FROM THE SHADOWS TO THE SPOTLIGHT
Shadow banking

Non-bank organisations are increasingly engaged in bank-like activities, filling the gaps that banks are leaving and finding entirely new opportunities, which has led authorities to take note and tighten up the regulatory and supervisory framework for the shadow banking system. Michael Imeson reports.

THE POPULAR TERM IS 'SHADOW BANKING'. It is the expression used by bankers, regulators, politicians and the press to describe bank-like activities – especially lending – undertaken by non-banking organisations such as insurance companies, hedge funds, money market funds, securitisation vehicles, consumer finance companies and securities brokers.

But it is not a description that is popular with shadow bankers and their supporters. Dr Pete Hahn, a banking lecturer at Cass Business School in London, sums it up well. "The menacing name 'shadow banking' should be replaced with the less ominous but more explicit term 'non-bank creditors'," he says. Non-bank creditors that are not linked to the banking system "offer us a welcome reduced dependence on banks", he stresses.

Most people, regulators included, would agree with Mr Hahn's second point, but not his point about changing the phraseology – the name has stuck and is used by none other than the Financial Stability Board (FSB), the Basel-based body that coordinates financial regulation and supervision around the world. The FSB insists that it attaches no pejorative sense to the name – it is simply the term "most commonly employed" – but it now has shadow banking firmly in its sights.

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GETTING TOUGH

In November 2012, the FSB published for public consultation a report on the potential regulation of shadow banking. The FSB defines the shadow banking system as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system, or non-bank credit intermediation, in short". It is looking at the issue from an activities-based (an economic function-based) perspective, as much as from an entities-based perspective.

Although there are non-bank activities that are not captured by the definition of credit intermediation, and which may pose risks to the financial system, the FSB makes it clear it is not seeking to regulate them at this stage. Non-banks carrying out equities trading and foreign exchange transactions, for example, are excluded from the proposals unless they form part of a credit intermediation chain.

The FSB believes the intermediation that non-banks engage in, if appropriately conducted, "provides a valuable alternative to bank funding that supports real economic activity". But it also notes that "experience from the crisis demonstrates the capacity for some non-bank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability", especially the extension of long-term credit based on short-term funding and leverage.

Whereas banks are subject to a well-developed system of prudential regulation and other safeguards, the shadow banking system is not. The FSB's objective, therefore, is to ensure that shadow banking is subject to stricter oversight and regulation to address bank-like risks to financial stability.

INSURERS AS LENDERS

Non-banks are entering new credit activities because they are seeking higher returns in an environment of ultra-low interest rates. But they are also being pulled into new areas by the exit of banks that are deleveraging or facing higher costs imposed on certain business lines by new regulations, such as capital and liquidity requirements. Insurance companies are becoming more active in the UK commercial property market, moving into the gap created by withdrawing banks. According to a report from law firm DLA Piper and the Centre for Economic and Business Research (CEBR), insurers will more than double commercial real estate lending over the next five years, bringing their total lending to borrowers in this market to £52bn ($83.6bn) by 2017.

Loans by insurers to commercial real estate borrowers will be typically medium dated, with terms of between seven and 10 years, and may feature higher loan-to-values than the current market norms of 50% to 65%, says the report.

"Because of the financial crisis and the Basel III capital rules, banks can no longer lend at the same competitive rates that they used to, and they are less inclined to lend," says Michael McKee, DLA Piper's head of financial services regulation. "As a result, it has become more attractive for insurers to lend, along with others such as property funds."

Emma Huepfl, director and co-founder of Laxfield Capital, which originates, executes and manages loans secured on UK commercial property on behalf of lenders, agrees that non-banks are increasingly active in this market. "We have been doing this since 1995 with bank clients, but since 2009 most lenders approaching us have been outside the banking sector, with insurance companies, pension funds, sovereign wealth funds and a variety of private equity funds and even high-net-worth individuals showing interest in the sector," says Ms Huepfl.

Laxfield currently manages loans for six lenders and has origination contracts with German bank MHB, MetLife and Cornerstone Real Estate Advisers (a subsidiary of the Massachusetts Mutual Life Insurance Company). "The loan appetite of our lenders ranges from £10m to £500m and for three to 20 years, so we see a broad range of deals," says Ms Huepfl.

HEDGE FUND INTERMEDIARIES

Alternative investment fund managers are increasing their involvement in credit intermediation through, for example, credit hedge funds which deploy a range of investment strategies including direct corporate lending.

Another path is the acquisition of portfolios of non-performing loans (NPLs) from banks. There is no shortage of banks keen to sell such portfolios to get rid of risky assets, cut their losses, improve their balance sheets and use the proceeds to boost capital reserves.

CarVal Investors, a subsidiary of US commodities trader Cargill, is one of many alternative fund managers that buys distressed bank loans at a discount from their face value. The objective is to manage the loans back to health better than the bank could hope to do, so that the sum of the improved loan repayments, along with the proceeds from any forced asset sales, exceeds the purchase price of the portfolio plus the costs of running it.

CarVal's NPL investments are in portfolios of industrial, commercial real estate, small business, consumer and residential property loans, from a variety of banks, ranging from small community banks to large financial institutions. Over the past 25 years it has managed 1300 NPL portfolios worth $7.9bn, mainly in the US and Europe.

"It is very much a core business for us, and the deal flow has picked up considerably in the past few years," says Jody Gunderson, a senior managing director at CarVal. "The best opportunities come from banks that have been recapitalised or bailed out, so that tends to be those in the UK and Ireland. We are also seeing a significant uptick in deal flow from US banks.

"Managing these loans is intensive from an asset management perspective, more so than managing distressed securities. We have to recover on the individual loans by negotiating with the borrowers."

Recovery can mean foreclosure and repossession of property or a call on collateral assets, but that is the least favoured option. For borrowers in real trouble, CarVal prefers to restructure the loans by, for example, extending the repayment term or even forgiving some of the principle.

SYSTEMIC RISKS

These are only a small selection of activities from the shadow banking sector. But these, along with many others, are the target of the Financial Stability Board's proposed supervisory and regulatory framework which member countries will eventually adopt.

In essence, the framework is intended to mitigate systemic risks and the 'spill-over effect' between the regular banking system and the shadow banking system. There is also a focus on reducing the risk of sudden outflows from money market funds, and dampening the dangers of pro-cyclical collateral calls associated with secured financing contracts such as repos and securities lending that may exacerbate funding strains at times of market stress. Finally, the FSB is concerned to align the incentives associated with securitisation, to avoid the negative selection of the securitised assets.

Meanwhile, the European Commission has taken steps of its own. In 2012, it issued a green paper on the issue for public consultation. Michel Barnier, the EC's internal market and services commissioner, is now considering what measures to take, but they are likely to mirror what the FSB is doing.

Despite all of this regulatory activity, gaps may still remain in the final rules. "The FSB's current recommendations on shadow banking are somewhat focused on specific mischiefs and could leave room for regulatory arbitrage between the shadow banking and banking sectors," warns Barney Reynolds, head of the financial regulatory group at law firm Shearman and Sterling.

On the other hand, Adair Turner, chairman of the Financial Services Authority and chairman of the FSB's supervisory and regulatory co-operation committee, and Paul Tucker, deputy governor of the Bank of England who also sits on that FSB committee, appear to want to deal with the broader issues in a manner that involves some level of conceptual consistency.

"If they get their way the eventual proposals may be something a little more radical, to prevent arbitrage. If you do not regulate shadow banks in a manner consistent with that for banks, there is enhanced contagion risk between the two sectors," says Mr Reynolds.

Shadow banking is here to stay. But it will be increasingly conducted in the full glare of the supervisory spotlight. TB

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