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CEPN Policy Brief

THE SHADOW BANKING SYSTEM. CAN IT BE REGULATED?

Dominique PLIHON

The subprime crisis that erupted in 2007 revealed the existence of a financial system parallel to the traditional banking system, known as the "shadow banking system" (SBS). The SBS can be defined as a system of financial intermediation encompassing those entities which lie outside the traditional banking sector but which perform partly similar functions.¹ The SBS is comprised of organisations involved in highly leveraged operations which do not have direct access to deposit insurance or to central bank refinancing, and which are not subject to prudential supervision. Investment banks, hedge funds, investment funds (mutual funds, pension funds, insurance companies), private equity funds and structured investment vehicles all participate in the SBS.

The origins of the shadow banking system

The SBS is the subject of an abundant literature from international public institutions² and academia. These works highlight two major changes that explain the emergence of the SBS. Firstly, the policies of financial liberalisation pursued in most of the developed countries and then in the developing countries from the 1980s on (Jeffers and Pollin, 2012).³ These policies were based on belief in the self-regulation of markets and the capacity of financial players to control themselves. The authorities thus allowed the development of over-the-counter (OTC) markets which, unlike the organised markets, operate in a totally opaque and therefore uncontrollable manner and are characterised by the absence of clearing houses and rules common to all the operators on the market. Derivatives operations carried out on the OTC markets (involving credit default swaps, for example) allowed financial institutions to take large speculative positions by exploiting strong leverage effects.

A new model of bank intermediation bancaire

Recent literature has shown that the SBS is associated with a new form of bank intermediation, known as "market-based banking". With this new form of intermediation, which renders obsolete the opposition between bank-based finance and market-based finance, the banks use the major financial innovations of derivatives and securitization to transfer their risks onto the markets. This has favoured the adoption of a new model ("originate to repackage and sell"), in which the banks do continue to issue loans, but with the idea of restructuring and selling them as fast as possible. In this model, the banks do not perform their traditional functions – financing the economy and controlling risks – which are transferred to non-bank players.

This new form of intermediation has given rise to a powerful financial industry, which lies at the heart of the SBS. The banks repackage the securitized loans and issue securities backed by these assets, called collateralized debt obligations (CDO). These structured products are bought by investors; the most risky tranches are bought by Special Investment Vehicles (SIV) and hedge funds. Acting like "quasi-banks", these financial players raise short-term capital from money market funds to finance long-term debts.⁴ The SBS has become an important factor of systemic risk, for two reasons. Firstly because these parallel financial institutions escape the surveillance of the banking authorities and do not apply prudential rules. And secondly because the players of the shadow banking system are highly interconnected with each other, making them susceptible to domino effects.

¹ Poszar Z., Adrian T., Ashcraft A. and Boesky H. (2010), "Shadow Banking", Federal Reserve Bank of New York Staff Reports, n° 458. See also, by the same authors, (2012), "Shadow Banking", *Revue d'économie financière* n° 105.

² European Economic and Social Committee, Green Paper – "Shadow banking", INT/643, 2012. Financial Stability Board, "Shadow Banking: Scoping the Issues", 2011.

³ Jeffers E. et Pollin J-P. (2012), « Déréglementation bancaire des années 1980 et crise financière, *Revue d'économie financière* n° 105.

⁴ Guttman R. et Plihon D. (2010), "Consumer debt at the center of finance-led capitalism", *International Review of Applied Economics*.

The shadow banking system, an important cog in globalized finance

The SBS developed in the United States in the 1990s. The European banks very soon came to play a major role in this financial network, which thus became an essential mechanism of global finance. The Financial Stability Board has attempted to measure the size of the global SBS. These estimates have led to two important and rather surprising conclusions. Firstly, the international financial crisis has not led to any reduced in the size of the global SBS.⁵ After strong growth during the early 2000s, increasing from 26 trillion dollars in 2002 to 62 trillion dollars in 2007, it fell slightly in 2008; but in 2011 it represented 67 trillion dollars: - more than its value on the eve of the crisis. The second conclusion is that in 2011, the SBS in the eurozone was of roughly the same size (22 trillion dollars) as that of the United States (23 trillion dollars). If we include the UK's parallel banking system (9 trillion dollars), then Europe weighs more (31 trillion dollars) than the United States in the global SBS!

European banks at the heart of the global shadow banking system

Recent works have demonstrated the active participation of European banks in the American SBS, leading to a close interconnection across the Atlantic.⁶ The big European banks like UBS, Deutsche Bank, BNP-Paribas and Barclays have been just as active as the US banks in the parallel banking system, operating through their subsidiaries in London and New York. By performing these operations, the European banks largely contributed to the globalization of the SBS.

French universal banks played a particularly active role

The dominant banking model in Europe has long been that of the universal bank, operating in the main activities of finance. The European banks, which are commercial and investment banks at the same time, have incorporated shadow banking into their scope of activities. In this perspective, the French banks are emblematic. They control the great majority of investment funds on the domestic market. These funds have acquired high-risk structured products which they finance

directly from the resources collected by the banking groups to which they belong (notably private deposits) and by benefiting from ECB refinancing. And so, because there is no clear separation between commercial banking and investment banking, the activity of shadow banking has become established at the very heart of European universal banks, representing a major source of fragility.

The collapse of the shadow banking system and the international financial crisis

The financial crisis that started in the United States in the summer of 2007 revealed the SBS as the weak link in the international finance system.⁷ In a traditional credit crisis, banks record losses, obtain short-term refinancing from the central bank and recapitalize by attracting investors. This time, however, because the bank loans had been transferred to the parallel banking system, there to be transformed into structured products and sold on to investors throughout the world, the crisis spread internationally. One of the first signals of the crisis was issued on 9 August 2007 by BNP-Paribas, which froze two of its investment funds, because they could no longer value the structured assets they had acquired on the American market. The crisis accelerated in 2008 with a chain of bankruptcies of hedge funds and big investment banks, who are the main players of the SBS. At the end of 2008, bank losses were estimated at 700 billion dollars, and the major stock markets had plummeted by 50%.

What regulation for the shadow banking system?

The unsupervised development of the SBS crowned the failure of policies of financial regulation based on the laissez-faire doctrine and belief in the self-regulation and efficiency of the financial system. It is now generally acknowledged that the scale of the crisis is due to deficiencies in regulation, which has led the authorities to implement financial reforms.⁸

The American administration passed the Dodd-Frank Act (July 2010), which included measures to limit risk-taking in commercial banks and in particular their relations with the players in the SBS. These measures include the prohibition of

⁵ Financial Stability Board (2011), "Shadow banking system – Scoping the issues".

⁶ Shin H. S. (2011), "Global Banking Glut and risk Premium", 12th Jacques Polack Annual Research Conference, 10-11 november.
Bouveret A. (2011), "An assessment of the shadow banking sector in Europe".
Electronic copy available: <http://ssrn.com/abstract=2027007>

⁷ Adrian T. and Shin H.S. (2010), "The Changing Nature of Financial Intermediation and the Financial Crisis of 2007-09", *Staff Report* no. 439, March 2010, Revised April.
Gorton G. & Metrick A. (2009), *Securitized Banking and the Run on Repo*, Working Paper 15223, NBER.

⁸ Plihon D. (2010), *La réforme de la régulation financière*, Cahiers français n° 359, Paris, La Documentation Française, november-décember

trading on own account, the limiting of investment in a hedge fund to no more than 3 % of a bank's total ownership interest and the creation of subsidiaries for activities on OTC derivative markets.

The British authorities adopted the main recommendation of the Vickers commission, that British banks should ring-fence their retail banking divisions, to protect them from the risks of investment bank activities.

For its part, the European Commission launched several reforms. A directive published in 2010 imposed obligations of transparency on hedge funds in exchange for a "passport" allowing them to be present in the 27 countries of the European Union. The "FIM" directive on financial instruments markets, the liberal inspiration of which had favoured the development of unsupervised OTC markets, was reformed in 2011 to make it obligatory to trade derivatives on organised platforms. And in 2012, the Liikanen report, commissioned by the European Commission, recommended that different types of banking activities should be separated, within each banking group, in order to isolate speculative, risky activities.

Insufficient reforms

On an international level, the Basel Committee on Banking Supervision published a new standard in 2011, known as "Basel III", which increases bank capital requirements, stipulating liquidity ratios and imposing a limit on the leverage used

by banks. In addition, banks must hold 5 % of the value of securitized loans on their balance sheets, to encourage them to be more prudent in the distribution of loans sold by techniques of securitization.

Lastly, on request by the G20, the Financial Stability Board has issued guidelines to strengthen the prudential requirements imposed on SIFIs (systemically important financial institutions). These latter are banking groups with two main characteristics: large size and strong interconnection (a source of systemic risk) with other financial players, such as investment banks, hedge funds, etc. Worldwide, 29 SIFIs have been named, of which 4 are French.

Most of these financial reforms move in the right direction, insofar as they seek to regulate the different players in the SBS. But they are insufficient. None of the current reforms (and that includes the new French banking law passed in March 2013) establish a strict separation – as the Glass-Steagall Act of 1933 did – between traditional banking activities on the one hand, and largely speculative, high-risk activities, performed by entities in the SBS and particularly by investment banks and hedge funds, on the other. This unresolved issue is all the more acute in Europe, where these different types of bank activity coexist, without any real separation, in universal banks. It is to be regretted that the authorities, and most economists, continue to favour the idea of regulating financial players within the context of a micro-prudential conception, whereas a global, systemic approach is needed to address the network effects and negative externalities of the SBS.

Séminars & Colloquia

June 7, 2013 - MSH Paris Nord : [CEPN Seminar \(CEPN, Université Paris 13\)](#)
CHRISTOPHE BOUCHER (Université de Lorraine) : *"Macroeconomics at Risk"*.

June 14, 2013 – MSH Paris Nord - [AMPK team Seminar \(CEPN, Université Paris 13\)](#)
STEVEN FAZZARI (Washington University in St. Louis, USA) - *"Unstable Demand Growth and Fiscal Policy"*.

June 21, 2013 – MSH Paris Nord - [AMPK team Seminar \(CEPN, Université Paris 13\)](#)
TAHA CHAIECHI (James Cook U., Australia) – *"Climate extreme events and macroeconomic synchronous response through a Post-Keynesian lens"*.

November 7-9, 2013 – Campus de Bobigny (IUT) – [25th EAEPE Conference: Beyond Deindustrialisation: The Future of Industries](#).
Local Organizers : NATHALIE COUTINET (CEPN) & PHILIPPE ABECASSIS (CEPN)
More information : www.eaepeparis2013.com

publications



MANUEL DES AFFAIRES

Or a theoretical treatise on industrial, commercial and agricultural companies

JEAN-GUSTAVE COURCELLE SENEUIL
Scientific editor: LUC MARCO (CEPN)

In November 1854, a Parisian economist put the finishing touches to a book devoted to entrepreneurs and their various enterprises of an industrial, commercial or agricultural nature. The book came out in January 1855 and quickly became a success. The author defends a very liberal position acquired in the famous monthly journal le Journal des Economistes. While taking economic stock of seventy years of the industrial revolution in Europe, Courcelle Seneuil also made a perceptive comparison between the French and British experience. As an exceptional account of the pensée gestionnaire ("management-based approach") of the 19th century, the book is proposed here in a scientific edition that places the author's quotations within the context of the period.

L'Harmattan, Coll. Recherches en gestion, mars 2013



TEACHING POST KEYNESIAN ECONOMICS

Edited by JESPER JESPERSEN (Roskilde University) & MOGENS OVE MADSEN (Aalborg University, Denmark)

Contribution by ANGEL ASENSIO (CEPN)

This book contends that post Keynesian economics has its own methodological and didactic starting point, and its realistic analysis comes close to a much-needed factor in the current economic and financial crisis. At a time when the original message of Keynes' General Theory is no longer present in the most university syllabuses, it book celebrates the uniqueness of teaching post Keynesian economics, providing comparisons with traditional economic rationale and illustrating the advantages of the post Keynesian economic teaching and thinking.

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www.e-elgar.com