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BANKING IN THE SHADOWS

"When I see a bird that walks like a duck and swims like a duck and quacks like a duck, I call that bird a duck."

– James Whitcomb Riley, American poet (1849–1916)

As long-term loans to small-sized businesses become harder to obtain from traditional banking sources, such enterprises are increasingly turning to institutional investors such as insurance companies, pension funds, and other "private debt" funds to extend credit that banks are denying. Although such lenders hold money like a bank, charge interest like a bank and lend to businesses like a bank, thus far neither domestic nor global regulators are calling such firms "banks."

All of the Bank Taste—None of the Regulatory Calories

Despite the fact that shadow banks extend loans as traditionally performed by a bank, they, nevertheless, remain unregulated. According to former Federal Reserve Board Chairman Ben Bernanke, "Shadow banking, as usually defined, comprises a diverse set of institutions and markets that, collectively, carry out traditional banking functions—but do so outside, or in ways only loosely linked to, the traditional system of regulated depository institutions."

A Contributing Cause of the Financial Crisis

Shadow banking—whose previous incarnation was off-balance sheet lending vehicles at major banks—was considered sufficiently separate from main banking activities to allow exclusion from liability accounting prior to the financial crisis. Banks funded such activity from short-term money-market products; yet, when these supposedly separate activities fell into trouble, the losses suddenly became actual bank liabilities contributing to the financial crisis.

The New Capitalization Rules

Under the new Federal Reserve and Basel III capitalization rules, regulated banks cannot maintain off-balance sheets and, in fact, will be required to hold reserves related to such loans the same as for any other potential loss. It is partly this risk-to-cushion requirement that has led banks to take a step back from long-term, small-business lending, which they deem to be unprofitable.

Only an "Intermediary"

While the traditional banking scenario has the bank acting as agent and clearinghouse for both accountholder activity and borrower activity—and consequently must bear the loss as an institution should a borrower default—the shadow banking arrangement has the firm acting as "matchmaker" between investor and borrower, thus placing all transactional risk on the investor, not the firm.

Private Debt Lending to Skyrocket

Last year, institutional and private debt funds raised $97 billion worldwide for shadow bank loans according to one trade source, and experts estimate that the figure is likely to double this year. As tougher regulation—and some say over-regulation—shows no sign of abating, this niche along with Peer-to-Peer (P2P) lending is poised to provide new opportunities

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