Into the shadows
A South African perspective on shadow banking

The shadow of the traditional banking system has lengthened in recent years as the golden sun of profit past is forced to the horizon by the weight of greater regulatory burden.

The shadow of the traditional banking system has lengthened in recent years as the golden sun of profit past is forced to the horizon by the weight of greater regulatory burden.

Indeed, we have seen the demise of traditional banking giants such as Lehman Brothers in the wake of the financial crisis. Subsequent regulatory reform has weighed heavily on the profit margins of banking institutions across the globe. In the United Kingdom, the five biggest banks (Barclays, RBS, HSBC, Lloyds and Standard Chartered) reported a 40% reduction in combined profit as a result of regulatory fines, redress of customer provisions, and accounting consequences.

Standard Bank Group's new joint chief executive officer Sim Tshabalala, was quoted by the Mail & Guardian in 2011 as saying that "[w]e've never faced so much regulation in the history of global banking". Mr Tshabalala continued to argue that South African banks have at least 150 pieces of non-banking legislation to contend with.

It is in these stringent regulatory conditions that shadow banking activities flourish. But what is shadow banking and why does it flourish where formal banking regulation is at its strongest?

Defining and quantifying the shadow banking sector

The United Kingdom Financial Stability Board ("FSB") broadly defines it as credit intermediation involving entities and activities outside the regular banking system. Based on the activities of these "other financial intermediaries", the FSB argues that the sector has grown from $26 trillion in 2002 to $62 trillion in 2007 before declining sharply in 2008. It estimates the current value of the sector at approximately $67 trillion.

But there are disparate definitions of the concept. For the purposes of compiling its Shadow Banking Index, Deloitte includes only money market mutual funds, asset-backed commercial paper conduits, asset-backed securities, non-agency mortgage-backed securities, collateralised debt obligations, repurchase agreements ("repos"), securities lending, and agency mortgage backed securities in its definition.

Based on this definition, Deloitte found dramatic growth in the United States shadow banking sector between 2004 (the base year for the index) and 2008. Thereafter, the index dropped significantly and has been stable ever since.

Why 'shadow banking'?

The term shadow banking arguably carries too negative a connotation.

Essentially, it is a sector that brings lenders and borrowers together in a less formal way than normal banking channels. As such they avoid the suite of regulation that banks are subjected to as well as the related costs. These transactions are therefore often more cost effective even though they may carry greater risk.

The concept is therefore not new – in fact one could argue that shadow banking established banking activities.

What could be lurking in the shadows?

Procyclicality found its place in the common vernacular over the past six years. The IMF argues that transaction within the shadow banking sphere may perpetuate this. At the beginning of the financial crisis it was asset-backed paper that showed the first signs of significant distress as the underlying assets devalued. Later it emerged that certain compensation arrangements may have incentivised executives to over expose themselves to assets with underestimated credit risk.

Monetary policy is affected by the state of capital markets where shadow banking appears to play a major role. In a low interest rate environment other financial intermediaries flourish as the returns they offer often exceed prevailing rates. This may have adverse implications when the economic cycle turns and asset bubbles burst.

And when the cycle turns it could be up to average Joe to bail out these other financial intermediaries. This may have significant implications for fiscal policy.

Understandably, many an investor is questioning the quality of the collateral underpinning their investments while those issuing assets in the shadows scratch their heads in terms of pricing.

South Africa in the shadows

South Africa has a very well developed and regulated financial services sector. Lenders and borrowers actively transact using all forms of shadow banking assets.

South Africa has a very well developed and regulated financial services sector.

However, Ingrid Goodspeed (the Governor of the South African Institute of Financial Markets) perhaps better defines shadow banking in the South African context as "non-banks carrying out bank-like activities… with limited (if any) supervision and regulation"

The key differentiator between banks and non-banks according to this definition lies not in their lending activities, but rather in their deposit taking capabilities – only registered banks are able to legally take deposits in South Africa. The South African Reserve Bank currently recognises 19 registered banks.

EM Foster once said that "... there are shadows because there are hills". This could not be more apt in the South African context. The World Economic Forum's Global Competitiveness Index rates South African banks as the second most sound of the 144 countries surveyed in 2012/13. It could be argued that our banking sector is not merely a landscape of hills but rather a vast mountain range. The emergence of other financial intermediaries follows naturally.

In terms of the National Credit Act ("NCA"), all entities who aim to provide loans and advances to both individuals and legal persons are required to register with the National Credit Regulator ("NCR") of South Africa. Currently, there are more than 4 000 credit providers registered with the NCR. These financial intermediaries profoundly influence the shape and size of the South African shadow banking sector.

While our banking sector is one of the best in the world, our population remains significantly under-banked.

Bringing this sub-section of South African shadow banking into sharper focus is the widely publicised concern regarding the levels of household debt in South Africa, and in particular the exponential growth in unsecured lending. Various publications have quoted Finance Minister Pravin Gordhan expressing his concern about levels of unsecured lending, especially as they relate to lower income earners.

In October 2012, the NCR conducted surprise inspections in reaction to the violent protests in Marikana. NCR chief executive Nomsa Motshegare said that ten of the twelve credit providers inspected in that area were found to be non-compliant with the NCA. In response to these findings Minister of Trade and Industry, Rob Davies, noted that his department had seen practices that verged on reckless lending.

Statistics from the NCR shows that total personal loans and advances grew from R1.21 trillion in quarter 1 ("Q1") 2011 to R1.32 trillion for the same period in 2012. Of this R110 billion growth, R40 billion can be attributed to pure unsecured credit and a further R15 billion to credit facilities.

It is important to note that not all unsecured lending originates in the shadow with major players African Bank and Capitec Bank taking the lion's share, but the shadow is certainly lengthening as a result of this growth.

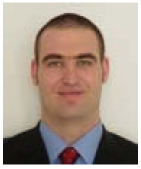
Is darkness upon us?

Valid concerns have been raised about the size and growth of shadow banking in the global sense. This has not been empirically quantified from a South African perspective, but all indicators are that the global trend applies here as well.

However, arguably the most risky of the South African shadow banking sub-segments is subject to some regulations and certainly to regulatory scrutiny even if it is indirectly via the central bank and credit watchdog. And while our banking sector is one of the best in the world, our population remains significantly under-banked. Other financial intermediaries have a noteworthy role to play in this particular segment of the population.

In South Africa it therefore seems that the lengthening shadow may be as a result of the dawn of future opportunity. Upon further investigation we may find that the sun is indeed rising not only on South Africa, but on the African continent as a whole.

Contact



Marius van Reenen
Senior manager
Financial Institutions Services Team
Deloitte
Email: mvanreenen@deloitte.co.za
Tel: 011 209 8811

Designed and produced by Creative Services at Deloitte, Johannesburg. (806286/jomaris)