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Reviews

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GLOBAL RISK – MONOGRAPH REVIEW

Jan Krzysztof Solarz, *Shadow Banking. A Systemic Financial Innovation*
Wydawnictwo SAN, Warszawa–Łódź 2014

1. THE GROWING POTENTIAL OF SHADOW BANKS

The parallel banking sector is still growing; however, less research and fewer publications are dedicated to it than to the banking sector. Jan Krzysztof Solarz takes up this subject in his latest book, whose strongest points include unique information, new statistics on the global approach and important references to the Polish reality.

In 2011 these entities had the following financial assets at their disposal (in billion dolars): on the global scale – USD 67 billion, in the USA – USD 23 billion, and in the Eurozone – USD 22 billion[1]. At the same time, the assets of the regulated banking in the USA amounted to USD 13 billion in 2011, whereas those of shadow banking

Were USD 8.5 billion. The share in the general financial intermediary activity of the non-bank intermediaries dropped from 27% in 2007 to 24% at the end of 2012. The intermediary activity of non-bank institutions is the equivalent of 117% of GDP of 20 countries and the Economic and Monetary Union. In 2007 this figure stood at 125%.

The book's author considers the financial sector to be oversized, as an excessively extended financial sector is deemed to be one in which its assets exceed 100% of GDP. When the size of the financial sector exceeds the needs of the real economic sector, then space opens for extraordinary profits and extreme populism – notes the author (p. 8).

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1 *Shadow Banking: Scoping the Issues*, Financial Stability Board, Basel 2011.

2. BROAD OR NARROW MEANING OF SHADOW BANKING

In the Polish and foreign literature there are many definitions of parallel banking, and some authors define it through an object approach (a list of institutions), including insurance companies and financial advisory services, which is subject to discussion. The analyses and opinions presented in the work in question would be more understandable if a comparative analysis of notions and definitions from the literature was conducted at the beginning. These definitions appear in different places in the publication, and synonyms such as shadow banking, non-banking, parallel banking or para-banking are incidentally treated even as ideas with only slightly different meaning. The author did not consider the analysis published in this regard by W. Szpringer, who offered a broad definition; likewise, McCulley, who in 2007 defined *shadow banking* as a "big segment of financial intermediary activities, which is located beyond the balance sheets of regulated commercial banks or other deposit institutions"[2]. Finally, J. K. Solarz offered his own, broad definition, which I consider to be very interesting, though, incomplete (e.g. payment service companies or Provident do not use deposits), i.e.: *Parallel banking is a financial intermediary service using the functional equivalents of deposits to gain a competitive edge over the remaining participants of the regulated banking sector. It is a systemic financial innovation. Its essence consists of stretching hidden public or private guarantees over the depositors of functional equivalents of deposits* (p. 109). It could be assumed that equity is also an equivalent of deposits, but this is probably too far-fetched a presumption.

However, the definition of a para-bank cited by I. Góral is rather erroneous, as it in fact refers to pyramid schemes (p. 36).

3. THREATS TO STABILITY

The coexistence of both forms of the financial system leads to many unexpected external effects – claims J. K. Solarz. Firstly, the relative size of shadow banking determines the stability of the financial system. If it is relatively small compared to the size of the secondary market for its assets, then the banking system is stable. If it is large, however, then the financial system becomes fragile. Secondly, when regulated financial intermediaries establish shadow banking themselves, its scale does not have such negative consequences for the stability of the financial system. Thirdly, when legal arbitration appears, then the safety network for the financial system may turn out to be inadequate in order to prevent the occurrence of systemic risk. In my opinion, a fourth aspect should be added here, i.e. the

[2] P. McCulley, *Teton Reflections*, PIMCO Global Central Banks Focus, no 9/2007.

appearance of unfair financial practices, such as financial pyramids, the black market for loans, etc., which jeopardize the financial security of households[3].

“We lack the time distance indispensable for mature reflection and disclosure of all actors and interests standing behind the development of parallel banking,” writes J. K. Solarz. For supporters of the exogenous theory of money, parallel banking is an attempt to weaken the financial discipline, an innovation directed towards limiting it. For supporters of the partly endogenous nature of money, parallel banking is natural feedback preventing arbitrary imposition of the state’s interest at the expense of the remaining actors on the financial market.

Parallel banking obviously increases the risk of a financial system if its activities are not transparent, it is not monitored and causes asymmetry of information. According to the author of the monograph: “The work on establishment of the Macroeconomic Financial Stability Board in Poland has become a good opportunity to review once again the question of risk management of the financial system. The Board’s priority task should be to investigate the substance of parallel banking and to specify its influence on the stability of the financial system in Poland. The present work constitutes a contribution to such indispensable studies. One must not use myths or stereotypes in financial system risk management. An in-depth, comprehensive analysis of this systemic financial innovation is indispensable.” (from the Foreword).

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In the first chapter, the author explains the notion of parallel banking (shadow banking) as product innovation, as process innovation, and parallel banking as attributional innovation. The author concludes, inter alia, that the final products of parallel banking are structured financial products and the functional equivalents of deposits – this list is far from complete (p. 28). The second and third chapters present the origin of shadow banking and statistics, with much unique data. The case studies presented are exceptionally valuable, one of the Bank of England and other. Some interesting deliberations on the function of lender of last resort lack the conclusion that contemporarily central banks offer this exclusively to classic banks. In the following chapter, theoretical aspects, including a review of research on parallel banking, systemic innovations and substitutes of deposits, are presented. The fifth chapter deals with the financial engineering used by para-banking entities.

The sixth chapter synthetically presents arguments concerning regulation of the shadow banking sector, including those in favour of abolishing regulatory arbitration and steps undertaken towards limiting negative external costs of the existence of parallel banking by the international community. The author points

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3 P. Masiukiewicz, *Piramidy finansowe*, PWN, Warszawa 2015.

out that the parties to a transaction are often unable to specify which court is to solve their potential disputes, and what type of proceedings need to be undertaken. A new phenomenon is the scale of tax optimization (tax havens, etc.). According to the author of the monograph, one of the ways to curb this is to introduce light-touch laws into the financial services, e.g. good practices (professional, corporate, industry-related).

Chapter seven presents systemic premises for considering parallel banking a natural reaction to the complexity and globalization of the contemporary financial system. It is simultaneously an attempt to systemize the relations between the financial system risk and parallel banking. Parallel banking is not the reason for the materialization of systemic risk, but only a premise for its appearance, thus it is necessary to search for a solution satisfying the market needs in the conditions of its excessive regulation. The illustration of theoretical reflections is the situation of parallel banking in China (the boom of parallel banking for the richest is, at the same time, a litmus test allowing an assessment the political situation in that country).

The last chapter presents parallel banking in Poland[4]. J. K. Solarz poses the following questions: What types of financial services can be considered to represent shadow banking? What perspectives are there for shadow banking in Poland?

He also conducts some pertinent criticism of the authorities regarding the lack of decent statistics conducted for this sector (p. 191).

The author of the monograph has confined his analysis to parallel banking acting de lege artis; thus it does not include activity on the black lending market and financial pyramids, whereas omission of an analysis of payment service companies constitutes a certain deficiency. These companies have been a problem for authorities in recent years (bankruptcies, siphoning off resources) – for this reason a European Committee directive was passed in this regard, and in Poland an Act on Payment Services was adopted. The issuance of bitcoin, which is becoming a global problem and has been called a financial pyramid by N. Roubini[5], was not raised in the monograph, either.

Several passages of the publications raise reservations as to their relevance to the subject matter, for example the discussion of the history of money (pp. 10–15), table 2.2. (in Chapter 2)and initial public offerings (p. 91). The deliberations on the socially rational financial lever and on the good and bad lever (p. 100 and further) are debatable – the theory of financial lever only specifies economic efficiency (hence, for example, the problem of over-indebtedness and losses of enterprises). The statement that parallel banking is not under the supervision of numerous

[4] K. Kozak, *Miejsce Shadow Banking w sektorze bankowym*, Prace Naukowe Uniwersytetu Ekonomicznego we Wrocławiu, nr 311/2013.

[5] *Dr Zagłada atakuje bitcoina. „To piramida finansowa”*, http://tvn24bis.pl/informacje,187/dr--zagłada-atakuje-bitcoina-to-piramida..., accessed on 13.05.2014.

regulatory bodies (…) is also outdated – after the subprime crisis, both in the USA and in the European Union, regulation and supervision were expanded to cover some of the shadow banks (the Dodd-Frank Act in the USA allowed FED to supervise any institution which can threaten financial security). In Poland the regulations and supervision covered co-operative credit unions and payment service companies. Moreover, SKOK credit unions were statutorily included in the deposit guarantee system, and the payment service companies were obliged to insure cash transactions.

4. CHINESE SHADOW BANKING – A POLITICAL OR ECONOMIC PROBLEM?

The problem of parallel banking is growing quickly in China; national and local financial pyramids have started to appear. It seems the authorities have noticed this problem (J. Solarz also indicates this); however, without clear decisions by the Communist Party of China it will not be comprehensively solved. Because of the few publications available on Chinese shadow banks, it is worth devoting this example some more attention (it. 7.2 of the monograph).

The parallel banking sector in China includes the following:

a) non-banking institutions such as financial corporations, trusts and brokerage houses (UDS 250.76 billion),
b) non-financial institutions such as pawn shops (12.79), lending companies (24.52), venture capital (USD 5.67 billion),
c) private equity companies (USD 19.61 billion),
d) remaining informal financial institutions[6].

In recent years lending co-operatives and pawn shops have been of great importance (at 2012 year-end there were 6,084 pawn shops operating, and the total value of collateral amounted to USD 11.23 billion). The estimation for parallel banking in China in 2011 was EUR 596 billion. Only one fifth of this parallel banking activity is realized outside credit institutions. This would mean that nearly 80% of parallel banking is, directly or indirectly, controlled by the state authorities. The People's Bank of China assessed the scale of parallel banking at RMB 28.8 trillion in 2012, the Guangfa Securities Brokerage House estimated this sector in China at RMB 30 trillion, JP Morgan Chase at RMB 36 trillion in 2013[7].

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6 Data for 2010 cf. L. Min, *Shadow Banking Activities and Its Supervision in China*, China Banking Regulatory Commission, Washington, 2011.

7 N. Borst, *Shadow Deposits as a Source of Financial Instability: Lessons from the American Experience for China*, Policy Brief Peterson Institute for International Economics no 13/2013.

The parallel banking risk in China is connected with private banking. Managing the assets of this customer group in 2012 required the issuance of derivative financial instruments of a value exceeding the newly-granted bank loans (yuan 20 trillion). According to J.K. Solarz, in China the systemic risk of parallel banking does not appear as an external cost of credit securitization, because the advantage of backwardness protects China against this type of threat. The main source of systemic risk to parallel banking in China is managing the financial assets of the richest citizens of that country[8]. China has officially notified the Financial Stability Board that it was preparing an operational definition of ***shadow banking*** and a regulation strategy according to the Board's guidelines.

J. Solarz notices that the majority of texts on parallel banking in China perform a propagandist function and prophesy crisis. According to other reviewers of the Chinese economy, the advantage of backwardness of the Chinese financial system protects the country against the negative consequences of the development of parallel banking. Since 1979, a grey area has existed in China for personal loans and credit for small and medium enterprises. The risk of this market is diversified and does not constitute a threat of a systemic nature (p. 176). In the absence of a comprehensive diagnosis, it is advisable to subject trusts, management of well-to-do Chinese's assets, securitization, micro-financial funds and financial intermediary activity to regulations and supervision - there is no clear attitude towards shadow banks.

The bureaucratic reaction to the appearance of parallel banking is not based on the risk map – says J. Solarz. The central place on a professionally prepared risk map is occupied by trusts. At the end of 2011 the functioning of four quasi-trusts for residential real estate, which invested and managed state-owned real estate, was suspended. Another problem is the guarantee funds which have infected a significant part of the official financial sector of China (p. 178). These examples, in my opinion, should be complemented with one more significant illustration, i.e. ROSCAs peer- to-peer lending; many local associations which operated according to the rules of financial pyramids were closed down by the authorities, the majority of them between 2010–13[9]. Informal loans in China, as the author cites, amount to approximately yuan 3.5 trillion(p. 180).

According to information released by the Chinese authorities, the risk of parallel banking amounted to about 16.3% of GDP in 2013, which was less than in the European Union.

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8 S. Hsu, J. Li, Y. Xue, *Shadow Banking and Systemic Risk in China*, Political Economy Research Institute, „University of Massachusetts Amherst Working Paper", no 349/ 2014.

9 P. Masiukiewicz, *Piramidy finansowe...*, *op. cit.*

The People's Bank of China has been introducing rigorous controls over local and systemic risk in recent years - this has included strengthening the framing of the credit system, effective regulation and supervision, in order to prevent the risk[10].

RESUME

The monograph includes many valuable opinions from international experts, as well as the author's reflections, rich statistical material and interesting case studies. After each chapter it includes problems and questions for students, thus it has the nature of a handbook. But, in my opinion, it will also be an important source publication for all of those interested in researching the shadow banking sector and designing business models which do not pose a threat to financial stability from the sector in question; its closing up would probably be nonsense.

The author of the monograph rightly concludes that legal arbitration creates development potential for parallel banking - its limitation by means of European Union regulations and international standards is vital but insufficient. The demand for private money issued by parallel banking, e.g. for the excluded or those looking for inexpensive money, is decisive. The conclusion that the international aspect of origin and functioning of parallel banking has been ignored in the analyses conducted to date, and that it will increase in importance, is also significant. This also concerns financial pyramids, which in recent years have appeared on both a local and international scale.

I presume these problems are also worth discussing more broadly with undergraduate and doctoral students (which, after all, was the intention of Professor Jan K. Solarz); unfortunately, finance and banking handbooks give shadow banking only rudimentary coverage, if any.

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10 S. Hsu, J. Li, Y. Xue, *Shadow Banking and Systemic Risk...*, *op. cit.*