Banks Don't Do Much Banking Anymore—and That's a Serious Problem

As hedge funds, private equity firms, and other asset managers that make up the shadow banking system gradually take over the role of lending, their risks—and the borrowed money they use to make them—are largely shielded from view.

One tension for anyone interested in reforming the financial system is the universal recognition that modern societies need banking. In the truest form, banks take savings deposits and, rather than hiding that money in vaults, lend it out for productiv purposes. This provides credit for families, small businesses, corporations, and state and local governments. Without banks, anyone looking to borrow money would have to find their own wealthy individual with extra available cash—and if your last name is not Romney or Rockefeller, that could prove an arduous task. Banks are middlemen, but they serve a vital role that, at its best, complements economic prosperity by making sure the best ideas get the financial support to grow.

Some U.S. banks, especially at the community level, still employ this basic model today, taking deposits and making loans. But our biggest, Wall Street-centered banks—the ones who hold the majority of the nation's deposits, slowly consolidating the banking system and growing ever larger—don't do a whole lot of banking anymore. They tend to focus, instead, on generating profits through a host of other complex methods. But in their absence, lending doesn't go away; it merely filters down to a different set of less-regulated intermediaries, typically known as the shadow banking sector. (Its nickname perfectl illustrates the core problem with its prominence: anyone concerned about the safety of the financial system does not want its critical activities happening in the shadows.)

The "big six" Wall Street mega-banks—Bank of America, JPMorgan Chase, Wells Fargo, and Citi, along with investment banks like Goldman Sachs and Morgan Stanley—take deposits these days almost as an afterthought. It gets them into communities (you can view bank branches as little more than building-sized billboards for more profitable financial services), and, more important, it unlocks federal safety net programs like Federal Deposit Insurance Corporation (FDIC) insurance and the "discount window," the Federal Reserve's program of low-interest loans. Mega-banks assert that they actually lose money on small deposits, and while we shouldn't take this claim too seriously, it's clear that deposits are not their primary concern.

With shadow banks making more and more traditional loans, the consequences will be far graver, especially because shadow banks are so intertwined with traditional banks.

The other mainstay of traditional banking is lending—handing out money to be paid back at a set interest rate. And while mega-banks still make a lot of loans, they have basically determined that they can't turn enough of a profit simply by sitting back and collecting interest. Loans to businesses represent just 11.5 percent of bank balance sheets, according to the St. Louis Federal Reserve. Loans to small businesses have shrunk for years. And overall bank lending to individuals and businesses remains stuck below 2008 levels.

Banks don't even lend much anymore to each other to cover short-term transaction needs, once a major function. The New York Federal Reserve finds that deposit-taking banks went from 60 percent of all interbank loans in 2006 to 26 percent at the end of 2012. The Federal Home Loan Banks, another government-created enterprise designed during the Depression to provide financing for housing, now controls most of the interbank lending market.

In fact, interbank lending exemplifies why mega-banks don't rely on traditional techniques to turn profits. The Federal Reserve began paying banks "interest on excess reserves" in fall 2008, essentially paying banks to park their money. Banks figured out that they could borrow cheaply from government entities like the Federal Home Loan Banks, and then receive a higher rate of cash from the Fed on their excess reserves, literally making money while doing nothing . If they flip cheap borrowing into U.S. Treasury bonds, which are more lucrative than interest on excess reserves, mega-banks can make ever more money with no risk.

This easy cash sustains the real profit model for today's mega-banks: speculation. Trading revenue at investment banks like Morgan Stanley and Goldman Sachs account for a far higher proportion of revenues than traditional investment bank activities like raising money for new businesses. And the biggest five mega-banks hold over 90 percent of all contracts in the $700 trillion market for derivatives, the second-order bets that accelerated and magnified the financial crisis. In effect, the "arbitrage" opportunities to capture risk-free money funds the speculative trading, where the real money lies. This runaway search for profit has contributed to the financial sector tripling in size since the 1940s, with six banks controlling two-thirds o total financial assets.

So if mega-banks derive less and less of their profits from lending, and if they are simultaneously consolidating the industry–

there are now under 7,000 banks in the entire country, down from over 18,000 in 1985—the question becomes, who is doinç the rest of the lending?

The answer is hedge funds, private equity firms, and other asset managers, which raise money from high-net worth individuals and institutions like pension funds, and make investments on their behalf. They collectively control over $53 trillion in assets, according to the Treasury Department's Office of Financial Research, up 60 percent over the past five year And lately they've poured a lot of that money into lending. The OFR report found that these asset managers effectively perform many of the same services as traditional banks, with the difference being that the risks they take, and the borrowed money they use to take them, are largely shielded from view.

This raises several concerns. First of all, contrary to the idea that more competition drives down prices, shadow lenders charge more for their services, essentially extorting from businesses that cannot secure loans from regular banks. This exploitation and rent-seeking is depressingly normal in modern finance: research from New York University shows that financial services cost more than they did 100 years ago. Borrowers also must put up extensive collateral, including patents, to backstop liabilities, making it a riskier practice.

Further, while the lack of oversight of shadow lending reduces compliance costs for financial institutions, it leaves regulators in the dark over what types of lending are happening in the system, and what risks exist. This renders irrelevant what was a very intelligently designed system for financial safety and soundness.

"The New Deal framework aligned every financial activity, including who you lend to, with a specific regulator who knew that business," says Marcus Stanley of the coalition Americans for Financial Reform. "Each regulator had government controls or a backstop meant to keep it secure." When that broke down with deregulation, you get the situation we have today, where practically anybody can become a financial intermediary. "It creates this endlessly powerful, endlessly morphing thing where the market flows to wherever regulatory controls are weakest," Stanley says.

And of course, shadow lenders aren't interested in playing a supplementary role in the economy, but will place money wherever it can generate the highest profit, threatening a rush of capital from one speculative bubble to the next. No limits or the borrowing activities of shadow banks means that they could ramp up their leverage, magnifying the impact of small losses.

Moreover, shadow lenders don't have the kinds of built-in safeguards that protect the entire financial system. A report from the Federal Reserve Bank of New York notes, "the lack of access to sources of government liquidity and credit backstops makes shadow banks inherently fragile." If a shadow bank makes a disastrously bad loan, without the need to carry capital t absorb the losses, they would basically suffer with bankruptcy and collapse.

That's fine if the rest of the economy isn't at stake. But with shadow banks making more and more traditional loans, the consequences will be far graver, especially because shadow banks are so intertwined with traditional banks.

"The story of the 2008 crisis is that you had these firms outside of the public safety net and regulatory perimeter, but hooked into banks inside the safety net," says Stanley of Americans for Financial Reform. "They all passed the hot potato of risk unti nobody knew where it was." The financial crisis showed, as Federal Reserve Governor Daniel Tarullo noted in a speech last month, that you cannot wall off shadow banking from traditional banking, and this allows unregulated firms like shadow bank to take greater risks, secure in the knowledge that they would get bailed out if they found themselves in trouble.

Despite the central role of shadow banking in the 2008 crisis, the Dodd-Frank law did little to reform it. It did include the Volcker rule, named for the one-time chairman of the Federal Reserve, to try and channel traditional banks back into lending and away from risky trading. But while mega-banks initially reduced their sales and trading while they determined how to comply with the new regulations, enterprising lobbyists uncovered plenty of exemptions to the restrictions, allowing continued distribution of a wide range of securities, like government bonds. Bank executives now believe the Volcker rule won't have much impact on their revenues. Indeed, there's more fear that the gambling has returned to Wall Street banks than that the Volcker rule has constrained their activities too much.

On the other side of the coin, Dodd-Frank included a provision that would force systemically important non-bank financial institutions into the regulatory framework, basically subjecting shadow banks to the same oversight as traditional banks. But Marcus Stanley doubts this will be effective. "Dodd-Frank says we have the power to designate them. I wish I had faith in that," Stanley says. This has been echoed by incoming Federal Reserve chair Janet Yellen, who called shadow banking "a major source of unaddressed risk" in a speech last year. Senators have similarly warned that the process of designating non bank firms is inadequate.

In particular, the Federal Reserve wants to reduce the dominance of shadow banking in the short-term funding of traditional banks. Breaking that link, they say, will reduce risks from that funding and close the perimeter of regulation and government support. You can tell that regulators might actually be serious about this, because the asset managers that control shadow banking have begun to object.

But cracking down on shadow loans to banks may just shift that lending to other areas. While shadow banking activity has shrunk since the financial crisis, it still represents over half of all traditional banking liabilities, and the interconnected nature of Wall Street in general makes it hard to discern between bank and non-bank activity.

One solution is to go back to the New Deal era, with traditional banking on one side and trading on the other, and a solid wal between them. Reinstating the Glass-Stegall Act, as senators like Elizabeth Warren have endorsed, would serve this purpose, providing clarity to regulators who would not need to understand multiple complex intricacies when monitoring a bank. “Banking should be boring,” Warren has said.

The best you can say for shadow bank lending is that it expands the opportunity for borrowers to access credit. But reformer are quick to point out that this expansion comes with a cost, in deregulation and the potential for outright fraud. Banks are uniquely equipped to do banking because of the safeguards and procedures built up around them for nearly a century. Casting this off into the wild west of shadow banking has consequences for all of us.

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