GARP Global Association of Risk Professionals

Enter search keyword SEARCH

FRM | ERP | RISK EDUCATION | RISK NEWS & RESOURCES | EVENTS | CAREER SERVICES | MEMBERSHIP

Departments | Topics | Research | Whitepapers | Webcasts | Podcasts | Digital Library | Risk Index | Risk Glossary | Advertise | Company Info

Light on the Shadow

Celent and Dallas Fed reports size up the shadow banking problem and map out some solutions

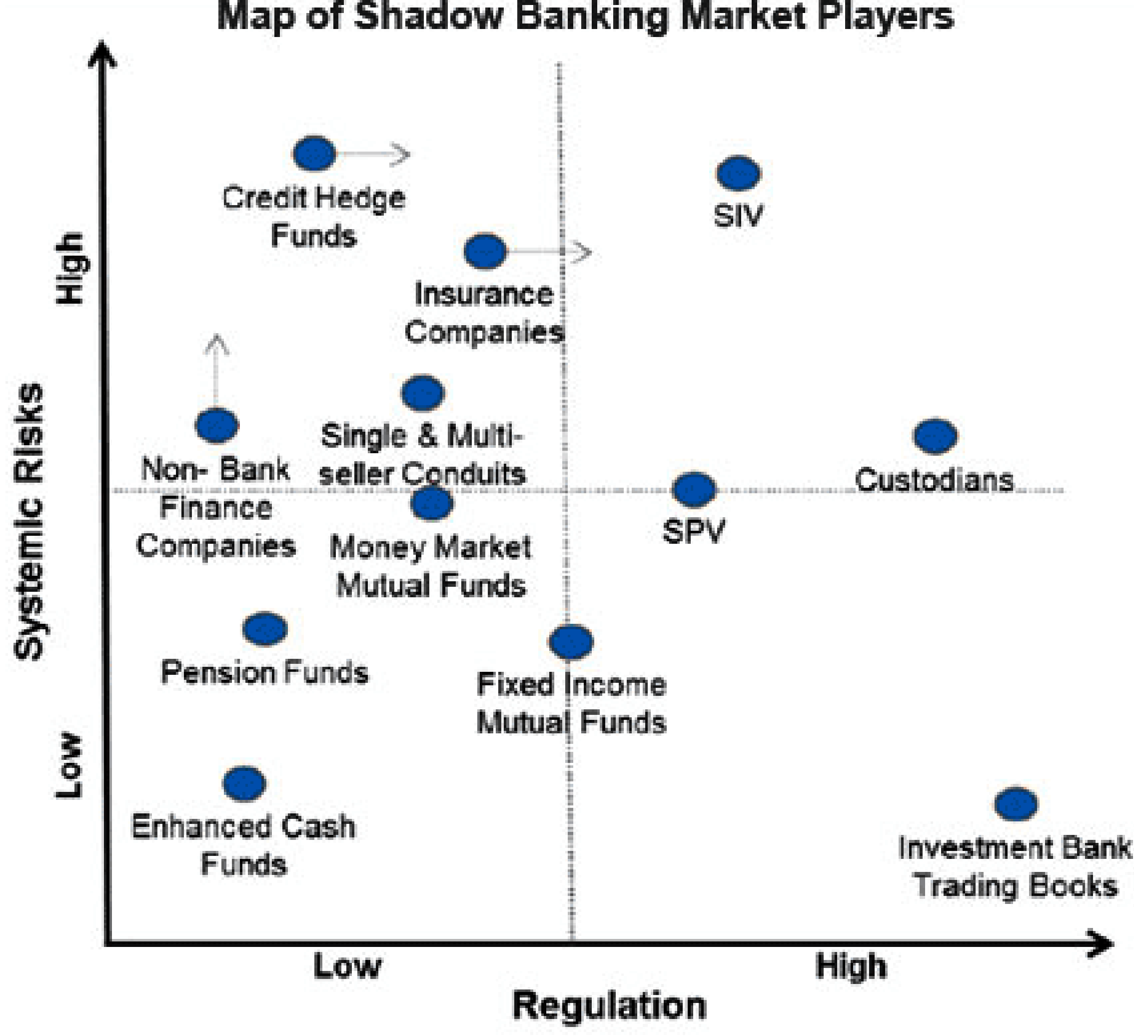
Wednesday, February 06, 2013 , By Katherine Heires

Print | Comment | Order | Email this Story | ShareThis

The term "shadow banking" may have negative connotations, but institutions meeting that definition have made necessary and integral contributions to the global financial system as sources of liquidity and credit. Shadow banking's perceived systemic risks and role in the 2008 financial crisis have prompted many calls to rein it in, yet regulators cannot and probably should not completely do away with it.

That is the key message in a report released in late 2012 by consulting firm Celent, written by analyst Medy Agami and senior analyst Josephine de Chazournes. Titled " Shadow Banking Products in Europe and North America: Different Seasonings for the Alphabet Soup," the report coincided closely with another on the subject by the Federal Reserve Bank of Dallas in November, " Understanding the Risks Inherent in Shadow Banking: A Primer and Practical Lessons Learned." The authors of the latter: Harvey Rosenblum, the Dallas Fed's veteran director of research, along with David Luttrell, senior economic analyst and coordinator of economic and financial analysis, and senior research analyst Jackson Thies.

In a similar vein, JPMorgan Chase & Co. chief executive Jamie Dimon, asked at the World Economic Forum in January about shadow banks, said, "It's a free market," and such banks should be allowed to provide a necessary service.



Source: Celent

Together, these documents and comments address issues concurrently under scrutiny by the Basel, Switzerland-based Financial Stability Board under the aegis of the Group of 20 nations and the Bank for International Settlements.

The experts from Celent, a Boston-based affiliate of Oliver Wyman Group, point out that "shadow banking" was coined by PIMCO executive Paul McCulley while speaking at a 2007 economics symposium. He defined it as "the whole alphabet soup of levered up, nonbank investment conduits, vehicles, and structures."

McCulley traced the phenomenon's beginnings to the advent of money market funds in 1971. They were functionally similar to deposit-taking banks but were not chartered or regulated as banks. They foreshadowed the interconnectedness among financial market players that would eventually raise dire alarms about counterparty and systemic risks.

Size and Impact

"Shadow banking and the traditional banking industry have become so intertwined at this point that if one part fails, the other does as well, and that is why government and regulators have to put them on their agenda," says de Chazournes in an interview.

The Celent report notes that the financial system has become "contingent" on shadow banking activities for liquidity and credit, and, by the firm's reckoning, the shadow sector has grown to represent 25% to 30% of the total financial system and half of total bank assets.

The Financial Stability Board estimates that shadow banking activity amounted to $67 trillion at the end of 2011, with the U.S. representing the largest portion, $23 trillion, and Europe $22 trillion.

"The inherent fragility of shadow banking becomes evident when viewed in light of the magnitude of securitization and money market wholesale funding activities," says the Dallas Fed report. "At its peak, in early 2008, the U.S. shadow banking system had about $20 trillion in liabilities, compared with commercial banks' $11 trillion."

According to the bank's timeline, "using the sum of liabilities related to securitization activity and short-term, noninsured money market transactions as a proxy, shadow banking first surpassed the traditional banking system in early 1996 and grew rapidly until the financial crisis. ... The capacity of shadow banking instruments is demonstrably larger than that of the commercial banking industry," though in the wake of the financial crisis, "commercial bank liabilities continued to grow while large portions of the shadow banking system eroded."

"Regulators cannot completely get rid of shadow banking, as it provides liquidity to many parts of the economy," says de Chazournes. Indeed, misguided or excessive regulation, she asserts, will inevitably result in other forms of shadow banking popping up.

"Four years after the financial crisis, shadow banking remains a disquieting buzzword for regulators who at this point are still figuring out how to regulate these entities," the Celent report says.

Who Is in the Shadow?

Celent defines shadow banks as nontraditional players that engage in activities parallel to banking functions, acting as credit intermediaries and reprocessing savings into loans via maturity transformation, or the process of using short-term borrowing to fund long-term credit. Some view these as positive, liquidity-enhancing functions.

But, at the same time, there could be systemic consequences as a result of runs on the system and follow-on, domino effects that do not have the benefit of conventional banking, central banking and regulatory safety nets or guarantees. What's more, product complexities and lack of transparency can pose serious management and regulatory challenges.

The Celent authors focus on four shadow banking product types: repurchase agreements, or repos; money market mutual funds; structured securities; and securities lending. "These are the four main categories that have had the most impact and were the most intertwined during the financial crisis," explains de Chazournes.

Editor's Choice

A weekly selection of insightful risk management articles and resources

- JPMorgan Wrestles With Risk Overhaul
- Shining a Light on Shadow Banking
- Market Data, Disrupted
- Turning Black Swans Gray
- The GRC Value Proposition

Advertisement

Risk Management e-Journal

The Risk Management e-Journal publishes paper abstracts on the topics that matter most to risk professionals. See what your risk manager colleagues are reading about today.

View

Advertisement

S&P CAPITAL IQ

BEGINS OCTOBER 13TH

The 2012 Financial Modeling World Championship

Registrations are now open for ModelOff, where skills, speed, innovation and knowledge of financial theory earn you a victory.

Register Now

Get Free Updates on the Dodd-Frank Act

FrankNDodd >>>>>>>>>>>>>>

Register for Morrison & Foerster's FrankNDodd service to receive Daily News Alerts on the Dodd-Frank Act, gain access to regulatory highlights and commentary, and use the exclusive FrankNDodd Tracker tool.

Subscribe

Light on the Shadow

Celent and Dallas Fed reports size up the shadow banking problem and map out some solutions

Wednesday, February 06, 2013 , By Katherine Heires

For the most part, she does not include private equity and hedge funds in her shadow bank research because they are not really providing credit or maturity or liquidity transformation -- they are asset managers, not bank-like.

But in the four principal categories, there is a great deal of diversity, complexity and interconnectedness.

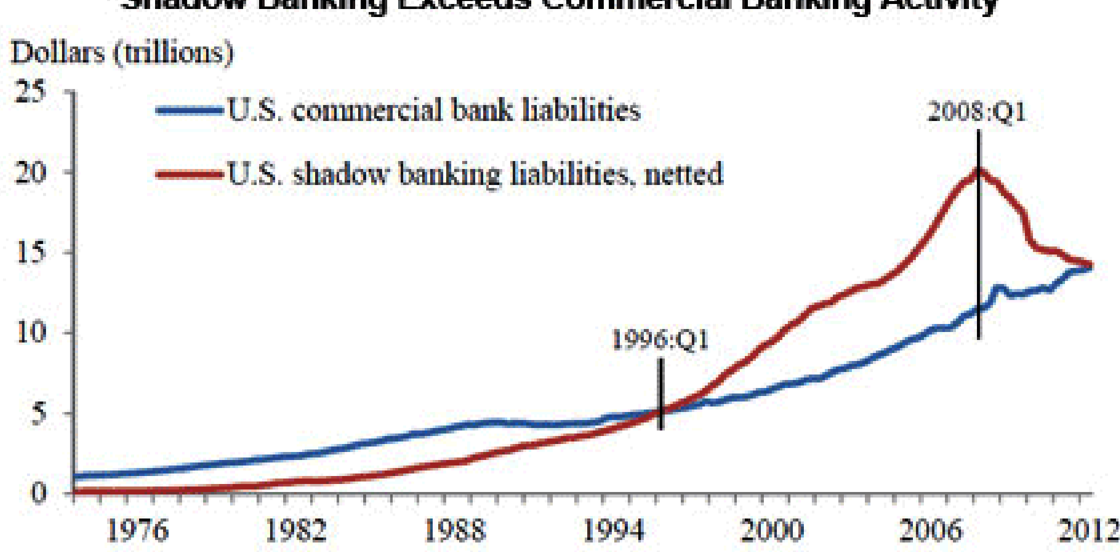
"What you see is more of a synergistic alliance between all these players," says Celent's Agami, and the report lists such shadow bank players as enhanced cash funds, fixed-income mutual funds, pension funds and insurance companies and their overlapping activities in areas that include repo, money market funds and securities lending.

To help delineate differences among the products, the report features a risk map that visually highlights relative systemic risk levels. Insurance companies, for example, are high on the systemic risk scale. Trading desks at investment banks are high on the regulatory scale and, therefore, representative of low risk. Credit hedge funds are on the map, de Chazournes says, because they sometimes engage in shadow banking activities such as securities lending.

"It may surprise some that the trading books of investment banks are in the low-risk category," she says. But the so-called London Whale episode -- a $6.2 billion trading loss attributed to JPMorgan's chief investment office last year -- had little or no systemic risk impact on the financial industry. "It just stayed on the book, and that was it," says the analyst.

Shadow Banking and Risk Management

One section of the Celent report summarizes the variety of risks associated with shadow banking and breaks it down by category, noting that the words "shadow banking" themselves have become synonymous with risk.



Source: Federal Reserve Bank of Dallas

Systemic, market and counterparty credit risks all come to the fore, but the key risk element at all times is the lack of regulatory oversight. For example, in securitization, risk levels can mount quickly when several events are left unchecked: When there is mispricing of credit and liquidity put options provided by banks; when there is mispricing of credit and liquidity risk by investors created in part by information asymmetries and overreliance on credit ratings; and asymmetric information between investors and issuers, resulting in risk-insensitive costs of funding.

The Celent report calls for a regulatory body to monitor the four key shadow banking areas, along with a "meta-regulator" to govern them all in parallel. But the authors also caution that overregulation can be counterproductive.

"Many of the rules associated with Solvency II are very stringent and, as a result, insurance companies are simply pulling out of markets. That is not a good thing for the economy," says de Chazournes. Recently, however, she has been encouraged by proposed rules and guidance that exhibit flexibility and intelligent thinking about the more positive and liquidity producing aspects of shadow banking.

She cites policy recommendations recently made by the International Organization of Securities Commissions (IOSCO) for money market funds, including redemption of shares at a floating net asset value, along with additional safeguards. She also thinks favorably of the new Prime Collateralized Securities label for asset-backed securities, an initiative of the Association of Financial Markets in Europe designed to rejuvenate the continent's ABS business.

"Intelligent regulation of shadow banking can bring more investors into the marketplace," says de Chazournes. "If you impose too much regulation or regulation that is just a harsh copy of what is done for traditional banks, it will not work for the overall system." Regulations that are too tight just encourage attempts to go around them.

Acting Like Banks

The Dallas Fed economists delved more deeply into how asset-backed commercial paper conduits, hedge funds, finance companies, money market funds and securities lenders all engage in such activities, as do large nonbank financial institutions, insurance companies and investment banks.

The report says shadow banking firms can closely resemble traditional banks that take deposits and make loans. However, they differ in the ever expanding chain of transactions they pursue: Shadow banks gather funds from investors, often issuing commercial paper, repurchase agreements or structured credit instruments. These debt instruments are in turn purchased by money market funds, bond funds and other entities, and as these transactions occur, risks mount up as the shadow banks are not closely monitored, regulated or provided with public sector credit guarantees.

The regional Federal Reserve Bank noted that because shadow banking activities involve a vast network of debt instruments that may be held at some point by regulated depository banks, it is often difficult to draw a bright line between shadow and traditional banking. However, "the distinguishing characteristic [of shadow banking] remains the absence of explicitly public sector backstops, leaving shadow intermediation activities susceptible to runs."

The report reviews what it calls the "spectacular" growth of shadow banking, its place at the heart of the credit crisis, its close ties to traditional banking, the benefits of shadow banking specialization and its growing complexity. "The largest BHCs [bank holding companies]," it points out, "have thousands of subsidiaries through which they intermediate credit and drive earnings. ... The majority of them are funds, trusts and financial vehicles that engage in shadow banking activities."

Advertisement
S&P CAPITAL IQ
BEGINS OCTOBER 13TH
The 2012 Financial Modeling World Championship
Registrations are now open for ModelOff, where skills, speed, innovation and knowledge of financial theory earn you a victory.
Register Now

Get Free Updates on the Dodd-Frank Act
FrankNDodd >>>>>>>>>>>>>>
Register for Morrison & Foerster's FrankNDodd service to receive Daily News Alerts on the Dodd-Frank Act, gain access to regulatory highlights and commentary, and use the exclusive FrankNDodd Tracker tool.
Subscribe

Light on the Shadow

Celent and Dallas Fed reports size up the shadow banking problem and map out some solutions

Wednesday, February 06, 2013 , By Katherine Heires

Print | Comment | Order | Email this Story | ShareThis

The report concludes that given the size, credit flows and economic benefits of shadow banking, "the proper dose and measure of reform is crucial."

Regulatory Questions and Options

What form should reform or regulation take? The Dallas Fed report says there are no easy answers, but important lessons from the financial crisis should be kept in mind.

One is the knowledge that new financial products and innovations can cause market instability. For example, securitization and derivative products were initially touted as risk reducers, but turned out to have a less favorable side. During the financial crisis, derivatives and counterparty exposures created an impenetrable web of complexity and a lack of risk transparency.

A second lesson is what the Fed report terms "devolution of risk management," caused by an increasing reliance by financial institutions on statistical measures of portfolio safety, such as value at risk. Because VAR only covers recognized risk, it can "lead firms to believe they have manageable risk exposure when, in reality, they are seriously underestimating the potential fallout from bad bets," the report says.

A third lesson centers on dangers that can arise from misguided incentives and regulations. When AAA-rated mortgage securities carried a very low capital charge, both traditional and shadow banks had a stronger incentive to hold these assets to maximize short-term profit.

The Dallas Fed recommends that regulators not forget these instances of misguided incentives that ultimately upended the financial system.

The report raises concerns about aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act and Basel III that could push some speculative activities further into the shadow banking world. Regulators have a "monumental task" before them, the Dallas Fed authors say, and they view another financial crisis as inevitable due to "ingrained human behavior such as complacency, exuberance and greed," and because the drivers of systemic risk remain largely intact.

"Shadow banking appears poised to grow considerably and dangerously, if it does not acquire the necessary market discipline to shape risk-taking activities," they warn.

The answer is in stronger regulatory standards for bank capital and liquidity, greater market discipline and changes to institutional incentives to lift "the veil of obfuscation and opacity" that inevitably leads to mispriced risk.

Under president and CEO Richard Fisher, the Federal Reserve Bank of Dallas has become a vocal advocate of systemic policy reforms, most recently calling for restructuring of so-called too-big-to-fail banks by breaking them into multiple business entities and keeping only their "downsized commercial banking operations" within the safety net of deposit insurance and the Fed discount window.

As Fisher put it in a Jan. 16 speech introducing the TBTF framework -- buttressed by research and analysis by Rosenblum and other staff -- "To simplify a complex issue, one might consider all the operations other than the commercial banking operation as *shadow banking affiliates*, including any special investment vehicles of the commercial bank. ... The shadow banking activities of financial institutions must not receive taxpayer support."

The cautionary lesson, from the Dallas bank's 2012 shadow banking report: "Traditional banks used the shadow banking system to move liquidity risk and credit risk off commercial bank balance sheets, transferring it outside the regulation and regulatory support (safety nets) of traditional banking. However, the risks were not eliminated from the financial system."

Celent's de Chazournes says that while there has already been a lot of work by regulators and others to make shadow banking far less risky, more needs to be done in repo markets and securities lending, which the FSB is actively working on. Moving forward, the focus needs to be "about education and changing the mentality of market participants," she says. "Change in shadow banking activity does not only come from new regulations."

Katherine Heires, founder of MediaKat llc, is a freelance business and technology journalist. She can be reached at mediakat@earthlink.net.

◀ Previous 1 | 2 | 3

Editor's Choice

A weekly selection of insightful risk management articles and resources

- **JPMorgan Wrestles With Risk Overhaul**
- **Shining a Light on Shadow Banking**
- **Market Data, Disrupted**
- **Turning Black Swans Gray**
- **The GRC Value Proposition**

Advertisement

Reduce errors in your risk analysis

Risk Management e-Journal

The Risk Management e-Journal publishes paper abstracts on the topics that matter most to risk professionals. See what your risk manager colleagues are reading about today.

View

Advertisement

S&P CAPITAL IQ

BEGINS OCTOBER 13TH

The 2012 Financial Modeling World Championship

Registrations are now open for ModelOff, where skills, speed, innovation and knowledge of financial theory earn you a victory.

Register Now

Get Free Updates on the Dodd-Frank Act

FrankNDodd >>>>>>>>>>>>>>

Register for Morrison & Foerster's FrankNDodd service to receive Daily News Alerts on the Dodd-Frank Act, gain access to regulatory highlights and commentary, and use the exclusive FrankNDodd Tracker tool.

Subscribe