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Into the shadows: Taking another path

By Patrick Jenkins and Sam Fleming

Shadow banking offers potential benefits and challenges as it goes mainstream

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When Jean-Pierre Mustier thinks about shadow banking, he remembers the "dark" days before the 2008 financial crisis. Back then, the term captured much of what was bad about the financial system – banks pushing chunks of loans through unsupervised "structured investment vehicles" and other exotic off-balance sheet entities designed to dodge rules on excessive risk taking.

"Before the crisis, there was a lot of 'dark' shadow banking, in the realm of SIVs and 'conduits' which was largely about regulatory arbitrage," says the former investment banking boss at France's Société Générale.

Despite the complexity of the shadow banking system, the outcome of its collapse was frighteningly simple. About $400bn worth of subprime loans and other assets that had been coursing through the shadow banking system shrank to zero in a matter of weeks, leaving banks and other investors with huge losses that magnified the impact of the crisis around the world. Mr Mustier witnessed it firsthand: SocGen was one of the dozens of banks in Europe and the US that was brought to the brink of collapse by the crisis.

Today, though, the softly spoken Frenchman, who now works in a similar role at Italy's UniCredit, is convinced that shadow banking is a force for good. "Now it's more about banks being disintermediated. It's 'light' shadow banking. What's going on today is like good cholesterol as opposed to the bad cholesterol we had before."

Mr Mustier is on one side of a hotly contested debate between those who believe shadow banking is a useful engine of growth and those convinced that, for the second time in a decade, it poses a dangerous risk to the global financial system.

Either way, the upheaval will force companies and individuals to rethink their financial affairs, and regulators to reform the way they monitor the global financial system. Already, shadow financing has supplanted much of traditional banking in China, worrying some policy makers in the country. Dramatic changes are also being felt in other parts of the world.

In Europe, there are signs that a structural shift is under way towards a US-style model of corporate finance that relies less on bank loans and more on bond funding and other non-bank alternatives. In the US, the shadow banking activity that characterised the pre-crisis era is well below former levels. But in other areas, such as non-bank lending through "business development companies", it has exploded in size and scope.

FT Series: Into the shadows

BDCs are similar to venture capital (VC) or private equity (PE) funds, however, BDCs tend to be publicly traded corporations.

"There is a vast restructuring of the financial landscape under way," says Lord Davies, a former banker and UK government minister turned private equity executive. "We're at a tipping point now where banks are shedding more and more assets. There is a real rethink of what is a bank, what is an insurance company, what is a hedge fund, what is a private equity firm. Over the next 10 or 15 years, what was shadow banking will become mainstream."

Much of the activity is happening in London and involves lending by a

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range of non-banks, from start-up crowdfunded boutiques to insurance companies. "Direct lending is the talk of the town," says Paul Watters, head of corporate research at Standard & Poor's, the credit rating agency.

The tale of London entrepreneur Charlotte Knight is typical. Armed a few years ago with a concoction of beetroot and mint and a spicy red pepper sauce, Ms Knight quit a high-flying career at Cisco and launched G'Nosh. The mission was to disrupt the British market for gourmet dips and ready meals, and the business has prospered. But when an expansion put pressure on her cash flow, Ms Knight did her bit to shake up the banking industry.

"I'm passionate about good food and cooking. But I'm a big fan of disruptive technologies, too," she says. So when it came to trying to accelerate her customer receipts, she shunned Lloyds, her long-time bank, and sought invoice financing instead from Market Invoice, an upstart crowdfunded online lender.

Paying a discount rate of about 1.5 per cent, a quarter of the normal bank rate, Ms Knight now uses the service to turn invoices outstanding with the likes of Ocado and Co-op into quick, ready cash. "It's efficient and affordable," she says. "I get a steady stream of £20,000 a month, with funds released within 24 hours."

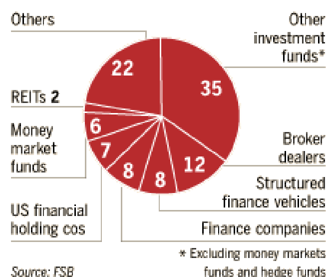
Peer-to-peer (P2P) lending of this kind is the visible tip of the shadow banking iceberg, made up – depending on whose definition is used – of insurers, pension funds, asset managers, hedge funds, specialist boutiques, broker dealers, exchange traded funds and money market mutual funds, all engaged in a range of activities that used to be performed by banks.

P2P lending companies lend on-line to individuals via their websites, using certain credit standards criteria.

Difficult to define

It should be no surprise, then, that the size of the shadow banking industry is difficult to pin down. Global regulators at the Financial Stability Board calculate that the industry ballooned from assets of $26.1tn in 2002 to $71.2tn a decade later – equivalent to a quarter of the world's total financial system. Although the boom and bust in SIVs and conduits inflated the number in the pre-crisis years, the total has continued to grow as other forms of shadow banking have taken their place.

But any attempt to quantify this fast-moving, loosely defined sector is fraught with problems. Even the FSB admits as much. Its best guess after narrowing its definition to exclude spurious "non-bank-like activity" leaves a $35tn industry. What is clear, however, is that shadow banking is expanding, and fast.



And behind that growth lies a crucial driver: regulators' clampdown on the banking sector, in particular the tougher capital requirements on riskier assets. Those rules have discouraged banks from doing much of the business that they used to, leaving other firms to pick up the slack.

"Finance is a shape shifter that is capable of converting itself in any number of ways at any time," says Paul Tucker, former deputy governor at the Bank of England and a leader in the attempt to co-ordinate an international regulatory response to shadow banking.

The opportunity is underpinned by alluring potential rewards. Non-banks such as private equity funds and hedge funds have been keen to invest in the potentially higher-yielding assets the banks are shedding – from cut-price bundles of mortgages or leveraged loans to complicated structured finance instruments – as a way to boost returns amid perennially low interest rates.

Assisting the shadow banks in their effort to go mainstream has been a steady flow of top executives from traditional banks. The career paths of a succession of right-hand men to Jamie Dimon, JPMorgan chief executive, tell the tale. The latest exit, in March, was that of Mike Cavanagh, who left for private equity house Carlyle. Before him Jes Staley quit to join hedge fund Blue Mountain. And before him, Bill Winters set up his own boutique fund, Renshaw Bay.

"The demands and pressures of running big banks these days are unappealing," says Lord Davies, now vice-chairman of US private equity firm Corsair. "Shadow institutions are less onerously regulated and they're more entrepreneurial."

Going global

If shadow banking was a US-centric activity before the financial crisis, it is now a global phenomenon. Some of the clearest evidence of the move away from traditional lending is emerging in the eurozone. Under pressure from the crisis, banks have shrunk their assets by close to €3tn, or 8 per cent, and further deleveraging is widely expected, making way for others. The Bank of England says that, while bank lending has declined since 2009, there was "a growing use of non-bank finance by SMEs, albeit from low levels, including peer-to-peer lending, crowdfunding and venture capital funds".

European financiers are convinced that the continent's historical reliance on traditional bank finance is giving way to a more US-like model. Insurers including Allianz, Axa and Generali, are extending loans to SMEs. In London, firms ranging from start-up boutiques to mainstream fund managers such as M&G are boosting their lending.

Omni Partners, a UK hedge fund, is offering short-term property loans as a way to exploit the "very big hole" banks have left in the

market. "We can advance you several million pounds in three days from a standing start," says Steve Clark, the founder. "That is the length of time it would have taken you to get an appointment with a bank relationship manager."

Given the usefulness of this type of gap-filling activity, some in the business say it is about time "shadow banking" was given a less pejorative name. Mr Winters likes to talk about "non-bank financial institutions", while others favour "direct lenders" or "market-based finance".

Tony James, president of private equity firm Blackstone, says: "Putting that [negative] definition of shadow banks out there is dangerous for the market. Distributing that risk is essential for banks to free up capital, because without it they would not lend money."

Beyond straightforward corporate lending, however, there still exist more aggressive forms of shadow banking. Some investment bankers and niche hedge funds are involved in the contentious area of regulatory capital arbitrage. Christofferson Robb in the US and Chenavari in the UK specialise in the area, while Renshaw Bay has also dabbled in it.

Yet even here, financiers insist that there is a genuine and transparent transfer of risk away from the banks, something that the most egregious arbitrage activity of the pre-crisis years did not properly facilitate.

Darwinist financial commentators hail all the change in the market as evidence of the vibrancy of capitalism. But for every enthusiast who applauds the economic imperative of ersatz banks, there is a sceptic who warns of the dangers, with particular concerns regarding oversight.

Assessing the risk

When Paul McCulley, an economist and former managing director at fund manager Pimco, coined the term "shadow banking" in 2007, he defined it as " a levered-up financial intermediary" whose liabilities were perceived to have the same qualities as conventional bank deposits. It quickly became shorthand for obscure regulation-dodging structures.

The industry has evolved since then, but it remains by its very nature outside the scope of mainstream regulation. Part of its *raison d'être* is arbitraging the regulated banking system.

Money market funds are a case in point. This $2.6tn sector is such a staple of the US financial system that many Americans would raise an eyebrow to hear the funds labelled shadow banks – but they are precisely that. After taking off in the 1970s as a way around bank regulation, they were considered to be ultra-safe quasi-deposits by retail and corporate customers alike.

This myth was exposed when Lehman Brothers' commercial paper, held by one fund, defaulted, triggering panic across the sector and forcing the US government to introduce a temporary guarantee on money market investments.

> Money market funds are clearly the largest risk in the system by sheer volume
>
> - Bill Winters, who set up boutique fund Renshaw Bay

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"Money market funds are clearly the largest risk in the system by sheer volume," says Mr Winters. "Regulators have moved in the direction of treating these bank-like institutions more like banks, but they are not being hit hard [by regulators] because the lobby behind them – some of the biggest financial companies in the world – is so ferocious."

The risks posed by the escalating size and complexity of the shadow banking market are a big concern for global regulators. They are keenly aware that such activity is prospering in part because of the tougher constraints they imposed on mainstream banking to make it safer. They now need robust ways of regulating shadow banking, too.

For the FSB, the umbrella body for the world's regulators, pinning down the shadow banking industry – not just its scale, but its shifting nature and the risks it poses to the world – is a top priority.

But it must first decide what a systemically important shadow bank looks like. Mr Tucker, now a Harvard academic, believes shadow banking should be defined as any activity that combines two of three characteristics: credit provision, maturity transformation (meaning that the institution borrows money for a shorter timeframe than it lends) and leverage (allowing it to gear up with debt).

Conventional wisdom says that there is potential systemic risk only when leverage is involved through debt sourced from banks. But regulators are coming to realise that the established ways of thinking about shadow banking may be short-sighted.

That approach ignores, for example, risks created by the shift of commodity trading away from banks, for which capital requirements have become uneconomic, and towards lightly regulated trading firms such as Glencore Xstrata and Trafigura. Similarly, there will be a build-up of risk in central counterparty (CCP) clearing houses, following the regulatory drive to reroute banks' trading activities via CCPs and exchanges.

An elusive target

Policy makers such as Mark Carney, governor of the Bank of England and head of the FSB, argue that some shadow banks will have to be supervised more like banks. The BoE is re-examining the UK's regulatory "perimeter" to assess whether some shadow banks need to be brought into the scope of mainstream regulation.

In a significant move towards bringing shadow banks into the fold, the BoE said last week that it would extend its liquidity facilities to some non-banks – specifically big broker-dealers and central counterparties.

Mr Carney has made it clear that he sees shadow banks as a potentially beneficial part of the financial ecosystem. He also says that bringing them into the mainstream will help contain risk in the system.

That, of course, is likely to fuel a whole new process of financial sector reinvention. Bill White, the former chief economist at the Bank for International Settlements, says: "It seems to me that nobody on the regulatory side has really got to grips with the reality of this constant innovation."

Torn between the desire to match lenders and borrowers of all hues, yet create a safer system, policy makers face an uncomfortable truth: no matter where you direct the light, there will always be shadows.

Additional reporting by Martin Arnold

Letter in response to this article:

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