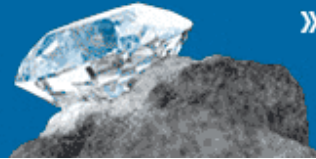


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FINANCIAL NEWS



No need to fear the shadows

Roy C Smith

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With the big banks under the boot of the regulators, tucked up with tougher capital ratios, trading restrictions and deferred incentives to rein in recklessness, some bank chief executives and academics have called for similar restrictions on the “non-bank monsters” of the shadow banking system where dangerous, unregulated risks are said still to reside.



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A shadow banker is anyone who participates in the lending of money or its near equivalent. These would include financial intermediaries, off-balance-sheet investment vehicles and hedge funds, as well as institutional asset managers.

Altogether, global institutional investors managed about \$150 trillion of securities and derivatives in 2009, compared with about \$95 trillion for all banks.

But the idea that the next meltdown will occur in the widely distributed shadow banking sector is nonsense, now that its riskier aspects have been addressed.

The five systemically important US non-bank intermediaries – investment banks – were dissolved by the crisis: Lehman Brothers failed, large banks acquired Bear Stearns and Merrill Lynch, and Morgan

Stanley and Goldman Sachs turned themselves into banks. The [Federal Reserve](#) now regulates them all.

Heavily regulated

Fragile off-balance-sheet innovations, notably conduits and structured investment vehicles created by banks during the credit boom, have been captured by consolidated regulatory reporting since the financial crisis, so these are no longer lurking in the shadows.

Hedge funds have not proved to be a threat. Most outperformed market indices during the crisis, though about 2,500 hedge funds went out of business subsequently with hardly a ripple of public attention.

Today there are more than 9,000 hedge funds that hold about \$2 trillion of assets. Dodd-Frank now requires them to be registered and to report their size and other information about their holdings.

We are often reminded of the fate of [Long-Term Capital Management](#), the hedge fund that failed in 1998, which, because of its large size and interconnectedness, was thought to have presented an important systemic risk.

LTCM's head, John [Meriwether](#), certainly made such a claim at the time, and the New York Fed held meetings with bankers to look into it, but the urgency quickly disappeared when LTCM was bought out by a group of Wall Street firms, topping an offer made by Warren Buffett, [AIG](#) and Goldman Sachs.

There was no bailout of any kind by the Fed or the US government and only LTCM's partners and investors lost money. Despite the fact that hedge funds were much larger and more numerous in 2008 than a decade earlier, no hedge fund was then considered to pose a systemic risk.

The heart of the problem remains the 10 largest banks that manage about 75% of global capital market transactions. These banks averaged \$1.8 trillion in total assets in 2010, with the top five averaging \$2.4 trillion, nearly 50 times the Dodd-Frank measure for systemic risk.

Few shadow non-banks come close to the \$50bn in assets that Dodd-Frank declares to be the key threshold among US banks. There are only about 40 US banks with assets of more than \$50bn.

Probably not more than 10 US non-bank financial companies control assets worth more than this figure.

The largest mutual fund managers, [Fidelity](#) and Vanguard, each managed about \$1.5bn at the end of 2010 in highly diversified, liquid securities in hundreds of different funds; the total assets of [General Electric](#) were \$750bn; Metropolitan Life manages \$330bn in customer accounts; Berkshire Hathaway's assets were \$300bn and BlackRock's, \$178bn.

All these are covered by Dodd-Frank and some soon may be designated as "systemically important" by the [Financial Stability Oversight Council](#) and thus become subject to regulatory risk limits similar to the large banks.

Overall, the shadow banking system does not present much by way of systemic risk to the financial system because it is so widely distributed over so many different types of risk, trading strategies and independent managers.

The world's largest banks remain too big to fail despite regulatory and political efforts to deny such a category still exists. To be sure they don't fail, regulators in the US and Europe have decided to

make them “fail-safe” by imposing extra heavy capital requirements and restricting some trading and other activities.

Reduced risk

Assuming regulators are more alert than they were last time, these banks will be unable to take on life-threatening exposures in loans or marketable securities.

They are being driven to become the solid, sensible public utilities of finance at the centre of a system that distributes risk to thousands of institutional investors with different appetites for risk that operate beyond the centre. Bank executives, of course, wish to resist being turned into public utilities.

The transfer of risk from the centre of the system, where it is concentrated, to its outer edges, where it is widely disbursed, has been one of the important safety features of the global financial system that has developed through capital markets over the past 40 years.

The system must be protected against another meltdown, principally by restricting the biggest banks, but the capacity of capital markets to generate competition and innovation needs also to be preserved. For this the shadow banks should be welcomed, not feared.

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