The FSB's "Shadow Banking" *Confusion*

By Peter J. Wallison

The G-20's true intentions are anyone's guess.

At the 2011 Cannes summit, and again at its Los Cabos summit in 2012, the G-20 leaders called on the Financial Stability Board—a largely European group of central bankers and financial regulators—to strengthen the oversight and regulation of "shadow banking." It would be interesting to know what the G-20 leaders thought they were approving when they endorsed a regulatory program for something as technical as shadow banking, but we now know what the FSB had in mind when it picked up this baton.

As defined by the FSB, shadow banking is "credit intermediation involving entities and activities (fully or partially) outside the regular banking system." Taken literally, this language is absurdly broad, since it covers all financial intermediation that is not subject to bank-like regulation, but in subsequent statements the FSB has not stepped back from the breadth of this definition.

It would be easy to define shadow banking narrowly and get at least some buy-in from the financial community. The defining characteristic of banks is that they perform something called maturity transformation—that is, they turn their short-term deposits into long-term assets by making loans. It's a risky business, and in the modern world is somewhat protected by deposit insurance, which reduces the tendency of depositors to withdraw their funds (often called a run) when they believe the bank's financial condition is weak.

During the financial crisis there were a number of institutions—Lehman Brothers and Bear Stearns being two—that

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failed or came close to failing because they attempted to use short-term repo financing to carry long-term assets such as mortgages. If we ignore the pejorative connotation associated with the term "shadow," the non-banks that did what banks traditionally do could logically be called "shadow banks."

But although this might be a reasonable inference from what happened in the financial crisis, it would not cover much of the shadow banking world. Thus, in 2012, the FSB noted that

> *"[E]xperience from the crisis demonstrates the capacity for some non-bank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability (longer-term credit extension based on short-term funding and leverage). Such risk creation may take place at an entity level but it can also form part of a* complex chain of transactions, in which leverage and maturity transformation occur in stages, *and in ways that create multiple forms of feedback into the regulated banking system"* [emphasis added].

As the FSB sees it, then, many entities in the shadow banking world work together to produce the maturity transformation that is the risky element of traditional banking. Former U.S. Federal Reserve Chair Ben Bernanke—a strong and persistent backer of regulating shadow banks—provided an example of what the FSB is getting at in a 2012 speech:

> *As an illustration of shadow banking at work, consider how an automobile loan can be made and funded outside of the banking system. The loan could be originated by a finance company that pools it with other loans in a securitization vehicle. An investment bank might sell tranches of the securitization to investors. The lower-risk tranches could be purchased by an asset-backed commercial paper (ABCP) conduit that, in turn, funds itself by issuing commercial paper that is purchased by money market funds.*

The problem with this, Bernanke went on, is that "Although the shadow banking system taken as a whole performs traditional banking functions, including credit intermediation and maturity transformation, unlike banks, it cannot rely on the protections afforded by deposit insurance and access to the Federal Reserve's discount window to help insure its stability."

Thus, to the extent that Bernanke reflects the underlying ideas circulating in the FSB—a good bet given the importance of the Fed in the world's financial system—the effort to control shadow banking is based on the idea that while the shadow banking system can create risky maturity transformation, it does not have the necessary access to either the deposit insurance or the Fed's discount window that protect banks against runs.

For this reason, apparently, the FSB is considering how to designate shadow banks—as defined above—as "systemically important financial institutions," or SIFIs. Thus, in September 2013, the FSB announced that it was "reviewing how to extend the SIFI Framework to global systemically important nonbank noninsurance (NBNI) financial institutions." This category of firms, said the FSB, "includes securities broker dealers, finance companies, asset managers, and investment funds, including hedge funds."

They are serious enough about this idea that they suggested in January of this year that asset managers with more than $100 billion under management could be designated as SIFIs. Since pension funds, bond funds, and

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Moral Hazard on Steroids?

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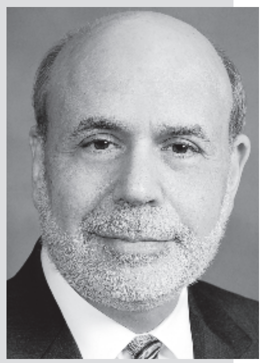
—*P. Wallison*



Ben Bernanke, *former chairman of the U.S. Federal Reserve.*

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mutual funds don't engage in maturity transformation on their own, this latest sally must come under the category of "a complex chain of transactions, in which leverage and maturity transformation occur in stages."

If such a designation is made by the FSB on this basis, it is likely that the Financial Stability Oversight Council—an agency created by the Dodd-Frank Act and consisting of all the U.S. federal financial regulators—would then implement it in the United States. This has already happened in the insurance industry, where the FSB has designated three U.S. firms—AIG, Prudential, and MetLife—as SIFIs, and the FSOC has thus far designated AIG and Prudential as SIFIs and is investigating MetLife for this purpose. When the FSB announced recently that asset managers should be considered for SIFI designation, the FSOC began the designation process for BlackRock and Fidelity. When a firm is designated as a SIFI, it is automatically turned over to the Federal Reserve for what apparently will be bank-like regulation and supervision, which could mean something as intrusive as control of a fund's investment policies.

But what could the FSB and Bernanke have in mind when they propose to include as SIFIs firms that participate in "a complex chain of transactions, in which leverage and maturity transformation occur in stages"? Regulating such firms because of their participation in chains of transactions seems impossible on its face. It would require detailed rules about, or direct oversight of, millions of transactions.

Let's take an example. An asset manager buys a twenty-year bond issued by IBM, part of a larger bond sale for the purpose of building a new plant. Having no immediate need for construction funds, IBM parks the funds with a subsidiary that makes loans to customers who purchase IBM servers under conditional sales agreements or leasing arrangements. The subsidiary then borrows short-term funds from a finance company, using conditional sales agreements or leases as collateral. According to the Bernanke example, this would be a chain of transactions that has transformed a twenty-year construction loan into a short-term financing arrangement. Somehow, SIFI regulation is supposed to capture this typical commercial transaction and millions like it. It seems lunatic in its ambition and scope.

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What the FSB really intends to do is anybody's guess, but since they are acting under the direction of the G-20, their determination and ability to carry through should not be underestimated. Nor should the FSOC's plenary authority and determination to designate SIFIs under Dodd-Frank be minimized. As the FSOC showed in designating Prudential as a SIFI in September, it can and will do so without dealing seriously with the arguments raised against designation by the firm under consideration.

The real problem they face is the irresistible pressure to borrow short and lend long, simply because long-term assets almost always yield more than the cost of short-term money.

The FSB and the FSOC may try to regulate all this through SIFI designations and control of investment policies, but it might be easier just to repeal the yield curve. ◆