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Road map that opens up shadow banking

By Gillian Tett
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This week, a senior banker friend gave me a poster that had been created by downloading a chart recently produced by economists at the New York Federal Reserve.* It was shocking stuff. Entitled *The Shadow Banking System*, the graphic depicts how money goes round the modern world, particularly (but not exclusively) in the US.

At the top lies a smart section labelled the "Traditional Banking System", in which a simple flow of boxes explains how investors' funds are deposited with traditional commercial banks, which then transform this into long and short-term loans, and equity.

So far, so comprehensible. But most of the poster is dominated by two sections called the "cash" and "synthetic" shadow banking systems, or those "financial intermediaries that conduct maturity, credit and liquid transformation without access to central bank liquidity or public sector credit guarantees", as the associated NY Fed working paper says. These flows are so extraordinarily complex that hundreds of boxes create a diagram comparable to the circuit board of a high-tech gadget. Even as poster size, it is difficult to decode.

But it should be mandatory reading for bankers, regulators, politicians and investors today. Indeed, they might do well to hang similar posters next to their desks, for at least three reasons. For one thing, this circuit board is a reminder of how clueless most investors, regulators and rating agencies were before 2007 about finance. After all, during the credit boom, there was plenty of research being conducted into the financial world; but I never saw anything remotely comparable to this road map.

That was a striking, terrible omission. The Fed now estimates that in early 2008 shadow banking was $20,000bn in size, dwarfing the $11,000bn traditional banking system. And though this shadow system has now shrunk to a "mere" $16,000bn, this remains bigger than traditional banking, at some $13,000bn. Little wonder, then, that so few people immediately appreciated the significance of the seizing up of shadow banking in 2007.

But secondly, this poster is also a reminder that many things about the modern financial system remain mysterious – even today. On the edges of the circuit board, the NY Fed economists list all the government programmes that have supported the system since 2007 (and, in effect, replaced shadow banks when they suffered runs). This "shadow, shadow bank system" – as it might be called – looks complex and baffling too. And in practical terms, the sheer breadth and complexity of that box makes it hard to know what will happen if – or when – government aid disappears.

Then, there is the current regulatory debate. So far this year, the Financial Stability Board and other international bodies have focused most of their reform attention on issues such as bank capital, and systems of oversight for large, systemically important banks. Next year, though, Mario Draghi, head of the FSB, wants to start discussing the shadow banking world.

Many national regulators are keen to do this too as they recognise the danger of looking at regulation just in terms of institutions. After all, the crisis has shown how risky it is to have $16,000bn worth of maturity transformation without any backstop, or clear rules. This week, for example, Adair Turner, head of the Financial Services Authority, the UK regulator, promised more scrutiny. Earlier this year Paul Tucker, deputy UK central bank governor, suggested that it was time to see which parts of the system were benign – or not.** The US government is now considering whether to extend the regulatory umbrella to large, non-bank institutions such as Citadel or GE Capital.

But whether this desire for a debate turns into sensible reform remains unclear. For getting politicians to focus on the issue may not be easy in 2011. There is already considerable regulatory fatigue. There are also other, more urgent distractions, such as the sovereign debt crises. And shadow banking issues rarely seem "sexy" in political terms, unless they involve hedge funds (which pose less systemic threat than, say, the vast $3,000bn-odd money market fund sector.)

So for my money, the best thing the NY Fed could do right now is print thousands of copies of that poster – and dispatch it across the world. I suspect it would be far more persuasive about the need for debate than any number of pious G20 speeches. After all, a key reason why that circuit board became so complex was that bankers were trying to arbitrage the last two sets of Basel rules. If shadow banking continues to be ignored (ie politicians focus just on the traditional banks) there is every chance Basel III will simply produce another complex labyrinth that will go largely ignored. Until the next crisis.

**Shadow Banking; FRB of New York Staff Report no 458; www.ny.frb.org/research/staff_reports/sr458.pdf. See Chart One, on page 2 and subsequent graphics, July 2010*

***Shadow banking, financing markets and financial stability, speech Paul Tucker January 2010.*

gillian.tett@ft.com