SHADOW CASTING

Misnamed and misunderstood, shadow banking has a highly visible (and vital) function, but does it also pose a systemic threat?

By Maha Khan Phillips

Illustration by Kelly Alder

Should the financial industry be worried about potential growth in shadow banking? Unease at the prospect would hardly be surprising. The shadow banking system played a significant part in the subprime crisis, and regulators around the world have been warning of the systemic risks posed by the sector for many years.

In April 2015, the International Monetary Fund (IMF) called—and not for the first time—for greater oversight of the industry. “The evidence calls for a better supervision of institution-level risks,” warned the IMF, identifying several key risks to which investors and regulators should be paying better attention.

Quoting the IMF’s unofficial motto that “complacency must be avoided,” former US Treasury Secretary Robert Rubin also issued warnings in a speech given in March 2015 at the Federal Reserve Bank of Atlanta. Pointing out that much had been done to strengthen the prudential regulation and supervision of the sector, he said more still would have to be done in the future. “We must remain vigilant for changes in the system that increase systematic [i.e., systemic] risk, and we should make appropriate changes to regulation and structure of regulation as necessary,” Rubin declared.

But the fundamental question about shadow banking’s potential threat remains a matter of debate. Does shadow banking pose risks to the financial system? The answer is a complicated one. The Financial Stability Board (FSB), the international body that monitors and makes recommendations about the global financial system, has defined shadow banking as “credit intermediation involving entities and activities outside the regular banking system.” In its “Global Shadow Banking Monitoring Report 2013,” the FSB stated, “Intermediating credit through non-bank channels can have important advantages and contributes to the financing of the real economy, but such channels can also become a source of systematic risk, especially when they are structured to perform bank-like functions, and when their interconnectedness with the regular banking system is strong. Therefore, appropriate monitoring of shadow banking helps mitigate the build-up of such systematic risks.”

So, by this definition, whether systemic risks are properly monitored plays a critical part. Some industry participants argue that regulators are being overzealous and that their efforts add more risk to the system, while others contend that regulators are not being zealous enough.

ASSET MANAGERS STEP UP

Part of the shadow banking world is already heavily regulated. The shadow banking industry includes money market funds, securities lending activities, repurchase agreements, securitisation, collateralised or secured finance, and hedge funds. According to the FSB, growth in non-bank financial intermediation grew by $5 trillion in 2013, reaching $75 trillion. This figure includes most of the asset management industry in its entirety, even though much of that industry is already regulated.

Europe’s asset managers looked after €19 trillion in assets under management as of the end of 2014, up 9% from the year before, according to the European Fund and Asset Management Association (EFAMA). Those asset managers are increasingly stepping into the space that banks once occupied.

The Future of "Parallel Banking"?

For proponents of lighter regulation of the sector, it doesn’t help that the term *shadow banking* itself suggests something murky or sinister. "Post the financial crisis, shadow banking was seen as being a contributory factor to the problems the market had at the time," explains Rhodri Preece, CFA, head of capital markets policy (EMEA) at CFA Institute. "The name itself, coined around 2007, draws parallels with opaque, complex, and lightly regulated financing activities. We saw that in securitisation vehicles linked to subprime mortgages and system-wide leverage and in the general lack of transparency in the system."

While the sector has moved on from the subprime crisis, the terminology has remained the same. "It is generally accepted that shadow banking is not a bad thing," comments Sidika Ulker, director at the Association for Financial Markets in Europe (AFME), the body which represents global and European banks and other significant capital market players. "It is just an unfortunate use of the term. It was used, and then it stuck. It incorporates a lot of things, and all it refers to are the sectors of the financial industry which are not regulated."

In a June 2012 green paper, one of the world’s largest asset managers, BlackRock, asserted that the term *shadow banking* was pejorative and belied the positive contribution that these activities made. "This reflects the fact that the debate has largely been viewed through the lens of banking supervision and the prudential regulatory tool kit," stated the green paper. "It also ignores the fact that many 'shadow banking' entities and activities are already highly regulated by securities legislation."

BlackRock wanted the European Commission to use the term *shadow banking* to refer *only* to certain off-balance-sheet structured finance entities sponsored by banks, noting that "This would appropriately focus regulatory attention on the area which gave rise to some of the greatest systemic issues during the financial crisis of 2007 and 2008." Furthermore, it recommended an alternative label, *market finance*, be used to refer to the broader set of activities (such as money market funds, securities lending, repurchase agreements, asset-backed commercial paper, and hedge funds) often included in the shadow banking discussion.

Sidika Ulker

AFME has suggested that the term *parallel banking* might be a more suitable description because it "does not imply that these activities are somehow hidden."

Either way, proponents of shadow banking agree that a name change would go a long way toward assuaging fears.

THERE IS A LOT OF SCOPE FOR THE ASSET MANAGEMENT INDUSTRY TO DIRECTLY STEP INTO THE LOAN PROVISION SPACE.

Changes in the banking sector are driving the shift. “Under Basel III, banks have to repair their broken balance sheets,” says Amin Rajan, CEO of CREATE-Research, an independent global forecasting centre in London. “Hence, they’re off-loading a lot of loans off their balance sheets. They have started to de-leverage in a significant way. This is opening up opportunities for specialist credit managers. They provide different kinds of debt. This covers senior loans and mezzanine finance, which is what banks used to provide. But it also covers distressed debt. As a result, we are seeing quite a lot of interest expressed by institutional investors in this alternative form of credit.”

KPMG, the financial services firm, has also said that the shrinking banking sector presents opportunities for asset managers. In its 2014 report “Evolving Investment Management Regulation,” the firm argued that the next five to ten years hold enormous potential for the asset management industry. “Regulators have followed through on their promise to restrict trading and private funds within banks, which has led to trillions of assets being spun off,” stated Tom Brown, global head of investment management at KPMG, in a press release on the report. “As talented traders have less access to bank balance sheets, we will increasingly see them migrate toward the asset management continuum, which is another positive for the industry.” [*Editor’s Note: For more on megatrends shaping the future of asset management, see the interview with Tom Brown (“A View to the Future”) in the March/April issue of* CFA Institute Magazine*, which is available at www.cfapubs.org and the* Enterprising Investor *blog (blogs.cfainstitute.org/investor).*]

And asset managers are stepping into the space in different ways. One is through direct lending. For example, M&G Direct Lending finances British companies in the £50 million to £500 million range. In 2014, the firm recorded a total private financing deal flow of £4.9 billion. More than £400 million was lent directly to medium-sized companies over the year. Examples include UK Brewers Hall and Woodhouse and Café Nero (Europe’s largest independent coffeehouse group). M&G also has £5 billion invested in real estate–based finance, with over £2 billion being invested between long-lease property and commercial mortgages in 2014 alone. It has also provided more than £400 million of lending to UK housing associations last year.

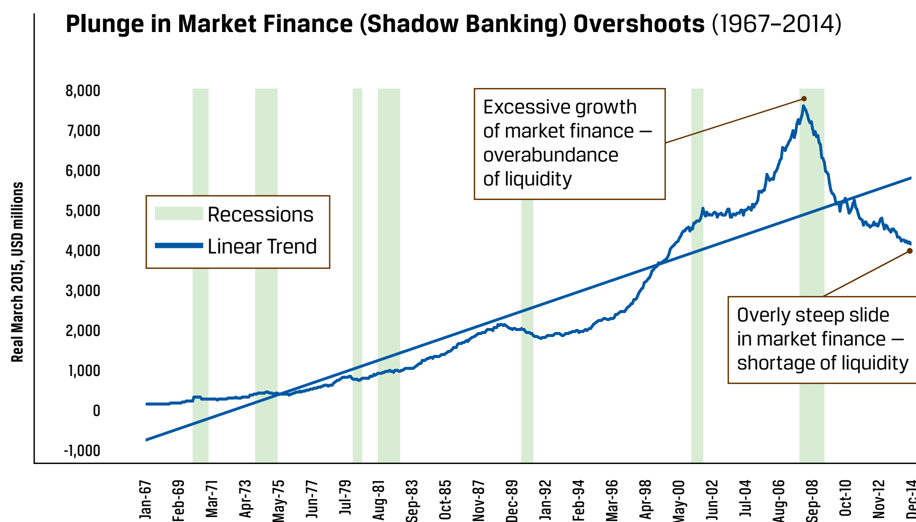
PEER-TO-PEER

Another way asset managers are getting involved is through peer-to-peer lending. In May 2014, UK hedge fund manager Marshall Wace launched a £200 million peer-to-peer lending investment trust listed in London. The trust was marketed predominately to institutional investors seeking high-yielding investments, with a small part offered to retail investors on demand.

“In asset management, you are starting to see private equity vehicles and hedge funds engaging in direct loan provisions to SMEs (small and medium-sized entities),” says Preece. “Asset managers are also operating retail-orientated funds that utilise the private placement markets. So, there is a lot of scope for the asset management industry to directly step into the loan provision space.”

But increased regulation might start to bite, according to Charles Muller, investment management regulatory partner at KPMG. “Shadow banking is viewed as the next big battleground, and greater transparency and consumer protection are the key objectives of regulators,” he says. “There will be increased pressure on data and reporting, with both investors and regulators requiring more meaningful communication from businesses.”

BlackRock has warned that banks and investment managers have different business models and manage certain risks in different ways, which regulators need to take into account. “These differences should be acknowledged when it comes to crafting regulation for market finance activities and entities,” argues its 2012 green paper on shadow banking. “The inappropriate application of macro prudential tools, such as capital requirements, to market finance activities and entities, is potentially fraught with unintended consequences.”



Note: The CFS definition of market finance includes: money market funds, repurchase agreements, and commercial paper.

Source: Based on data from the US Federal Reserve, Bloomberg LP, and the Center for Financial Stability.

Robert Mellor, partner in asset management for PricewaterhouseCoopers, also argues that the risk models of banks and asset managers are completely different. "Asset managers are a very different proposition [from] banks. Pre-crisis, the banks were lending against their own balance sheets, often in a highly leveraged way with a view of making gains for the bank itself. The asset management model is completely different. It is a pool of institutional investor capital which is put into a separate legal fund structure that is completely separate from the manager. The manager has a clear fiduciary duty towards the investors, and there is a board of directors which represents the investors and holds the manager to account."

That arrangement means that managers have a completely different alignment of interests with the investors, according to Mellor. For one thing, managers have to prove to their investors that they have invested wisely. "The investors undertake their own due diligence over the manager and the risk management processes in place. The managers may receive some element of performance reward, but it is once the investors have had their return."

Whether the asset management sector will be subject to more regulation remains to be seen, as Preece points out. "The asset management sector is already heavily regulated," he says. "The big unknown is whether global policymakers will consider whether asset managers will pose any systemic risk. That's the big question mark over the industry, and we'll see how that plays out."

SYSTEMIC RISK AND REGULATION

Regulators are beginning to realise that shadow banking is now part of a solution to sluggish financial markets. "I would like to highlight that I see many benefits to a viable and well-functioning shadow banking system," said Pentti Hakkarainen, deputy governor of the Bank of Finland, in a recent speech. "Shadow banking is a modern, sophisticated, and complementary way to share risks efficiently. It is also an alternative way to allocate resources in the economy outside the regular banking sector, upon which we here in Europe are particularly dependent."

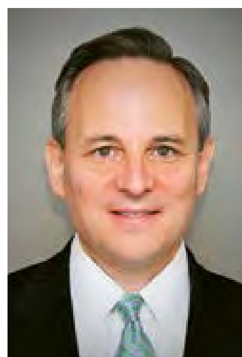
Hakkarainen warned, however, that investors should understand that shadow banking activities would not be supported and guaranteed by governments. "As some risks are likely to shift to the shadow banking system due to the tighter regulation in the regular banking sector, risk concentrations may very well be built up in the shadow banking system. There is an externality that calls for regulation."

Part of the scrutiny follows on from the proposed Capital Markets Union (CMU) in Europe, which would enable investors from around the continent to invest more easily in companies wishing to raise capital. According to the European Commission, the CMU will explore ways of reducing fragmentation in financial markets, diversifying financing sources, strengthening cross-border capital flows, and improving access to finance for business, particularly SMEs.

The CMU is one of the reasons why regulators are rethinking the merits of shadow banking. "I would place this in the context of the Capital Markets Union that is now being planned in Europe. From their perspective, shadow banking is not part of the problem but the solution being pushed by the European Union," says Matthias Thiemann, professor at Goethe University.

But Thiemann argues that the correct approach is not about rules so much as processes. "In the end, the question is, Do we have the right processes in place that are capable of piercing the legal whale that smart legal engineers design in order to circumvent banking regulation?" Noting that regulators get "cues" that help with their decision making, he adds, "Right now, the cues they are getting in Europe [are] that we need shadow banking for growth and innovation. I think the danger with these cues is that they are not balanced well."

Thiemann has argued in the past that shadow banking has benefitted from the structural separation of global and national financial regulators. When the Basel Accords opened up a "global" market for banking services across many countries, they set a regulatory global minimum, and national regulators resisted imposing heavier regulations because they wanted to protect the competitiveness of their markets. In his 2013 paper "In the Shadow of Basel: How Competitive Politics Bred the Crisis," Thiemann writes, "Although it was known to the international regulatory community since 1999 that regulatory arbitrage was rampant in the securitisation business, modest national regulators were waiting for the new Basel Accord to come into force, rather than taking decisive steps nationally beforehand. The problem of coordinating the coinstantaneous introduction of national rules closing the regulatory loopholes in a global market prevented regulatory action, as national authorities supported the competitiveness of national banks."



Lawrence Goodman

RESTRICTIVE REGULATION

Others argue that regulation is going too far. Lawrence Goodman, president of the Center for Financial Stability (CFS), a New York–based think tank, argues that there are very significant liquidity concerns in the market and that regulation will make it worse. "Many authorities are working from the perspective that shadow banking was the driving force behind the crisis and, therefore, regulators need to get a grip on it and integrate it into the regulatory apparatus. My perspective, reinforced by CFS data, is that we have overshot. A shrivelling of shadow banking is severely hampering economic activity."

According to the CFS, this shrivelling of liquidity puts markets and economies at risk for "excessive amplification of minor shocks and a resultant major loss of confidence." Evidence of such amplification occurred in 2014. On 15 October, the deepest and most liquid market in the world, the US Treasury market, was hit by a six-standard-deviation move that happened over the span of less than two hours. Statistically, according to the CFS, such a move ought to happen only once in 506,797,346 days.

THE FOCUS HAS SHIFTED FROM SYSTEMIC RISKS TO THE ROLE THAT SHADOW BANKING CAN PLAY IN SOLVING THE LACK OF ACCESS TO CAPITAL IN THE EUROZONE.

Shadow banking, which the CFS refers to as market finance, is down a stunning 46% in real terms since its peak in March 2008 (see chart on page 26). According to a statement released by the firm, "This phenomenon starves the financial markets from needed liquidity and is detrimental to future growth by exposing the economy to potentially unnecessary shocks. In fact, the reduction of available market finance shows no sign of abating, with a series of successive drops from the beginning of the crisis to the latest CFS monetary data available through January 2015."

Regulators and other industry participants need to move past the 2008 view of shadow banking, according to Goodman. "Shadow banking and regulatory arbitrage enabled the financial crisis to be deeper than it might have been in the absence of a more actively regulated sector, but it really was only one of many components contributing to the crisis," he says. "Central bank liquidity creation was an equal, if not more important, driver of risk-seeking behaviour. Yet, today, there is a vigorous effort to regulate shadow banking and pull it into the fold."

NEW REGULATION

And more regulation is in the cards. In November 2011, the FSB was tasked by G20 leaders, alongside other international standard-setting bodies, to come up with recommendations to strengthen oversight for shadow banking. The FSB and other bodies have identified five areas, or "work streams," to focus on. The first work stream (led by the Basel Committee) deals with the interactions of banks with shadow banking entities. The second work stream (led by IOSCO) is concentrating on money market funds. The third work stream (led by the FSB) is evaluating other shadow banking entities. The fourth (led by IOSCO) is examining securitisation. Finally, the fifth work stream (led by the FSB) is looking at securities lending and repo markets.

"The securities financing lending [work stream] is a big one, and it is about introducing greater transparency," says Ulker of AFME. "From our perspective, these transactions are vital to the movement of collateral in the system, and the FSB has to recognise this. We absolutely support the need for transparency, but anything beyond that needs to be contemplated carefully so that we don't have collateral flow constraints."

CFA INSTITUTE PERSPECTIVE

CFA Institute's global study (see sidebar, right) on alternative channels for capital from shadow banking proposes its own policy recommendations, which have particular relevance for Europe and the Capital Markets Union initiative. In terms of securitisation, policy initiatives should focus on increasing standardisation and simplification of issuance structures, as well as improving transparency via initial and ongoing disclosures to investors. Standardisation of legal frameworks across markets would also improve the ease and certainty of enforcing ownership rights and creditor protections.

In terms of securities financing transactions and collateral, the report suggests that a robust framework surrounding the reuse of collateral is needed to mitigate the build-up of excessive leverage and to prevent associated financial stability risks. Key elements include greater transparency for securities financing transactions via reporting transaction data to trade repositories and to investors.

"The focus has shifted from systemic risks to the role that shadow banking can play in solving the lack of access to capital in the eurozone," says Preece. "But safeguards are needed. It's about making sure that the right policies are in place."

Maha Khan Phillips is a financial writer in London and author of the novel *Beautiful from This Angle*.

What Investors Think about Shadow Banking

Shadow Banking, the new report from Standards and Financial Market Integrity at CFA Institute, is informed by a survey of CFA Institute members that includes the perspectives of more than 600 investment professionals around the globe on the risks and policy priorities surrounding shadow banking. Key findings include the following:

- The greatest potential systemic risk is posed by the potential default of Chinese trust and wealth management products, according to 25% of members. Collateral management risks were cited as the second greatest systemic risk (23% of members).
- Improving transparency and disclosures over shadow banking activities should be the highest priority for regulators, according to respondents in APAC and EMEA.
- 55% of all survey respondents identified a need for greater standardisation and simplification of issuance structures in securitisation markets.
- 47% of all survey respondents agreed that the risks associated with securities financing transactions would be mitigated most effectively with greater transparency through reporting of transactions to trade repositories and to investors.

The full report is available online at cfainstitute.org.