FINANCIAL TIMES

June 2, 2013 1:03 pm

On Monday: Time to throw some light on shadow banking

By John Authers

Image problem will only be fixed by sensible re-regulation

Shadow banking has an image problem. Everyone agrees that it badly needs at least a rebranding. Meanwhile, its defenders keenly argue against the idea that it needs drastic re-regulation if it is to survive in any recognisable form at all.

They are wrong about that. But they are right that regulating to bring in the sector from the shadows will cause pain – mostly, perhaps, for hedge funds. Tightly regulated shadow banks could hurt their returns.

Defenders have their work cut out. The credit crisis that began in 2007 makes it beyond evident that regulation at the time was ineffective.

What exactly is "shadow banking"? The term, surely pejorative, refers in general to the ever-more-convoluted plumbing that banks constructed in the years leading up to 2007. Infamous "conduits" and "structured investment vehicles" (Sivs), are definitely included in shadow banking while some, more contentiously, add money market mutual funds to the list. All have in common that they would take in relatively illiquid, long-term assets and in return issue shorter-term assets.

This is the same task as that of a bank, which takes in relatively safe deposits and invests in riskier and less liquid loans. Why "shadows"? Much of this plumbing was incorporated offshore. The composite effect was to remove assets from banks' balance sheets. Arguably therefore, they were not fully regulated.

And why did it come into being? The depth of demand from institutional credit pools ultimately stemmed from the bubble in US housing. It is hard to argue that there was a "good" reason for shadow banking to have grown as big as it did.

But there were other reasons. Shadow banking's defenders argue that it is not truly in the shadows; even Sivs and conduits appeared within bank holding companies' accounts, and derived their power from banks' guarantees; they were within the regulatory ambit. And the unintended effects of regulations, such as heavy implicit subsidies for the mortgage agencies Fannie Mae and Freddie Mac, or limits on deposit rates, drove the setting up of an institutionalised system to raise cash outside traditional banks.

As for money market funds, they are regulated and offer their products directly to retail customers – but critically are not subject to all the rules for banks. Not having to pay deposit insurance premiums, they could pay higher rates than banks, while appearing no less safe.

This is the nub of the problem. Money market funds' management companies created moral hazard in the run-up to the crisis by stepping in to make sure that the funds' investors never suffered a loss (in the jargon, as the fund's share price is fixed at $1, they never "broke the buck"). The correct marketing pitch should have been "higher returns for only very slightly greater risk", because the funds did not have deposit insurance.

Had perception of money market funds been clearer, it is unlikely that the loss announced by the Reserve Fund in the wake of the Lehman Brothers bankruptcy would have led to a catastrophic bank run. But the fact is that the run happened, demonstrating that the sector had been ineffectively regulated. Change is needed.

If shadow banking were truly outlawed by the regulators, would it be necessary to invent it again? The demand for it arose because there were not enough safe assets to go around, and this problem has since intensified, now that eurozone peripheral government debt, and US mortgage agency debt are no longer regarded as safe. But if financial engineers want to make another attempt at creating apparently risk-free assets, there is no reason to do it in the shadows once more. Shadow banks can operate in jurisdictions where all can see them, rather than offshore.

One group, however, is already suffering from the decline of shadow banking. Hedge funds' performance post-crisis has been disappointing. Extreme correlations, and the difficulty of timing swings between "risk-on" and "risk-off" moves, are probably the greatest reasons for this.

But hedge funds' critical advantages over conventional funds are that they can use leverage, and that they can sell short. In the years leading up to the crisis, when hedge funds performed very well, leverage tended to come from shadow banks.

Now, the travails of shadow banking imply that the supply of both shorting and leverage is constricting. Meanwhile, the money pumping into hedge funds, whose total assets are at a fresh record, will increase demand.

That implies that it will keep growing more expensive for hedge funds to borrow and sell short – which in turn means that their advantage over other funds will be reduced, and their returns will be less than they otherwise would be.

Shadow banks' image problem will only be fixed by sensible re-regulation that restores confidence in the sector. And that is bad news for hedge funds.

Printed from: http://www.ft.com/cms/s/0/6ef557fa-ca09-11e2-8f55-00144feab7de.html

Print a single copy of this article for personal use. Contact us if you wish to print more to distribute to others.

© **THE FINANCIAL TIMES LTD 2013** FT and 'Financial Times' are trademarks of The Financial Times Ltd.