The Growth of Shadow Banking

The "Shadow Banking System" refers to a system of credit provision occurring outside of the official regulatory perimeter of commercial banks. Facilitated by securitization vehicles, mutual funds, hedge funds, investment banks, and mortgage companies, the function and regulation of these shadow banking institutions have come under increasing scrutiny after the subprime crisis of 2007–8. Matthias Thiemann examines how regulators came to tolerate the emergence of links between the banking and shadow banking systems. Through a comparative analysis of the United States, France, the Netherlands, and Germany, he argues that fractured domestic and global governance systems determining the regulatory approach to these links ultimately aggravated the recent financial crisis. Since 2008, shadow banking has even expanded and the incentives for banks to bend the rules have only increased with increasing regulation. Thiemann's empirical work suggests how state–finance relations could be restructured to keep the banking system under state control and mitigate, if not avoid future financial collapses.

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A Comparative Institutional Analysis

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To Karl and Katharina

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Preface

As this book goes to press, there is an eerie calm in financial markets.

Ten years after the first major turbulences in Western financial markets that heralded the beginning of the Great Financial Crisis, stock indexes are at all-time highs. After the seizure of 2008/2009, and a long tepid recovery, countries in the West have finally regained a growth momentum, which allows the International Monetary Fund (IMF) concurrently to provide an optimistic assessment for the near future (IMF 2017a). Large banks have been forced to recapitalize over the course of the last ten years, almost doubling their tier 1 capital (Vojtech 2017). In general, Basel III, the new global capital accord for banking regulation, is seen to be much stricter than its predecessors. Including a simplified leverage ratio (which limits the degree of borrowing banks can undertake and limits short-term debt), it allegedly makes the system much more resilient (Financial Stability Board 2017a). As the chair of the Financial Stability Board, Mark Carney, stated in rather self-congratulatory terms, "The fault lines of the crisis have been repaired. The financial system is now better supervised and regulated … leaving a safer, simpler, and fairer financial system" (Carney 2017).

Yet, as the IMF points out, beneath this rosy picture, risks are lurking (IMF 2017b). Growth has come at the price of a further buildup of household debt; persistently low to negative interest rates have led to a search for yield, fueling the growth of speculative bubbles in different asset classes, including property prices in global cities such as New York, London, and Paris. Investment banks, particularly in the United States, have reached new peaks of profitability riding a wave of leveraged loan buyouts financed by collateralized loan obligations, structured debt products once described as toxic (Johnson 2017). New "nonbanks" have emerged and engage in lending to riskier, high-yield borrowers – while the banks stand behind financing them (Tett 2017). Overall, financialized capitalism, fueled by asset-led rather than demand-led growth, seems to have been restored and any intrusive change to finance averted (Arestis and Karakitsos 2013).

Arguably, this trend has been nowhere more evident than in the regulatory treatment of shadow banking, the provision of credit outside of banks' balance sheets but often involving banks after the financial crisis (Financial Stability Board 2011a). In the current official discourse, shadow banking is rebranded as "market-based finance" and is to be turned into resilient market-based finance by vigilant regulators, allowing further diversification of funding sources in a financial system seen as too dependent on banks (Carney 2014). Yet, in a glaring omission, no anticyclical regulations to contain booms emanating from that sector of the financial system have been created, nor are they forthcoming.[1]

It seems fair to say that we are witnessing a cyclical upswing, driven by finance, which, if no regulatory intervention occurs, will likely lead to another crisis. But far from that, the regulatory pendulum seems to have swung in favor of finance. This impression is reinforced by a US government seeking to undo much of the regulatory burden imposed after the financial crisis. As of October 2017, there are nineteen measures in front of the US Congress to revoke or lower postcrisis regulation (AFR 2017).[2] In Europe, in the context of the initiative for a capital markets union, simple, transparent, and standardized securitization is supposed to revive the market for asset-backed securities as an alternative, nonbank financing channel for Europe, deliberately ignoring the fact that securitization always involves banks. Innovative debt contracts are seen as a way to wean Europe off from its dependency on bank credit (Langfield and Pagano, 2016). This attempt to expand nonbank finance in the EU will be further encouraged by the new Basel III Accord, which will be applied to global as well as regional and local banks. Owing to their coarse measures, they will again align European policymakers and

1 Indeed, a recent study in the United States found that US banking regulators had no means at their disposal to control a financial boom emanating from the shadow banking system and driven by house price appreciation, ironically exactly the factors that led to the last crisis (Adrian et al. 2015).

2 One of them is the risk retention tool by banks issuing asset-backed securities, which is supposed to align the interests of issuers and investors by forcing issuers to have "skin in the game," that is, to share the losses if securitized loans default.

banks in their search for loopholes, to facilitate credit provision outside of the official balance sheets of banks, albeit being continuously linked to them.

This recurrence of the same pattern could remain indifferent to the populace at large, were it not for both the deleterious consequences of the last financial crisis and the state of defense for the next one. The bailing out of banks led to a ballooning of state debt, to which most governments in the West reacted with a regime of austerity, in the case of the EU imposed by Germany and its allies (Blyth 2014). This wave was used to reduce welfare state provisions and stripped many European policymakers of policy space for policies seeking to foster social inclusion. On the other hand, central banks, acting as lenders of last resort, bought up much of the debt produced during the last upswing to cushion the economic busts. With the interest rate at zero and with central banks already having large balance sheets, the question is: Which tools will the central banks have available to cushion the next crisis? If it is just more of the same, more quantitative easing that has benefited the rich overproportionately by inflating their asset wealth and more austerity-imposed welfare curtailment, the tensions within the social fabric will become even more difficult to bear.

In that context, looking back and understanding the reasons for the development of shadow banking, its contribution to the last crisis, and its mitigated regulation afterwards is a worthwhile endeavor. Shadow banking, simply put, denotes a system of credit intermediation outside of banks' balance sheets. As I argue in this book, it is the outcome of a domestically and globally fractured governance system, which unites the interests of banks and their regulators as they face the threat of losing business to much less regulated capital market actors domestically and/or much less regulated international banks operating within the turf of domestic banks. As a consequence, banks have decided to merge their business models with capital market actors, and banking regulators have all too often acquiesced to their demands, regulatory competition playing a major role in these dynamics. That such a policy setup does not automatically lead to a situation of laissez-faire is well demonstrated by the case of the French regulation of shadow banking studied in this book, which was able to channel the off-balance-sheet activities of its banks into credit provision for domestic industry, while avoiding the excesses of repackaging of debt encountered in most other legislations. This stance and the actions by French regulators demonstrate that regulatory agency does matter.

But it also demonstrates that such agency requires institutional empowerment, both within the regulatory networks that determine compliance with banking regulation, but also in the general setup of the governance of domestic banking systems. Most notably, in France large domestic banks were well protected from foreign takeovers and from aggressive competition by nonbank capital market actors, enfeebling deregulatory discourses by banks. This finding questions the unambiguous embrace of competition we still too often find in the discourse of regulators. Hopefully, this book can lead to a rethinking on this issue as well as others – for instance, the myth of regulators as hapless victims of bankers who simply outsmart them. The growth of shadow banking, and the form and extent it takes, is in no way the outcome of a natural process, unpreventable in its path. Instead, it is shaped by the institutional constraints banking regulators impose on their banks and how these are adjusted to changing circumstances. This book sets out to contribute to a better understanding of when and how these institutional constraints are adjusted by regulators and which factors impinge on their action. It is at the same time a call to arms for critical academics, to spot contradictions within regulatory discourses and to support those regulators critical of the rule circumventing activities of "their" banks. Pointing them out might just be a small contribution we can provide, but not a useless one either.

This book has been a long time in the making. Initially conceived as my dissertation project at Columbia University, it has kept me busy for most of the last seven years, going through multiple iterations and amendments.[3] My gratitude goes to my thesis advisor at Columbia University, Tom DiPrete, who pushed me to pursue a comparative study to better understand the variegated impact of the financial crisis; to David Stark, for pushing me to better engage with the sociological literature on financial markets; and to Katharina Pistor, for encouraging me to confront thorny legal issues and to include Minsky in my writing.

[3] Parts of Chapters 2, 5, 6, and 7 have been published as articles in *Competition and Change* (Thiemann 2012), *Business and Politics* (Thiemann 2014a), the *Review of International Political Economy* (Thiemann 2014b), and the *American Journal of Sociology* (Thiemann and Lepoutre 2017).

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