Shadow Banking System

What it is:

The **shadow banking system (or shadow financial system)** is a network of financial institutions comprised of non-depository banks -- e.g., investment banks, structured investment vehicles (SIVs), conduits, hedge funds, non-bank financial institutions and money market funds.

How it works/Example:

Shadow banking institutions generally serve as intermediaries between investors and borrowers, providing credit and capital for investors, institutional investors, and corporations, and profiting from fees and/or from the arbitrage in interest rates.

Because shadow banking institutions don't receive traditional deposits like a depository bank, they have escaped most regulatory limits and laws imposed on the traditional banking system. Members are able to operate without being subject to regulatory oversight for unregulated activities. An example of an unregulated activity is a credit default swap (CDS).

Before the market collapse in 2008, one of the classic strategies employed by shadow institutions was borrowing via short-term, liquid markets -- typically commercial paper markets -- and using these short-term funds to invest in longer-term, less liquid assets like securitized mortgages.

When the housing market melted in 2008, resulting in waves of foreclosures, these shadow banking institutions could no longer borrow sufficient funds to operate. Short-term lending dried up almost overnight because lenders were afraid of who or what was a credit risk; at the same time, shadow institutions couldn't get funds from their collapsing investments in mortgage-backed securities because no one would buy the "toxic assets."

This "perfect storm" of financial woes precipitated the 2008 bankruptcy of the once powerful shadow banking institutions, Bear Stearns and Lehman Brothers --leading to the subsequent market panic, economic recession and global credit crunch.

Why it matters:

Many institutions in the *shadow banking system* have come to play an increasingly significant role in facilitating credit throughout the global financial system. Many believe the lack of government regulatory oversight of the shadow banking system led to excesses precipitating in the global financial meltdown and Great Recession of 2008-09 -- the worst economic contraction since the Great Depression of the 1930s.

On the eve of the Great Recession, the shadow financial system in the United States had grown to roughly the same size as the country's traditional depository banking system. The equivalent of a "bank run" within the shadow banking system was the trigger for the Wall Street crash in the fall of 2008. This instability within the global banking system laid the foundation for the continuing subprime mortgage crisis.

Despite modest reforms passed by Congress in 2010, shadow financial institutions still aren't subject to the same regulations as traditional, depository banks. This means they remain highly leveraged, with a high ratio of debt relative to their liquid assets on hand to pay immediate claims. Higher leverage equates higher returns, but it also carries outsized risk.

The shadow banking system may still be exposing the larger financial markets to excessive systemic risk. While all investments expose the investor to some level of risk, the unknown consequences of having such a large shadow banking system may lead some investors to prefer more conservative investment strategies in the years ahead.