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Matthias Thiemann
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1 *States and the Regulation of a Globalized Finance*

In September 2008, as Lehman failed and AIG neared a similar fate, three decades of relentless financial innovation and the expansion of financial markets in the Western world came to an abrupt halt. Following suit, the neoclassical regulatory utopia of self-regulating markets died as well. This utopian worldview had sought the creation of complete markets that would allow rational agents to make optimal decisions regarding their risk exposure, thereby making regulatory intervention unnecessary. Financial innovations in securitization, which facilitated the pooling of risk and its subsequent trading, held the promise of optimal risk spreading, thus making the financial system ever more resilient (Bhattacharya et al. 1998). In this idealized world of self-regulating and self-disciplining markets, what other role could regulators take on than to facilitate innovation that would allow the completion of markets and the subsequent spreading of risk in the financial system?

Permitting the creativity of bankers who would use these new securitization techniques as a means of circumventing regulatory requirements, and thus shifting the risks onto the ultimate guarantor of the financial system, the state, seemingly remains the most profound regulatory shortcoming precrisis. When the crisis hit, the world came to realize that, rather than spreading the risk, securitization had led to the concentration of risk in the banking system itself (Greenlaw et al. 2008, p. 35; Acharya et al. 2013, p. 515). The crisis revealed the close interlinkage between the banking system and a complex system of credit intermediation that had formed outside of banking regulation – the shadow banking system. The latter system, in effect, experienced a situation analogous to a bank run, which is the sudden and self-reinforcing withdrawal of funds from the system that requires fire-sale liquidation of assets (Gorton 2010). The return of impaired, "toxic" assets on the balance sheets of banks from the shadow banking system impacted them heavily, contributing to the $2.6 trillion of losses concentrated in the banking sector (see IMF 2009c, p. xii). The unexpected reappearance of these assets increased uncertainty over the true risk exposure of these banks, thereby sowing distrust and contributing to the freeze in the interbanking market. This system, its emergence, its underlying practices, and the lack of regulatory intervention that allowed it to grow and to "prosper" serve as the focus of this book.

With the breakdown of financial markets in 2008, the intellectual edifice of potentially self-perfecting markets that influenced regulators' outlook on financial markets lies in shambles. This raises the questions of when and how much regulatory intervention into the evolution of financial markets is appropriate to secure financial stability (FSB 2011a; Omarova 2012; Black 2013). There is a consensus that to prevent a recurrence of events requires more comprehensive regulation as well as the inclusion of these shadow banks into the system of banking regulation (FSB 2011b). Indeed, a whole host of regulatory measures has been instituted postcrisis to disentangle banks and the shadow banking system and to transform the shadow banking system into "resilient market based financing" (FSB 2014), led by efforts of the newly empowered transnational regulatory body, the Financial Stability Board. Regulators now insist that there exists a need both to monitor and to update the frontiers of regulatory supervision continuously (FSB 2014). However, we know little about the sociopolitical context in which regulators do observe this frontier and its implication for regulatory practices. The reasons that impeded such action on the regulatory frontier precrisis are insufficiently understood.

To assess how "robust" these new regulations are and whether they "can withstand attempts at circumvention" (Stiglitz 2009, p. 12) for the banking sector in the future,[1] we need to understand why so few regulators put financial institutions in the shadow banking system under banking regulation in the first place. The financial sector exists as one of the most heavily regulated sectors of the economy (owing to its potential to produce large negative social externalities), which makes explaining this regulatory permissiveness before the crisis that

[1] Stiglitz rightly emphasizes that "the ingenuity of man knows no bounds, and whatever system we design, there will be those who will figure out how to circumvent the regulations and the rules put in place to protect us" (Stiglitz 2010b, p. xxv; see also Kane 1988, 2008). In response to this immutable fact, we need regulations and regulatory systems that can adapt quickly to such circumvention and, as such, will become robust in achieving their goals.

much more confounding. Without an understanding of the failures of banking regulation precrisis, we run the risk of instituting rules that, on the one hand, close current loopholes, but, on the other hand, remain incapable of dealing with the underlying dynamics from which the shadow banking sector emerges. This effectively means coming to terms with the attempts at circumventing rules by banks, where incentives to do so have only increased postcrisis (Blundell-Wignall and Atkinson 2010) and the larger institutional context within which it evolves. Given that regulatory costs have only increased as a major component of overall costs for the banking business, the innovative spirit of financial and legal engineers now even more often turns to the question of how to circumvent them (Blundell-Wignall and Atkinson 2010). By undermining regulatory constraints, however, these extra profits come at the expense of systemic stability, thus creating a threat of future calamities.

Nowhere has this tendency expressed itself more virulently than in the bank-based shadow banking system. There, banks used regulatory arbitrage and securitization techniques to engage in off-balance-sheet banking activities, that is, outside of banking regulation, booking the savings on regulatory costs as profits (Pozsar et al. 2010). The vulnerabilities stemming from the exposure to these activities, which were part of a broader trend toward market-based banking since the 1980s (Hardie et al. 2013a, b),[2] were powerfully demonstrated during the market turmoil of 2007–9. The impact of the financial crisis was greater on those national banking systems that were more exposed to the use of wholesale markets in general and of shadow banking in particular (Hardie and Howarth 2009, 2013a; Chang and Jones 2013; Howarth 2013; Royo 2013; Fligstein and Habinek 2014). Despite these events, market-based banking, the fusion of capital markets and bank business models, is here to stay. While the crisis has evoked substantial regulatory change, causing shrinkages in the field of investment banking (Helleiner 2014), regulatory change has been incremental

2 Market-based banking designates the increasing exposure of banks' balance sheets on the asset and liability side to developments in financial markets, as commercial banks come to rely more on wholesale funding for their lending capacities (Hardie and Howarth 2013b, p. 24) and engage in shadow banking, "lending activity that is "wholly or partially off the banks' balance sheets" (Hardie et al. 2013a, p. 714).

(Moschella and Tsingou 2013) and no clear-cut separation between capital markets and banking conglomerates has been installed.[3]

Going forward, a central question thus remains as to how regulators should monitor the innovative activities that financial market actors, banks in particular, develop in capital markets. How can they ensure that useful innovation is not unnecessarily strangled while at the same time preventing innovations that have the sole purpose of rule evasion? This book contends that we can learn some of these lessons by looking at the differential evolution of the size and activities of a central market for shadow banking activity, the asset-backed commercial paper market in different countries. This evolution was driven by decision making of banking regulators as much as by the regulated. Studying the regulator–regulated interactions regarding this market in their sociopolitical context will provide us with insights about the conditions for regulatory action, both in terms of context as well as in terms of the institutional setup and temporal patterns of interacting between the regulators and the regulated.

Context Conditions for Regulatory Action

To appreciate properly the way in which regulators related to the shadow banking system precrisis, we need, first, to understand the ideological and institutional context within which the large international banks were operating. The massive bank failures in 2007 and 2008 clarified with astounding ferocity that, as Mervyn King, then governor of the Bank of England puts it, international banks are "global in life, but national in death" (King 2009). This statement already goes a long way toward capturing the hybridity that characterizes the institutional context for large international banks then and today. However, to understand the dynamics of diffusion of the financial crisis from the USA to the entire Western developed world via large international banks (Shin 2011), one needs to qualify Sir Mervyn's statement regarding the life of large international banks. They are also hybrids in

[3] In the eurozone, reforms have completely stalled, whereas in the UK, following the Vickers report, a certain bank separation regime has been installed. In the USA, the Volcker rule is supposed to differentiate market making from proprietary trading, but faces difficulties in implementation. Furthermore, President Trump is likely to scrap the rule.

life: largely global in their business activity, but subject to the national interpretation of global regulation and national regulation tout court. Every time a bank creatively employs a financial product, national regulators need to decide how to deal with that long before any international decision on the issue is taken. As Kane (1987) pointed out long ago, the reaction time of international regulation is much too long to deal with local financial innovation properly. Thus, national regulators have no choice but to react on their own.

While transnational banks are widely perceived to have escaped national regulatory control before the crisis (Christophers 2013), their engagement in the shadow banking system was very often predicated on their national regulatory frame of action. Their engagement in global markets, such as the asset-backed commercial paper market, was dependent on national regulations, and hence on national regulatory decision making. Regulatory decisions regarding these markets occurred in a larger societal context that was shaped by the hegemonic ideology regarding finance of their time and the existing global financial architecture within which national regulatory action is placed. At the base of this ideology was a perception of finance as a productive force for the evolution of economics, in which an increase in financial activity was unequivocally contributing to gross domestic product (GDP) growth (Christophers 2011; Turner 2015, critical Bezemer 2009). Financial liberalization and attendant increases in competition were seen as beneficial to economic growth, in particular by the USA, which as the hegemon of the time was unilaterally pushing for an agenda of financial liberalization (Helleiner 1994). These ideological views, undergirded by political economic interests, fostered the support by state agencies for the liberalization and growth of finance.

In the 1990s, this hegemonic ideology of finance expressed a belief in the self-regulating power of markets and the incapacity of regulators to assess market developments properly, setting the ideological basis for delegating regulation to market actors themselves. This agenda was based on a selective reading of financial economics (Turner 2012) that understood market actors as able to assess properly the risks they were taking, and financial markets as informationally efficient and capable of disciplining misbehavior by market agents. Most importantly, securitization, with its capacity to slice credit risk and to spread it to those agents in financial markets most able to bear them, was seen as a revolutionary technique that would increase the resilience of the financial systems as a whole. And this ideology seemed to be borne out by the facts of the financialized boom of the 2000s (Epstein 2005; Krippner 2011). Ever-expanding liquidity in global financial wholesale markets, growing profitability of banks, and the attendant fear of national political economies to be left behind in what seemed like a new era of prosperous finance-led capitalism (Guttmann 2016) were the context of national regulatory action at the time.

When the global banking accords were revised in 2004 and Basel II was adopted, it carried much of these ideological convictions. Thus, it has been attacked as an example of cognitive and regulatory capture (Seabrooke and Tsingou 2009; Baker 2010; Lall 2012), where the industry wrote the rules in its favor (critical Young 2012; Baud and Chiapello 2014). But this focus on global accords often causes analysts to overlook the fact that for most of the financial innovations in which banks engaged, local and national adaptation played a major role: deciding if and how they could do so. While these banks sought to carve out niches for themselves among a field of global peers, one important actor for them was their respective national regulator and these regulators' views on the merits and dangers of the financial innovations in question. So that they fit well with the innovations of structured finance – whether the international tradability of domestic mortgage-backed securities (see Wainwright 2009, 2011 for the case of the UK) or the regulation of these trades, which, as banks requested, should occur with as light a touch as possible – national regulatory regimes needed reshaping.

In this situation, the regulators are largely influenced by the way the international scene within which their respective banks must compete is set up. Financial liberalization since the 1970s led to financial turbulences not experienced in the period from 1944 to 1973, as the internationalization of banking business brought about a degree of connectedness hitherto unexperienced (Goodhart 2011). When the failure of the small German Herstatt Bank in 1974 threatened turmoil in the USA, banking regulators of the developed world started to coordinate in the Basel Committee for Banking Supervision. Seeking to control the behavior of banks, regulators were coordinating their supervision between host and home countries from 1975 onwards (Kapstein 1991). The problem of securing domestic stability while keeping domestic banks internationally competitive led to negotiations over a globally harmonized set of rules for banking regulation, which crystallized in 1988 into the Basel Rules for banking regulation.

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While establishing a level playing field at this point in time, it also established inhibitions for further regulatory action by national regulators at the margins of this accord, as I will show. The global architecture installed by the Basel Accords granted banks the right to operate globally based on their domestic regulatory framework, installing competitive inequity concerns right at the heart of national regulatory decisions. Postcrisis, several amendments have been made to this fact by national regulators, especially in the USA, where foreign bank subsidiaries are often forced to incorporate domestically, thereby making them subject to US regulation (Dodd-Frank Act Section 165/166; see Fed 2014).

As Saskia Sassen (1996) and others pointed out long ago, globalization in this situation does not mean the withering away of the state; instead, globalization tends to become internalized and shapes the activities of state administrations faced with globalizing markets. By internalizing the effects of their actions in the globalized context, the respective regulatory agencies and the ministries of finance may well cede to the deregulatory demands of their primary clientele, the banks. In a situation in which regulation of banks is not yet fully global, but no longer national only, regulation tends toward leniency because of the intention of each to support its national champions in the international marketplace. As the literature on the evolution of global regulatory standards for banking points out, regulators need to weigh the competing goals of financial stability and the competitiveness of their industry with respect to foreign banks, seeking to avoid squashing profitable activities by too stringent regulation (cf. Singer 2007).

In addition to international competitiveness concerns, regulators also needed to weigh the emerging threats to their commercial banks that stemmed from evolving business models of nonbanks. Based on abundant money market funding, these became active competitors for the business of credit intermediation, a fact that was most pronounced in the USA. Prior accounts of the shift toward shadow banking activities have focused on bankers' agency in this context of increasing competition (Acharya and Schnabl 2010; Hardie et al. 2013b, p. 1; Bell and Hindmoor 2015), largely ignoring regulatory agency.[4] However,

[4] Bell and Hindmoor's (2015a) empirical analysis of the Australian and Canadian cases shows the role of regulators rather well. However, in their theorization of their four cases, this crucial role of regulators and regulation remains underemphasized.

shadow banking activities, such as securitization, require favorable regulatory environments to flourish as they are quite sensitive to regulatory costs. As shadow banking activities generate only very low margins (Claessens and Ratnovski 2014, p. 5), including them in costly banking regulation would thwart their growth. Regulatory agency is thus an important factor in constraining or facilitating these activities.

Research on the shift to shadow banking activities in banking systems has acknowledged this structuring role, but it has not properly focused on the factors driving regulatory agency.

As Hardie et al. put it, "Clearly, institutional factors shape bankers' business choices: *banking regulation and banking supervision … and protectionism in the banking sector*" (2013a, p. 697, emphasis mine). Researchers to date, however, have emphasized the agency of bankers within these regulatory constraints (Acharya and Schnabel 2010; Hardie and Howarth 2013b, p. 51; Hardie et al. 2013a, p. 697; Hardie et al. 2013b, p. 1), but have neglected regulators' agency that shaped these constraints as well as the institutional constraints within which it itself evolves.[5] This is problematic, as the shift to shadow banking was more than bankers "acting out institutional change" prepared by the (de-)regulatory efforts of rule makers (O'Sullivan 2007). Instead, banks actively circumvented the rules, and a crucial question regarding the profitability of these activities was whether regulators updated regulation to include them or not.

To overcome the bank-centric focus in current explanations, this book focuses on those regulatory decisions that hindered or facilitated these activities and places all of this in the context of global and European financial market integration,[6] providing a more complete account for the differential exposure of national banking systems to shadow banking activities. The shift to shadow banking can then be analyzed as the endogenous outcome of the interaction of rule takers and rule makers (Streeck and Thelen 2005, pp. 13–14) within a larger and changing institutional context, where rule takers seek to circumvent regulation and rule makers either do or do not expand regulation to capture these activities (Kane 1988).

[5] But see the contributions by Gabor (2016) and Gabor and Ban (2015), which show the active intervention by the European Central Bank for the case of the European repo market.

[6] Deeg (2010, pp. 426ff) similarly suggests theories of European financial market integration as mid-range theories to explain financial system change.

The Dialectical Unity of Regulators and the Regulated

This book argues that to understand the evolution of this regulatory framework properly, we need to employ a dialectical understanding of the relationship between regulators and more broadly conceived state agencies as well as the regulated. Regulators and regulated together form a dialectical unity of opposing and shared interests and together determine the evolution of financial systems, as both actors depend on each other. Absent state regulation and state support, banking systems are too unstable to exist (Ingham 2004). Collective action problems and the danger of the overextension of individual banks, which can lead to the demise of the entire system, cannot be overcome through self-regulation, despite the arguments of extreme liberals to the contrary (see Dowd 1992 for the argument for regulation; see Calomiris and Gorton 1991 for the liberal argument). Conversely, nation-states have depended on stable banking systems for their projection of power and their developmental projects at large.[7] This dependence is even more evident with respect to regulators, whose existence, without a prospering domestically owned banking sector, would become largely redundant. In the context of financial liberalization, which permitted the acquisition of domestic by foreign banks, such a scenario became a distinct possibility.

United in their mutual dependence, these actors also carry opposing interests. Whereas individual banks will seek to maximize returns within existing regulatory constraints and to evade those constraints, which they see as unnecessarily burdensome, regulators seek to maintain the stability of the sector, concerned about financial stability as a public good, while taking the competitiveness of their banks into account (Singer 2007). Hence, conflict evolves around what is perceived as privately rational action by banks that endangers the public good as understood by the regulators. The outcome of this regulatory dialectic (Kane 1988) determines the regulatory framework as a dynamic synthesis of these opposing interests, which determines the evolution of the system. In this evolution, the system might veer toward excessive risk taking on the one hand, as banks escape regulatory control, which ends in financial crisis and reregulation. On the

[7] This state finance nexus was forged at the latest with the founding of the Bank of England in 1694 (Ingham 2004), a public–private partnership that sought to mobilize private resources to finance war capacities of the state.

other hand, however, risk taking can be subdued by excessive regulatory constraints, which lead to a crisis of profitability and threaten the existence of banks, as nonbanks unburdened by regulatory constraints challenge them. This crisis, in turn, will lead to a process of deregulation, one brought forth by both regulators and the regulated to protect the banks.

Using this dialectical view and its explicit temporal dimension, we can better appreciate that the agency of one actor in this pas de deux can constitute an important part of the structural constraints within which the other must act. That is to say that the regulators and the regulated "collectively and interactively shape the environment that they confront" (Muegge 2010, p. 7). If we consider structure and agency from the point of view of both the regulator and the regulated, we gain the notion of an evolving ecosystem, in which timing is of crucial importance. As the regulated circumvent the regulation, how quickly do regulators understand and react to these innovations? As Funk and Hirschman (2014) point out regarding the case of the regulation of swaps before the crisis, at a certain point the sheer size of such markets limits the capacity for regulatory intervention as market segments become quasi-irreversible. Regulatory intervention then can act only at the margins, without questioning these markets themselves. Conversely, once regulation has undergone negotiation and implementation, there is only little that the regulated can do to change these structures directly. Instead, creative actors will seek to circumvent these regulations through new financial products, which achieve similar results in economic substance but are sufficiently different in legal form.

But a crucial point is that the agency of both is driven also by their dialectical unity, by an attempt to secure the survival of the domestic banking system in the face of competitive challenges, be they internal or from abroad. Changing and increasing competition both from foreign banks and from domestic nonbank actors who exert their agency in the face of changing forms of financial intermediation require responses by this contradictory unit of banks and regulators. Adapting to a changing competitive landscape that involved the (re-)ascendance of capital markets as new sources of financing as well as threats from foreign banks, banks sought to integrate the provision of services to capital markets into their business models (Hardie et al. 2013a, b). The decisive question then was how regulators would react to this