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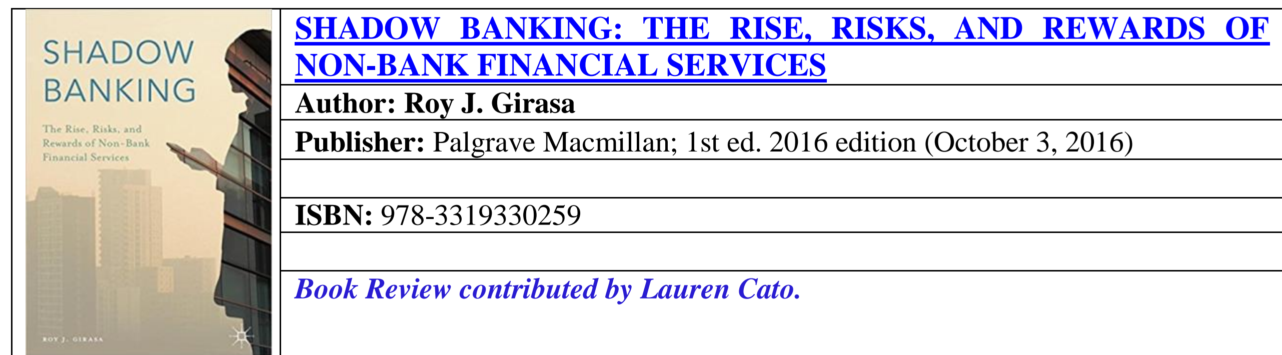

	SHADOW BANKING: THE RISE, RISKS, AND REWARDS OF NON-BANK FINANCIAL SERVICES
	Author: Roy J. Girasa
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	Book Review contributed by Lauren Cato.

The rapid development[1] of the shadow banking system has been a hot button topic among financial regulators worldwide as the sector has shown remarkable and sustained growth during the aftermath of the global financial crisis[2]. In fact, as part of its 2016 Global Financial Stability Report, the International Monetary Fund (IMF) found[3] the transmission of monetary policy to be slightly stronger in countries with large shadow banking sectors. This book is therefore a timely entry on the subject matter as it chronicles, as suggested by its title, the factors attributed to the sector's rise in prominence, the tenets of its operations and a comparison of shadow banking and traditional commercial banking.

The author, Mr. Roy Girasa, uses his legal expertise to expertly provide the reader with a comprehensive and comparative view of the regulations that govern both the traditional and shadow banking industries. The book is divided into three sections, the first of which delves into traditional banking as well as the Dodd-Frank Act and its impact. Part two examines shadow banking and its risks while part three explores the opinions, efforts and recommendations of several reputable international institutions and concludes with a discussion of possible future developments.

The term shadow banking was first used by economist Paul McCulley in 2007 at a financial symposium hosted by the Kansas City Federal Reserve Bank to refer to "*the whole alphabet soup of levered up non-bank investment conduits, vehicle and structures*". While shadow banks

1 Gorton and Metrick (2012) estimated that just before the financial crisis, the assets of the shadow banking system were at least as large as the assets of commercial banks. They further suggested that this could have been an underestimate as their comparison involved the assets of only a fraction of the shadow banking system.
2 The sector has seen more than $25 trillion in funds flowing through the system in 2015.
3 https://www.bloomberg.com/news/articles/2016-09-29/rise-of-shadow-banks-is-amplifying-monetary-policy-imf-says

have several characteristics that are similar to traditional banks, shadow banking differs as their services offered are not funded by deposits. Traditional banks utilize these short term deposits to fund their long term services whereas shadow banks mostly borrow short term funds in the money markets and use those funds to buy assets with long term maturities. This has allowed shadow banks to escape many of the stringent regulations that govern traditional banking.

There is a common perception that shadow banking is associated with illicit activities given that the word shadow has a negative connotation in this instance. However, the validity of the industry has been recognized. In 2011, the Financial Stability Board (FSB) noted that the advent of the term shadow banking reflected, "*a recognition of the increased importance of entities and activities structured outside the regular banking system that perform bank-like functions*". The author discusses in the Introduction, the several definitions of shadow banking previously employed and surmised that they are not comprehensive as they depend on the approaches scholars and organizations opine in examining the term. In this regard, he suggests the term refers to the broad range of financial services that in many ways are duplicative of traditional banking services but are exempt from both the onerous regulatory environment and from its consumer protective reimbursements in the event of losses.

In order to obtain a greater understanding of shadow banking, the book provides a thorough overview of traditional banking which gives the reader an excellent baseline to understand the dynamics of today's financial environment. The chapter "Traditional Banking in the United States and its Evolution as Bank Holding Companies" chronicles the advent of the US financial system as spearheaded by the nation's first Treasury Secretary Alexander Hamilton and the statutory enactment that initially prohibited the entwining of commercial and investment banking[4] and its subsequent repeal[5]. A justified emphasis is placed on the legal response to the financial crisis, the Dodd-Frank Act, as the regulations enforced[6] placed stronger restrictions on the traditional banking system and lead to the regulatory arbitrage[7] that ensured the growth of the shadow banking system.

Other factors that contributed to the progression of the shadow banking system include, inter alia, the increased demand for safe, short-term liquid assets larger than those provided by short-term government debt coupled with ample liquidity conditions (Claessens, Pozsar, Ratnovski, & Singh, 2012), the creation of safe assets through specialization and innovation in the composition of money given that shadow credit intermediation is an example of financial innovation embedded in the aggregate money supply (Adrian, Ashcroft, & Cetorelli, 2013). Duca (2014) found that changing information and reserve requirement costs in addition to shifts in the impact of regulations[8] on bank versus non-bank credit sources drives the shadow banking system in the long run while in the short run, shadow banking thrived when deposit interest rate ceilings were

4 The Glass-Steagall Act of 1933

5 Gramm-Leach-Bliley Act of 1999. Several critics argued that this repeal of the Glass-Steagall Act was a primary contributor to the financial crisis and have been vocal in advocating for the original law's return

6 The Economist (2014) noted that traditional banks are on the decline as they have been subjected to losses incurred during the financial crisis and beset by heavier regulation, higher capital requirements, endless legal troubles and severe fines.

7 Regulatory arbitrage is a practice whereby firms capitalize on loopholes in regulatory systems in order to circumvent unfavorable regulation. This is a hallmark of shadow banking.

8 For example, Basel I in 1990 and reregulation in 2010

binding, the economic outlook improved and risk premiums declined. The industry notably faltered when event risks disrupted financial markets. In contributing to the literature, the author identified further causes as being mispriced guarantees from government backstops and informational frictions in the securitization of subprime mortgage credit between several parties involved.

Given the context set above, the discussion veers to the author's main thesis of shadow banking potentially posing a systemic threat to the United States' financial system as is evidenced by the inherent risk loosely regulated banks posed during the 2007 crisis. Several facets of shadow banking activities involve a vast network of debt instruments that may be held at some point by the traditional banking sector and as such, credit intermediation has become more widespread and interconnected (Luttrell, Rosenblum, & Thies, 2012). The systemic risks of shadow banking is further exacerbated by several shadow banks being designated as systemically important financial institutions[9] (SIFIs) and is especially pertinent in light of the Dodd-Frank Act's main focus of preventing systemic risk to the financial system by entities deemed too big to fail. In this regard, the author details the International Organization of Securities Commissions' indicators of systemic risk at both the macro and micro level and offers a detailed explanation of the suggestions put forward by the FSB and the IMF to mitigate systemic risk.

The book's third chapter discusses the tenets of shadow banking that are covered by regulations and highlights the misleading view that the shadow banking system is wholly bereft of regulation. The Dodd-Frank Act does in fact contain authority for the regulation of shadow banks[10] which lays out prudential standards for both US and foreign non-bank financial companies determined to pose a threat to the financial stability of the USA based on its nature, scope, size, scale, concentration, interconnectedness or mix thereof. SIFIs of interest include any company, inclusive of foreign non-bank firms that are predominantly engaged[11], that had $50 billion or more in total consolidated assets at the end of its most recent fiscal year. Other significant factors include firms' exposure, asset liquidation, critical function or service and material financial distress[12]. Any firm found to be a SIFI is then subjected to enhanced prudential standards as a form of hedging against risk. The author engages the reader by illustrating the case of General Electric Capital Corporation Inc. (GECC) and debating whether its SIFI designation was of merit. As a result of heightened regulations, GECC notably decided to divest itself of most of its non-bank financial holdings which lead to the company's removal as a SIFI.

The types and processes of shadow banking including its four main areas: securitization, repurchase agreements (repos), hedge funds and mutual funds (with particular focus on money market mutual funds) are extensively deliberated in chapters five and six. Securitization is of utmost importance as it permits banks to concentrate risk on their balance which lends to risk

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9 A systemically important financial institution (SIFI) is a bank, insurance company, or other financial institution whose failure might trigger a financial crisis. The Financial Stability Oversight Council, as established by the Dodd-Frank Act, is responsible for determining which institutions are designated as SIFIs.

10 Section 113 of the Dodd-Frank Act entitled "Authority to Require Supervision and Regulation of Certain Non-bank Financial Companies.

11 A foreign non-bank company is predominantly engaged if the company's annual gross reserves and consolidated assets are 85% or more of the consolidated annual gross revenues and consolidated assets of the company.

12 Material financial distress is defined as when a non-bank financial company is in imminent danger of insolvency or defaulting on its financial obligation

taking being more profitable as well as allows financial intermediation by shadow banks to rely on securitization for external funding (Kolm, 2012). The author defines each area and illustrates their evolution in addition to providing a broad look at the corresponding US and international regulations. The comparison between domestic and foreign laws is especially illuminating as it also includes the views of the FSB, IMF and the European Union.

Insurance companies are the focus of a fascinating chapter seven that deftly looks at whether these firms should be classified as SIFIs via the use of real world examples. In contrast to traditional banking, insurance companies are generally state regulated[13] rather than being supervised by the Federal Reserve. The author begins by discussing the $182 billion dollar bailout of the insurance company AIG following the financial crisis. This case study emphasizes the failure of regulators to oversee the derivatives operations in addition to the interdependence of the financial system as the bailout effectively meant rescuing Goldman Sachs, Morgan Stanley, Bank of America, Merrill Lynch and several European banks from huge losses. The chapter continues with a look at the current predicament of the Metropolitan Life Insurance Company (MetLife Inc.). Regulators designated MetLife Inc. as a non-bank SIFI in December 2014 and the company has since initiated legal action against authorities to rescind the label. As a reader, understanding this incident proved to be beneficial as it demonstrated how non-bank companies are determined to be a SIFI, the issues initiated by the findings of the Financial Stability Oversight Council and the consequences of being a SIFI. The book concludes with a look at the international institutions[14] that affect shadow banking. It gives details about the organization, their views on non-bank industry and their recommendations for its regulation.

This book provides a fascinating, wide-ranging look at shadow banking and its effect on the US financial system. The author expertly crafts a compelling argument for authorities to consider imposing austere regulations on the relatively unregulated shadow banking system given the systemic threat posed. The publication of this book should be applauded as it will assist with providing the public with information that is unfortunately obscure and debunk the popular misconceptions regarding the industry. The book should be required reading for regulators and policymakers as the eloquent and in-depth discussion of the legal underpinnings of the financial system alongside the examples included will generate a focused and timely discourse.

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13 The McCarran-Ferguson Act of 1945 exempts the business of insurance from most federal regulation, including federal antitrust laws to a limited extent. The Act allows the Fed to preempt state regulations in specifically defined areas.

14 G20, FSB, IOSCO, EU, China and other national entities

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