Shadow banking in the UK
Marnoch Aston – Ruffer LLP
Topics

- Shadow banking and the UK pre-crisis
  - Supporting UK real economy lending
  - Shadow banking activity

- Collateral upgrade trades – how they are metamorphosing

- Non-bank lending to the SME sector
Shadow banking supporting UK real economy lending

UK real economy lending

Banks

Non-banks

Customer funding gap >£800bn 2008*

Securitisation

SIVs, conduits

Money funds and securities lending reinvestment programs

Wholesale funding

→ Syndicated loans – CLOs

→ ABS funding of businesses, eg car hire

Pre-crisis UK based shadow banking activity

- UK banks were also big owner/operators of shadow banks
- SIVs, CDOs, CLOs, money and credit hedge funds were all run from London
- Investment banking
  - Rehypothecation of hedge fund assets
  - Credit repo
  - Structured products and asymmetric margining
Topics

- Shadow banking and the UK pre-crisis
  - Supporting UK real economy lending
  - Shadow banking activity

- Collateral upgrade trades – how they are metamorphosing

- Non-bank lending to the SME sector
Collateral upgrade trades, a win-win?

Derivatives margin Funding

HQLA user

Net of fee received versus fee paid

Improved return

Benefits /uses

HQLA provider

Collateral transformation agent

Liquidity ‘shortage’

Less liquid assets + fee

Less liquid assets + fee

HQLA

Has ‘surplus’ liquidity

Net of fee received versus fee paid

Improved return

Benefits /uses
Metamorphosis, increasing risks

Newly created HQLA providers
- Structured products
- Synthetic ETFs
- Client services
  - asset manager using TRS
  - ‘optimisation’ of collateral

Derivatives margin

Funding

LCR requirements

HQLA user

Collateral transformation agent

HQLA

Less liquid assets + fee
Topics

- Shadow banking and the UK pre-crisis
  - Supporting UK real economy lending
  - Shadow banking activity

- Collateral upgrade trades – how they are metamorphosing

- Non-bank lending to the SME sector
Why can banks be dis-intermediated from SME lending

- Condition of banks
  - Important, but the Bank of England’s Funding for Lending Scheme should have increased availability of funding
  - Regulation – biased against certain types of lending eg mezzanine

- The nature of SME lending

- Differing business models
  - The law of large numbers versus intensive credit work and structuring
Structures and risks

- Two main structures
  - Locked up funds
  - Private equity structures – reinvestment period followed by self liquidation

- Risks
  - Introduction of leverage
  - Introduction of maturity transformation
Summary

- Shadow banking was very important to the UK

- Collateral upgrade trades may pose increasing risks

- Non-bank SME lending is providing real benefits with very few of the risks posed pre crisis by shadow banks