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Light or shade? The future of bank-intermediated credit

Some issues and implications of shadow banking – July 2012

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INTRODUCTION

As the implications of the slew of financial services regulation targeting the banking sector becomes clear, governments and regulators around the world are turning their attention to shadow banking.

This is an incredibly complex and complicated subject which regulators themselves still do not know how to tackle but which has some fundamental implications for the future provision of credit.

Light or shade?

If you compete in the financial services industry (including providing services to financial institutions) it is unlikely to have escaped your notice that "shadow banking" has become a topic of major importance. In recent months, it has been the subject of keynote lectures and presentations by senior industry figures ranging from Adair Turner, Andrew Haldane and Paul Tucker, not to mention gaining attention from global institutions such as the FSB, the New York Federal Reserve Bank and the European Union.

What is "shadow banking" and why has it become such a focus of attention? We think it is important that clients understand some of the dimensions of the subject, including policy implications. In light of recent election results in Europe, debate about state-sponsored austerity has resurfaced, lifting economic uncertainty to new highs. The role of non-state credit provision is likely to come under increasing scrutiny and to remain a highly contentious and politicised issue. Perhaps more fundamentally, non-bank intermediated credit represents a potential competitive dynamic that could drive fundamental changes to a vital economic function – the financing not just of private enterprise, but also of significant public projects including infrastructure and capital projects designed to increase currently weak economic growth. Put simply, shadow banking goes to the heart of current policy and social agendas.

Increasingly discussions about shadow banking are cohering around some key definitions and policy implications. It is defined as "credit intermediation, involving leverage and maturity transformation, that occurs outside or partly outside the banking system" (Tucker, April 27th 2012 speech). This is a helpful, because clear, definition, but it is also rather narrow – there might be other aspects of the financial system that it would also be important for regulators to monitor and for market participants to understand. For example, it might be sensible for market participants to go further and consider not just credit intermediation but also the provision of general banking services including savings and investment products for consumers and a broad range of services offered to corporate clients. Disintermediation of banks can certainly occur on both sides of their balance sheets. Indeed the strategic implications of non-lending disintermediation could be nastier for some institutions than the prospect of secular decline in bank-originated lending.

However, the above definition has some benefits. It points to certain functions and activities while looking away from others. Thus, *pace* Tucker, there is little need to be interested in the role of the majority of hedge funds, which have no role in credit intermediation or in otherwise illiquid markets where risk concentrations might have bad outcomes. That is not to say that hedge funds are not relevant to the debate around shadow banking. Rather, one must be clear why they are relevant and why they represent different challenges, mainly to the business models and incentives that drive the fund management industry more broadly.

If credit ultimately drives economies (something that is poorly understood and needs a lot more research, says Adair Turner, among others), does it matter which type of institution delivers it? For regulators, the answer is a definite 'yes' – their job has been redefined to include systemic oversight, so monitoring credit creation is essential. Even if non-bank finance escapes the full regulatory burden associated with bank licensing, it will almost certainly not escape regulatory oversight in the form of overt monitoring and perhaps the use of 'cease & desist' tactics. Although one could also argue that if non-banks do not accept retail deposits then the regulatory burden should be lower than for deposit takers.

Does it matter for borrowers where their loans come from? Arguably a further 'yes'. Borrowing from a regulated bank can have important agency advantages, including rating benefits based on investor perceptions of funding stability. Credit based on non-bank finance can both appear to be, and in fact be, less reliable than bank-originated credit. But it does not have to be so. For some borrowers the principal driver of a decision to buy credit is price. Basel III is just one regulatory trend making it systematically more difficult for banks to extend credit to corporates at attractive prices in some market segments, notably project finance where there is a detectable rationing of banks' capital. This pressure might affect other market segments in future, driving borrowers into the arms of other lenders – whether willingly or not.

Here we enter paradoxical territory. Governments in Europe and other developed economies want banks to lend more, particularly to SMEs, in the belief that this can help fragile economies to recover and grow. Banks have said they want to lend more in their role as good citizens. But the reality of growing regulatory costs in the form of capital constraints and limits on leverage means that banks are much less active; in fact, deleveraging. However, governments have begun to acknowledge again that the shadow banking sector does have an important role to play in the provision of credit. The UK's Breedon Report on SME lending acknowledges the funding gap which needs to be filled by non-bank lenders. Is the shadow system the only alternative? Only time will tell, but there are plausible scenarios that see shadow or shadow-like institutions emerging as ever more important providers of credit in future.

Some calculations suggest that this type of scenario is inevitable. A recent report by Morgan Stanley/Oliver Wyman estimated that there is a global "funding gap" of $5 trillion, $3 trillion of which is in Europe. Allowing for further deleveraging and using historical data to extrapolate funding out to 2017, non-banks are likely to have a $300 billion – $400 billion funding gap available to be filled that will offer them the opportunity to participate directly in loan markets.

Which non-bank institutions might emerge? Insurance companies have significant scope to compete, although in the form of Solvency II have their own regulatory and capital challenges to overcome. Large well-funded private equity firms are a potential source of long-term funding for the corporate sector and for public-sector projects, subject to reservations about the political acceptability of their involvement in some markets. Large pension schemes and sovereign wealth funds are plausible, indeed incipient, players, using long-term investments to improve their liability matching in the growing absence of government debt instruments offering meaningful yields.

Agency problems aside, they could become significant providers of credit who largely if not completely by-pass the conventional banking system in order to maximise their share of available investment returns. However, to do so, they will need to obtain, in short order, the internal expertise and systems to play in the market which we have seen them start to do by building internal teams. Those that choose not to bring this expertise in house, may still invest in the market through current intermediation structures.

Aside from these relatively benign sources of credit, regulators are concerned by what they perceive, rightly or wrongly, as opaque lenders whose capacity to fill the funding gap they find hard to calculate. A recent study by the New York Fed caused much comment about its attempt to understand how credit can be created in a complex shadow system. This system, reliant upon leverage and pass-through mechanisms, is not the inevitable future of shadow banking, but it has to be observed that it remains the dominant model for now.

Rightly, those with a mandate to monitor or protect the financial system from avoidable shocks are grappling with this. But there are wide variations by country and regulatory region. In Europe, for example, corporate lending is fraught territory for non-banks – at least on the face of it. In practice, credit can flow via investment vehicles and mechanisms to shift regulatory accountability to lighter-touch regimes. In the UK, credit extension has long been much easier for non-banks, although market forces have made this much more difficult since the crisis. Meanwhile, in Asia local financial systems are awash with credit, but it remains too early to judge whether there will be a new 'credit rush' as funds become available for global borrowing, or whether emergent local banking and financial crises will mop up today's excess supply. In future, tracking investment and product flows is likely to assume much greater importance for understanding how credit is being priced and allocated.

It is also important to remember that it is very unlikely that banks will be eclipsed by non-bank credit intermediation – the underlying trend is for a shift in business models, not a total paradigm shift. Plenty of market observers have noted that banks retain powerful advantages thanks to their deposit-taking networks and long experience of credit portfolio management and credit assessment of non-quoted corporate entities. Few investors will have the scale to match these skills, opening the possibility that banks will continue with and perhaps expand their origination activities but seek explicitly to pass credits through to investors via joint-ventures or consortia that agree to share the available returns. New markets for banking services related to an originate-distribute model could create important annuity-like fee streams for banks, stretching the existing model of prime brokerage into new areas. There could be significant market evolution in the next three to five years as these competitive forces play out, with transaction opportunities across markets and product categories, as well as in the financial plumbing – the trading, clearing and servicing areas that make the industry of intermediation tick. If some types of derivative are no longer economic for banks to underwrite, they might nevertheless capture valuable rents if they have a direct economic stake in the clearing house through which the instruments are traded.

It should be clear that shadow banking is a complex topic that will require ongoing monitoring. For anyone deciding on strategic moves, understanding the dynamics of credit intermediation will be a vital attribute. Some might find competitive advantage in unexpected ways, using their global reach to seek out as yet unknown regulatory allowances to originate loans that are economic even under capital-constrained conditions. Tighter regulation could act as a deterrent to shadow providers unwilling to accept greater scrutiny even if there is no capital regime. Evolving systemic or macro-prudential approaches could lead to new policies that remove today's distinctions by imposing functional regulation. If the political winds shift, so market conditions and opportunities might follow. We might posit that the term "shadow banking" is already losing its potency because many shadow assets and liabilities have disappeared or have been brought back into the light of banks' more transparent balance sheets. The real long-term issue is who provides credit under what regulatory burden and to what degree of efficiency.

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