

## Explainer: shadow banking and where it came from

Written by The Conversation

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The term “shadow banking” often has connotations of dodgy lending and borrowing practices, out of reach of regulators. And while its use may contribute to risk, in reality shadow banking does serve a purpose in our economy, one that is increasingly connected to our day-to-day lives.

Shadow banking affects not only the property market, but also superannuation, central banking policy and, increasingly, fiscal and social policy. It refers to the non-bank financial intermediaries that supply services similar to commercial banks.

This system provides funding for credit, by converting risky and long-term assets that can't be sold quickly or easily (like mortgages) into a money-like, short-term debt (like mortgage-backed securities).

Shadow banking is not a bank in the sense that we know it but more a strategy or accounting technique. A range of institutions deploy these strategies including superannuation funds, insurance companies and [local governments](#) . Asset managers, like Macquarie Group in Australia and BlackRock in the United States, also employ these techniques.

In short, shadow banking provides institutions the means to create accounting entities to isolate risks, transfer profits, avoid regulation and increase the range of money-like financial products available for investment.

### Where shadow banking came from

There are both supply and demand reasons for the emergence of the shadow banking system. Shadow banking has emerged as a means for financial firms to bypass regulation (for example by using tax havens) and increase opportunities for financial innovation and speculative activity.

Banks have an incentive to lower the number of risky assets on their balance sheets, in order to reduce the amount of capital they need to hold to cover these risks. Because of this the banks create off-balance sheet entities (assets that use shadow banking).

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Shadow banking also offers a means for investors to access different forms of money across the financial system. Institutional investors trade in volume, and cannot physically [“handle billions in cash in the form of currency”](#);

This type of finance is normally best met by Treasury bills and government bonds (which presently offer low returns) and repurchase agreements - a form of short-term borrowing in these sorts of bonds. The shadow banking system then fills the gap in the absence of availability of other secure assets.

However these supply and demand explanations only tell part of the story.

The global environment is characterised by a [small population](#) ) of individuals and institutions with large pools of money seeking safe returns; and, cash-poor individuals with stagnant incomes and a need for credit. One example of this is the growing investment class of securities based on private debt, for example credit cards, mortgage debt and [small business loans](#)

Low inflation across the globe and governments not spending or encouraging investment in assets that offer good returns, means investors are limited in the ways they can currently make money.

## The problems with and solutions for shadow banking

Shadow banking has made the task of governments more difficult. However it would be mistaken to assume that governments do not have some control over shadow banking. All levels of government are already linked to aspects of shadow banking whether they like it or not.

[Local governments](#) were stung by exposure to shadow banking practices in the lead up to the global financial crisis. Councils were persuaded to invest in a structured financial product that offered unrealistic, and deceptive returns.

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The NSW government is currently following shadow banking trends by borrowing and [partnering with asset managers](#) to build long-term infrastructure like Westconnex and the Sydney Light Rail.

At the national level, the Rudd-Gillard Government followed trends that originated in shadow banking by developing institutions like the [Clean Energy Finance Corporation](#) and the National Broadband Network. Both policies tried to diversify the investment base in Australia, but have been held up by the Abbott-Turnbull governments.

Australia can't do much to remedy global uncertainty. However, policies it pursues do link into shadow banking practices in multiple ways.

Policies that erode the standard employment relation and [cut pay rates](#) increase consumer demand for [short-term credit](#) products. This increases private debt for consumers, but feeds its attractiveness into an asset class for institutional investors.

Reserve Bank of Australia Governor, Phillip Lowe, was surprisingly strident in his [critique](#) of the cut to corporate tax rates and negative gearing last week. Reading between the lines you can sense frustration with the lack of attention on how Australia stands to benefit or lose from current global investment trends.

Institutional investors don't need more piles of cash (via company tax cuts), they need ways to invest it. If you think about Australia from the perspective of institutional investors, it lacks a diverse range of assets (besides property!).

Australia only registers [17 specialised goods industries compared](#) with 35 for New Zealand and 44 for Canada. Consequently, real estate and infrastructure debt are some of the only things available to sop up the pile of [cash](#) currently sloshing around the global economy.

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This leads to [claims](#) that self-managed super funds (those run by institutional investors) are potentially exacerbating Sydney and Melbourne's already expensive property market.

There are three growing areas of shadow banking: catastrophe bonds, which bet on the risk of natural disasters; renewable energy infrastructure banks, and [build-to-rent](#) investments. These examples offer the two sides of shadow banking.

Catastrophe bonds are parasitic in the way they provide finance - betting on the destruction from disasters. Renewable energy and build-to-rent show the potential for using finance for potentially progressive outcomes, to provide sustainable energy and housing. Australia could harness this progressive side of finance to create a more diverse economy.

*Huon Curtis ne travaille pas, ne conseille pas, ne possède pas de parts, ne reçoit pas de fonds d'une organisation qui pourrait tirer profit de cet article, et n'a déclaré aucune autre affiliation que son poste universitaire.*

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