The Moonshine *of* Our Times

The global rise of shadow banking.

By Roger Davies

The infamous American gangster Al Capone once said that "prohibition has made nothing but trouble." Similarly, it is the expansion of banking regulation with a knock-on restriction on lending that has proved the catalyst for the growth of a shadow banking sector now a victim of its own success. The term was coined as much of what goes on lies in the shadows. Banking reform has long been focused on restraining the activities of retail and investment banks, but until an alarm was recently raised about systemic risk, it appears shadow banking has not been on supervisors' main agendas. Most economists, with the benefit of hindsight, are concluding that the risk built up in the shadow banking system played a key part by contagion in the collapse of credit in the 2008 global financial crisis.

The Financial Stability Board defines shadow banking as "credit intermediation involving entities and activities (fully or partly) outside the regular banking system"—essentially, credit obtained outside the banking system. It covers derivatives, money-market funds, securities lending, and repurchase agreements as well as the riskier investment products and loan-shark activities. In November 2014, the FSB published "Transforming Shadow Banking into Resilient Market-based Financing." The FSB was concerned that a largely unregulated sector had grown globally to $75 trillion in 2013, an increase of $5 trillion from the preceding year. The paper also included an updated "roadmap" from the G-20 for the "Strengthened Oversight and Regulation of Shadow Banking in 2015." While the "too big to fail" issue dominates bank supervision, many recognize that the

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core problem with shadow banking is that it is too diverse to regulate effectively and indeed much activity is hidden from official scrutiny. The FSB is now proposing to combine bank- and market-based finance, its new name for shadow banking, into a more diverse financial system, hoping it will prove more resilient and, through greater competition, more effective.

We should be mindful that net credit growth since the economic crisis has fundamentally been in bond rather than bank finance and the importance of shadow banking to the economic success of China and India cannot be overemphasized. In practice, many shadow banking operations rely on short-term funding, often channelling funds through various unregulated institutions in a chain of transactions with risk building up at each stage. Since the operations are unregulated, there are no safeguards for depositors. It should be noted that in the United States, where pension fund return expectations have stayed at around 8 percent despite plunging interest rates globally, the large mutual funds have entered the shadow banking industry in an effort to boost yields. The need for higher returns involves riskier investments but the use of derivatives and repos can greatly amplify the potential rewards. On the downside, any fire sale could drive down asset prices and cause big problems for the mainstream banks. The International Monetary Fund estimates the U.S. shadow banking system to be somewhere between $15 trillion and $25 trillion!

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FSB Chairman Mark Carney has declared that the global economic crisis exposed significant "fault lines" in shadow banking activities and regulators had not fully understood the interconnectivity between banks and shadow banks. Heavy reliance by the latter on short-term wholesale funding and a lack of transparency hid the leverage and maturity mismatch. In 2008, credit intermediation through the shadow banking system came to an abrupt halt, threatening the viability of the entire financial system when the funding markets simply dried up.

Going forward, the FSB is adopting a two-pronged high-level strategy to deal with these "fault lines," although there is no easy solution. First, the FSB has created a global monitoring framework to track developments in the shadow banking sector specifically to identify systemic risks and apply corrective actions, if necessary. This monitoring started in 2011 and now covers twenty-five jurisdictions representing 80 percent of global GDP.

The systemic threat is very real.

Second, and more important, the FSB is looking to significantly increase the regulation of the sector in five core areas to prevent the re-emergence of systemic risk. These are officially identified as mitigating the risks in banks' interactions with shadow banking entities, improving transparency and aligning incentives in securitization, reducing the susceptibility of money market funds to "runs," dampening pro-cyclicality and other financial stability risks in securities financing transactions, and assessing and mitigating financial stability risks posed by other shadow banking entities and activities. Specific FSB policies will focus on the economic functions in order to cater for innovations and adaptations on or outside of the regulatory perimeter. The G-20 roadmap of planned activities for 2015 covers actions by the FSB, International Organization of Securities Commissions, and the Basel Committee on Banking Supervision. It includes an analysis of the global hedge fund sector, a review on the progress of money market fund reforms, and a study of global securities financing data. Clearly, a massive change program is in the pipeline.

Action by regulators appears to many observers as long overdue as serious concerns have been raised across the

Argentina Watch

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globe. In China, shadow banking had grown to between $2.3 trillion and $4.8 trillion by the end of 2012, responding to a government-controlled lending environment. Chinese banks tend to lend more money to state-owned enterprises with only minimal support for small businesses. In relatively shallow financial markets, Chinese borrowers have exploited unregulated internet finance including peer-to-peer platforms while investors have also sought higher returns in wealth management products. Although the collapse of the Shanxi Platinum Assemblage Investment company in December 2014 was relatively small fry, it serves to highlight the financial risks lurking in China's shadow banking system, especially where high-yielding wealth management products blur into grey-market lending. The *Financial Times* has stressed "a series of similar incidents … suggests China's slowing economy has created fertile ground for hucksters as companies become increasingly desperate for funds amid a pullback in lending from banks as well as more mainstream non-bank lenders such as trust companies."

Chinese regulators have been slow to react. Although a new Oliver Wyman report concludes that the shadow banking situation in China is currently manageable, urgent attention is required to preempt any escalation in non-performing loans. We should not forget, however, that China is a net lender to the rest of the world and any emerging debt problem should fundamentally be a domestic issue. Elsewhere, shadow banking can, of course, make it far harder for countries to control their economies by fiscal policy. Argentina, whose stuttering economy is increasingly fragile, saw a 50 percent increase in the shadow banking sector in 2013. Nearly half of the $70 trillion in managed assets worldwide is in funds offering investors redemption at short notice but, conversely, funds are investing increasingly in higher-yielding, less liquid assets. Surely, the writing is on the wall?

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European Central Bank Vice President Vítor Constâncio oversees financial stability. Speaking at the University of Warwick in February 2015, he flagged his worries about hedge funds, money market funds, and offshoots of the insurance industry. In terms of assets held, he foretold that, if unrestrained, shadow banking would be bigger than the regulated banking industry within five years. "The tools needed to prevent the building-up of excessive risks in that sector are currently not in the set of instruments available to the ECB or to macro-prudential authorities at large—and some need yet to be devised." He did not rule out direct regulations including cash buffer requirements and redemption fees. Many impartial experts will agree, and hedge funds and private equity firms in particular should be mindful they will face increased regulatory scrutiny.

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Reflecting the steer of the G-20 for sustainable economic growth, the FSB strategy is to implement a series of integrated policies worldwide to help mitigate the financial stability risks and to transform shadow banking into "resilient market-based financing." This is far easier said than done and wildly optimistic. Experience tells us that regulators in different jurisdictions are poorly coordinated and reform programs are constantly delayed in implementation. Dodd-Frank, for example, became law in the United States in 2010, but a quarter of the rulemaking requirements have not yet even been proposed. This is the result of intensive lobbying from the banking industry. Any reform of shadow banking will also incur aggravated distrust from emerging economies. In the emerging world, shadow banking fills a vacuum, and the FSB has come up with no viable alternatives. Mark Carney has stated that the world has turned a corner in reducing the probability of another financial crisis, but globally there is a voracious appetite for market-based finance that will not succumb easily to regulatory restraint. We must not forget that shadow banking is enormously successful for the very fact that it is unregulated. It is a hotbed for innovation because it is unstifled by the rules. Like moonshine, it meets a market need, but the systemic threat is very real. Accordingly, regulators globally must target specific problem areas with appropriate prudential regulation and adopt proportionate conduct rules to protect all parties. A safer financial world with correctly capitalized banking operations and minimized systemic risk? I'll drink to that! ◆