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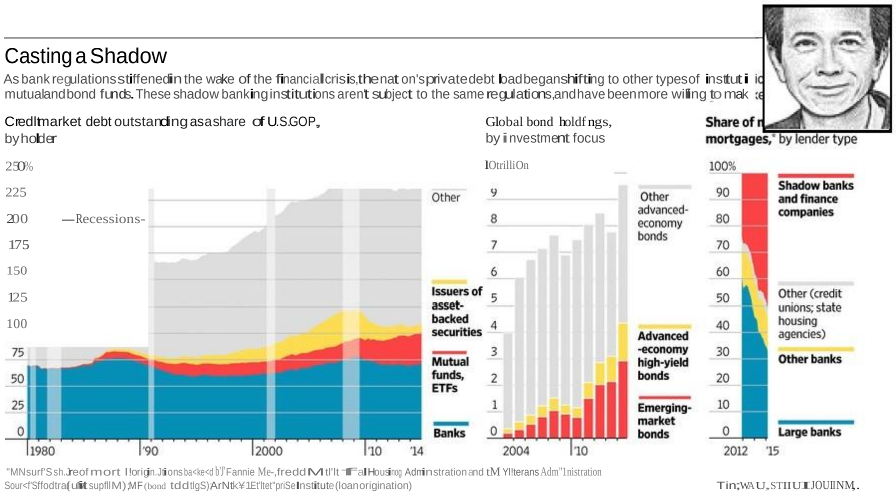
CAPITAL ACCOUNT

Post-Crisis Risk Casts a Darkening Shadow

Regulators' banking safeguards drive an increasing amount of financial activity away from conventional venues



By GREG IP

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Squeezing risk out of the economy can be like pressing down on a water bed: The risk often re-emerges elsewhere. So it goes with efforts to make the financial system safer since the financial crisis.

Officials have forced banks to bulk up their capital buffers, ditch dangerous lines of business and pay more than $100 billion in penalties for bad behavior. As a result, risky activity is migrating to the shadow banking system, where different threats may be growing.

Shadow bank is a catch-all label for any entity that supplies credit but doesn't fund itself with deposits as banks do. Shadow banks have long played a vital, innovative role in the U.S. Between 1980 and 2008, banks' share of the supply of credit to businesses and households in the U.S. fell from 44% to 20%. The rest came from finance companies, asset-backed securities, investment banks, institutional fund managers and government-sponsored enterprises such as Fannie Mae and Freddie Mac.

Shadow banks were central to the mortgage bubble. Subprime mortgages were originated largely by lightly regulated firms, bundled into securities and sold to opaque funds financed with short-term IOUs. When the subprime bubble popped, many died or shrank.

Banks have only partly filled the gap. Instead, the primary beneficiaries have been other kinds of shadow banks, such as exchange-traded funds and private-equity funds. The shift, according to an International Monetary Fund report issued Wednesday, stems from "tighter regulations on banks, rising compliance costs," and banks' "deleveraging"-reducing the ratio of their loans to the capital they have to absorb losses.

In some cases, this makes the financial system safer. Because most alternative lenders lack the safety net of deposit insurance or access to emergency cash from the Federal Reserve, they pay more to borrow. That is reflected in what they charge their customers: stiff interest rates, tough conditions and short maturities.

MORE READING

- IMF warns (Again) of Growing Shadow-Banking Risk (htlp:/lblogs.wsj.com/economicsi2015.104108Jimf-wams-again-of-growing-shadow-banking-risksl)
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Alternative lenders usually depend more on equity from shareholders or partners than do banks, and are thus less leveraged. "Business-development companies," for example, which make loans to small and midsize companies, typically use as much equity as debt. Private-equity funds make loans that are pooled into "collateralized loan obligations" and sold to investors.

In other cases, the effect on the financial system's stability is more ambiguous. Mutual funds and exchange-traded funds now rival banks as suppliers of credit, in particular "leveraged loans" to highly indebted companies. Total bond-fund holdings world-wide last year totaled $9.6 trillion, up 25% from 2008, according to the IMF. Mutual funds' leveraged loans have shot up 60% to $151 billion in the U.S., and by 223%, to $126 billion, in the eurozone.

These funds also finance themselves with shareholders' equity. But there's a wrinkle: Open-ended funds usually allow share redemptions at the end of each day, and sometimes during the day. If shareholders redeemed en masse, the effect would be similar to a run on a bank. While the fund wouldn't fail as a bank would, it might have to liquidate its investments.

The IMF notes these funds increasingly favor hard-to-sell securities such as emerging-market and corporate junk bonds, concentrate their bets and copy each other. This could generate contagion: *As* one fund dumps its holdings, it drives down the value of other funds'assets, triggering more redemptions and liquidations. The IMF found that big outflows from mutual funds that invest in emerging-market, high-yield and municipal bonds tend to depress those bonds'later returns.

In the wake of the mortgage crisis, traditionalbanks have pulled back from lending to homeowners. Here, a foreclosed home in Miamiin 2010. *PHOTO: JOE RAEDLEIGETTY IMAGES*

Big banks have also pulled back from mortgage lending to households. Since late 2012, the share of federally guaranteed mortgages originated by big banks has declined to 33% from 61%, while the share originated by finance companies-many small, stand-alone mortgage lenders-has risen to 51% from 24%, according to a report by the American Enterprise Institute, a think tank. Moreover, these companies have been much more willing to lend to customers with poor credit histories, who are more likely to default.

Why have banks retreated?' They took a big hit during the crisis from the bad publicity and huge fines,"says Steve Oliner, one of the authors of the AEI report."They have other lines of business besides mortgage lending where they can make money."

Shadow banks are more specialized, have shorter expected life spans and have less reputation to lose if the loans go bad. Since the loans in question are federally guaranteed there is little threat that a wave of defaults will set off a panic, as happened with subprime loans. But, Mr. Oliner says, it could still saddle taxpayers with steep losses and devastate many low-income borrowers.

Regulators have responded by tightening oversight of shadow banks, for example, by forcing some to submit to bank-like regulation.

But that may not be enough."The financial-services industry is a shape-shifter/'Paul

Tucker, a former deputy governor of the Bank of England, warned last year. It continuously seeks out gaps in the rules, leaving "policy makers in a game of catch-up..a game that sooner or later the authorities would lose."

As policy makers tighten the regulatory net around banks, they should keep this dynamic in mind, lest they end up with safer banks and a less safe financial system.

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