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SHADOW BANKING

A Geographical Interpretation

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Abstract

Shadow banking is a peculiar kind of business organisation, or better a set of institutions, products and markets, closely intertwined. Its purpose is to run credit activities partly or mainly outside the regulated banking system.

This paper tries to analyse the subject from a structural point of view, within the wider context of the emerging globalized economy. A comparison with the "classic" banking system is here proposed, drawing a parallel with the evolution experienced by other economic sectors.

Two main points are considered: 1) the system was already well known but neither assessed, nor regulated; 2) we are not facing a parallel market, but a set of activities which do not develop "under one roof", but are fragmented into a variety of companies. All this stresses the scarce visibility of the sector, hence the nickname of "shadow".

As for the "official" banking, the relationship is both competitive and cooperative, so that the anomaly is to be credited to the entire credit/finance sector. The influence of this process on the spatial distribution of real economy activities is also discussed.

Theme: G_T Regional finances, investments and capital markets.

Jel codes: G1, G2, N2.

Keywords: financialization, financial geography, globalization, shadow banking.

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1. Introduction

Basically, shadow banking is an original kind of business organization, or better a set of institutions, products and markets which make it possible to run credit activities in part or mainly outside the banking system, thus avoiding existing regulations. Nowadays, tackling the subject means penetrating the hard core of financialization. Shadow banking (SB) manifests itself through a variety of activities carried out since time immemorial. Scholars generally agree that SB was operating already in the 30s and some find evidence of its existence as early as in the 17th century. It seems however that certain procedures and entire phases were established well before the institutionalization of banks as we know them. In this field, the aim of bypassing regulations in force seems to be a genetic component. Suffice it to mention the so-called *trinus contractus*, developed to bypass the canonical prohibition of loans during the Middle Ages¹.

Although the SB structure was active in the 30s, not casually another period of global financial troubles, it attracted the attention of a wider public only with the outbreak of the present crisis (McCulley, 2007). The first analyses made within national institutions and international bodies were carried out in the wake of the emergency, thus projecting a negative light on it. The tendency is to consider shadow banking as an anomaly of financial markets, to which it however appears thoroughly linked.

2. A problem of definition

Charged with being an underworld sector that has plunged the U.S. and the entire world into the 2007/2008 financial crisis (the painful *ex-post* "discovery" of the regulators), and now with appropriating the credit functions of the banks (Tett, 2014), SB is actually a transformation of the banking system, of which it now represents an integral part. A bitter truth to accept, which however international researchers have gradually come to recognize. This growing awareness is clearly readable in official statements:

1. "The 'shadow banking system' can broadly be described as credit intermediation involving entities and activities outside the regular bank system" (FSB, November 18, 2012);
2. "... credit intermediation involving entities *fully or partially* (italics added) outside the regular bank system" (FSB, November 14, 2013).

The embarrassment of regulators in tackling the subject (especially in the U.S., where the business reached its apex²) is understandable – the last logic step is therefore left to independent scholars, if not to economic journalists.

To identify the SB system, we first need to consider the non-banking operators active in the field. Among them, the literature lists money market funds, hedge funds, private equity funds, credit investment funds, exchange-traded funds, credit hedge funds, structured investment vehicles (SIV), special purpose entity conduits (SPE), repurchase agreement (repo) markets, security broker dealers, credit insurance providers, securities and finance dealers.

(Insert here Figure 1)

1 Under this theorization, the commercial loan was interpreted as incorporating three different contracts: a commercial partnership, an insurance on the investment and a second insurance covering the profit expected from the business (E. James, 1959).

2 Two economists of the Federal Reserve for instance insisted to credit SB with an increase in efficiency and even in transparency and disclosure (Noeth & Sengupta, 2011: 13), an opinion readable also in the European Commission *Green paper* (2012).

To understand the phenomenon we also need to focus on the relations linking the different actors, which leaves no doubt whatsoever. As shown in Fig.1, the diagram of SB published by the FSB (2011: 9) encompasses all kinds of financial institutions (insurance companies, investment banks, mortgage companies, etc.), including credit rating agencies (Hunt, 2009), whose influence on the credit market is outstanding because of their role in fixing the quality of loans and debtors. They all are participating in the SB system, the only difference being their level of involvement, so that we may conclude that

3. SB is simply a (growing) sector of credit intermediation carried out jointly by the regular bank system and other financial operators.

The investigation on what is known as "shadow banking" becomes therefore an analysis of the present banking & finance system, which has been provided with an array of structures functional to the carrying out of new types of business.

3. The origins

Far from being born covertly, behind regulators' backs, SB has been built up following their suggestions and thanks to their support (Roselli, 1995: 166-167; Fein, 2014). All this happened for very good reasons, that is to allow the system of commercial banks to survive under changed market conditions (Gorton, 2010). Besides strategic errors (like the Mexican loans crisis) and the consequences of the loss of competitiveness of corporate America, the banks had to face a progressive erosion of their core business, namely the financing of private enterprises, on part of other institutions. The stock exchange played a crucial role among them, becoming the fulcrum for the growing sector of new financial intermediaries: investment banks, insurance companies, mutual funds, pension funds, etc. A thorough analysis of the U.S. credit system (Roselli, 1995) reveals that in the 80s national banks have been retreating from commercial credit to corporate America, with European and Japanese institutions filling the vacuum. U.S. capitals, instead, were looking for more profitable investments on financial markets, a sector in which industry, at home and abroad, had been struggling for at least twenty years to replace banking (Pastré, 1979).

As we all know, the economic development of America was based since the beginning on an uninterrupted flow of capitals coming from Europe. This put the U.S. in the position of the greatest world debtor, a role it maintained till the end of W.W.I. The growing role of foreign banks in the last decades of the 20th century somehow represented a return to the past, albeit in a quite different environment. Given the preminence of FDI portfolio in the hands of American firms, this might be considered an indicator of economic subalternity rather than a strategic success. This means that a consistent amount of world savings was diverted from productive investment in the countries where it had been originated to support American businesses, gaining a profit that was not considered attractive by local capitalists³, as the latter found it more convenient to offshore their productions, in order to reap the benefits of multinationalization. The level of profits thus accumulated was so outstanding it made them autonomous from credit institutions. Once freed from the need to finance American enterprises, both onshore and offshore, a growing share of U.S. capitals (coming from corporate surplus) has been directed towards finance, an activity offering returns on investment no other sector could guarantee. Obviously, it was only a matter of time for foreign banks to follow the tide and begin to speculate themselves. Indeed, in the U.S. since the middle of 70s deregulation and increased competition made the traditional model of banking less and less profitable.

3 An analysis of the Comptroller of the Currency revealed that foreign banks in the U.S. have always had lower profits than local ones (Nolle, 1994, quoted in Roselli: 185).

4. The great transformation

The SB is not only the product of financialization of economy, it is the core of the transformation undergone by capitalism in the last decades of the 20th century, and its structures are instrumental to the same. Through financial innovation, banks have in turn experienced a genetic mutation. Basically, this mutation relies on five pillars:

- a) retreat from financing production;
- b) enlargement of the field of activity to asset management and inter-dealer brokerage;
- c) splitting of the different functions developed inside the traditional banking business;
- d) swift and continuous disinvestment of credits, with leveraging at all levels;
- e) spreading of off-balance sheet items.

These phases are the equivalent in the credit sector of the transformations undergone by corporations when they lose their original industrial or trading character to become holdings.

Step (b) means the entry into new markets, and is in some way related to (a), (c) and (d), which refer to the abandon of traditional activities. Step (c) is also the counterpart of product cycle disintegration, and is related to (e), namely outsourcing of some of its phases.

All this implies conspicuous spatial fallouts. As regards the market area of credit companies (a typical activity considered in Christaller's theoretical frame), phases (a), (b) and (e) bring about shifts of real activities in the physical space, at least partially. But the deepest and long-term effects are to be found in the quality of areal relationships, which are disrupted and changed. The transformation from a type of bank maintaining lendings in its balance sheets till their expiration, into an institution selling them as soon as possible, separates the economic interest of the lender from the future of the borrower, leaving the latter to his fate. This means shifting the investment perspective from long to short period, cutting the existing ties without substituting them with new ones. The result is an unprecedented acceleration of the "creative destruction" characterizing capitalism, a process that in the globalized era is no longer spatially confined. Money being the main factor of economic development, all this results in the continuous shifting in space of enterprises, with the prevailing of the destructive phase in the formerly developed areas and the swift (but ephemeral) boom of the underdeveloped ones. Such a dynamics is now active at all spatial levels, from regions to nations, continents and the whole earth. What deserves to be noted is, more than the change in the distribution of wealth and economic power itself, the pace of the change affecting economic structures.

The functionalist approach interpreted the geographical space as the result of the linkages permanently established between sets of entities (Christaller, 1933; Loesch, 1940; Isard, 1956; Harris, 1945; Berry, 1958; Juillard, 1962; etc.). This seems particularly true of certain activities like the central ones, which are literally "moulding" the space around service units. In the economic space these are mainly companies, created through efforts carried out by communities, no matter their dimension. All of them represent a decision-making center, independent of the others.

This way the dissolution of the linkages established by firms, especially in the case of banks, triggers a process of destructuration of geographical space whose consequences we are now experiencing almost everywhere in the once industrialized countries of Europe (Battisti, 2013) and North America. The most evident symptom is the scarcity of loans now plaguing the economy of countries like Italy, which is rapidly causing the loss of the heritage of small industries that made its fortunes and constituted its essence.

In a historical perspective, a picture of the consequences may be obtained by looking at the South of Italy. Since the unification of the state, this area has been suffering from the lack of a net of banks engaged in the development of local enterprises, despite the fact that in 1861 Southern Italy was the only part of the peninsula with a modern-type banking institution (Zitara, 2011). The growing unavailability of capitals produced locally for projects of regional development moves the decisional centers farther away from the territories. The economy is gradually extranged from local communities, which are then bound to undergo a process of neocolonization.

5. The economic structure of SB

A new credit structure is taking the place of the dying-out classic commercial bank, made of a chain of entities, legally autonomous from each other, though in reality bound with linkages of functional interdependence. This gives birth to plenty of vehicles that in many cases are simply shell companies, like those used to transfer capitals towards tax havens (Battisti, 2014).

The basic structure of this new bank-model is readable in Fig. 2, b. Central to the system are the concepts of pooling and securitization. Pools of loans, dishomogeneous with respect to both origin (mortgages, students loans, advance lendings, etc.) and *originator* (banks and/or finance companies) are put together and sold to a *sponsor* (or *aggregator*), usually a warehouse bank. These pools are then sold to an *administrator*, typically a subsidiary of large commercial or investment banks. This in turn creates a *special purpose vehicle*, namely a company which holds the loans in its portfolio, issuing securities on this basis. The administrator sells the securities to an *underwriter*, generally an investment bank, which offers them to the public.

(Insert here Figure 2)

In the layout we deliberately chose to enumerate the steps from the bottom to the top to underline the fact that the system is more oriented to meet the demand for opportunities of financial investment than the demand for lendings. In the classic model of commercial banking, on the contrary (see Fig. 2/a), the primary company mission is to supply money to the borrowers. As a consequence, the borrower used to become a sort of associate of the banker, who had a direct interest in the solvency of the former. In this frame the backer (depositor, investor or the same banker with his capital) is instrumental in financing consumption/production.

In the securitized bank, on the contrary, it is the borrower who is instrumental in creating financial values for the investor. The subprime business proved that the hole in the SB business was not a shortage of capital, but rather of eligible borrowers, who were needed in great number to allow the uninterrupted growth of investments.

As we noted before, in Fig. 2/b four phases out of seven (2, 3, 5, and 6) are usually part of the banking system. Moreover, phases 5 and 6 may be performed inside a unique institution. On the other hand, all phases from 2 to 6 may be comprized inside the perimeter of the same bank holding or financial firm. Even if SB is a multi-faceted system, the regulated banks have deep connections with the securities business.

A comparison between the two structures reveals a substantial lengthening of the credit chain, basically from 3 steps to 7. Considering other additional functions, like *credit enhancement* and *liquidity provision* in "b" and of *capital market* intervention in "a", we reach the number of 9 steps against 4. From the economic point of view, this means eight more actors to be paid, against only two in the old system. And one should consider that this is only an oversimplified outline.

Over time, all additional steps gave rise to as many specialized markets, an increase in economic activity not justified by the real needs of production. All the labor engaged in the system is

performing an activity useless for the bulk of the community, thus representing a parasitic sector. Surely it is true that the inherent burden is not charged directly to the single borrowers, but sooner or later it is doomed to fall on the economic system as a whole, and this is precisely what happened with the financial crash. It was not a technical accident, it was something that had been foreseen in advance, and this means that the crash was simply the price to be paid – at the end of the business cycle – for the anomalous growth of the system.

In the light of these considerations, it is very hard to accept that SB realized an increase in efficiency. Also transparency leaves much to be desired, considering the number of different subjects involved, all of them with a right to their privacy. Particularly disturbing is the fact that the common investor is unable to know which is the mind behind the games and therefore to appreciate the level of risks he is confronted with. This might be considered of little relevance, but it is precisely the lack of confidence the ultimate reason for the catastrophic chain of insolvencies that led the system to its collapse in 2007/2008. Above all, in every kind of activity long chains usually increase the risk of facing dangerous events⁴.

In the traditional securities transactions the presence of multiple actors is a positive factor, because it makes it possible to cumulate the guarantees offered by all underwriters. On the contrary, in the particular case of SB the risk is increased not only due to the fact that functions are rarely developed at each step with the required level of professional skill. To this is to be added the banking nature of the activities performed by different brokers. In this field they operate outside banking regulations (unsupervised and not even monitored), but leverage may be used at all steps, thus increasing potential losses to untenable dimensions.

6. The new organisation of finance

In a stimulating essay on financial capitalism (Gallino, 2013: 9-12) the contemporary worldwide financial system is divided into three structural components (real subsystems in themselves): a) the banks, b) the shadow finance, and c) the institutional investors. The last component, made of the large category of investment funds, is seen as occupying the central position between the other two. We do not share this view: in our opinion, banking and institutional investors are two contiguous structures, having the same purpose, namely collecting and investing community savings. After all, both perform credit functions, which means essentially the arbitrage of financial assets in time and space.⁵

This appears evident for instance in the case of hedge funds⁶. An analysis of their activity reveals that since the beginning (Lhabitant, 2006: 7-9) they have been operating arbitrages in the financial market combining short selling and long buying, keeping capitals from short operations to invest in long positions. If we add to this management of clients assets and leverage, we find in the essence the core of banking activity.

The key differences between the two structures are to be found in the time span perspective of the operations and the clients they are addressing. Shadow banking locates in the middle, linking both structures together (being in fact part of them) and providing both with the services they require. Furthermore, Gallino himself uses the term *shadow finance* instead of *banking*, thus indicating that SB is something else, with no clear borders, not merely a concept parallel to that of banking.⁷

4 The FSB staff focused several dangerous segments in some of the markets involved, f.i. those of security lending, leveraged investment fund, financing and security borrowing, inter-dealer repo, repo financing (FSB, 2012 a).

5 American economists speak of maturity transformation, quality transformation and credit risk transfer.

6 According to Gallino they belong to the category of institutional investors. From our analysis, however, they should be rather considered part of the SB system (see § 2).

7 The language of business, especially that of finance, is generally cryptic, and this is very useful to confuse clients

To tell the truth, there is no clear divide between banking and finance, both in principle and practice. The differentiation depends on the legislations, that on both sides of the Atlantic originally were made following the lesson of the "great crash" of 1929, as was apparent in the case of the Glass-Steagall Act, which was practically abolished to allow the financialization of economy. An evolution that made it impossible to maintain the separation between short and long term lending and borrowing, once masterly organised in the Italian Bank Reform of 1936.

To get to the point, we must rely on a voice from the environment where SB took its origin. M.L. Fein (2013)⁸ reveals that SB is "a myth", a false flag diffused by the regulators of the market to misinform public opinion and specifically legislators, "as to the true nature of the causes that destabilized the financial system". In fact, SB, not called under this sinister name before the emergence of the 2007 crisis, "emerged in the regulated bank system in the 1980 and 1990s, when the traditional banking model became outmoded". It was simply "part of the evolution of the business of banking" and therefore was "encouraged" by banking regulators. The experience now tells us that it is simply the sick portion of banking & finance.

Besides the interest of banking, there is another reason why speculation at such level was tolerated and encouraged, a reason still unconfessed owing to political considerations and U.S. national interest at large. The shrinking of the American productive machine has consistently reduced national income, creating the problem of how to run an economy based on mass internal consumption. It was therefore necessary to create *ex nihilo* a huge stock of means of payment to distribute in order to make the process viable. The goal was reached by putting at work a set of not regulated and therefore not coordinated entities, but the price was the overproduction of financial assets, technically defined as a bubble. By confining the inflation to real estate and financial assets, the general system, at the level of consumer prices, has been somehow insulated from the inflation threat. Being accustomed to exchange derivatives among them, bankers underestimated the danger, trusting in their technical skills to control millions of short and long positions and keep them inside specialized markets. In the long run, however, the sheer dimension of the sector⁹ made it impossible to continue separating the real economy from the virtual one.

7. A glance at the future

In the climate characterized by the worldwide economic crisis triggered by the 2007/2008 crash, Western banking & finance industry is now facing the threat of national – and supranational, in the case of the E.U. (European Commission, 2014) – legislation providing restrictions to its activity to avoid a future catastrophe. This obviously contrasts with the interests of the industry, which is strongly opposing new regulations and bans on new financial service "products". To prevent this from happening, they are actively lobbying in all national bodies, and also trying to shift the question to a wider level, promoting new agreements in the frame of WTO and outside it. This is

and treasury offices. It is made of stock phrases and words, perfectly integrated into the English language, which is rather imprecise.

8 Fein is a former senior counsel to the Board of Governors of the Federal Reserve System.

9 The analysis made after the crash show how the real dimension of the bubble was unknown to most operators. Estimates vary depending on the type of activities considered, and grow every time new phases of the process are taken into consideration. Including re-hypotecation, an IMF staff investigation for the U.S. revealed an amount of assets "larger than documented", estimated at more than \$10 trillion at Nov. 2007 (Singh & Aithen, 2010). A further IMF document (Pozsar & Singh, 2011) speaks of \$27 trillion at the end of 2007, reduced to 18 trillion at the end of 2010. But the "American sickness", as for re-pledged collaterals, was equally shared with European banks (*idem*: 11). An estimate for the phenomenon at world scale for the period 2003-2012 provides these figures: \$61 trillion in 2007 and 64 in 2010 (FSB, 2012). Taking for granted that SB is a set of businesses concerning the entire banking system, a further estimate, probably in excess, based on peculiar mathematical models, peaks at more than \$101 in 2003 and 61 in 2012 (Fiaschi et al., 2013).

the case of the Trade in Services Agreement (TISA), launched in 2012 by the biggest world debtor, the U.S., and aimed at a complete liberalisation of financial services from whatever national control. What is particularly worrying is the clause that the text of the agreement is to be kept secret for five years after its coming into force (Wikileaks, 2014).

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