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Web of shadow banking must be unravelled

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A couple of years ago, it occurred to me that the 21st century financial system had come to resemble a huge ball of candy floss (or cotton candy, as Americans might say). For bankers had become so adept at slicing and dicing debt instruments, and then re-using these in numerous deals, they had in effect spun a great web of leverage and trading activity – in much the same way that sugar is spun in a bowl to create candy floss.

From a distance, that activity looked impressive. But the underlying asset base was surprisingly small. Thus the key question that has hung over the system – and is doubly relevant now – is whether that cloud of trading activity could crumble back into itself? And what might the impact of that be?

Now, a fascinating little paper has just emerged from the International Monetary Fund that sheds light on this. This article*, by Manmohan Singh and James Aitken, is not pitched at a mainstream audience; it focuses on the issue of "rehypothecation" and its link to shadow banking. But that is a pity.

For while the issue of rehypothecation might sound arcane, it is central to the financial system. The issue involves the collateral that typically underpins trading and lending deals cut by banks with hedge funds and other banks. In recent decades, whenever a bank has made a loan to a hedge fund or cuts a deal with another bank, this is typically backed by collateral, such as a mortgage-backed security or treasury bond.

In a sense this is similar to an ordinary mortgage loan: if a hedge fund fails to repay a loan, or honour a trade, a bank can seize that collateral in much the same way that a bank might grab a house if a mortgage defaults. But what makes these complex financial trades different from, say, a mortgage loan is that banks tend constantly to revalue the collateral, and adjust the deals to compensate.

More important still, banks often churn, or "rehypothecate", that collateral. More specifically, when banks receive collateral from hedge funds, they often act as if they owned that collateral outright – and post that as collateral to support their own deals. Thus one piece of collateral can be churned several times to support several deals; hence that great financial candy floss cloud.

Now, until 2007 regulators tended to pay remarkably little attention to this, and even now the issue of rehypothecation is apt to be ignored by investors and policymakers, partly because most of this activity is very opaque. However, there are two reasons why it would make sense to track it much more closely. First, the price at which banks value collateral is a telling indication and early warning signal of how savvy financiers really feel about the risks in the system.

Second, as the IMF paper shows, this rehypothecation activity can be so frenetic it can significantly affect the overall volume of leverage in the system. The IMF paper calculates that, by 2007, the seven largest US brokers were getting about $4,500bn of funding from rehypothecation activity, most of which was not recorded in their accounts or the US government's flow of fund data.

Moreover, if you factor that activity into estimates of the size of the shadow banking world, this sector had swelled to about $10,000bn in size in the US – double previous estimates. And, this had a fascinating cross-border dimension. In the UK, as the IMF notes, "an unlimited amount of customers' assets can be rehypothecated and there are no customer protection rules". In the US accounts were segregated. Thus most funding has hitherto come from London.

Now, the "good" news, as it were, is that some of this candy floss cloud has now collapsed, because banks have become more risk-averse, and the collapse of Lehman Brothers alerted hedge funds to the risks of letting their collateral be rehypothecated in this way. Thus the IMF calculates that US bank funding from rehypothecation is now "only" $2,000bn-odd – or less than half its former size. That decline has clearly been painful for the banks. However, it does mean that some of the necessary, post-bubble adjustment is now taking place.

But the bad news is that it is still unclear how much more adjustment will occur, or what its impact on bank behaviour will be. After all, much of this rehypothecation activity remains rather mysterious.

Meanwhile, that odd discrepancy between UK and US law appears to remain in place, creating scope for future cross-border arbitrage. That might not matter now. But it could become important if risk appetite returns. Just one more reminder of why regulators will need to stay on their toes, particularly given the shortcomings of financial reform – and the propensity of the financial world to keep spinning those candy floss clouds.

** The (Sizeable) Role of Rehypothecation in the Shadow Banking system; Manmohan Singh and James Aitken, IMF July 2010.*