax laws and other components of national economies. The integration process can both smooth out and deepen the differences between national economic systems. However, as practice shows, integrated markets more actively influence the liquidation of the border between

economies and contribute to the preservation of the macroeconomic balance of domestic economies.

In parallel with the integration of international financial capital markets, another process is taking place, which is called convergence. The essence of the convergence of financial markets, which is largely similar to integration, is that as a result of eliminating regulatory barriers and low restrictions, there is a gradual elimination of the boundaries between the various sectors of the global financial markets.

For example, in the United States and some other countries, due to the weakening of regulatory requirements, the removal of barriers that prevent foreign borrowers from penetrating local markets, the weakening of the antimonopoly legislation in regard to the place of creation of financial holdings that unite various spheres of investment and commercial activity, a clear merger of the world banking market and world of the debt securities market.

It becomes obvious that the integration of global financial relations is a complex and multifaceted phenomenon, the study of which requires appropriate structuring and use of modern analytical tools.

The globalization of financial markets, "side by side" with positive effects (the ability of financial transactions on the market in 24-hour mode, thanks to the integration of exchange and OTC trading systems into one global communication network; reduction of scarcity of financial resources in the world's countries, increased competition in the domestic financial markets, a reduction in the costs of goods and services, resulting in a decline in prices for resources, etc.), lead to negative results of the effect.

In particular, financial globalization is accompanied by such a negative effect as high capital mobility (although this may seem strange). It is known that capital moves to places where profit margins are higher, and business prospects are better in terms of economic growth. In the event of any political or economic problems in the country, financial resources begin to migrate, while generating an

outflow of significant instability in the national financial markets, which becomes more sensitive to crises due to liberalization.

It should also be noted that the independence of the real sector of the world economy from the monetary component reduces the stability of the national economies of countries and regions in the world financial crises and restrictions on access of some market participants to the world financial markets.

It is obvious that in the near future globalization will determine the state of the world financial system, therefore the analysis of the current trends of the international banking capital movement allows access to the prospects of Azerbaijan's integration into the global financial space.

A serious problem faced by the republican regulator was the development of methods for supervising the activities of branches of foreign banks and their parent structures in Azerbaijan.

Today, the world industry of financial speculation is at its peak - this is confirmed in the Financial Stability Board (FSB) in Basel. Financiers continue to actively hide in the "shadow". Result: Over the past 10 years, the volume of shadow banking around the world has more than doubled (from \$ 26 to \$ 67 million) and corresponds to 86% of world GDP, although the growth rate compared to the pre-crisis reduction (this is shown by official statistics).

In this situation, all attempts by politicians and financial authorities to regulate this industry are insufficient. The financial world is still very far from creating a system that effectively regulates the activities of shadow banks.

In this regard, we believe that it is extremely important to understand deeply the phenomenon of shadow banking, incl. that today is a shadow banking service, which is represented by its functions, what regulation and supervision by the regulatory bodies can be applied to it. And, of course, it is necessary to determine the importance of shadow banking for the Azerbaijani economy.

In our opinion, the urgent task for the Azerbaijani financial authorities is to determine the optimal level of regulatory measures that should not allow money to

migrate to shadow banking, as well as develop measures to ensure the necessary control over systemic risks based on the best world practices.

It is necessary to start active work on the principles and mechanisms of regulation of the informal sector, taking into account the recommendations of the FSB, establish basic rules for financing and monitoring.

### **2.3. Analysis of trends in the development of Azerbaijan's banking system and shadow banking until 2020**

Lately there has been a lively discussion about which types of financial institutions and operations should be referred to the shadow (parallel) banking system and taken into account when assessing the scope of its activities. The Financial Stability Board is guided by the establishment of the TBS structure, their lack of regulation and support from the official banking authorities.

Such a position, supported by a number of economists, can be called an institutional approach (entity-based approach). It is opposed by an operational-based approach, according to which the special character of the formation of a resource base with the use of short-term funds of the wholesale money and stock markets is the basis for the allocation of TBS participants.

Developing this topic, the authors of the IMF report on financial stability propose to use as a criterion for belonging to the shadow sector the concept of "core obligations" (coreliabilities). These include deposits of "ultimate investors" (households, non-financial corporations, local authorities) serving as the main type of resources in the traditional banking system. Shadow structures for financing their operations use different types of "noncore liabilities" by placing short-term debt in the wholesale market. According to the authors of the report, the advantage of this approach is the possibility of including in the assessment of the size of the shadow sector of a number of non-deposit sources of financing used by traditional banks and reflected in their balances.

The greatest popularity was obtained by global estimates of the scale and trends in the development of shadow banking, published by the Financial Stability Board in its annual reviews on monitoring this segment of the financial system.

According to calculations made by the FRS on the basis of the data of the national accounts statistics (Flow of Funds Accounts) for 20 country jurisdictions plus the euro area countries as one jurisdiction (20 + Eu), the total assets of non-banking financial institutions were 2013, 2 trillion dol. This amount is equal to 50% of banking assets in these countries and 25% of all financial assets in the world [16, p.4].

The authors of the report cite these figures as the "broad conservative assessment" of the assets of "Other Financial Intermediaries" (OFIs) on a global scale. The report also provides a "narrow" estimate of the size of the informal sector, obtained by excluding from the calculation of assets those non-banking financial institutions that are not directly involved in the process of credit intermediation (for example, equity investment funds, certain types of REITs, etc.) as well as assets of institutions that are part of banking holdings under the supervision of official authorities. The institutions of the "narrow" group are given special attention, since it is assumed that their activities have an increased level of systemic risk. When calculating 23 country jurisdictions, the amount of shadow institutions' assets in the "narrow" version amounted to \$ 35 trillion in 2013. (compared to a broad estimate for these countries of \$ 62 trillion)..

The value of the shadow sector (a broad estimate for 20 jurisdictions plus the euro area) increased in 2013 by 4.8 trillion dol. But the growth trends were different for countries with different levels of economic development. In countries with a well-developed financial system, the ratio of assets of TBS and traditional banks in recent years has stabilized after a sharp rise in this indicator in the early 2000s. and its subsequent fall during the crisis of 2007-2009. As for the developing countries, the share of TBS there has been growing rapidly in recent years.

In the shadow banking system, new financial instruments and technologies are widely used, developed and developed in practice during the last decades. This, above all, asset securitization and repo operations, which contribute to the formation of systemic risk,

Before the onset of the global financial crisis of 2007-2009. securitization on

the scale of distribution and influence took the leading place in the system of shadow banking. It emerged as an alternative strategy aimed at overcoming the tendency of declining profitability in the traditional banking sector in the 1970s. last century. To reduce the costs associated with prudential prohibitions and restrictions on competition, banks began to create shadow (parallel) structures (SPVs, conduits) and transfer part of the assets there, reducing the risk of their portfolio and reducing the amount of equity required by law. In addition, securitization allows you to quickly mobilize liquid funds by converting loan debt into cash.

Securitization consists in the creation of a pool of non-liquid asset assets and the issuance, on its basis, of debt securities that are sold on the stock market with various risk profile and profitability.

There are three main players involved in the operation: 1) the originator of the loan (usually a bank or a financial company); 2) an institution that issues securities on security of debt on a loan (special legal entity - SPV); and 3) the service provider (an institution that performs administrative functions and receives interest and payments for repayment of loans issued (this work is often performed for the commission of the originator bank) .In addition, other special institutions - legal and accounting firms , underwriters, insurers, rating agencies, etc..

Participants of the securitization "chain" carry out a number of transformations similar to those that take place in the system of traditional banking. Ultimately, illiquid financial assets (undrawn liabilities for loans granted) are converted into marketable securities. At the same time, there is a redistribution of credit risks between different groups of investors, for which the income from the sale of individual issues of securities is divided into a number of classes - tranches. On securities of higher tranches that have the lowest risk (senior tranches), payment of interest and repayment of principal is made as a priority, and for obligations of lower tranches with lesser quality security (mezzanine and equity tranches) - only after satisfying investors' category of this issue.

TBS structures take an active part in securitization processes: they form

pools of assets, participate in the distribution of assets to homogeneous packages, deal with the issue and placement of securities, and so on.

Thus, securitization is an innovative tool that allows you to involve a significant mass of illiquid assets in financial turnover and create new sources of liquidity replenishment. However, the practice of using this tool has shown that the creation of intermediary "chains" with a large number of participants can be a source of systemic risks.

Risks and regulation. Shadow banking institutions are carriers of systemic risk, which has a negative impact on the state of the entire system of financial markets or on its individual important segments.

The main source of systemic risks in TBS is the transformation of terms and liquidity in operations of shadow structures, as well as the conversion and dispersal of credit risks between different categories of participants in the financial market.

The main types of risks of shadow banking are:

- the likelihood of a mass presentation of claims for redemption of debt obligations (shares or shares), which can cause a disorderly liquidation of the investment portfolio;
- increasing the cycle of processes in financial markets;
- Increase in the interdependence of participants in shadow operations and traditional banking;
- increase in counterparty risk and leverage;
- Opacity of the shadow business and lack of up-to-date information about its structure and operations.

As for the first and second of these types of risk, the main threat, as already noted, is connected with the "inconsistency" of the terms and liquidity of assets and passives in the balance of TBS structures. In a normal situation, such a risk is not of great danger, since managers of investment funds have sufficient funds to satisfy claims for withdrawal of money during this period. But in conditions of financial stress, the demands for the repurchase of obligations by shadow structures take on the character of an uncontrolled avalanche. Particularly

susceptible to such raids are mutual funds of the money market, some types of hedge funds and other investment companies, whose clients, who have applied first, have a priority to repurchase shares to the detriment of other shareholders.

This behavior has a pro-cyclical effect and intensifies fluctuations in the financial situation, since in this situation, to meet the claims of shareholders, investment funds are forced to market their assets at bargain prices. This, in turn, undermines the solvency of other financial institutions that cannot fulfill their obligations due to a decline in the market value of securities in the portfolio.

The situation is exacerbated by the fact that the shadow banking has a high level of leverage due to the widespread practice in this sector of the repeated reuse (reuse or rehypothecation) of securities received to secure repo transactions and other transactions with securities. This leads to increased tension in the financial system and to an even greater fall in asset prices.

With the practice of securities re-negotiation, there are other risks associated with TBS. It leads to increased interdependence of financial institutions and increased counterparty risk (the third and fourth of the listed types of risk). Creation of "chains" by repeatedly using the same securities involves the new participants in this process and expose them to the risk of non-repayment of their obligations (the effect of "infection"). The institutions of the traditional sector - banks and insurance companies that sponsor various investment funds - may become victims of the intensification of interdependence. With the emergence of difficulties in the securities market, they are forced to provide financial assistance to sponsored institutions and to intervene in the market, buying up depreciating securities.

Finally, another important condition for increasing risks in TBS is the lack of transparency in the activities of its institutions. This may be a consequence of a number of factors - the complexity of the applied innovative tools and technologies, the shortcomings in the organizational structure of market processes, the weakness or lack of regulatory rules in this area, or the inadequacy of information collection and processing systems. Meanwhile, the transparency of



shadow institutions and the availability of reliable information about their operations are necessary to make a sound investment decision, to properly assess risks, to establish adequate prices for financial assets and the cost of collateral for credit transactions.

Thus, transparency in the sphere of shadow banking is an important condition for reducing systemic risks. The actions of legislative bodies of the United States, the EU and other countries are aimed at this, and the significance of these initiatives has increased sharply after analyzing the causes of the crisis of 2007-2009 and revealing the negative role of TBS in its emergence and development.

In 2011, the Financial Stability Board determined the main directions for regulating shadow banking. This, first, measures to reduce the possibility of transferring risks from the scope of the shadow structures to the area of traditional banking operations. It is, in particular, the suppression of the practice of so-called regulatory arbitrage, that is, the movement of transactions by banks to the informal sector to reduce the costs associated with meeting minimum capital requirements and liquidity requirements.

Secondly, measures on direct regulation governed the work of TBS institutions and the use of financial instruments and markets to reduce the risks of financial intermediation.

And thirdly, the implementation of macro prudential policy aimed at reducing the procyclical effect and increasing the stability of market structures to the risk of "infection".

In the post-crisis period, a number of legislative measures were taken at the national and international levels in the West to tighten control over the work of TBS participants (primarily investment funds), as well as securitization and lending transactions with securities.

Especially intensive work in this area was carried out in the European Union. An example is the "Directive for Managers of Alternative Investment Funds" (AIFMD, 2011/61 / EU), adopted in 2011, which regulated the work of

hedge funds and equity funds of private companies. The managers of these institutions were charged with strengthening the control over the liquidity risk and, in this connection, the closer linkage of the share buy-back policy to the liquidity of the asset portfolio. Restrictions were imposed on the purchase of stock funds during periods of financial stress and a number of qualitative and quantitative limits were adopted. There were also measures to limit leverage: setting the maximum size of this indicator and reducing the use of collateral in repeat transactions. In order to combat the counterparty's risk and interdependence, it was the duty of managers to submit reports to national supervisory authorities on the existence of such risks and the degree of concentration of ties with participants in regulated banking. Finally, the requirements for the transparency of the policy of the funds and the protection of investors' interests were tightened (inviting independent experts to assess the quality of portfolio assets, reporting managers to investors, introducing a minimum level of operating capital, etc.).

Another Directive of the European Council of 2014 (UCITS 2014/91 / EU) established mandatory requirements for collective investment funds, aimed at non-professional participants. In addition to the general requirements of openness and fulfillment of business standards, measures were envisaged for the structure of the investment portfolio, limiting the use of derivative instruments (no more than 100% of the fund's net assets) and collateral. The use of REPO was allowed only on a temporary basis and in an amount not exceeding 10% of the assets.

Specific requirements are imposed on the activity of mutual funds of the money market. They are especially vulnerable to the risk of mismatching the timing and liquidity of the portfolio of assets held before the expiration of the term, and the obligations that can be brought against the repurchase at any time at the request of investors. Therefore, the regulation of this type of funds was aimed primarily at limiting the duration of the portfolio of assets and determining how to set the price of shares.

So, after the crisis of 2007-2009. The European Commission on Securities and Markets (ESMA) divided all MMMFs in EU countries into two categories -

short and medium - and set mandatory limits for them on the weighted terms of financial instruments in assets (60 days and 6 months, respectively) and weighted average portfolio terms (120 days and 12 months). In 2013, limits were added to these restrictions on the share in the portfolio of the instrument stock with the remaining period of 1 day (10% of the assets) and a week (20%).

High rates of development of the Azerbaijani financial market by foreign banks require in-depth study of issues related to the presence and possible directions of the influence of these banks on the development of the domestic banking system and the economy as a whole, the impact of their entry into the Azerbaijani financial services market. Taking into account foreign experience, the presence of foreign investment in the form of foreign banking organizations in Azerbaijan can be viewed as an effect of such economic processes.

The processes mentioned above began at the end of the 20th century, and their influence on the national economy becomes more and more noticeable. Even today, we can assume that no country in the world can escape from it. The question that needs to be answered is: what is the result of this influence?

The processes of globalization of the world economy did not bypass Azerbaijan, especially in conditions of full openness of the national economy. The reality showed that the Azerbaijani banking system has been in the process of accelerating integration for almost 25 years by expanding the presence of foreign capital. Banks with non-residents participate in 37 entities in Azerbaijan, 65% of which are in Baku.

The development of transnational corporations creates demand for banking services in host countries, which encourages the largest banks to create branches to meet the needs of their customers. In Azerbaijan, the purchase of an active Azerbaijani bank with a license and its re-branding is less risky for a foreign bank than creating its own subsidiary bank from scratch.

World practice shows that all countries participating in the WTO accession process tried to use various mechanisms to protect national economies.

The main attention was paid to the sphere of financial services because of its exceptional importance for the economic security of the country. That is why the national financial markets of most countries are characterized by the presence of restrictions on foreign capital.

More than 100 countries in the WTO continue to withhold restrictions on access of foreign capital to national financial markets. Moreover, 75% of all restrictions apply to banking services, and 60% - to services provided by subsidiaries and branches of foreign banks.

The experience of developing countries proves that uncontrolled cross-border currency transactions weaken any undeveloped banking system. Free access to cross-border services is the final stage of liberalization of the financial system, which has already reached stability. That's why this process is quite long.

The increase in the presence of foreign banking capital in Azerbaijan should be carried out in accordance, first of all, with the readiness of the Azerbaijani economy as a whole and the system of internal banks in particular; secondly, within the framework of an elaborate, balanced and step-by-step access strategy based on the priority of national interests, with due regard to recommendations. In accordance with the current legislation, subsidiaries, branches and offices of foreign banks can operate in Azerbaijan.

However, the branches of foreign banks in Azerbaijan are not actually registered. Foreign capital is present in the Azerbaijani banking sector in the form of subsidiaries registered in accordance with Azerbaijani legislation.

In foreign works it is stated that during negotiations on WTO accession, in addition to other developing countries, Azerbaijan could avoid obligations to obtain branches of foreign banks, since in the legal plan the industry is not an independent legal entity, because of what it does not fall under the rules of regulation of the host country, and all its obligations are borne by the main bank. Formally, the opening of a branch of foreign banks is possible, but in fact, there are no instruments for regulating this process in Azerbaijan.

Shadow banking makes financial markets more mobile, but to maintain stability, oversight is necessary. At present, we see fewer risks here, but speaking of the development of financial markets, this is also the back side of the coin, which means that they are less developed, that is, according to preliminary estimates, the shadow banking in Azerbaijan is less than 10% of GDP " . Since 2016, the Chamber of Control of the Financial Zones of the Republic of Azerbaijan has been monitoring this sector and regulating it. In this regard, banking institutions need proper regulation, regulation based on monitoring, understanding of what is happening in this area.

### **CHAPTER 3. THE MAIN DIRECTIONS OF IMPROVING THE MECHANISMS OF COUNTERACTION OF THE SHADOW PROCESSES IN THE BANKING SPHERE**

#### **3.1. Prospects for development shadow banking**

The concepts of "shadow banking sector" or "shadow banking" are quite new for the financial system in Azerbaijan, therefore there are some uncertainties in the definition of these concepts. There are difficulties in precisely separating them from the classical banking sector among many legal scholars and practicing lawyers and financiers, carrying out their research or law enforcement activities in the field of banking law and banking, both in Azerbaijan and abroad. Some scholars identify the lack of supervision as determining when separating shadow banking from the classical one, while others emphasize the nature of the operations involved and the availability of licenses for their implementation, including in this category credit institutions that carry out banking activities without a corresponding license.

It is worth noting that the essence of the activities of the shadow banking sector does not directly violate international standards for combating money laundering, financing of terrorism and the proliferation of weapons of mass

destruction, does not contradict the recommendations in the field of legislative support for the legalization (laundering) of proceeds from crime and the financing of terrorism.

Professor A.E. Butler rightly notes: "The term" shadow "does not mean unofficial and, moreover, the illegal status of entities in this sector of the financial market - it is only a statement of the alternative nature of their functioning in comparison with a more tightly controlled banking segment".

However, shadow banking is seen in the West, as in our country, as a parallel credit intermediation system that is beyond the scope of traditional financial regulation and supervision.

The development of the parallel banking sector is perceived by financiers and lawyers extremely mixed. On the one hand, alternative institutions of support and financing help develop the real sector of the economy, often even more efficiently than classical banks, since they can offer more favorable terms. On the other hand, the active development of the shadow banking sector can lead to large-scale and systemic crisis phenomena that cannot be stopped under the scheme used for classical banks.

Since the classical schemes of suppression of high systemic risks are based on the use of prudential supervision and prudential standards of financial activity used to determine the magnitude of these systemic risks, it can be concluded that the lack of such supervision or its smaller volume will lead to an uncontrolled increase in the risk component of credit and investment activity, as well as to such phenomena as outflow of capital abroad, bribes and kickbacks to officials, financing of gray imports, implementation of chem of tax evasion, laundering of crime, etc..

Adhering to the above interpretation of "shadow banking", we consider from this position the factors of its spread, the impact on the state of the monetary sphere, the risks of shadow banking and ways of minimizing them by developing regulation of this sector of the Azerbaijani financial market.

The main factors that contributed to the spread of this financial technology

in our country can be attributed:

3. Exacerbation of competition in the market of banking services and disintermediation of banks, namely, the reduction of the intermediary role of banks as a result of aggravation of competition with specialized non-banking financial institutions;

Inaccessibility of legal financial services for certain categories of borrowers - individuals and legal entities. At the same time, shadow banking meets the existing demand for loans, including for those economic entities whose development has a positive impact on the economy, namely, small and medium-sized businesses;

4. Low level of financial literacy of the population. Today, the promotion of new banking products, especially complex ones, the interaction of retail customers with the bank in the implementation of salary projects, the transfer of pensions to bank cards, the use of remote banking services is often confronted with a lack of understanding of the benefits of such innovations.

At the same time, these shadow banking institutions are carriers of systemic risk, which has a negative impact on the state of the entire system of financial markets or on its separate important segments.

The main source of systemic risks in the shadow banking sector is the transformation of terms and liquidity in operations of shadow structures, as well as the transfer and dispersal of credit risks between different categories of financial market participants.

The main types of shadow banking risks include:

- the likelihood of a massive demand for redemption of debt obligations, which, in the final analysis, can cause a disorderly liquidation of the investment portfolio;
- increasing the cycle of processes in financial markets;
- increased interdependence of participants in shadow operations and traditional banking;
- increase in counterparty risk and leverage;

- Opacity of the shadow business and lack of reliable information about its structure and operations.

At the same time, it should be noted that in the future for the Azerbaijani economy and the banking sector in particular, the development of shadow banking can lead to such favorable consequences as:

- intensive development of the real economy in Azerbaijan;
- review by state bank organizations of the conditions for lending, both physical and legal persons;
- expansion of opportunities for various segments of the population to accumulate and invest financial capital.

But it is important to remember that with all possible positive aspects of development of this branch of the shadow economy, this financial technology, in case of its lack of control and lack of proper supervision over it, can bring a lot of negative consequences, such as the possibility of criminal activity and high-risk activity in the financial markets, which, in turn, may entail systemic financial crises and other negative phenomena.

Therefore, taking into account the structure of the modern financial system and the peculiarities of the functioning of the banking sector of Azerbaijan, modernization of the supervision system will play a key role in the development and regulation of the shadow banking sector, both for classical banking structures and for shadow financial institutions.

Undoubtedly, one of the most important factors for the modernization and actualization of the legal regulation of shadow banking activities is the need to consolidate this concept in normative legal acts, as well as the formation of a more rigorous and modern system for licensing activities. With the help of these measures, it will be possible to develop a system for overseeing shadow banking, including the adaptation of supervisory procedures to such financial institutions depending on their activities.

Improving supervision will avoid unnecessarily risky activities of these financial institutions, as well as avoid global financial crises that are destructive,



both for classical banks and for representatives of the shadow banking sector.

All the above circumstances indicate the inevitability of the development of the shadow banking sector, its rising role in the modern financial system of society. Undoubtedly, one of the factors that require more elaboration and unambiguity is the need to form a unified view of the nature of shadow banking as a phenomenon, consolidating the concept of shadow banking as a parallel banking activity. At the present stage, there is an understanding in the society of the obligatory connection of shadow banking with the legalization (laundering) of proceeds from crime and financing of terrorism, which is far from always correct. However, in many cases it is through shadow banking that the financing and organization of illegal activities.

Shadow banking has become an important element of the modern financial system. It relies on the use of the latest tools and financial technologies and contributes to the effectiveness of financial intermediation processes.

The tightening of regulatory requirements for shadow structures in recent years by national and international organizations is aimed at significantly improving the business climate in this area, reducing systemic risks and increasing the contribution of the shadow banking sector to the financial servicing of the production and consumer sectors of the economy.

The shadow banking showed itself as usury. Generally usury started to develop after 1990 years, after independence of Azerbaijan Republic. But among 2006-2014 usury weakening was observed. Especially commercial banks in 2014 made credit conditions so easy and accessible. And in most cases banks did not check payment ability of costumers. In a result all interests decreased against usury. Because shadow banking per cents which are so high are less than commercial banks. But recently shadow banking is increasing in Azerbaijan. The reason for this increase is restrictions of banks opportunities.in a result in Azerbaijan shadoü banking show itself in 2 forms. 1-st some people offer their money with high per cents. And this registration is done illegally. And it shows it self-alternative to commercial banks. But here per cents are so high and entrance is

so easy. Meanwhile Verification of employment is not required. And guarantor is not required. Gold in the form of collateral is required.

Recently shadow banking shows it self like Lombards. Experts say In spite of the fact that 600 lombards operate in Azerbaijan in 2011, this number has risen to 1200 banks in 2018. Their credit percent is more than 36 %. The people who cannot get any credit from banks move to Lombard. When lombards lend money they accept the golds which 30% less of its price.

Lombard are not responsible in front of Centre bank and Financial Ministry.

Although percent are so high, in current context entrance is so easy to shadow banking. 2-nd form is shadow banking in commercial banks too. Because some commercial banks lend money to some people who close to them with low per cents. And in some banks discrimination is observed.

Sometimes the commercial banks lend money to the people who have low payment ability, and in a result when those people do not return money back many problems appear. I so regret that shadow banking was observed during oil boom in Azerbaijan. In a result some banks in Azerbaijan went bankruptcy. But all figures are illegal and we need to solve this problem Azerbaijan. Additionally, shadow banking is developing when people send money abroad. for example, in Azerbaijan one person gives money to another person who working for shadow banking, and after the known person gives that money to his relative who lives in Russia or Georgia. This shadow banking way is used with most post-soviet countries. where supervising is so little there.

Thus, having analyzed the main problems that resulted from the global financial crisis of 2007-2009, and as a result led to serious shifts in the functioning of the main segments of the world economy, including the banking sector, it can be noted that intensive distribution in the territory of Azerbaijan the so-called shadow banking, the degree of its influence on the economy of Azerbaijan, as well as the prospects for its regulation within the framework of the current Azerbaijani legislation are important aspects that require close scrutiny by the state.

### **3.2. Fighting against the shadow economy and development of the banking system as a mechanism to ensure the economic security of the country**

The shadow economy is a special activity, the signs of which are relatively easy to determine, but cannot be accurately measured, since virtually all information necessary for analysis remains confidential and cannot be published in the open press. The mechanism of manifestation of the shadow economy in modern society is well known. The objective reason for the emergence of the shadow economy is the transition from a bureaucratic, command-based management system to a market economy, the undeveloped development institutions and business structures. The change in the social system is accompanied by a change in the old management model, while the shadow economy is based and developed from specific sources [11, p.119].

If we open the "shadow veil", then it will be a "pyramid" of the driving forces of the informal sector of the economy. These include businessmen, businessmen, financiers, industrialists, small and medium-sized businessmen, shadow business executives, including shuttle traders. These people are the "motor" of legal and illegal economic activity. A key feature of shadow activities can be considered as evasion from the official registration of commercial contracts or deliberate distortion of their content during registration. In this case, the main means of payment are cash and especially foreign currency.

A special group is represented by hired workers, both physical and intellectual labor. They may be adjoined by corrupt civil servants, in whose income a certain proportion may be bribes. Of course, this division is to some extent conditional and controversial, but it covers a large part of the active population. The common interest for all layers of the "pyramid" is the receipt of illegal revenues. Thus, the export of capital abroad is inherent in all. True, representatives of criminal and middle levels do this, mainly through illegal operations with raw materials and strategic materials, imported goods, investments, forgery of payment documents.

Representatives of the middle stratum, as a rule, are originally the legal owners of the produced incomes. And only in the future, according to the will of circumstances, tax revenues are "diverted". Often they cannot be otherwise: the use of existing fines and penalties threatens the existence of their own business.

For the role of arbitrators in the implementation of transactions, they attract representatives of criminal structures. The criminal layer of the "pyramid" is objectively interested in existing conditions, under which the shadow economy is gaining momentum, sometimes its representatives control a certain part of enterprises and organizations. Objectively, hired workers-professionals turn out to be in worse conditions. In developed countries, wages at the main place of business are 70-80% of the employee's income, and in Azerbaijan - about 65% .

As the sources of benefits from the shadow economy, the following areas can be noted. Export of capital, raw materials and energy resources, in which the bulk of transactions are carried out legally, but at understated prices, the difference of which and the corresponding profit is paid to intermediary companies. Unregistered economic activity of the state bodies is confirmed by the viability of a broad stratum of the population whose incomes, according to official statistics, are significantly lower than the subsistence minimum.

The world economic community recognized that one of the biggest threats to business security is the use of the banking system to commit financial crimes, concealment and "laundering" of money obtained illegally. Criminal circles effectively take advantage of the traditional closed banking information from external control, the desire of financial institutions to attract customers at any cost. Absolutization of bank secrecy, which for many years served for the benefit of banking, turns today its opposite side, the opposite.

Civilized banking communities understand the need to establish contacts with regulatory authorities in the interests of both their own security and the security of the entire system. If domestic banks and other credit institutions lose control over the situation, they may find themselves isolated from the global financial community. Azerbaijan has adopted and is improving the system of

measures to prevent and suppress the use of financial and credit institutions for criminal purposes. This allows you to put under control a legal, legal means of a wide range of revenues that are eluding taxes, and replenish the budget. When particularly large funds are put under the control of the state and society, organized crime is deprived of its powerful economic basis.

The shadow banking sector is used to refer to non-transparent, non-transparent banking transactions leading to the outbreak of the 2008 crisis. There are many factors that fall within the shadow banking sector in the characteristics that emerge as a result of the development of primary and secondary markets. A number of measures have been taken following the Enron scandal, one of the major financial scandals in the recent history of the United States. The most important of these measures are considered to be the issuance of the GAAP (Audit General Agreement) and the Sarbanes Oxley Act. However, in the 2008 crisis, the shadow banking sector, the ever-expanding financial markets and the innovation of financial markets, has become an unforeseeable form.

The shadow banking system is separated from the traditional banking system in that shadow banking system products are not covered by government securities, they can use high leverage ratios, large liquidity supplements, investments they can make and the need not to work under strict supervision. The shadow banking system, acting like a central bank in the past 10 years, has become one of the most important financial institutions in the world, including commercial banks, monoline insurance companies, hedge funds, private equity. The options and innovations created by this system are households, investors, investment managers and old-fashioned speculators who have come together to create this uncontrolled and regulated system Households and firms that consider these options to be more advantageous have invested their joint funds and savings in social security and pension funds in an increasing course, rather than keeping their savings predominantly in local banks and credit cooperatives.

The US repo market peaked at US \$ 4.5 trillion in 2008, about \$ 220 billion in ABCPs and almost 600 billion dollars in securities lending. Besides these, the

shadow banking system; for a large part of consumer and business loans, for automobile loans, for student loans and for securitization of small business loans. Besides these seemingly positive developments, the mortgage funding of many channels of the shadow banking system has played a crucial role in the financial crisis.

The shadow banking system used various instruments while performing all these activities. If the instruments used are to be ordered; money market funds, asset-backed securities (ABS), hedge funds, repo, asset-based financing bills, derivatives, trade notes or papers (CP). Money market mutual funds provide short-term liquidity for financial intermediaries, but they are not regulated as traditional banking systems. government bonds include low-risk joint funds such as commercial bonds (CP), guarantee receipts, repurchase agreements / repo, and discounted bonds (bonds sold at a lower price than the nominal value).

Unlike the financial crisis, unlike the shadow banking system, commercial banks and savings-credit unions, the government did not benefit from open support. Specifically, the government has provided; mitigating liquidity risk, providing deposit insurance, and being the last lender of credit were not provided to the shadow banking system. The lack of all these possibilities has led to a great fragility. Deposit insurance alleviates the negative consequences for many banks and savings institutions when many people claim all their receivables at the same time. At the end of 2007, approximately 51% of deposits in commercial banks and savings institutions in the US were insured by the FDIC (Federal Deposit Insurance Corporation).

In an environment where safeguards and banks are so safe, funds have the advantage of being able to withdraw their money whenever they want. However, contrary to what is happening here, funds in the shadow banking system are not insured as federal. In addition to this, the shadow banking system has not been linked to the Federal Reserve, which has assumed the role of "lender of last resort". The shadow banking system, which works almost exclusively in bank regulation

despite its legal means, has caused one of the biggest credit explosions in history. This has caused one of the most staggering financial crises to be seen.

The shadow banking system, which is largely lacking in supervision, has collapsed and tried to include the 2008 crisis, one of the biggest financial crises in history. In the first stage, the crisis, which started from 2000 and reached its peak in 2008, was tried to be drawn in the crisis stages in the subsequent sections where the general course was tried to be drawn.

Between 2000 and 2007, banks and financial institutions bought stocks of securities products including housing loans worth over \$ 1 trillion. They have formed many off-balance-sheet institutions and structures, which they do not specify in their reports. This is expressed as "Rach" (random uncertainty) and "Rahd" (randomly acted credit).

Despite the compound decline in interest rates in major developed economies in October and November 2008 and the sudden decline in the basic interest rate in the US, the difference between the bid-ask spreads between US treasury papers and Libor (interest rates between London banks) they are at very high levels. On the other hand, preferences for the US Treasury Paper have changed direction, resulting in an escape from the dollar. Even if an attempt is made to take countermeasures against this situation, it has not been effective. For example, The Bank of England has taken similar measures to mean swap operations, but all of this has not hindered the fragmentation of the global shadow banking system. The process in which the financial crisis fully strengthens includes the period from the beginning of 2007 until the end of 2008. Throughout this process, a mortgage market, especially lending to the low income group, has created a panic that has led to a gradual loss of confidence in sensitive markets and ultimately to shrinking banking instruments. This panic has led to suspicion that the allele rush to sell assets first and then to pay for the losses of some financial companies.

In order to better understand how the crisis has progressed, we can express it in various phases: the 2007 article liquidity crisis, the growing concern in various

liquidity markets, the Bear Stearns incident in 2008 and finally the September 2008 crisis. Following the housing market explosion, in 2006 mortgage lenders, which started to decline rapidly in house prices and given high interest rates to low income groups, began to default. This trend continued without interruption from the beginning of 2007 until the end of 2007, and it started to get even worse. The first victims of these developments in the financial market. This crisis is seen as one of the most spectacular examples of the narrowing of the market-based credit supply. However, this collapse of credit supply is not limited to a single category but is observed in all categories of categories, from automobile loans to student loans.

Shadow banking financial institutions are contributing to the deepening of the financial system by transforming the use of liquidity, which has a low level of liquidity, into liquid use in periods of liquidity squeeze. As the deposit insurance system like traditional banks does not apply when collecting resources, the costs are also lower, which gives cost savings to institutions that make shadow banking. Credit financing is also lower than the collateral demanded by traditional banks. Therefore, credit customers are always ready.

These advantages are increasing the demand for shadow banking. For this reason, some traditional banks are also setting up shadow banks. So they maximize their profits. As the profits of the banks increase and the capital adequacy rises, these banks can be considered as dangerous.

The danger is that shadow banking is unprotected in the event of fund raising. They collect short-term funding and fall short of liquidity for long-term sales. This happened in the 2007/2008 crisis.

Now these banks are starting to grow again. Although the US and Japan have achieved growth stability, the continuation of the growth constraints in the EU may cause them to default on credit returns using these funds, which could clog the system. He is asking for restrictions on shadow banking because he is afraid of this possible development in the IMF.



The processes of integration and globalization of the economy are making changes in the system of customs administration. Customs should be receptive to change, there is only one way to respond to current events - to adapt to new conditions, carry out appropriate changes and try to foresee the further development of the situation. To date, Azerbaijan has developed ways to simplify procedures, reduce workflow, improve services provided by customs. Using international experience in regulating foreign economic activity, the state strengthens external borders, improves the legislative base, creates the most favored nation regime for foreign investments and develops its own business structures. Significant funds are allocated for the technical equipping of customs posts with modern equipment, control, design and surveillance. Widely introduced information technology, computer technology of the new generation.

To form a favorable situation, it is necessary to conduct an adequate economic policy. In this regard, it is necessary to identify, from a variety of threats to economic security, those factors that have the strongest impact on the economy. In our opinion, we can identify the following most serious threats:

- Absence of long-term recovery of production in some industries and loss of markets (phosphorus, tires, machinery).
- "Brain drain" and technological safety.
- Threats in the social sphere (unemployment, inflation, disproportion in income).
- Danger of loss of food independence of the country.

Summarizing the aforesaid, it can be noted that economic security is the ability of the economy to provide effective satisfaction of social needs at the national level. In other words, economic security is a combination of internal and external conditions that favor the effective dynamic growth of the national economy, its ability to meet the needs of society, the state, the individual, to ensure the competitiveness of domestic goods in foreign and domestic markets.

### **3.3. Directions for improving the mechanisms of counteraction to shadow banking**

The bank is a financial institution that has a license to accept and lend money. At the same time, currency change, wealth management, lending and a number of such financial services are within the competence of banks. It is impossible for commercial banks to fully meet the credit needs that are needed in the economy. This, in turn, increases the demand for shadow banking.

Shadow banking, usually illegal, is meant for banking. Shadow banking was more prevalent in previous years. Because of limited access to bank loans in previous years, it created the basis for the development of illegal banking. In developed countries, practically, shadow banking has dropped or decreased significantly.

Shadow banking characterizes a large number of financial system errors that can lead to global financial crisis. This term was first featured in 2007 at the annual financial symposium hosted by the Federal Reserve System (FED), financed by Paul McCulley in 2007. In his speech, McCulley identified shadow banking with the maturity transformation used by non-bank organizations. Thus, shadow banking accepts short-term deposits as long as commercial banks and lends long-term loans. They generate short-term funds in the securities market and use these funds to buy long-term assets. However, they did not comply with traditional banking laws.

Shadow banking attracted the attention of experts for the first time as a result of turning mortgages into securities. The "Securities chain" began with the creation of a mortgage and was subsequently bought and sold by a number of financial companies. The value of the securities is determined by the value of the mortgage loan, and the interest rates on mortgage-backed loans are repaid by the homeowners.

The Financial Stability Board, which was established in 2009, considered shadow banking as a financial intermediary and, according to the Chamber, shadow banking has the following functions:

- Maturity transformation: Attraction of short-term funds to invest in long-term assets.
- Liquidity transformation: Purchase of hard-to-sell loans, using cash balances.
- Leverage (Leverage): Investment in fixed assets for long-term profit as a result of borrowing.
- Credit risk transfer (Credit risk transfer): Transfer of default risk from borrower to borrower.

The shadow bank was well developed before the problems emerged in the last financial crisis. As a result of these problems, some investors have already started to behave in awe and regain their funds. To return investors' funds, shadow banks began to sell their assets, and the assets of shadow banks were severely reduced as a result of these fire sales (Fire sales). This led to the shadow banks' assets being degraded in the financial market, and ultimately they were sold less than the value of the shadow bank assets. In the peak phase of the crisis, many investors failed to invest in shadow banks and, as a result, many banks and non-bank financial institutions were in a difficult situation.

Since shadow banks do not report to government agencies, their size cannot be determined. Shadow banking is most widely spread in the United States. FED has started to collect information about such banks since 2010, and in 2012 the Financial Stability Chamber conducted a second global monitoring of shadow banking. However, the results have never been heartwarming and shadow banking has still been peak in the US. According to the Financial Stability Palatra, funds attracted to shadow banking in 2007 totaled \$ 62 trillion, while the financial crisis fell to \$ 59 trillion, but rebounded to \$ 67 trillion in 2011.

Shadow banking in Azerbaijan is more commonly used as usual. Looking back on previous years, uselessness in the 1990s began to develop more and more.

At the same time, there was a serious weakening of usury in 2006-2014. Especially in 2014, commercial banks' lending terms and credit enhancement opportunities, in many cases, allocating loans without banks' ability to pay solvency led to a decrease in interest in usury. Because in all cases, the shadow banking interest rates offered are higher than the legal banks. In recent years shadow banking in Azerbaijan has increased.

This is due to the limitation of banks' credit facilities. As a result, shadow banking shows itself in two ways. Firstly, certain individuals use high interest rates. In this case, crediting is granted without legal registration. It also shows itself as an alternative to bank loans. But here, interest rates are high and simply accessible. At the same time, unlike banks, no workplace reference is required, gold is not real estate, gold and precious stones are not accepted, no need for floor.

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At the same time, shadow banking is gaining more money in money transfers. There is a swap system. The Azerbaijani living in Russia transfers the money to the person engaged in exchange and activity in Russia. Money is brought to his relative in Azerbaijan. As a result, money is delivered to the address without any bank transfer, without any transfer operation. This is more of a kind used by Russia in Azerbaijan. Unlawful ways of remittances to other European countries are not used.

The shadow banking system, which is one of the major drivers of a serious problem, such as the global financial crisis, has a very dangerous character that can destabilize the economy for several months. While the issue of regulating a system that demonstrates a clear model of the free market economy seems to be the subject of banking regulation, legal regulation and economic control, shadow

banking is a far-away system without tacit regulation. The universal regulation system, which involves both economic and legal factors to control risk and reduce the system's uncontaminated aspects, and the settlement of disputes over the circumstances of the case, in particular, raising the role of arbitration in the settlement of the disputes may put the shadow bank's "dreadful" identity.

In general, if we want to explain shadow banking in Azerbaijan in recent years, it can be shown on mortgage loans. For example, any person wishing to take a mortgage loan applies to the bank to obtain a loan, and the bank offers this amount to interest rate of 10%. On the other hand, he can get this amount from a non-bank credit organization at a rate of 9%. Of course, at that time, the same person will choose the second offer because of the low interest rate.

Banks, for example, receive deposits at a rate of 3% and get 7% profits when lending with a rate of 10%. All these indicators, as well as the entire loan portfolio, should be reflected in the bank's report because banks are under state control and these reports show the bank's financial status. The shadow banking system differs from the fact that there is no adjustment or low level. Here, people who get a loan intend to increase their money by selling them to securities (securitized) to market securities and selling them to other investors.

## **CONCLUSION**

Evaluate the size of the banknote bank system is particularly difficult, since many of these entities are state-owned and regulated by the regulator. The largest shadow banking system appears to be in the US, but the mediation of non-bank organizations in obtaining credit is also taking place in other countries, and this segment is growing. In 2010, the Federal Republic of Germany started working on a part of a shadow banking system, which is partly due to credit repayment. In 2012, the SPS, with its 20 percent stake in the emerging market economy and the emerging market, launched a globalized monitoring operation for all operations in the non-banking creditworthiness of 25 jurisdictions and euros. The resulting outcomes are relatively straightforward, as they use the universal category of "other financial institutions", but not all, or even suggest that the shadow banking system in the United States remains the same as the majority, but still has a share

of 44 to 35 per cent in total. The Global Compact, with a global gross turnover rate of 62 trillion US dollars in 2007, has dropped to 59 trillion US dollars, with the crisis rising to 67 trillion US dollars in 2011. The dollar-to-dollar banking system was ranked at 27 per cent in 2007, roughly 25 per cent in 2009-2011. No procedure is provided for the SPS, which indicates that the transmitter's own funds and funds are not used, nor does it evaluate the risk of the bank's bankruptcy for the financial system. Otherwise, the SPS does not measure the amount of assets that are used for the acquisition of a Leverage, often in a system or system, the problem is spread across one of the other sectors. The plan is to plan a sequence of "schemes on macrolevel " information, collected from the reports of organs regulation and information on the analysis of the markets, particularly relevant to new trends, tools and communications. The SPS plans to use the information obtained about the shadow banks and link this information to four types of shadow banking activities (conversion of maturity and liquidity, credit risk transfer and leverage) to compile a "systemic risk scheme" to determine whether any activities can create systemic risk, and if so, which ones. The first SPS survey showed that the scale of the bankruptcy business, linked with the internal resources, in the majority of the jurisdictions, though not foreseeable transboundary business. It also seems to be a good idea, how can it be possible to communicate with different types of components. Here, in some of the financially outsized companies, they are expanding their business, and their role in crediting. No matter what has been set up, these are just a few of the things that are really important to the public. The official sector is more and more aware of the fact that there is a great deal of information that is distorted. The bank management of the bank also analyzes traditional banks' transactions with offshore banks and creates restrictions on their capital, as well as capital markets and liquidity, which allows banks to denominate the traditional financial sector and economy. As a matter of fact, many of these banks have either been regulated or have been officially regulated by a regulatory body, the official authorities will consider the possibility of expanding information and regulation, how to set up, and how to use them for markets. At the same time,

all of the potential commercial banks or entities have been controlled by the shady banks to control their own business, as well as to prevent the downfall of organs regulator (or vice versa), within the country or internationally.

Current conditions require the focus of Azerbaijan's focus on the development of the non-oil sector. One of the ways to develop the non-oil sector in the country is the fight against the shadow economy. State Statistical Committee reports that it is 19 in the economy and 60% in international organizations. Hence, the existence of the shadow economy should not be denied, but must be fought against it. It would be better if a public body to fight against the shadow economy be created in the Milli Majlis".

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