CARRRESEARCH

THE EVOLUTION OF NOWHERE BANKING

Anastasia Nesvetailova explains why we need more research on financial innovation.

"It takes me about two hours to assemble a team of finance geeks and lawyers to devise a product or a transaction that will bypass any new rule or regulation coming our way," the senior French banker said over dinner. We were in Southern Europe at a conference on financial intermediation, in the midst of the financial crisis in the autumn of 2008.

The comment felt like a confession. Although this banker was visibly concerned about the state of the financial system, his job is to organize a team that will relentlessly move around any new rules or restrictions designed to tame risk.

Regulators and policymakers are in a battle against the blunt logic of financial managers who increase the complexity of the financial system each time they respond to new regulation. I call this process "financial evolution", to draw a heuristic connection to living organisms and the old assumption of the natural order of things. In finance, it seems futile to question or criticize innovation, defined as a sign of progress and a good thing. Progress, in turn, implies a form of linear evolution.

"Shadow banking" is the most compelling illustration of how the process of financial evolution actually happens. This term coined by Paul McCulley, then managing director at PIMCO, is both a stroke of genius and an unfortunate choice of words. Unfortunate, because it implies this activity is "shady"; it wrongly ascribes pejorative connotations to an essential part of the financial sector. Genius, because the confusion over which entities should count as "shadow banks" has matured into an important debate among industry experts, regulators, academics and civil society.

Shadow banking started out as a benign force of financial innovation and competition. It has been broadly defined as a complex network of credit intermediation that occurs outside the boundaries of traditional, regulated banks. A more precise definition suggests it is a system of market-based funding, or "money market funding of capital market lending" (Mehrling et al. 2013).

The Financial Stability Board (FSB) puts the global size of the shadow banking system at $71 trillion. This accounts for roughly half of total banking assets globally and a third of the world's financial system. Anglo-Saxon countries predominate, with US and UK accounting for 46 per cent and 13 per cent of the global shadow banking system respectively. Japan and the Netherlands follow closely with 8 per cent each.

The system's international reach is deep. Shadow banking reportedly provides 40 per cent of credit in the emerging markets. And analysts at all levels tend to admit that current figures on non-bank activities tend to be underestimated.

Shadow banking became a political problem between 2007 and 2009, and continues to pose some major political dilemmas. On the one hand, the system helps banks meet liquidity needs, conduct securitization and lending functions, and it accommodates a variety of economic interests, from investment banks and pension funds to high-net worth individuals and sovereign wealth funds. On the other hand, shadow banking raises at least three problems related to financial stability.

Firstly, when banks rely on long, complex and opaque structures of credit creation, they are able to enlarge their de facto size which adds to the problem of "too big to fail."

Secondly, by netting several entities into opaque chains of credit intermediation, the shadow banking system amplifies the scope for regulatory arbitrage. Each fund, special purpose vehicle, trust, broker or holding company may be safe, legal and compliant with regulatory requirements, but what spring out of this group of entities all together – the net effect – helps official institutions minimize costs, transparency and taxes.

Thirdly, shadow banking thrives on complexity. It obscures the sources and real dimensions of systemic risk in the financial system and exacerbates the problem of non-transparency. For the first time in modern economic history, regulators, senior managers and academics have been able to resort to this concept of "complexity" to excuse and even justify their ignorance about the developments in the financial system, as well as in their own institutions (Datz 2013).

Researchers at the US Treasury, the International Monetary Fund, the Bank of England, the FSB and the Bank of International Settlements have been pioneering the first generation of scholarship to expose the shadow banking system. The most notable effort is the ground-breaking study by Zoltan Pozsar and his colleagues at New York Fed who have produced some astonishingly refined regulatory maps (Pozsar et al. 2010). The maps show that what the public and many academics believe is the banking system, is in fact only a fragment of a much larger universe of financial and legal entities, transactions and products that, while previously unseen, play a crucial role in real economic sectors, like trade and services.

Nowhere banking has become the very infrastructure of financial innovation, without which finance can no longer function.

This kind of detailed empirical work poses an important challenge to the usefulness of economic modelling for managing real-life systems. Academic research has been forced to confront its shocking lack of knowledge about the course of financial innovation. This is because "innovation" has always been seen as a natural, organic and progressive element of capitalist development that is driven by the demand of economic agents for new techniques and products. Viewed as a universal engine of economic growth, financial innovation has never merited specialized attention in academic research.

Despite intensive scrutiny, shadow banking will continue to belie the global economy. As accountant and economist Richard Murphy (2009:2) explains it is "a space that has no specific location. This space is created by tax haven legislation which assumes that the entities registered in such places are 'elsewhere' for operational purposes."

He continues: "To locate these transactions in a place is not only impossible in many cases, it is also futile: they are not intended to be and cannot be located in that way. They float over and around the locations which are used to facilitate their existence as if in an unregulated either."

Ronen Palan and I have argued that the notion of "elsewhere" is firmly linked to the idea of 'nowhere' for the conduct of financial transactions, and what is perhaps more important, for the process of credit creation as well. We prefer the term "nowhere" because it captures an ideal that drives shadow banking forward.

We do not need to wait for academic theory or quantitative data to prove that "nowhere" is not a paranormal or misguided development of the economy, when even the most critically minded regulators like Andy Haldane are calling for the return of securitization to boost investment and credit flow. This political pressure is the most poignant evidence we have that "nowhere" is here to stay. Nowhere banking has become the very infrastructure of financial innovation, without which finance can no longer function.

The next bout of financial instability will likely begin at the nexus of the official and the nowhere banking systems. Optimists say regulators are better informed, better equipped and better staffed to deal with this inevitable event than they were in say, 2000 or 2006. Yes, they are. But pessimists would do well to remind us that in a perpetually evolving financial system, it only takes a team of finance geeks and lawyers a couple of hours to devise a product bypassing any new rule or restriction.

Reference

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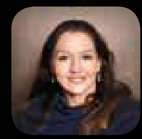

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