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We need to deal with regulatory blind spots in the financial system

The power of hedge funds and other shadow banks continues to grow – and with it the risk of a renewed crash

In its '2023 Global Investment Outlook', BlackRock paints a gloomy picture. The world's most powerful asset management firm forecasts a painful recession and an unstable environment for investments. Contrary to what many investors assume, they would not be able to count on the support of the central banks in an emergency. What this seemingly frank assessment neglects to mention, however, is the considerable systemic risk posed by 'shadow banks' such as BlackRock itself. In December, the President of Germany's Federal Financial Supervisory Authority *(Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) expressed his concern at a lack of regulation around 'non-bank financial intermediaries' (NFBI), while the Bank for International Settlements in Basel was already sounded the alarm about the growing risk from financial services companies a year back.

But what are shadow banks and what makes them so dangerous? The term applies to participants in financial markets such as monetary market funds, hedge funds and other investment funds, as well as credit insurers, all of whom provide some banking services without actually being banks. Like banks, they can lend money and provide wealth management. Unlike banks, however, they cannot create money. Banks do this by booking deposits, which in turn increases the sum of money in circulation. Shadow banks are also unable to borrow money from central banks. Lastly – and crucially – shadow banks are, unlike traditional lenders, not subject to banking regulations.

The threat posed by shadow banks

In principle, it makes sense to bundle assets of individual investors in order to enable larger investments. The problem arises when the structure of these funds is opaque and it becomes impossible to understand the purposes to which the managed wealth is being put. Furthermore, the low interest rates of recent years have pushed investors seeking ever-higher returns to select riskier forms of investment. It is for this reason that there have been repeated warnings that financial regulatory authorities are not keeping a close enough eye on NFBIs – and this at a time when shadow banks have become even more powerful forces on the market. In 2019, funds and insurers managed almost half of all global financial wealth, placing them tangibly ahead of established lenders and investment banks.

You don't have to go all too far back in recent history to find an instance of fatally underestimated systemic risks in the financial sector, throwing the industrialised economies of the globe into a deep recession: in 2023, it will be exactly 15 years since, the collapse of Lehman Brothers on 15 September 2008, at the height of the financial crisis. The fallout from the implosion of one of Wall Street's eldest and most renowned investment banks was devastating – and its effects have remained tangible to the present day. Even an unprecedented rescue package of $ 700 bn, put together by the Bush administration to stabilise the banking sector, was not enough to prevent a global financial crisis. This led to a sovereign debt and banking crisis as well as a broader economic crisis which, just over a year later, would go on to shake the euro area to its core. International trade stalled and millions of jobs across the world disappeared.

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In the US alone, the total economic loss over the decade following the crisis is estimated at around $ 70,000 per capita. Yet, what is harder to quantify is the loss of trust in political figures revealed to be helpless against the destructive power of an unchained financial system whose sheer size and relevance meant that its participants were considered 'too big to fail', meaning they could not be allowed to go into insolvency as the consequences for the international financial system and the wider economy would have been even worse. It was the dissatisfaction at the way these banks were rescued through taxpayers' money and at the concentration of global financial wealth in the hands of a small group of super-rich individuals which mobilised the worldwide 'Occupy Wall Street' demonstrations. United behind the slogan 'we are the 99 per cent', protesters demanded better regulation and a recoupling between the economy and international finance.

At first, it appeared as if the international community had learned its lesson. At the 2009 Pittsburgh G20 Summit, the assembled heads of government condemned the 'era of irresponsibility' and introduced regulations which should prevent banks from entering into high-risk transactions. In the US, the Obama administration passed the Dodd-Frank Act, a piece of legislation to ensure stability in financial markets, increase transparency and clarify responsibilities while setting limits to public money being used to bail out financial lenders. In the European Union, a broadly unified approach was taken to regulating banks, with a key plank in legislation consisting of EU-wide capital requirements for lenders to insure themselves against risks. In addition, a suite of instruments was put in place to regularly evaluate the effectiveness of these reforms. There was a lot of public support for the idea of a tax on financial transactions intended to decrease the speed of trades, render speculation unattractive and recover some of the costs of the rescue packages from the sector. Acclaimed as a 'tax against poverty', income generated from the instrument would, so the idea, be used to invest in sustainable development initiatives. Yet, to this day, powerful lobbyists have succeeded in preventing its introduction.

Need for regulation

Even if some of the measures applied were lifted again quickly once Donald Trump came to power, when compared to the situation in 2008, banks today operate in a markedly stricter legislative environment. For shadow banks, however, things are quite different, even though they offer banking-style services and continue to deal in the kind of opaque financial instruments which led to the 2008 crisis. The systemic relevance of NFBIs nowadays can no longer be ignored. There has been an extreme concentration of market power around the three largest 'Big Three' asset management companies: BlackRock, Vanguard and State Street. In 2022, they controlled 79 per cent of the US market for exchange-traded funds (ETFs), with BlackRock alone booking over $ 8.5 bn of assets under management – twice the gross domestic product of the world's fourth-largest economy, Germany. What is more, Black Rock operates in a variety of roles, further cementing its market heft: as well as its wealth management activities, the firm is also a major shareholder in all of Germany's DAX (German stock index) -listed corporates, for instance, while also offering consultancy to central banks and, in the form of 'Aladdin', operating a gigantic platform to analyse markets and companies' data.

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Similarly to the banks in the financial crisis, these wealth management funds have now become 'too big to fail': when investors began to move their money out of monetary markets during the Pandemic and the shadow banks' business model started to look shaky, massive central bank support was quickly forthcoming. And yet, thanks to aggressive lobbying, shadow banks have still not been classified as systematically-critical by the relevant international body, the Financial Stability Board. In the view of economist Daniela Gabor, shadow banks are comparable to nuclear power stations in that they 'are perhaps necessary, but also prone to catastrophic system failure'. She further warns of the growing importance of shadow banks in low-wage economies – especially in providing development loans. In view of an acute sovereign debt squeeze, this latter issue could prove problematic: 15 years after the financial crisis and in the wake of a global pandemic, more than two-thirds of all countries worldwide are critically indebted.

Here, close attention is required: as debt soared in 2009, it was speculation on increases in yields on state bonds which triggered the euro crisis. Now, in the face of the Covid-19 pandemic and the war in Ukraine, private capital has been continually withdrawn from developing countries, and despite regulations in the banking sector, global wealth disparity has further increased. According to estimates by Oxfam, in 2009, the poorer 50 per cent of the global population had assets equal to those of the 380 wealthiest individuals in the world; 10 years after the Financial Crisis, this group had declined to just 26 multi-billionaires.

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In Germany, the pressure group *Bürgerbewegung Finanzwende* argues for structural reform to financial markets which it considers outsized and has produced a comprehensive range of measures to regulate and unpick shadow banking structures. These include using competition authorities to limit the market power of wealth management firms and break the 'Big Three's' oligopoly. The initiative is also demanding that shadow banks be placed under the direct supervision of the European Central Bank, that opaque fund structures are put through a thorough examination prior to being authorised, and that monetary markets and credit funds beyond the core principles of investment funds be outright forbidden. In the proposed model, a central bank safety network funded by subscription fees would be on hand to ensure that open funds provide their own liquidity reserves. The initiative also proposes a range of measures to untangle different business areas, preventing conflicts of interest and distortion to competition. In order to provide alternative investment options, it wants to see public funds created along the lines of the Swedish model. In the Netherlands, the Centre for Research on Multinational Corporations (SOMO) has provided a catalogue of recommendations on how to reduce the risks shadow banks pose to highly-indebted countries and emerging economies.

The next crisis has already been in gestation for some time. In late 2022, Nouriel Roubini – who, through his prediction of the 2007/2008 crash beforehand had earned himself the moniker 'Dr Doom' – warned that an explosive cocktail of economic, financial and debt crises are set to combine into 'the mother of all economic crises'. Fifteen years after the collapse of Lehman Brothers, it is high time the lessons from it are finally learned and regulatory blind spots dealt with. There is no shortage of good suggestions on how to bring the systemic risks of the shadow banking sector under control, and the concept for a tax on financial transactions – prepared years ago – is just waiting to be taken back out of the drawer and put back on the agenda. Banking regulation since 2008 has shown that politics can shape markets: finance is not a force of nature to whose whims all humanity must remain subject.

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