The Regulation of Banks, the Shadow Banking System and implications for Alpha Investment Strategies

Since the financial crisis of 2008 it was patently clear that regulators would begin to regulate banks as utilities. Since then there has been a steady and gradual reanimation of the Glass-Steagall act, albeit not in a single legislation; this in a series of fragmented but correlated measures including Basel 3, Solvency 2, Dodd-Frank and the Volcker Rule. Henceforth, banks will be focused on their role as conduits and intermediaries of credit and funding and step away from principal activities and risk taking. Banks will be going back to basics, as it were. This wave of banking system reform is likely to be gradual and sustained, providing interesting investment opportunities. The complexity, multi jurisdictional, multi regional nature of current banking regulation will make a quick repeal such as was done to Glass Steagall, difficult and highly unlikely. The trend to greater regulation is therefore expected to be protracted and long lasting.

In the immediate aftermath of the crisis it was expected that banks would have to reorganize themselves by way of asset sales. This expectation was wrong. Asset sales would have decimated balance sheets and annihilated bank capital. Regulators and banks concluded, quite rightly, that liability solutions would be more pragmatic. The raising of bank capital and other capital solutions such as regulatory capital relief

and accounting stratagems were more effective in stabilizing balance sheets while markets and the economy were given time to heal. Only once markets and economies had stabilized could asset solutions be implemented. We are now in the early stages of this phase. Some significant capital was raised in the past 2 years to take advantage of this opportunity, which now seems premature. The opportunities will now begin to present themselves. For funds still within their investment periods and with spare capital, this could be an exciting period.

Not all asset sales are stressed or distressed assets. As banks consolidate their businesses, spin outs of going concern business units are likely. Not only will prop desks be forced out through capital starvation and closure, but non core businesses are likely to be spun out as well. Banking regulation will render synergies difficult to realize or monetize. Expect energy trading and storage, real estate, asset management, and other non core businesses to be sold off.

Bank's emergency capital structures will likely be restructured now that the state of emergency has abated. Two related themes are at play here. Firstly, emergency capital structures are likely to be sub optimal for the business. Certain types of bank capital have been or will be reclassified as debt rendering them expensive. Issuers would like to retire such liabilities. Retiring such liabilities will require funding. Banks with recourse to capital market funding will do so by issuing new securities. Banks with limited access to markets will seek structured solutions. Secondly, emergency capitalizations were funded with public funds, read taxpayers' money, a politically sensitive source of funds. The continuation of such public financing is not politically sustainable and will be rolled back as soon as conditions allow. With the current stability and growth in the developed markets, the epicenter of the financial crisis, it is an opportune time for the withdrawal of public funds. This

has to be refinanced. Private funding vehicles are in a position to profit from providing capital solutions to the banking industry, and to the public coffers as well.

As bank’s activities become more regulated and narrow, many activities undertaken by banks will need to find new sources of capital. The shadow banking system is not homogenous but is rather a collection of disparate businesses designed to augment the banks where they were or are unable or unwilling to venture. If economic growth potential is to be realized and financed, the economy will need to turn to the shadow banking industry. Without access to deposits, the shadow banking industry is less likely to come under the same scrutiny or increased regulation as banks. At some stage, regulators may want to address the systemic risk of the shadow banking system. This is a much broader subject. The investment implications are that opportunities will arise for private funding vehicles to finance economic growth and obtain an attractive return in the bargain. Direct lending, private equity, venture capital are examples of private funding vehicles operating outside the regulated banking system.

Securitizations are a huge part of the shadow banking system, in large part created by the banks themselves in their efforts at balance sheet and profit optimization. The US mortgage backed security market is one of the largest single asset markets in the world. While securitized products were at the centre of the financial crisis and have thus derived a questionable reputation, the technology remains highly useful, if not abused, or mismanaged. The regulation of banks is likely to shift the burden of financing to securitizations. Provided such products are properly structured and managed, some significant risk will be transferred away from the fractional reserve banking system. At the same time, these products provide investors with potentially more efficient and specific investment instruments for their investment strategies.

The success of financing the economy will depend on the success of distributing these alternative investment products in a way that is clear, fair and not misleading, to investors for whom such investments are suitable. This will not be easy. For the intermediaries and fiduciaries, the complexity of such markets and assets provide ample opportunity for generating attractive risk adjusted returns.