Shadow Banking-Should We Be Worried?

By Wes McComb

April 12, 2021

We get most of our ideas for articles from clients. The questions they ask us are usually on topics that other people would also like some answers to. This week I was asked about Shadow Banking and were there some risks to the financial system during the pandemic because of it? We answered him but thought maybe a written note expanding on that verbal answer would be of interest. Plus, the term shadow banking has that sinister, omnipresent feel to it which piques most people's curiosity.

First, we have to understand the strengths and weaknesses of our regular banking system and why there is even a need for shadow banking. There is one major, insurmountable problem in all banking and that is maturity risk. When we put a thousand dollars on deposit at a schedule A bank, that bank then turns around and lends out $15 000 dollars in longer term loans. This leverage of 15:1 combined with a demand deposit (meaning we should be able to get our 1000 dollars back anytime we want) turned into a long-term loan creates the possibility of a bank run. If a large percentage of depositors ask for their money back at the same time the bank may not have enough cash available to supply the demand. This can cause a panic. If rumours start that a bank can't settle then the ensuing rush can be self fulfilling and cause the bank to be insolvent. The one that comes to mind is in the classic movie It's A Wonderful Life when George Bailey, played by Jimmy Stewart, has a run on his small community bank.

This type of situation was frequent until the solution came about by the establishment of central banks. These politically independent government institutions provide the necessary liquidity to commercial banks in case of a panic. This government assurance combined with deposit insurance-in Canada the Canadian Deposit Insurance Corp (a federal Crown Corp)-has made bank runs a thing of the past. In exchange for this government backing commercial banks have accepted strict regulation.

Shadow banking came about to avoid this heavy regulation. The primary players would be insurance companies, some hedge funds, some private equity funds, mutual funds, some pension funds, mortgage brokers, structured investment vehicles, divisions of banks that are not regulated, and some people also include money market funds.

The primary investments in shadow banking are Securitizations. Securitizations are when pools of debts are put together and sold to investors. So Canadian Tire can pool all their credit card debt together and sell it to an insurance company or hedge fund. Or residential mortgages or commercial paper or corporate loans. The list goes on.

Like all financial innovations these securitizations made sense at the beginning. But initial success combined with greed and a disconnect between lender and borrower caused shadow banking to grow to the point that it was bigger than the actual real banking system. Increasing leverage, mismatching maturities and then derivatives on top of all of this eventually nearly caused the collapse in 2008 of the entire financial system.

After 2008, shadow banking nearly disappeared. However, new regulations governing it allowed a remarkable resurgence. Depending on how you measure it and what assets are included, it could be between $30 trillion to over a $100 trillion-dollar market worldwide. In Canada today it is almost two trillion dollars.

Though shadow banking is more regulated there can still be problems, as seen during the pandemic. Bond markets began to freeze up the spring of 2020 because there were so many investors trying to sell to get into cash that the traditional dealers began to be unable to offer bids-at guaranteed sell price. Central banks had to step in to provide that liquidity. So, once again shadow banking could have caused us all financial distress. The central banks are just now starting to unwind some of the purchases they had to make last year.

Yet, shadow banking has its place in the world of finance. It provides competition, caters to underserved markets and is a source of innovation. As it continues to evolve, the companies participating are attempting to revamp its image by changing its name to Non-Bank Financial Intermediaries (NBFI). I am sure that is the right move for a maturing sector, but it feels to me like the rock band Stillwater in the movie Almost Famous that sells out to the record label by giving up their old tour bus Doris for a new corporate jet. Some of the rich history of the sector is being sacrificed for anodyne reasons.

But shadow banking's history is not over. It is a growing and necessary sector. And not all the wrinkles have been worked out. There is some concern that China has let its NBFIs to get ahead of regulation and the sector could be setting up the Asian power for a scenario like the one we had in 2008. Just this weekend Chinese regulators fined Ali Baba 2.75 billion dollars and are scrutinizing Tencent Holdings.

Our banks have been stalwart corporate champions in Canada. They have avoided most of the world's financial excesses and are, for good reason, the envy of the rest of the world. But we also have some very large pension funds, insurance companies, investment funds and a myriad of smaller players that can offer different ideas and approaches to finance. This competition is healthy, and if we regulate properly and offer the right incentives to them, we can all benefit. So next time someone tells you that they work for a Non-Bank Financial Intermediary explain to them that you know they are a shadow banker and respect them for it.

Have a good week.