From banks to shadow banks

> “The money that we possess is the instrument of liberty, that which we lack and strive to obtain is the instrument of slavery.”
>
> Jean-Jacques Rousseau

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The history of finance shows that crises are not a modern-day phenomenon. My goal here is to discuss the links between certain past events and other, more recent ones, and to examine the role of the banks. Although essential to the smooth functioning of our financial system, these institutions are paradoxically at the heart of financial crises. To what can we attribute this? To access to credit, or to an excess of credit? To laxness on the part of regulatory agencies?

A look back

1792 – Alexander Hamilton, the first Treasury secretary of the United States, was the instigator of the first public central bank, the First Bank of the United States (FBUS). This institution had to deal with speculative fever on the part of investors and encouraged a dramatic increase in credit and loans. To rectify the situation, the FBUS cut its supply of credit by 25% in two months, which caused the markets to plummet in 1792.[1] The scope of the collapse prompted bankers and leaders to think of ways of avoiding future crises.

1857 – The railway industry was booming in the United States, and economic ties between the U.S. and Britain were so close that British investors held huge quantities of U.S. stocks and bonds, in addition to sitting on the boards of many railway companies. The crisis triggered by the massive devaluation of these securities in spring 1857 was attributable to discount houses, institutions which, at the beginning, were meant to serve solely as middlemen between investors and firms that needed cash, but which quickly assumed the role of banks. Relying on the central bank to bail them out, they were little concerned about excessive leverage, which was then on the order of 90 to 1.[2] After the collapse of railway stocks in 1857, 135 institutions went bankrupt and panic swept through all of Europe.

1907 – Fifty years later, trust companies took over from discount houses in the United States. With a mandate of holding clients' investments, they became involved in lending, distributing shares, and managing property and railways, while being less regulated than the banks (capital ratio of 25% for the banks versus 5% for trusts).[3] When the economic slowdown depressed prices of raw materials, the bankruptcy of Knickerbocker Trust triggered a chain reaction. In New York, investors panicked when they realized that their money was no longer available. This financial crisis led to the creation of the Fed in 1912 as a lender of last resort.

And today, shadow banks

Shadow banks define themselves as financial institutions that are not regulated like banks, but with the same areas of activity. Like the discount houses of 1857, they do not have recourse to central banks to bail them out in case of problems. The Financial Stability Board, a U.S. financial watchdog, reckons that shadow lending in all its forms accounts for roughly 25% of all financial assets. According to the FSB, shadow loans have risen from $26 trillion in 2002 to $71 trillion in 2012.[4] It is not the function of these institutions, which are essential to maintaining the flow of money, that is in question, but rather their lack of regulation. In such a lax environment, the term shadow bank aptly describes these institutions.

Total U.S. Debt as a % of GDP (annual)

Source: Bureau of Economic Analysis, Federal Reserve, Census Bureau : *Historical Statistics of the United States. Colonial Times to 1970. Through Q3 2009.*

Your portfolio is your business

Financial history shows that crises are not only recurrent, but inevitable. Both advisors and investors have a key role to play in managing their risk.

Our financial system is based on three asset classes (cash, bonds and stocks). Each has its place in your portfolio, as well as an associated risk. It's up to each investor to determine their investor profile with their advisor to allow for an appropriate weighting of each asset class in their portfolio. Don't forget that ultimately, the protection of your wealth depends directly on this weighting. If you have done your homework, you'll think of Jean-Jacques Rousseau during the next crisis…

[1] The Economist, April 2014.
[2] Excessive leverage is an accounting measure that refers to the ratio of cash reserves that a bank must hold relative to deposits. A ratio of 90 to 1 means that for each $90 deposited by investors, the bank physically held $1.
[3] BRUNER, Robert F., CARR, Sean D., *The Panic of 1907*, 2007.
[4] The Economist, April 2014.

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