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The Epoch of Market Based Funding: Shadow Banking

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In the midst of a 2008 financial crisis, a senior French banker revealed that "It takes me about two hours to assemble a team of finance geeks and lawyers to devise a product or a transaction that would bypass any new rule or regulation coming our way". And it is this confession that captured the essence of the challenge that daunts the regulators and policy-makers in the aftermath of the most devastating financial crisis since the 1930s. It seems that whatever financial regulators come up with, industry players are likely to find a way to bypass it. Or at the very least, minimize its impact. The most compelling illustration of this blunt logic of financial evolution is the phenomenon of shadow banking, a term that entered public debate in 2007 and has since preoccupied regulators and finance experts.

What's in the name?

Simply-put, shadow banking depicts a market-based funding system (rather than bank-based), or "money market funding of capital market lending" (Mehrling et al 2012). More extensively, it implies a complex network of credit intermediation outside the boundaries of the traditional, regulated bank. It was the crisis of 2007-09 that brought the scale of shadow banking to light and transformed a phenomenon considered to be a benign force of financial innovation and competition, into a political problem. Paul McCulley (2009) argued that the growth of the shadow banking system, which operated legally yet entirely outside the regulatory realm "drove one of the biggest lending booms in history, and collapsed into one of the most crushing financial crises we've ever seen."

Soon after the term was coined, it became clear that 'shadow banking' was both a stroke of genius and an unfortunate choice of words. Unfortunate, because confusingly (and wrongly), 'shadow' banking resonates with 'shady' or unlawful economic activity, ascribing pejorative connotations to an essential segment of the banking system. Ingenious, because the continuing disputes over definitions of shadow banking evolved into a wide-ranging debate among industry experts, regulators, academics and civil society. Key issues being debated include the precise nature of shadow banking, the type of entities that should be included under this umbrella and why, and what to do with this parallel system of financial intermediation in the post-crisis economy.

Academic and policy work on shadow banking show that over the past three to four decades, banks and financial institutions have developed what amounts to a parallel financial universe. Today, behind the facade of any major banking conglomerate, there is a plethora of entities, transactions and quasi-legal cells 'orphaned' from the visible part of the bank by complex legal and financial operations and often embedded in offshore financial havens, yet which have become absolutely integral to the functioning of our banks. Such entities include: special purpose entities (SPEs), special investment vehicles (SIVs)[1] or asset-backed commercial paper (ABCP)[2] but also more established institutions, such as hedge funds, money market funds and government sponsored financial institutions like the American mortgage giants, Fannie Mae and Freddie Mac.

The Financial Service Board (FSB) put the global size of the shadow banking system at $71 trillion, accounting for roughly half of total banking assets globally and a third of the world's financial system. Global shadow banking is predominately Anglo-Saxon, with the United States of America (USA) and the United Kingdom (UK) accounting for 46% and 13% of the global shadow banking system, and Japan and the Netherlands following closely (8% each). At the same time, shadow banking is an internationally diverse phenomenon, with approximately 40% of credit provided by the nonbanking sector in emerging markets (Ghosh et al 2012). But analysts, at all levels, admit that current figures about the scale and scope of shadow banking activities tend to be under-estimations.

The pros and cons of shadow banking

Since the crisis erupted in 2007, research into shadow banking has progressed rapidly, and our knowledge and understanding of this complex web of finance have vastly improved. At the same time, some major political dilemmas, relating to shadow banking, remain unresolved.

On the one hand, shadow banking is vital part to financial activity today, helping banks conduct securitization and lending functions, also accommodating a variety of economic interests, from investment banks and pension funds to high-net worth individuals and sovereign wealth funds.

On the other hand, it raises at least three problems related to financial stability. First, relying on long, complex and opaque structures of credit creation, many visible banks are able to enlarge their *de facto* size, often creating undetected leverage and thus, adding to the problem of 'too big to fail.' Second, by netting several entities into a long and opaque chain of credit intermediation, the shadow banking system amplifies the scope for regulatory arbitrage. Third, relying and thriving on complexity, it obscures the sources and real dimensions of systemic risk in the financial system and aggravates the problem of non-transparency of finance.

The art of complexity

These three problems are inter-related. Complexity has become a social and even cultural tool of opacity, employed by financial elites in efforts to isolate themselves in 'silos of silence' (Tett 2009). During the boom years and even in the wake of the crisis, professional jargon and heavy mathematics served as barriers against transparency of the controversial (yet profitable) business of financial innovation that is often akin to financial sabotage (Nesvetailova and Palan 2013). In the largely self-governed financial system, this complexity could prove implosive: the increasing sophistication and precision of financial practices were mirrored by the growing ignorance about the actual developments in finance. In the midst of 2007-09 meltdown, possibly for the first time in modern economic history, regulators, senior managers and academics resorted to the concept of complexity to excuse and even justify their ignorance about the developments in the financial system in general and in their own institutions (Datz 2010).

The recognition that shadow banking played a leading role in the global financial meltdown has served to empower national and international financial regulatory bodies. Remarkably, the first generation of scholarship on shadow banking has been led by the regulators themselves, with major studies and insights suggested by teams working with Zoltan Pozsar (US Treasury), Manmohan Singh (IMF), Andy Haldane (Bank of England) and Adair Turner (the British FSA), Claudio Borio (BIS) and research staff in other national and international regulatory institutions. These efforts helped produce refined regulatory maps, which in the post-2007 world inform thinking at the monetary and financial regulatory institutions (link to Pozsar). And while it is an open question whether the rules and safeguards (such as new capital requirements on banks) would suffice in minimizing the costs of the next crisis; it is likely that the next bout of financial instability would involve a nexus between 'official' and shadow banking systems.

Shadow Banking Here to Stay!

Against this background, it is notable that, confronted with protracted recession and lack of funding for the economy, regulators today call for the return of securitization in order to boost investment and credit flow. These calls confirm that shadow banking is not a paranormal development of the economy or an outcome of bankers' misguided behavior. It is rather, the infrastructure of financial innovation. Without shadow banking, finance cannot function; and that is why shadow banking, however defined, is here to stay.

[1] SIVs can either be affiliated with a single banking institution, or obtain support from multiple institutions. Adrian and Ashcraft (2012) report that since 2008, SIVs have stopped operating.

[2] Commercial paper collateralized by a specific pool of financial assets. The bankruptcy remoteness of all of these entities implies that the collateral backing the ABCP is exempt from the potential bankruptcy of the institution that provides the backup lines of credit and liquidity (Adrian and Ashcraft 2012).

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