Carmen BOGHEAN
Stefan cel MareUniversity, Faculty of Economics and Public Administration

THE SHADOW BANKING SYSTEM AND ITS ROLE IN TRIGGERING THE GLOBAL CRISIS

Empirical studies

Keywords
Financial crisis
Financial system
Shadow banks
Financial innovations

JEL Classification
G15,G21, G23

Abstract

Financial innovation, the deficiencies of corporate governance, moral hazard, easy money policies, government inefficiency, and mainly the activity of the shadow banking system have all played a critical role in setting off the global financial crisis.

Due to the imbalances it has triggered, the shadow banking system has been at the core of the most widespread and profound world crisis of all time, as the attempt to use financial capital as efficiently as possible by resorting to "innovative" products has significantly contributed to the advent of the financial crisis.

The present crisis has already proved that the banking and financial activity can have a deeply disturbing impact on our economy, but the flexibility of lending mechanisms and the various reactions of the players on the market that are otherwise inherent in a dynamic economic system, cannot exist in the absence of banking mechanisms.

1. The traditional banking system versus the modern banking system

Both the shadow banking system as well as a significant number of traditional banks have become dependent on various short term funding sources during the years preceding the current financial crisis. The shadow banks' dependency on uninsured short term funds has made them vulnerable to massive and sudden withdrawals, while commercial banks and savings banks have equally dealt with massive withdrawals of funds (capital) before deposits were insured. [Bernake, 2010]

The balance between the frailties of the financial structure that conveys stability to the economic system is generated by the quality and the types of loans granted by bankers. The banks' orientation towards cash flows strengthens the foundation of a solid and resilient financial structure, while the banks' and the bankers' orientation towards the anticipated value of assets will lead to the occurrence of a frail financial structure.

The lending function of a traditional bank entails three distinct aspects:

- the demand of the potential customers that would like to take a loan;
- the structuring of the loans;
- monitoring the borrowers.

In order to keep their activities profitable, banks must structure the loans they grant in such a manner that the borrowers would be capable of meeting their contract terms. Before the advent of the modern innovations in the world of finance, banks operated in a simple world. They assessed the solvability of their customers, granted loans, monitored the loans in order to make sure the debtors spent the money as they had declared they would and then received the money back with interest. During the period that preceded the financial crisis, banks believed they could use their capital more efficiently by means of financial engineering – thus allowing them to take the most risk that regulators would allow for. [Stiglitz, 2010]

Given the way the banking system is structured today, there is a certain category of banks – commercial banks – that are particularly important, due to their size and to the fact that their liabilities account for an important part of the money supply in the financial system. The standard activity of the banking system has triggered a game that involves both central banks and other banks as profit oriented economic entities. The game is regulated by the authorities that establish the rates of interest and other regulations in order to obtain an adequate currency supply, while banks invent and innovate the products they offer in order to avoid what the regulators impose.

We believe that both the financial markets and the banking activity highly influence the volume of investments, since the current value of assets is influenced by financial markets and banking transactions – i.e. by the cost of the loan. The separation of the commercial activity from the investment one within banks is rather artificial and, during the past years, this separation has been practically non-existent, as more and more commercial banks currently fund fixed assets positions, while investment/merchant banks accumulate liabilities in the form of deposits.

At present, the banking activity covers a much wider range of activities than those developed by those institutions and organisations authorised to function as banking institutions. The line separating commercial banks whose liabilities include deposit accounts, other institutions offering savings accounts and other various organisations managing portfolios (insurance companies, pension funds and investment funds) from investment banks actually highlights the legal framework and the organisation of institutions on a national level. This difference we have mentioned above is currently fading, even though in certain capitalist economies, this separation has never existed. [Minsky, 2011]

2. The shadow banking system – concept and importance

Our global financial system currently includes an increasingly large part of the non-banking lending activities, the unnamed parallel or "shadow" banking system. For a long period of time, but particularly before the economic crisis, this sector hasn't been a priority for the regulatory agencies concerned with prudential regulations and monitoring. Shadow banks are financial entities, other than the regulated depository banks, serving as intermediaries between depositors and investors. These entities can grant loans just like any other bank, but, unlike traditional banks, they are not subject to the attention of regulatory agencies. Before the crisis, the "shadow banking" system had been playing a major part in the global financial system, but was also the source of important vulnerabilities.

The parallel banking sector carries out important functions as part of the financial system. This banking sector creates new funding sources, providing investors with various alternatives in terms of bank deposits and, on the other hand, it entails major risks as far as long term financial stability is concerned. The shadow banking system is made up of financial institutions that look like banks, operate as banks do, lend and borrow money, invest just like banks, but the problem is that these institutions do not match the banking regulatory framework.

The shadow banking system is based on two interrelated backgrounds. The first one comprises the entities operating outside the classical banking system and develop specific activities, while the second background comprises the activities that may become important lending sources for non-banking institutions (securitization, mortgage backed securities, repurchase agreements, etc.).

Shadow banks carry out certain specific financial activities, including deposit-like funding; transforming the maturity of the credit and/or liquid assets, transferring credit risks and, last but not least, direct or indirect use of leverage.

These complex activities, specific to the parallel banking system, have been carried out by special institutions that have gradually started to compete with the traditional banking system itself, granting consistent loans to borrowers. (As seen in Figure 1)

Most banks operating in the parallel banking system had one thing in common: a profound maturity inconsistency. They mostly borrowed money from liquid markets that used short term maturities and then invested this money into non-liquid assets with a longer maturity. Abiding by this rule, shadow banks entailed high risks in the case of massive withdrawals of cash. [Roubini, 2010] This risk they would take on wouldn't have been dangerous, if these parallel banks had complied with strict regulations, just as traditional banks, in exchange for guaranteeing these deposits and having access to last resort loans.

The new financial innovations directed at assisting risk management have actually triggered a reverse movement – risk augmentation, and there have been many instances when these "innovative" financial products have helped the shadow banking system conceal what was actually happening, by eliminating the risks from their financial records. Many of these innovative products were meant to spare the shadow bank from as many risks as possible, to generate as many types of commissions as possible and to get round those restrictions that might have significantly limited their credit and risk taking ranking.

Beyond the above mentioned risks, the shadow banking system also entails significant benefits:

- it provides funds when banks become more restrictive with the lending terms;
- increase access to loans, especially for investors from emerging countries;
- improve the efficiency of the financial system by increasing liquidities on the market and through a better distribution of risks.

At present, the shadow banking system accounts for a significant part – almost one third – of the total systemic risk, a share that almost equals that of official banks.

The figure below highlights the simplified structure of the financial system, tracing the activity of the traditional banking system versus that of the shadow banking system. The graph presents the route taken by financial flows from debtors to creditors through specific institutions, also highlighting the main types of activities of the shadow banking system, but particularly the activity of those operating in developed countries. (As seen in Figure 2)

Important European financial institutions have guaranteed the liabilities of some of the shadow banks in the period that preceded the current financial crisis, mainly buying securities backed by collateral expressed in American dollars (USD), thus amplifying the funding on the USD bill of exchange market. When these vehicles have lost access to bill of exchange funding, lenders have looked for funding in dollars on the inter-bank lending market and currency swap markets. The huge dollar demand, associated with the investors' concerns related to the stability and performance of certain important European banks have caused significant pressures on these markets, thus further amplifying the financial imbalance. The financial crisis has highlighted the fact that self-regulation – so adamantly promoted in the past few years – doesn't work. This is also proved by the failure of the financial and banking system that couldn't assess its own risks.

If we assess the effects of the shadow banking system on a global scale, we will find that the risks that the Euro zone and the UK are facing because of the shadow banking system are less threatening than those caused by the official banks, thus highlighting the fact that many of the companies operating on these markets rely more on bank loans than companies from the US.

The stricter regulations imposed on the banking system after the global financial crisis have caused the migration of certain activities towards the non-banking sector, such as hedge funds, whose activity is not formally regulated. As a consequence of this phenomenon, the assets of European banks have decreased by 11% since the end of 2012 and until now, while the assets managed by investment funds have increased by 30%. On certain emergent markets, the bank lending activity is mostly constrained by the regulatory agencies, while in developed countries, various non-banking financial intermediaries have replaced banks as long-term lenders to the private sector. Due to these unexpected turns of events, and in order to restore the balance in terms of the regulation of banks and non-banks, the systemic risk regulatory agencies have taken measures in order to extend the macro prudential policies.

The global financial crisis has led to the reformation of the regulatory framework in almost all the segments of the financial system, from derivatives to the capital supply needed by banks.

3. Conclusions

Easily accessible foreign loans, accompanied by relaxed monetary policies, fierce financial innovations and a non-regulated shadow (parallel) banking system have all contributed to what was to become a financial disaster that affected the entire world for a long period of time. The prerequisite for growth and stability, for creating a business environment that would allow companies to flourish, innovate and expand their activities is the presence of more resilient and more responsible financial markets. The large financial organisations that develop banking activities but are not actually banks could soon become very important for the financial system, so important that they will have to comply with the same regulations as traditional banks. In order to ensure the resilience of the global financial system, the regulatory agencies and authorities will have to find new ways to make sure that banks do not grant too many loans to shadow banks and also that they will not be subject to contagion if some of these shadow banks face financial difficulties.

The regulatory agencies in the financial sector should pay close attention to the shadow banking system, as it becomes a risk for the global financial stability, but the monitoring of this sector is currently lacking or insufficient.

Based on the conducted research, we believe that the shadow banking system tends to expand when strict bank regulations are imposed. It also increases when the actual rates of interest and the spread of the yield of government bonds is rather low and investors are trying to get a higher rate of return or when there is a higher institutional demand for safe securities.

Acknowledgements

This paper has been financially supported within the project entitled *„SOCERT. Knowledge society, dynamism through research”*, contract number POSDRU/159/1.5/S/132406. This project is co-financed by European Social Fund through Sectorial Operational Programme for Human Resources Development2007-2013. Investing in people!”

References

[1] Bernake, B., (2010), *Causes of financial crisis*, Financial Crisis Inquiry Commission, Retrieved from www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm

[2] International Monetary Fund, *Global Financial Stability Report*, IMF, October 2014, pp.68, Retrieved from http://www.imf.org/external/pubs/FT/GFSR/2014/01/index.htm

[3] Minsky, H., (2011), *Cum stabilizăm o economie instabilă* [*Stabilizing an anstable economy*]. Publica Publishing House, Bucharest, pp.448

[4] Roubini, N., Mihm, S., (2010), *Economia crizelor – curs fulger despre viitorul finanţelor* [*Crisis Economics: A Crash Course in the Future of Finance*]. Publica Publishing House, Bucharest, pp.143

[5] Stiglitz, J., (2010), *În cădere liberă: America, piaţa liberă şi prăbuşirea economiei mondiale* [*Freefall: America, Free Markets, and the Sinking of the World Economy*]. Publica Publishing House, Bucharest, pp.158

Endnotes

The size of the shadow banking system that has reached a global size of $ 60,000 billion: in the USA, it ranges between $ 15,000-25,000 billion, in the Eurozone between $ 13,500-22,500 billion, in Japan between 2,500-6,000 billion and approximately $ 7,000 billion on emerging markets.

Figure no.1. Specific institution that make up the parallel banking system

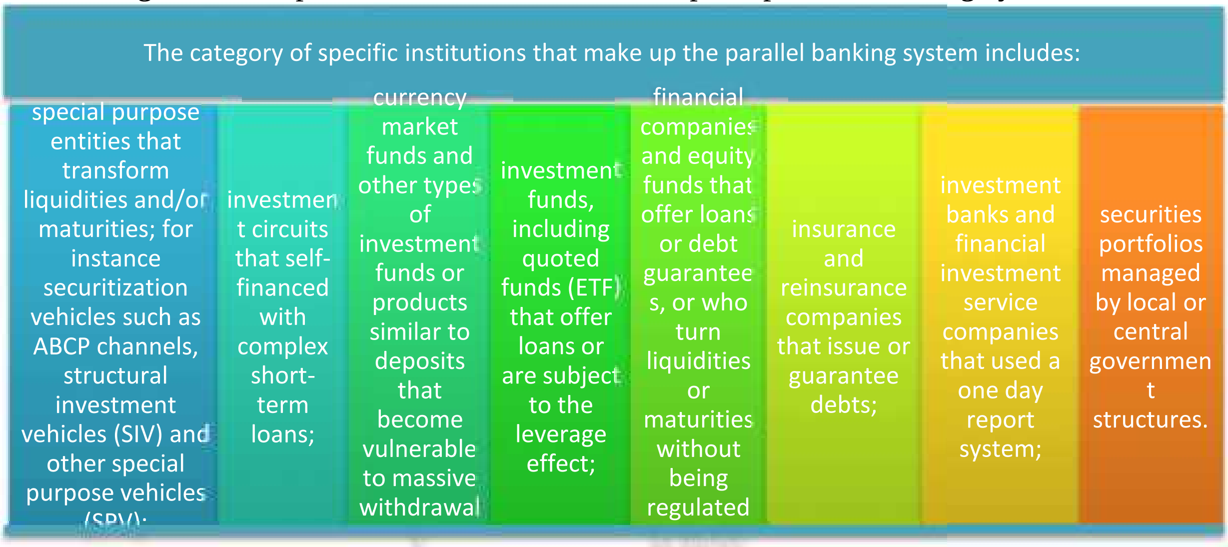
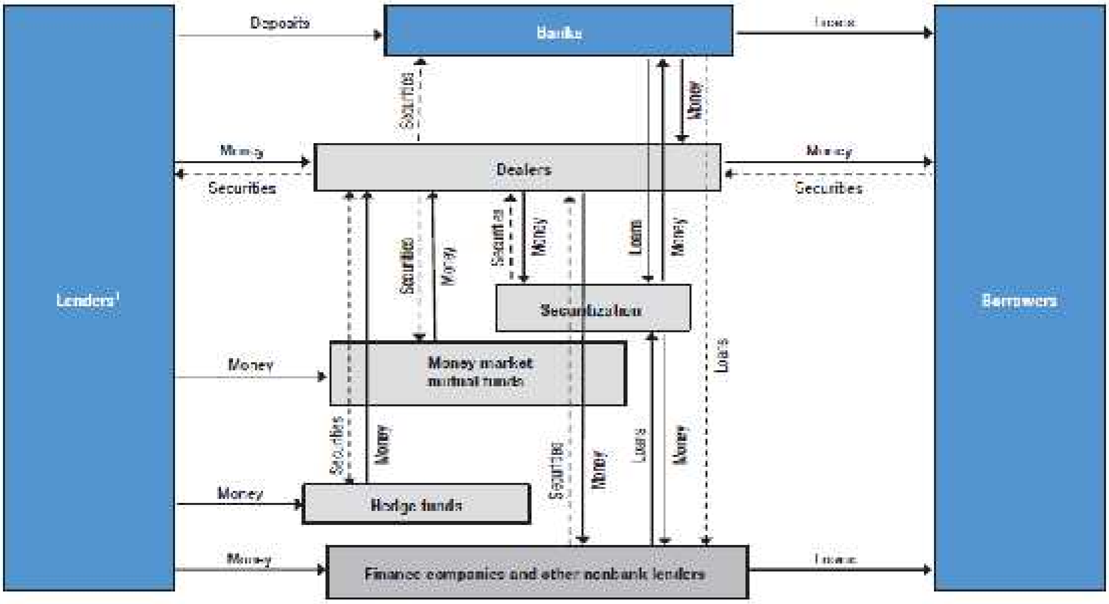


Figure no.2. Intermediation activities of the traditional banking system versus the shadow banking system



Source: Global Financial Stability Report, IMF, pp.68