MarketWatch
From DOWJONES

WEEKEND EDITION

Brokers threatened by run on shadow bank system

Regulators eye $10 trillion market that boomed outside traditional banking

By Alistair Barr, MarketWatch
Last update: 2:37 p.m. EDT June 20, 2008

SAN FRANCISCO (MarketWatch) -- A network of lenders, brokers and opaque financing vehicles outside traditional banking that ballooned during the bull market now is under siege as regulators threaten a crackdown on the so-called shadow banking system.

Big brokerage firms like Goldman Sachs, Lehman Brothers, Lehman Brothers and Merrill Lynch , which some say are the biggest players in this non-bank financial network, may have the most to lose from stricter regulation.

The shadow banking system grew rapidly during the past decade, accumulating more than $10 trillion in assets by early 2007. That made it roughly the same size as the traditional banking system, according to the Federal Reserve.

Unless radical changes are made to bring this shadow network under an updated regulatory umbrella, the current crisis may be just a gust compared to the storm that would follow a collapse of the global financial system, experts warn.

Such vulnerability helped transform what may have been an uncomfortable correction in credit markets into the worst global credit crunch in more than a decade as monetary policymakers and regulators struggled to contain the damage.

Unless radical changes are made to bring this shadow network under an updated regulatory umbrella, the current crisis may be just a gust compared to the storm that would follow a collapse of the global financial system, experts warn.

“The shadow banking system model as practiced in recent years has been discredited,” Ramin Toloui, executive vice president at bond investment giant Pimco, said.

Toloui expects greater regulation of big brokerage firms which may face stricter capital requirements and requirements to hold more liquid, or easily sellable, assets.

‘Clarion call’

“The bright new financial system -- for all its talented participants, for all its rich rewards -- has failed the test of the market place,” Paul Volcker, former chairman of the Federal Reserve, said during a speech in April. “It all adds up to a clarion call for an effective response.”

Two months later, Timothy Geithner, president of the Federal Reserve Bank of New York, and others have begun to answer that call.

"The structure of the financial system changed fundamentally during the boom, with dramatic growth in the share of assets outside the traditional banking system," he warned in a speech last week. That "made the crisis more difficult to manage."

On Thursday, Treasury Secretary and former Goldman Chief Executive Henry Paulson said the Fed should be given the authority to collect information from large complex financial institutions and intervene if necessary to stabilize future crises. Regulators should also have a clear way of taking over and closing a failed brokerage firm, he added.

Banking bedrock

The bedrock of traditional banking is borrowing money over the short term from customers who deposit savings in accounts and then lending it back out as mortgages and other higher-yielding loans over longer periods.

The owners of banks are required by regulators to invest some of their own money and reinvest some of the profit to keep an extra level of money in reserve in case the business suffers losses on some of its loans. That ensures that there's still enough money to repay all depositors after such losses.

In recent decades, lots of new businesses and investment vehicles have evolved that do the same thing, but outside the purview of traditional banking regulation.

Instead of getting money from depositors, these financial intermediaries often borrow by selling commercial paper, which is a type of short-term loan that has to be re-financed over and over again. And rather than offering home loans, these entities buy mortgage-backed securities and other more complex securities.

A $10 trillion shadow

By early 2007, conduits, structured investment vehicles and similar entities that borrowed in the commercial paper market and bought longer-term asset-backed securities, held roughly $2.2 trillion in assets, according to the Fed's Geithner.

Another $2.5 trillion in assets were financed overnight in the so-called repo market, Geithner said.

"These things act like banks, but they're not."

— James Hamilton,Economics professor

Geithner also highlighted big brokerage firms, saying that their combined balance sheets held $4 trillion in assets in early 2007.

Hedge funds held another $1.8 trillion, bringing the total value of asset in the "non-bank" financial system to $10.5 trillion, he added.

That dwarfed the total assets of the five largest banks in the U.S., which held just over $6 trillion at the time, Geithner noted. The traditional banking system as a whole held about $10 trillion, he said.

While acting like banks, these shadow banking entities weren't subject to the same supervision, so they didn't hold as much capital to cushion against potential losses. When subprime mortgage losses started last year,

their sources of short-term financing dried up.

“These things act like banks, but they’re not,” James Hamilton, professor of economics at the University of California, San Diego, said. “The fundamental inadequacy of their own capital caused these problems.”

Big brokers targeted

Geithner said the most fundamental reform that’s needed is to regulate big brokerage firms and global banks under a unified system with stronger supervision and “appropriate” requirements for capital and liquidity.

Financial institutions should be persuaded to keep strong capital cushions and more liquid assets during periods of calm in the market, he explained, noting that’s the best way to limit the damage during a crisis.

At a minimum, major investment banks and brokerage firms should adhere to similar rules on capital, liquidity and risk management as commercial banks, Sheila Bair, chairman of the Federal Deposit Insurance Corp., said on Wednesday.

“It makes sense to extend some form of greater prudential regulation to investment banks,” she said.
Separation dwindled

After the stock market crash of 1929, the U.S. Congress passed laws that separated commercial banks from investment banks.

The Fed, the Office of the Comptroller of the Currency and state regulators oversaw commercial banks, which took in customer deposits and lent that money out. The Securities and Exchange Commission regulated brokerage firms, which underwrote offerings of stocks and corporate bonds.

This separation dwindled during the 1980s and 1990s as commercial banks tried to push into investment banking -- following their large corporate clients which were selling more bonds, rather than borrowing directly from banks.

By 1999, the Gramm-Leach-Bliley Act rolled back Depression-era restrictions, allowing banks, brokerage firms and insurers to merge into financial holding companies that would be regulated by the Fed.

Commercial banks like Citigroup Inc. , Bank of America and J.P. Morgan Chase signed up and developed large investment banking businesses.

However, big brokerage firms like Goldman, Morgan Stanley and Lehman didn’t become financial holding companies and stayed out of commercial banking partly to avoid increased regulation by the Fed.

Run on a shadow bank

The Fed’s bailout of Bear Stearns in March will probably change all that, experts said this week.

Bear, a leading underwriter of mortgage securities, almost collapsed after customers and counterparties deserted the firm.

It was like a run on a bank. But Bear wasn't a bank. It financed a lot of its activity by borrowing short term in repo and commercial paper markets and couldn't borrow from the Fed if things got really bad.

Bear's low capital levels left it with highly leveraged exposures to risky mortgage-related securities, which triggered initial doubts among customers and trading partners.

The Fed quickly helped J.P. Morgan Chase, one of the largest commercial banks, acquire Bear. To prevent further damage to the financial system, the Fed also started lending directly to brokerage firms for the first time since the Depression.

"They stepped in because Bear was facing a traditional bank run -- customers were pulling short-term assets and the firm couldn't sell its long-term assets quickly enough," Hamilton said. "Rules should apply here: You should have enough of your own capital available to pay back customers to avoid a run like that."

Bear necessity

A more worrying question from the Bear Stearns debacle is why customers and investors were willing to lend money to the firm in the absence of an adequate capital cushion, Hamilton said.

"The creditors thought that Bear was too big to fail and that the government would step in to prevent creditors losing their money," he explained. "They were right because that's exactly what happened."

"This is a system in which institutions like Bear Stearns are taking far too much risk and a lot of that risk is being borne by the government, not these firms or the market," he added.

The Fed has lent between $8 billion and more than $30 billion each week directly to brokerage firms since it set up its new program in March. Most experts say this source of emergency funding is unlikely to disappear, even though it's scheduled to end in September.

"It's almost impossible to go back," FDIC's Bair said on Wednesday.

With taxpayer money permanently on the line to save big brokers, these firms should now be more strictly regulated to keep future bailouts to a minimum, Bair and others said.

"By definition, if they're going to give the investment banks access to the window, I for one do believe they have the right for oversight," Richard Fuld, chief executive of Lehman, told analysts during a conference call this week. "What that means, though, particularly as far as capital levels or asset requirements, it's way too early to tell."

Super Fed

Next year, Congress likely will pass legislation forcing big brokerage firms to be regulated fully by the Fed as financial holding companies, Brad Hintz, a securities analyst at Bernstein Research and former chief financial officer of Lehman, said.

Legislators will probably also call for tighter limits on the leverage and trading risk taken on by large brokers, while demanding more conservative funding and liquidity policies, he added.

Restrictions on these firms' forays into venture capital, private equity, real estate, commodities and potentially hedge funds may also follow too, Hintz warned.

This may undermine the source of much of the surging profit generated by big brokerage firms in recent years. A newly empowered "super Fed" will likely encourage these firms to arrange longer-term, more secure sources of borrowing and even promote the development of deposit bases, just like commercial and retail banks, the analyst explained.

This will make borrowing more expensive for brokerage firms, undermining the profitability of businesses that require a lot of capital, such as fixed income, institutional equities, commodities and prime brokerage, Hintz said.

Such regulatory changes will cut big brokers' return on equity -- a closely watched measure of profitability -- to roughly 15.5% from 19%, Hintz estimated in a note to investors this week.

Lehman and Goldman will be most affected by this -- seeing return on equity drop by about four percentage points over the business cycle -- because they have larger trading books and greater exposure to revenue from sales and trading. Goldman also has a major merchant banking business that may also be constrained, Hintz added.

Morgan Stanley and Merrill Lynch will see declines of 3.2 percentage points and 2.2 percentage points in their return on equity, the analyst forecast.

If you can't beat them...

Facing lower returns and more stringent bank-like regulation, some big brokerage firms may decide they're better off as part of a large commercial bank, some experts said.

"If you're being regulated like a bank and your leverage ratio looks something like a bank's, can you really earn the returns you were making as a broker dealer? Probably not," Margaret Cannella, global head of credit research at J.P. Morgan, said.

Regulatory changes will be unpopular with some brokerage CEOs and could result in a shakeup of the industry and more consolidation, she added.

Hintz said the business models of some brokerage firms may evolve into something similar to Bankers Trust and the old J.P. Morgan.

In the mid 1990s, Bankers Trust and J.P. Morgan relied more on deposits and less on the repo market to finance their assets. They also operated with leverage ratios of roughly 20 times capital. That's lower than today's brokerage firms, which were levered roughly 30 times during the peak of the credit bubble last year, according to Hintz.

However, both firms soon ended up in the arms of more regulated commercial banks. Bankers Trust was acquired by Deutsche Bank in 1998. Chase Manhattan Bank bought J.P. Morgan in 2000.

Past performance is not indicative of future results. The risk of loss exists in futures trading.