In a sign of growing instability, loans to US shadow banks pass $1 trillion

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12 February 2024

The US Federal Reserve has revealed that a significant financial milestone was passed last week. The amount of money lent by US banks to so-called shadow banks, otherwise known as non-bank financial institutions (NBFIs), has passed the $1 trillion mark.

As significant as the amount is, equally important is the speed with which it has occurred.

As the *Financial Times* (FT) reported, the lending is "up 12 percent in the past year, making it one of banking's fastest-growing businesses when overall loans growth has been sluggish, up just 2 percent."

The rapid rise in lending by banks to shadow banks is causing concern among financial regulators. Numerous reports, including from the International Monetary Fund, as well as statements from the regulators themselves, have made clear very little is known of the connections between them.

The FT reported that Michael Hsu, a top regulator at the US Office of the Comptroller of the Currency, had noted in a recent interview that the lightly regulated lenders, the shadow banks, were pushing the banks into lower-quality and higher-risk loans.

"We need to solve the race to the bottom," he said. "And I think part of the way to solve it is to put due attention on those non-banks."

The acceleration is indicated by the fact that when banks were first required to reveal their lending to non-banks in 2010 the total was just $50 billion for the entire banking sector. It is now 20 times that level and comprises 6 percent of all loans. This is more than auto loans, at 5 percent and just under credit card loans at 7 percent.

Across the Atlantic, European Union regulators are also seeking to probe the connections between the banks and NBFIs about which they confess to know very little. The worry is that if operations by a shadow bank go sour it can pass into the broader banking and financial system.

The potential damage was seen most notably in the crisis of the US Treasury market in March 2020 when a "dash for cash" was sparked, at least in part, by the activities of hedge funds. The freeze in the market, which went on for days, meant there were virtually no buyers for US government debt. It was only ended, and a major financial crisis averted, through a massive intervention by the Fed to the tune of $4 trillion.

Last month the chair of the European Banking Authority (EBA), José Manuel Campa said regulators intended to dig deeper into the links between banks and NBFIs.

"We should be doing more and we are going to be doing more," he said. "We need to have an understanding of the whole underlying chain in NBFIs."

The fact that regulators do not have such an understanding was an astonishing admission given that NBFIs hold almost half of the world's financial assets of $218 trillion.

Campa told the FT the EBA would work with the European Systemic Risk Board (ESRB) and the Financial Stability Board (FSB), an international body, to develop an understanding of how a shock in the shadow banking system could be transmitted more broadly.

"We are at very early stages but [understanding that] is the core of what the ESRB and the FSB would like to do," he said.

One of the ways a shock could develop is if NBFIs were forced to sell US Treasury bonds or financial products based on real estate.

Emphasising the lack of knowledge about the connections and links, Campa said: "The first step in this situation is always getting information; it’s an obscure sector where the quality of the data is not homogeneous.”

The financial authorities would like to believe that if they had a better understanding of the workings of the system over which they supposedly preside, then they would be able to introduce regulations to prevent future crises that could assume a systemic character.

However, historical experience speaks loudly against such a perspective. The problems arise from the very nature of the capitalist economy and its financial system which has come to play such a dominant role.

While production and finance are social—every sector in the real economy and in finance is connected to and linked with every other on a global scale—the productive forces and finance are privately owned.

This means that, in the final analysis, attempts at control and regulation flounder on the anarchy of the market where the driving force is the accumulation of private profit, whatever the consequences for overall stability.

Banking regulation is a case in point. In the wake of the global financial crisis of 2008, the Obama administration put in place the Dodds-Frank Act which it claimed would prevent a repetition of this catastrophe by the restrictions, limited as they were, placed on the banks.

But, as has now been widely acknowledged, even this relatively light-touch legislation only resulted in finance capital devising ways to get around it. This led to the rise of NBFIs which now have the potential to set off a crisis, accounting for 50 percent of financial asset services today.

As the FT noted in an article published at the start of the year, the NBFI sector “grew after [a] wave of post-crisis regulation drove some activities beyond the traditional banking sector while other areas outside the reach of regulators expanded, such as cryptocurrency.”

Well-known financial analyst Satyajit Das noted in an FT piece last month that the potential problems were not just a question of the quantum of debt but also of the increasingly complicated nature of modern-day leverage.

Investors often make investments in assets that are already leveraged, and the underlying source of cash flow must be sufficient to “meet multiple claims, reducing the margin of safety.”

Another factor was that lenders, often not only banks but institutional investors, public and private funds, and wealthy individuals, lent to another lender who in turn financed another party. Risk then became “diffused through an often lengthy chain with complicated financial and legal rights and claim priorities.”

Describing leverage as an arms race, in which the authorities are handicapped, Das cited the observation of the late financial economist Hyman Minsky that “in a world of businessmen and intermediaries who aggressively seek profit, innovators will always outpace regulators.”

Broadening the outlook to take in the present situation, Das concluded: “The real constraint is that over time the economy has become reliant on speculation to generate activity and paper wealth, backstopped when needed by governments and central banks using public resources to maintain stability. Ultimately, it is difficult to limit leverage in a world where everyone is incentivized to get rich quickly using other people’s money.”