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'W Coleman & Co 'The Realist's view from the armchair'

Dear Reader,

"Shadow Banking…a crisis waiting to happen or a necessary solution?"

A lack of supply or excessive exclusivity can lead to a cartel creating opportunities that would not otherwise become available. While this analogy is a little extreme, the same principle applies for 'Shadow Banking', a topic discussed at the recent G20 summit in Mexico given the contribution it has made to the financial crisis and its ongoing impact on the economic recovery.

Shadow Banking is the system of credit intermediation that involves entities and activities that are outside of the regular banking system, and therefore not regulated in the same way as banks. This less orthodox method of procuring credit will often take greater risks in order to achieve higher returns for investors. The upside is that debt is more readily available to prospects that might be considered too risky for a recently downgraded bank that is purely lending to low-risk clients and further protecting and conserving balance sheet

With risks come inevitable consequences and there is general concern that the underlying factors will produce future instability of banking development. In a speech to the CASS Business School, the Chairman of the FSA, Lord Turner, said how the Shadow Banking sector is not a standalone system running parallel to the regular banking system, but is linked to the banking system in complex and difficult to discern ways that can make the whole system less stable.

The lack of regulation means that the exact size of this system is unknown, but researchers estimate it is around $60 trillion globally. With the collapse of lending as we know it, the world's regulators and central banks have focused on building a more stable system for the future to involve less leverage, more liquidity and less reliance on tax-payer's support – Shadow Banking could be viewed as a loose cannon and the consequence of being unregulated has the prospect to threaten to not only delay, but sabotage the recovery.

A contrasting argument is that with the consolidation of banking activities and active locations in order to generate sustained return on equity in excess of the weighted average cost of capital, Shadow Banking facilitates a more flexible alternative. As a result, bank sales of non-core asset books, for example to sovereign wealth funds and private equity houses, will continue to grow.

While governing bodies are looking at new legislation to control this perceived rogue sector and ensure more money is available to prop up the regulated banks, it pays to be cautious about financial representation.

Best Regards,

Wayne Coleman