

Regulating 'creative' financial engineers

About: Matthias Thiemann, *The Growth of Shadow Banking*, Cambridge UP

by Andreas Eisl

Shadow banking refers to bank-like financial activities that do not fall under traditional regulations; they have been one of the root causes of the recent financial crisis. M. Thiemann identifies the structural causes for their rapid growth, and shows which institutional reforms could prevent the circumvention of regulations.

In his new book, Matthias Thiemann analyzes *The Growth of Shadow Banking*, which was one of the root causes of the recent financial and economic crisis. In contrast to existing approaches, which explain the rise of the shadow banking sector as a consequence of regulatory or cognitive capture, he shows how a fragmented system of global and national regulation has allowed financial market actors to engage in regulatory arbitrage. Thiemann's comparative study of the US and several European countries draws on interviews with financial market actors and regulators to explain why the regulation of shadow banks has largely failed so far and how it can better withstand evasion attempts in the future. He highlights the importance of structural constraints and disembedded regulators for understanding regulatory leniency and calls for a more principles-based approach for regulatory action. In this way, he contributes to the literatures of political economy, the social studies of finance, as well as research on experimental governance and regulatory dialogue.

The Shadow Banking System

The shadow banking system (others refer to it as the ‘non-bank financial system’ or simply ‘market-based finance’) consists of a complex set of financial intermediaries. These provide services similar to banks, such as maturity, liquidity and credit transformation, but do not fall under traditional banking regulations. Over the last decades, the shadow banking system has grown dramatically, including institutions such as investment banks, mortgage companies, money market mutual funds (MMMFs), structured investment vehicles (SIVs), asset-backed commercial paper (ABCP) conduits and markets for repurchase agreements (Repo-markets). Intermediating between investors and borrowers, these institutions provide services such as securitization and collateral intermediation.

As Thiemann points out, however, the shadow banking system does not simply take over tasks complementary to the traditional banking system but has actually replaced many of its key functions. This is made possible by regulatory arbitrage, whereby ‘creative’ financial engineers take advantage of loopholes in existing regulations. They set up shadow banking institutions which may differ in their legal form from the regulated services provided by traditional banks but are equivalent in terms of economic substance. Shadow banking entities are thus used to circumvent costs related to regulation, such as core capital requirements.

This has allowed for the creation of a highly leveraged financial sector which spreads risk—such as credit or liquidity risk—through seemingly safe financial products across different shadow banking institutions and beyond. And rather than being clearly delimited from traditional banks, many shadow banking institutions are actually sponsored by them. Both sectors are thus tightly interrelated. This practice has allowed traditional banks to create new revenue streams through the fees they take for the provision of shadow banking services. But, according to Thiemann, this circumvention of regulatory requirements has shifted the risks inside the system via traditional banks “onto the ultimate guarantor of the financial system, the state”.

Understanding the Growth and Forms of Shadow Banking

If many shadow banking activities are thus based on regulatory arbitrage and posing substantial risks for the whole financial and economic system, why did neither politicians nor regulators interfere before it was too late? Thiemann addresses this conundrum in a two-fold

way. First, he seeks to identify the main influence factors that have led to the rapid growth of the shadow banking system before the financial crisis of 2007/8. Second, he aims at understanding why the growth of specific components of the shadow banking system has differed across countries and which lessons might be drawn from such an exercise. To get a better hold on the complex phenomenon of shadow banking and tackle these two guiding research questions, Thiemann focuses on one specific institution of the sector, the asset-backed commercial paper (ABCP) market. In general, ABCPs are promissory notes with fixed maturities below a year, which are collateralized by other financial assets. During the US housing bubble, ABCPs became important short-term investment vehicles to finance longer-term mortgage-backed securities. As a key component fostering the outbreak of the financial crisis, the book uses ABCPs as a privileged site to explore the growth of shadow banking and its differential evolution across countries.

In methodological terms, the book follows a largely qualitative approach. Through process-tracing and the comparative analysis of four country cases (the US, Germany, France and the Netherlands), Thiemann aims to get a better understanding of the evolution of the ABCP market, and hence the shadow banking system more broadly. Interviews are at the center of his empirical analysis, including actors such as banking supervisors, financial market regulators, auditors, bank managers, specialists in accounting and standard setting, as well as rating analysts. This approach allows Thiemann to focus on the interactions between regulators and the regulated in their national and international socio-political context. This helps to gain an in-depth understanding of the regulatory decisions which facilitated or hindered regulatory arbitrage.

The Shortcomings of Theories of Regulatory and Cognitive Capture

To understand the evolution of shadow banking activities over time, Thiemann engages especially with theories of regulatory and cognitive capture. Regulatory capture assumes that “over time, regulation will come to serve the interests of the industry involved”. Thiemann criticizes this approach for lacking in empirical rigor and stresses that its conclusion will always tend towards ‘enlightened self-regulation’ rather than strong external oversight.

Cognitive capture can be interpreted as a variant of regulatory capture, where regulators become convinced that the “techniques and methods for risk assessment developed by the industry for regulatory purposes” are appropriate, dismissing alternative interpretations. In Thiemann’s view, this approach has, however, difficulties to account for cases where there has not been any cognitive capture. As a solution, the author provides a ‘positive theory of regulatory action’. It stresses, on the one hand, the importance of structural constraints for

understanding regulatory leniency. On the other hand, it highlights the role of regulators in evaluating the circumvention of rules and accounting standards.

Structural Constraints

Thiemann identifies a number of structural constraints which can help to explain why the shadow banking system grew so rapidly across many advanced economies. First, concerns about competitiveness have driven traditional banks to enter the shadow banking sector during the last decades. They also led to regulatory leniency towards regulatory arbitrage. Thiemann shows convincingly how attempts to create a global level playing field through the Basel accords fostered banks' attempts to circumvent existing national regulations. The 'rule of home country regulation' made it attractive to exercise regulatory leniency towards domestic banks to make them more competitive internationally and support them as national champions. This was only possible because common regulatory norms were to be interpreted by national banking supervision and accounting frameworks, creating a fragmented regulatory landscape. Thiemann finds, however, that regulatory leniency was less pronounced in countries where domestic banks were better protected from foreign take-over attempts, diminishing the need to improve their competitiveness via regulatory arbitrage. Second, the idea of the "self-regulating power of markets and the incapacity of regulators to assess market development properly" became increasingly dominant among banks and regulators. This further supported leniency towards regulatory arbitrage.

Regulators and the Regulated

While the structural constraints identified by Thiemann can explain the general growth of shadow banking activities across countries, they provide less leverage to explain trends of divergence in national ABCP markets. In some countries, regulatory arbitrage was identified and dealt with early, while in some others shadow banking activities to circumvent existing regulations could continue unhindered. To address this issue Thiemann conducts an in-depth analysis of the relationship between regulators and the regulated. He points out that in a technical field such as the regulation of the financial sector, it is important for the regulators to be close to (shadow) banks, auditors, and accounting standard setters, forming so-called 'interpretive communities'. Being in a constant dialogue with these institutions, regulators are better able to detect attempts of regulatory arbitrage and deal with them in a timely fashion. Thiemann further stresses the advantages of a principles-based approach to assess compliance with existing regulations, focusing on economic substance rather than legal form. This gives regulators more discretion to deal with instances of regulatory arbitrage and

denies financial engineers the legal certainty that they need to set-up complicated legal evasion strategies. The book, however, points out that regulatory discretion is not enough. Regulators also need to be equipped with sanctioning powers, and technical capabilities and expertise to be able to curb regulatory arbitrage.

In his case studies, Thiemann finds that in France, the central and powerful position of the banking regulator has hindered the growth of the ABCP market. In the Netherlands, the external position of the accounting standard setter made it difficult for the central regulator to detect regulatory arbitrage based on accounting standards. And in Germany finally, the banking regulator was completely disembedded from evaluating rule compliance and standard setting. This in turn allowed for a rapid growth of the ABCP market.

What a Look at the Technicalities of Shadow Banking Reveals

Taken together, Thiemann's book provides a very rich and in-depth analysis of the factors explaining, at the same time, the commonalities and divergences in the evolution of an important part of the shadow banking system, the ABCP market. Particularly the detailed account of the interactions between regulators and regulated in the field of regulatory practices and accounting standards constitutes impressive theoretical and empirical work. This comes, however, at the cost of a considerable degree of technicality, pointing to a trade-off between meticulous process tracing and the accessibility of the book for a broader public. More detailed explanations of different institutions supported by additional graphs would have been useful to better map the national and global fields of regulatory and standard setting bodies.

Thiemann's findings themselves are important contributions to the literatures of political economy and the socio-legal studies of finance. He masterfully traces the evolution of the shadow banking system over time and shows how the structural constraints of a fragmented system of global and national regulation have fostered regulatory arbitrage. At the same time, his detailed account of the relationship between regulators and regulated, and the importance of their close continuous interactions to reign in regulatory arbitrage, provides a blow to theories of regulatory and cognitive capture. He shows how the formation of 'interpretive communities', the focus on principles-based evaluations and the capacities of regulators can positively impact the regulation of the shadow banking system. Beyond a purely academic endeavor, these findings provide a clear set of suggestions for how to set up the regulation of shadow banking. They also seem to be relevant for a number of other policy fields. Tax avoidance, for example, works in a similar logic to regulatory arbitrage, where complicated constructs in line with the 'letter of the law' are used to circumvent national and international tax laws in terms of economic substance. Giving tax authorities more expertise

to follow up on tax avoidance strategies and to transform the application of tax laws to a more principles-based approach might curb tax avoidance. But while Thiemann lays out a proposal for improving the regulation of the shadow banking system, an analysis of the actual post-crisis reforms of the financial sector reveals that not much has changed. Rather pessimistically, he contends that the structural constraints, which have facilitated the growth of shadow banking in the first place are still present among modern advanced countries.

Overall, *The Growth of Shadow Banking* aims to integrate macro-developments with a micro-level analysis of the evolution of shadow banking, taking a comprehensive view on the topic. Nevertheless, a few issues that seem relevant were not addressed in the book but might form avenues for future research. First, Thiemann's focus on the ABCP market implies that evolutions in other important components of the shadow banking sector were only discussed in passing. A more thorough comparison of the evolution of different shadow banking institutions and respective regulatory actions could have, however, been fruitful to identify potential co-developments and their drivers over time. Second, while it was the relationship between ABCPs and mortgage-backed securities which fostered the financial crisis, it was the latter which actually 'drove the financial sector off the cliff'. The book itself highlights that ABCPs had no difficulties during the Asian financial crisis. It would have been thus interesting to get some more insights into why ABCPs were not hit back then but became crucial for the 2007/8 financial crisis. Third, *The Growth of Shadow Banking* repeatedly discusses the role of crises and scandals (e.g. the Latin American debt crisis, Enron) in driving regulatory actions. Surprisingly, however, their role is not theorized very much. And finally, the book shows how global regulations such as the Basel Accords actually increased the temptations for national regulatory arbitrage. It would have been interesting to push this analysis a bit further, to evaluate if the mismatch between the supranational and national levels based on the Basel accords was planned or if it was rather due to unintended consequences.

Notwithstanding such further avenues for research, Thiemann's *The Growth of Shadow Banking* provides a very convincing analysis of the factors influencing regulatory arbitrage and identifies effective ways to better regulate the shadow banking sector. Fiscal policy-makers would be well-advised to have a look at this book and find ways to better curb 'creative' financial engineers before the next financial crisis strikes.

Matthias Thiemann, *The Growth of Shadow Banking*, Cambridge University Press, 2018, 302 p.

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