No. 7 : January-April 2013

Academic Foresights

Anastasia Nesvetailova

Shadow banking

How do you analyze the present situation of shadow banking?

Capitalism evolves through cycles. Throughout centuries, many of these boom and bust waves were driven by financial speculation. The Dutch tulip mania in the 17th century was fuelled by voracious appetite of the Dutch elites for exotic flower bulbs and saw one of the first instances of speculation on financial derivatives. The tulip boom ended rather abruptly in 1637, yet Holland emerged in its wake as a major horticultural centre in the world economy. The dotcom bubble of the late 1990s centred on new internet technologies and was fuelled by Wall Street and accounting firms. It did implode in 2000-01, yet it did leave behind the tangible economic legacy of new information and communication technologies. In this perspective, the recent financial crisis is only the most recent manifestation of a broader historical trend: the credit boom of 2002-07 was underpinned by the policies of cheap credit and was driven by aggressive financial innovation, yet notwithstanding the collapse of the credit super-bubble in 2007-08, the financialisation of the economy has yielded some, albeit selective, economic benefits, such as newly built real estate and infrastructure, financial as well as technological.

At the same time it is difficult to overestimate the historical and educational significance of the global financial crisis. Never before, apart from the lost decade of the 1930s, have so many widely held beliefs were undermined or destroyed, along with billions of dollars worth of financial wealth. Indeed, the financial crisis is as much a crisis of the financial and economic system as it as the crisis of the economic orthodoxy and economics as a profession (no mainstream economist had foreseen the coming crisis). The financial meltdown has exposed most of the key pillars of the existing economic doctrine as flawed or deluded. We have seen that no major international governing body, with the important exception of the Bank for International Settlements, has had the insight into the destructive potential of private financial markets. We know now that central banks are not, and cannot plausibly be, independent from the political process. We have learned that complex financial techniques do not optimise risk, instead they actually propagate it; while the highly sophisticated financial terminology can be used to obscure illicit practices. We know that banking and financial industry are not serving the interests of the 'real' economy. We also have learnt, and this is probably the most crucial lesson of the continuing crisis, that no existing textbook or popular knowledge captures the true nature of banking today.

That is because over the past three or 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, many of which are 'orphaned' from the visible part of the bank by complex legal and financial operations, yet which have become absolutely integral to the functioning of our banks. These practices and cells of credit creation include the rather obscure entities such as special investment vehicles (SIVs) or asset-backed commercial paper (ABCP) but also more established institutions, such as hedge fund, money market funds and government sponsored financial institutions like the American mortgage giants, Fannie Mae and Freddie Mac.

In 2007, the scale of this web of financial innovation was captured by Paul McCulley of PIMCO, an investment fund, who 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" (McCulley 2009). 'Shadow banking' is an unfortunate phrase because it brings rather derogatory connotations into a concept that describes a vital part of the global financial system today. Yet the term has stuck, as McCulley's focus on the complex, opaque and under-reported world of unregulated financial innovation and credit creation spurred further studies of the phenomenon of shadow banking.

The efforts of academics and regulators on both sides of the Atlantic yielded unsettling results. In the USA on the eve of the financial crisis in 2007, the size of the unregulated financial system ($27 trillion) dwarfed the volume of the official banking system. In the wake of the crisis in 2010, shadow banks in the USA still controlled about $12 trillion of assets. Observers and regulators in Europe are struggling to quantify the precise volume of the shadow banking in the region, yet they note that unlike in the USA, its growth has continued even after the financial crisis. In the last quarter of 2010, the shadow banking sector represented around $13 trillion in Europe and $15.8 trillion in the USA (Bouveret 2011: 6).

The Financial Stability Board estimates that globally, shadow banking expanded rapidly before the crisis, from an estimated $27 trillion in 2002 to $60 trillion in 2007, and $67 trillion in 2011. It is the equivalent of a third of the financial system worldwide. The so-called Anglo-Saxon financial system dominates shadow banking, with US and UK accounting for 46% and 13% of the global shadow banking system, respectively; Japan and the Netherlands follow closely (8% each). Yet credit intermediation outside the regulatory realm is not an exclusive problem of advanced financial capitalism. A recent World Bank study found that for the emerging and developing economies of East Central Europe and Asia (including China), the role of shadow banking in credit intermediation has been growing in the past few years. In the emerging market context, shadow banking tends to assume the form of rather simple chains of credit intermediation, and involves weakly regulated or un-regulated mechanisms of raising funding. In the sample of countries analysed by the World Bank, the shadow banking sector was found to contribute to up to 39% of the overall financial system. Data for China suggests that the size of the Chinese shadow banking system has reached worrisome proportions since last year. Off-balance sheet and underground lending is estimated to have more than tripled by end-2010, from RMB 3 trillion in 2007, compared to an 84% increase (to RMB 50.7 trillion) in recorded bank lending over the same period, and only part of such lending is covered in official statistics (Ghosh et al 2012). What is most unsettling about this data, is that analysts at all levels admit that because so many of the practices of shadow banking remain obscure and take place under the regulators' radar, current figures on the scale and global reach of shadow banking activities are under-estimations.

In your opinion, how will the situation likely evolve over the next five years?

The medium-term prospects for shadow banking are marked by the lessons of the global financial crisis. As such, the trajectory of developing of shadow banking will depend on the ways in which the balance between perceived economic benefits of financial innovation through shadow banking, and the costs of such financial innovation, are internalised in the national economies. Views on the impact of the shadow banking system on the global economy and financial stability differ. Most current studies tend to see shadow banking as an integral and ultimately constructive part of the global credit chain. Techniques and instruments of disintermediation and securitisation, it is argued, help banking groups minimise costs, achieve efficiency gains and diversify their portfolios (Pozasr et al. 2010). Others however argue that the obscurity of shadow banking entities and practices magnifies uncertainty and lack of knowledge about the true financial state of many companies, contributing to the growth of offshore financial havens and 'secrecy spaces', and financial fragility.

At present, questions about the role and scope of shadow banking are on top of the regulatory and research agenda of major financial governance institutions, including the Financial Stability Board, national central banks and the European Financial Market Authority. The financial crisis has demonstrated that shadow banking structures contribute to the fragility of credit chains and can crush individual banks, as in the cases of Lehman Brothers or Northern Rock. Tight interconnectedness between official banks and shadow banking entities pose tremendous difficulties in terms of crisis management policies.

Unsurprisingly, regulatory reform and the public debate about the place and value of shadow banking (and by extension, banking in general) gets increasingly political, with the main battle fought by the regulators and financial industry representatives. Academics and regulators argue that a parallel system of unregulated financial intermediation raises serious prudential, regulatory and systemic risks concerns. In turn, private financial companies, such as money market funds and hedge funds, insist that shadow banking has existed for a long time and has brought efficiency and liquidity benefits to the economy, and that the most problematic nodes of shadow banking have been addressed in the post-crisis clear-up.

It is too soon to anticipate which side will win the battle. On the one hand, reflecting on the lessons of the global financial crisis, regulators in the USA, UK and Europe are striving to map the various structures and processes of shadow banking, as a first and essential step towards a more efficient framework of financial governance. Many post-crisis reform initiatives (such as Basle II/III, the Dodd-Frank Act or the Volcker and Vicker rules) , while not targeting shadow banking specifically, are aimed at enhancing market discipline associated with the use of these entities, increase transparency and prudential regulation of activities linked to shadow banking entities and processes. Some of the new requirements already had an impact on the shadow banking practices (for instance, a recent report suggests that SIVs have not been used since 2008, and that ABCP conduits have been 'folded in').

On the other hand, given its scale, it is naive to assume that the universe of financial innovation can simply be regulated away by regulatory rules and new capital requirements. The darkest fact about shadow banking is that without direct and guaranteed access to public liquidity support, shadow banks remain the most fragile nodes of the financial system and can threaten the viability of many 'visible' financial institutions. Bankrolling opaque and often secretive structures of financial innovation, many of which are embedded in tax havens and are constructed with the aim of avoiding taxation and regulation, will be a controversial and an extremely costly exercise. Incidentally, available data from the Securities and Exchange Commission (SEC) suggests that money-market mutual funds have been rescued from financial trouble by their parent companies more than 300 times since such funds were created in the 1970s, a greater number than estimated previously. A review conducted by the SEC in 2012 found that parent companies had to step in to support their funds on more than 300 occasions as a result of a number of different 'credit events', including the Orange County, California, bankruptcy in 1994 and the 2008 Lehman bankruptcy (Acherman 2012).

What are the structural long-term perspectives?

These and many other facts about the destructive power of private financial innovation are slowly assembling into a mosaic that portrays the world of finance as not exactly a glorious type of economic activity. Questions that some twenty years ago were mostly the prerogative of left-wing academics, are today being raised, and answered, by high-profile regulators. Have our banks become too big to be a healthy foundation of a stable economy? Yes, they have. Does financial innovation bring benefits to economy and society? Only partly, and these benefits are hard to quantify. Is it a problem that banks are publicly-traded companies? Yes, because the principle of shareholder value helps the banks externalise the costs of a crisis. Can we hope to be able to prevent the next financial crisis? No. Will a financial crisis happen again, in the next 5 to 10 years? Yes, it will, and it is likely to involve shadow banking structures.

Arguments of this type are gearing the public debate about the place and value of finance closer to its state in the 1930s. Back then, academic and policy discussion of the nature and implications of the economic crisis led to the establishment of what is commonly considered as the most successful mechanism of making the financial sector accountable to society: the Glass-Steagall Act of 1933. It separated commercial accountable to society: the Glass-Steagall Act of 1933. It separated commercial (socially useful) from investment (casino-type) banking. The depression of the 1930s also opened the space for a radically different vision of the economic system and the role of the state in it, pioneered by JM Keynes.

It is quite possible that the currently developing multi-level work on financial stability and regulation of shadow banking will eventually mature into a 21st century version of Glass-Steagall Act. The Dodd-Frank Act and the Vickers plan, as well as the plans for a banking union in Europe, notwithstanding their flaws, ambiguities and protracted plan for implementations, are steps into that direction. These legislative acts were unthinkable in say, 2000. In this respect, the most positive shift that may have come out of the crisis and reflections on its lessons, may be seen as an epiphany of regulators. The fact that an opaque, unregulated and often secretive web of financial cells and transactions has become the backbone of the contemporary financial system, has propelled the issue of the public accountability of the privatised credit system not only into the public realm, but also, to the agenda of key national and international regulatory bodies.

However the greatest hurdle towards a world of more accountable financial innovation is that despite the change in tone, the regulatory efforts of financial architects are constrained by the political environment of the yesteryear. Represented most vividly by the political regimes in the UK and Germany, but also by national economic policies that continue to be built on the benign view of financial innovation (and by association, private financial leverage that had been magnified through shadow banking), and an a priori negative understanding of the role of public debt in the economy. Unless this dogma is challenged by a 21st century Keynes, shadow banking, and fragility driven by financial innovation, will continue to thrive in the economy where pretty much any activity, from taking out a pension plan to having a pet or buying a mobile phone on a contract, is a foundation of a cash flow to be securitised, and thus is a part of the shadow banking universe.

References:

Ackerman, A. 2012, ”SEC's Schapiro: More Than 300 Money Funds Rescued Since 1970s”, Wall Street Journal Online, 20 June.

Adrian, T. and A. Ashcraft 2012, Shadow Banking: A Review of the Literature, Staff Report No. 380. Federal Reserve Bank of New York.

Bouveret, A. 2011 “An assessment of the shadow banking sector in Europe”, SSRN wprking Paper, July.

Ghosh, S., I. Gonzalez del Mazo, and İnci Ötker-Robe Chasing the Shadows: How Significant Is Shadow Banking in Emerging Markets?, Economic Premise, No. 88, the World Bank.

McCulley, P. 2009, "The Shadow banking System and Hyman Minsky's Economic Journey", Global Central Bank Focus, PIMCO, May.

Pozsar Z., T. Adrian, A. Ashcraft, H. Boesky, 2010, Shadow banking", Staff Report No. 458, Federal Reserve Bank of New York, July.

Anastasia Nesvetailova *is a Reader in International Political Economy at City University London and Director of City Political Economy Research Centre (CITYPERC). She has published extensively on the issues of financial instability, crisis and governance. Her main publications include* Fragile Finance: Debt, Speculation and Crisis in the Age of Global Credit *(2007 Palgrave); and* Financial Alchemy in Crisis: the Great Liquidity Illusion *(2010, Pluto).*