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FINANCIAL REGULATION WITHOUT GLOBAL ECONOMIC GOVERNANCE: CAN IT WORK?

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Abstract

The literature on the crisis-reform nexus has documented the relationship between governments' interventions and banking crisis explained by the mass public demand. Nonetheless, the determinant of a global economic governance and coordination for an effective regulatory regime is lacking. In this context, the trade-off effect between regulatory burden for banks and shadow banking ballooning poses crucial questions on the post crisis regulations' effectiveness. The paper argues that the financial reform policy relies on its interaction with a minimum of global governance and domestic regulations. Studying shadow banks' development, we show that (a) without a minimum multilateral governance, controlling global imbalances limiting global leverage and financial interconectness is hardly possible. At the same time, shadow banks' multiple-causes development in the biggest financial centers tell us that (b) global banking regulations don't fit all due to uneven financial development and varieties of financial capitalism at the national level. Following the conventional approaches for a new governance regime, the contribution focuses on the governance-regulations nexus involved and sketches out a middle way prospective towards a "flexsecure" global governance.

Keywords*:* Governance, financial regulation, multilateralism, shadow banking, regulatory burden

JEL Classification: F3; F5; G010.

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1. Introduction

In November 2010, the G20 leaders "called on the FSB, IMF and BIS to do further work on macroprudential policy frameworks, including tools to mitigate the impact of excessive capital flows" (Summit Declaration 2010). To cope with that the G20 leaders decided to introduce three macroprudential policy instruments: (a) limiting systemic risk, that is focusing on the financial system as a whole (b) setting up instruments and (c) associated governance to mitigate the sources of systemic risk (FSB et al. 2011). These instruments refer to specific regulations like for example caps on debt service-to-income ratio and reserve requirements.

However, the associated governance is the *condition sine qua non* for mitigating the sources of systemic risk. Given free capital mobility, which accelerated global financial imbalances and created "Ponzi schemes", financial capital is able to bypass overregulated market areas. In sort, effective Financial Regulation without Economic Governance does not exist. So, the analysis of capital movements is essential for policymakers, given that capital flows can have not only welfare implications, but also regulatory ones. Reliance on capital flows can be a source of vulnerability (let alone in crisis times) to the financial stability. "Coupling with local macroeconomic conditions and financial innovation capital flows movement can put at stake the domestic regulatory status quo" (Claeys et al. 2018).

We explore the dynamic relationship between financial crises and various areas of financial reform. Some recent researches concluded that financial regulation is inherently pro-cyclical (Dagher 2018, Almasi et al. 2018). That means crises may act as turning points for stricter regulations during recessions in contrast with more lenient regulatory regime during booms. But, the main stake is whether such regulatory cycles are triggered due to electoral incentives interwoven with changing sentiments in the public or may be attributed to the structural power of the financial sector.

The literature of political economy of financial policy and the studies of the crisis-reform nexus have produced inconsistent results. More recently, Jeffrey Chwieroth and Andrew Walter (2019) demonstrated that the politics of major banking crises have been transformed by the "wealth effect": rising middle class wealth has generated "great expectations" regarding government responsibilities for the protection of this wealth, forcing governments to bail out troubled financial institutions. Also, others have argued that in the aftermath of financial crises, governments end up reversing some of previously liberal policies (Saka et al. 2019, Dagher 2018) due to mass public demands turn against "light touch" financial regulation. In this vein, Calomiris (2010), more critically, points out the aftermath of crises are moments of high risk in public policy because post-crisis reform initiatives facilitates the enactment of ill-conceived ideas and special interest measures that otherwise would not have passed. Nevertheless, it is well documented that in the medium-to-long-term, countries gradually catch up with the others and the initial effect of state interventionism disappears in each and every reform area (Campos et al. 2019).

But, electoral incentives alone cannot conceive the whole story of financial reforms. More specifically, this part of literature review does not take account of the structural power of financial sector and the distinct bail out policies in the varieties of financial capitalism. The most recent literature on bank rescues, (Mitchell 2016, Johal et al. 2014) documents that in the more liberal economies (market-based), governments are more likely to undertake a more active role in rescuing the domestic banking system. Paradoxically, the influence of banks shrinks, throughout a financial stress. This is due to the fact that, in economies, such as the United States and United Kingdom, banking competition is highly intense and there are no strong collective financial federations with "esprit de corps". Thus, a bank's bankruptcy is not considered as a systemic risk, but rather as a benefit by the competitors. Therefore, a bank rescue is very difficult to be organized by the private sector itself. In sort, the lack of private solutions, the more competitive interbank relationships; and the absence of a common safety net imply higher state capacity to impose stricter conditions on failed banks. Consequently, governments have higher discretion, while at the same time deposits insurance is the crucial priority. For this reason, Anglo-Saxon administrations have imposed mandatory rescue programs on troubled banks. On the other hand, in bank-centered economies, such as Germany and Spain, the bankers' influence is higher on the policy making of rescue plans. In these countries, the state sought to intervene early in order to reduce the overall rescue costs. However, banks had stronger incentive to delay accepting the government proposal, looking for money firstly from private resources.

This paper provides one such case study examining the trade-off effect between the regulatory burden for banks and the shadow banks' ballooning. One important lesson from the financial crisis is the prudential regulation should take a "holistic approach", setting "requirements for capital, liquidity and disclosure together and considering their potential interactions, together with the competitive conditions" of the shadow banks (Bolton et al. 2019).

Up to now, the study of regulatory policy for financial sector has mainly been concentrated on the regulations and not the governance. The "added value" of this paper lies in stressing the governance-regulations nexus. Attributing the shadow banks rise to the uncontrollable -by a multilateral governance agreement- global financial flows we support that the overall financial reform depends more on a multilateral cooperation than spatial regulations (e.g. banking regulation). Moreover, highlighting the specific factors contributing to shadow banks' development in three financial centers (US, Europe, China) we argue that global regulations (Basel III Accord) on their own cannot create a level playing field because of various national diversities. Within this context, the divergent compliance with the rules doesn't imply higher regulatory discretion. By contrast, it means that governments intend to adapt in defensive manner their regulatory policy to financial capital movements in order to achieve domestic policy targets. For these reasons we conclude that effective domestic regulations adapted to national diversities could be possible provided a multilateral cooperation that smooth out global imbalances.

2. Two visions for a Global Governance Strategy

Although recent literature on bank rescues recognizes the structural power of financial sector in the context of varieties of financial capitalism, the studies of on the political economy of financial reforms ignore the importance of a minimum Global Economic Governance regime as a crucial reform determinant. The financial crisis has revealed the need to "rethink global economic governance and to launch a debate on what the limits of financial liberalisation should be" (Steinberg 2010). In particular, a governance which guarantees “a better coherence of the decentralized system that characterizes global arrangements” (Ocambo 2010). Olivier Blanchard, IMF’s Chief Economist, also sketched two rebalancing acts required for the global recovery to be sustainable: “internal rebalancing -replacing government spending with private-sector demand, and external rebalancing- addressing the global imbalances between exporting and importing countries the externally oriented reforms must be coordinated at the international level” (Blanchard 2010). While “internal balancing” is a domestic task, the “externally oriented reforms” require coordination at the international level.

Global governance can be defined broadly as “a set of formal and informal rules that regulate the global economy and the collection of authority relationships that promulgate, coordinate, monitor, or enforce said rules” (Drezner 2014:123). In the wake of the crisis, intergovernmental coordination has institutionalized a fragmented governance pattern. Domestic structures of the political economy thereby have become major stakes in financial regulation (Bach & Newman 2010). An “active inertia”, a tendency to make changes on the margin, has fallen short of a collective response that is scaled to the task at hand (Bhattacharya et al. 2018). Undoubtedly, this “inertia” has been fed by the shift of economic power from the North to the South, which undermines hegemonic incorporation and collectivist cooperation, leading instead to gridlock and fragmentation (Chodor 2017). As a result, a host of new institutions have been created often with overlapping mandates and no clear roadmap for cooperation (Buti & Tomasi 2018).

Paradoxically, the demand for global governance has not diminished, since global -negative- externalities demand collective action at the global level (Stiglitz 2002); but nonetheless the answers on the form of coordination vary. First of all, as Slaughter put it, global governance has to fulfill (1) the need for global rules and centralized power; and (2) the need for mechanisms of political accountability for regulatory actors (Slaughter 2004). Within this context “multilateralists” and “regionalists” unfold two distinct narratives (Pisani Ferry 2018). The former support binding multilateral arrangements and require compulsory. The latter demand flexibility and voluntary participation.

In the field of financial regulation, specifically, multilateralism implies centralized institutions such as a “World Financial Organization” or “World Financial Authority” with the power to sanction members or to dispute settlements for finance (Eichengreen 2009). However, the main objections on these proposals stem from the change in the geopolitical environment. The post- war global cooperation was importantly relied on the US global leadership and the economic and political power of the ‘West’ (Keohane 1982). Today, both are undermined. Furthermore, the second thoughts on globalization from many governments reinforce the reluctance of countries to delegate national financial regulations to any supranational authority.

On the other side, the most crucial objection on global regulation rests on differences in financial cycles and local politics. So, even if there was a single set of regulations, different national enforcement would be one source of regulatory arbitrage. Desirable forms of financial regulation differ across countries depending on their variety of financial capitalism, credit structures as well as levels of development, institutional capacity and financial needs. In short, “there is strong revealed demand for institutional diversity among nations, rooted in differences in historical, cultural, or development trajectories" (Rodrik 2019). So, as Dani Rodrik wrote "Financial regulation entails trade-offs along many dimensions. The more you value financial stability, the more you have to sacrifice financial innovation" (Rodrik 2009). All these undermine the global authority, e.g, Basel Committee and encourage domestic jurisdictions to introduce exceptions of their own. The clearest example is the EU's incomplete adoption of Basel III. The US unlike the EU, having largely resolved the financial crisis in 2009-10, made the implementation of Basel III requirements less challenging than in several EU member states (Véron 2013). Given these, the second option ("regionalism") lies in flexibility and voluntary participation. For this approach rules and centralized power are neither feasible nor desirable. In this view, the most appropriate regulatory regime should be relied on home country regulation of financial institutions in accordance with a global set of principles (soft law). In sort, the principles-based approach respects national diversity, and implies a set of informal norms; and fora without judicial enforcement (Warwick Commission 2009).

3. The alternative middle way: towards a "flexsecure" regime

Leaving the responsibility for regulating leverage, setting capital standards; and supervising financial markets at the national level; it creates a policy gridlock. But if we agree that the causes of financial crisis rest on rapid financial (hyper) globalization, which generated excess leverage and accelerated the severity with which illiquidity and losses diffused in the system as a whole, then regulating the total quantity of credit creation is not just a national matter.

In this vein, we have to distinct between governance matters and regulatory ones. On the one side, governance matters guarantee global financial stability ("security"). These imply a form of global control of the creation and allocation of credit. Given free capital mobility, setting alone liquidity and leverage ratios nationally is ineffective. What is needed to protect financial stability is a mixture of quantitative and qualitative guidance on the direction of lending. Monitoring whether newly credit is used for transactions that contribute directly to GDP, it is crucial for preventing speculation, asset inflation and "Minsky moments". These types of restrictions on credit are by no means a new policy instrument. Countries like Germany, the US, Japan, Korea, Taiwan adopted the so-called "window guidance"- that is, central banks determine desired nominal GDP growth, then calculate the necessary amount of credit creation and then allocate this credit across real sectors in economy. Some prominent central bankers, support that the cooperation between regulators is a crucial stake for a much needed "Money-Credit Constitution" (Tucker 2018: 463), which will enable macroprudential measures to be successful in today's world of borderless capital markets. But the entry of central banks into the field of direct controls on lending is bound to raise the question of whether this is taking delegation too far (King 2016: 174). On the other side, "flexibility" means domestic regulations adapted to national diversity, varieties of financial capitalism; and different levels of development. To achieve that we have to immune these regulations from external pressure through the mentioned above governance.

Considering that, "flexsecurity" for global governance means both global rules and national discretion or in Pisani-Ferry's words "a sufficient, critical multilateral base for flexible arrangements and to equip policymakers with a precise toolkit for determining, on a field-by-field basis, the minimum requirements for effective collective action" (Pisani Ferry 2018, 2019).

Global rules are a precondition for the other. Take for example the 2007/8 financial crisis. Created jointly in the US and Europe as before 2007, the US and northern European banks engaged in irresponsible lending in real estate in the US and the periphery of the Eurozone. European banks were the most enthusiastic buyers for toxic debt securities. Uncontrolled capital flaws facilitated the interconnectedness feeding an undetermined by local economic fundamentals global financial cycle in capital flows, asset prices and in credit growth. This increase in synchronisation is primarily driven by fluctuations in risk appetite, time variation in investor sentiment, and financial frictions (Jordà et al. 2018). But, if there were qualitative guidance controls preventing financial booms, governments would have more discretion and autonomy to set out stricter regulation at national level.

For example, the Section 619 of the Dodd-Frank Act (the Volcker Rule) prohibited banks that enjoyed government guarantees from engaging in using their own funds to make a profit (proprietary trading). Also, it prohibited banks in investing in shadow banking activities. But, due to above mentioned interconnectedness European regulators supported that the tougher drafts of the Volcker Rule carried the threat of imposing restrictions on non-US market participants. Michel Barnier, EU Commissioner for the Internal Market, objected that the draft rule exempted US government securities from the ban on proprietary trading, but allowed no other sovereign debt instruments under the same exemption. This would limit the market for European sovereign issuers - an urgent concern given the sovereign debt difficulties of euro-area countries in 2012. In response to comments from European regulators, the final rule adopted by the five US agencies on December 9, 2013 exempted sovereign debt issued by European and other governments from the ban on proprietary trading (Ryan and Ziegler 2016: 79,80).

This example tells us that financial regulations, to be effective, have to take place in the context of a minimum supranational governance framework. Indeed, one size doesn't fit all for global regulations. In modern economy financial regulations are inherently compatible with distinct financial models, completely different political priorities and uneven levels of financial innovation. Prohibiting proprietary trading for US banks does not hamper neither credit expansion nor threaten macroeconomic imbalances. In a market based economy that's not a problem; rather is a right choice for financial stability. On the other hand, in the bank centered European economies prohibiting proprietary trading involves hidden risks. These come from the bank-sovereign nexus that multiplies and accelerates vulnerabilities in each sector, and lead to adverse feedback loops. So, the health of banks and governments affect and is affected by economic activity.

Concluding, financial rulebook it is neither feasible nor desirable to be single, but at the same time regulatory capacity at the national level depends on a minimum binding multilateral arrangement.

4. Chance lost for a Global Economic Governance

A lesson not yet learned by the policy makers is that it's not possible governing or setting global regulations without a form of global governance. In global financial system particularly, the unfinished business on the reforming the Global Economic Governance led to an inadequate limited incrementalism. In other words, the governance of financial regulation status quo has remained weak. As Eric Helleiner commented successfully: “Unlike in the realm of international trade, there is no supranational institution to enforce international financial regulatory standards and the key international regulatory institutions have no formal power; their main roles are that of fostering networks of informal cooperation, information sharing and the development of international “soft law” whose implementation is left to the discretion of national authorities” (Helleiner 2011: 10).

Since the emergence of global financial crisis, global community neither reached the target of the establishment of a new Bretton Woods, or a Banking Constitution, nor the creation of an effective Fourth Pillar of Global Economic Governance alongside the IMF, World Bank and GATT/WTO. In contrast, the post-crisis governance framework is pure renovation of the pre-crisis loosen governance of international financial standards.

In the aftermath of the East Asian financial crisis, the G7 occidental economies undertook the command of the global regulatory governance establishing the Financial Stability Forum (FSF). Ironically, the financial crisis of 2007/8 reversed the scenario. Because of that time the culprits were the developed economies the G7 transformed into the G20 including the leaders of several powerful economic centers from Latin America to Africa and Asia. But the G20 has remained a political institution that works by consensus and steers the work of technical bodies by issuing political guidelines. After initial high hopes and some success, negotiations within the G20 forum have slowed, progress is less visible and disagreement rather than agreement has come to the fore. The G20 had its high noon moment in 2008-09, but its achievements in 2010-11 have nevertheless been disappointing (Angeloni & Pisani-Ferry 2012). The G20 leaders gradually abandoned the commitment on financial stability setting out as the highest priority raising global growth to deliver better living standards and quality jobs for people across the world (G20 Leaders’ Communiqué Brisbane Summit 2014). In sort, the G20 forum it is no international organization (Angeloni & Pisani-Ferry 2012).

Furthermore, at the Pittsburgh Summit 2009, the G20 leaders established the Financial Stability Board (FSB) assuming a key-role in promoting the reform of international financial regulation and supervision. Despite the advancement from Forum to Board, the FSB continues to lack accountability and create any legal rights or obligations. The picture of incomplete financial reform strategy involves also the soft law Basel Accords on banking regulations. Apart from their pro-market orientation, these regulations have adopted by the governments in a very divergent manner.

The hesitated reform of Global Economic Governance, therefore has not attempted to curb excessive leverage, credit growth; and financialization. As Helene Rey pointed out there is a global financial cycle in capital flows, asset prices and in credit growth which is not aligned with countries’ specific macroeconomic conditions. As a consequence, the “financial trilemma” has been transformed into a “dilemma” or an “irreconcilable duo” (Rey 2015). The past assumption that with free capital mobility, independent monetary policies are feasible if and only if exchange rates are floating became a little bit obsolete. The global financial cycle independent monetary policies are possible if and only if the capital account is managed. In other words, the importance of global financial developments (external pressure), such as global liquidity and asset price fluctuations transform a domestic vulnerability into financial crisis (Cerutti et al. 2014).

One of the sticking points of Rey's analysis rests on the possible solutions offered by her. To deal with the "dilemma", Rey proposes some restrictive policies on capital mobility: (a) targeted capital controls; (b) limiting credit growth and leverage during the upturn of the cycle, using national macroprudential policies; (c) imposing stricter limits on leverage for all financial intermediaries.

Taking these into account it is hardly possible the weak and informal Global Economic Governance to manage the global financial cycle. Financial capital flowing freely is able to bypass different regulatory regimes or to offset limited profit margin in some more regulatory burdened activities with business in less restrictive segments. Take for example the ineffective financial regulation both in Europe and the US. As Tamim Bayoumi showed, citing a series of regulatory mistakes in Europe and the US, the European banks in mid 80s made a transition from lightly capitalized universal banks to better capitalized commercial periphery banks. In 1992 Maastricht treaty kept bank regulation at a national, not EU level. This provoked two tendencies, which are a focus of regulators on national level and the fast expansion of banks. In the US, in comparison to the EU, there were highly separated either commercial or investment banks. In 2002 the structure of the US banking system changed from the strongly capitalized commercial banks to lightly capitalized US investment banks, which led to the transfer of mortgage from commercial to less regulated investment banks (Bayoumi 2017).

In this vein, it's not a coincidence that increased banking regulation -coupling with institutional inability and political reluctance to restrict capital flows- has prompted activity to migrate to the less regulated non-banking sector.

5. Basel III: an ineffective regulatory response

In the aftermath of the global financial crisis of 2007/8, the Group of Twenty ("G-20") countries agreed to set up a new regulatory framework for the financial system to address and mitigate the systematic risk problem. In this regard, in December 2010, the Basel Committee released Basel III focusing on the macroprudetial policy; that is to mitigate risk to the financial system as a whole and to encourage a system-wide perspective in financial regulation to create the right set of incentives for market participants.

Except of increasing the level of capital requirements, the Basel III added certain macroprudential elements to the regulatory framework, by: (i) introducing capital buffers that are built up in good times and can be drawn down in times of stress to limit procyclicality; (ii) establishing a large exposures regime that mitigates systemic risks arising from interlinkages across financial institutions and concentrated exposures; and (iii) specifying a minimum leverage ratio requirement to constrain excess leverage in the banking system and complement the risk-weighted capital requirements (Basel Committee 2010).

Paradoxically, a decade after the initial form of the Basel III, the systemic risk however has not reduced. The distinctive political priorities, between the United States and the Europe, led to a divergent implementation. For US authorities the focus was on the financial stability; in contrast, European pursuits were to preserve banking competitiveness. That divergence stems from the distinct models of financial capitalism. On the one hand, American economy, as more market-based, is less dependent on bank lending. Increasing therefore regulatory burden for banks, it does not imply important credit restrictions. On the other, overbanking in many European economies is the key-factor explaining political reluctance for stricter banking rules by the European authorities.

Given that divergence, on December 7, 2017, the Basel Committee for Banking Supervision (BCBS) published the final regulatory standards in its post-crisis Basel III reforms. According to Stefan Ingves, Chairman of the Basel Committee, the aim was a level playing field "ensuring the standards are implemented consistently around the world". In the same vein, Mario Draghi commented from his side that "It is time for implementation, not design".

So, Basel III's pre-market orientation has been maintained. Among others, one of the most important altered rules is the revised floor, which places a limit on the regulatory capital benefits that a bank using internal models can derive relative to the standardised approaches. Thereby, banks' risk-weighted assets must be calculated as the higher of 72.5% of the total risk-weighted assets calculated using only the standardized approaches (Basel Committee 2017).

6. Shadow banking ballooning: A trade-off effect

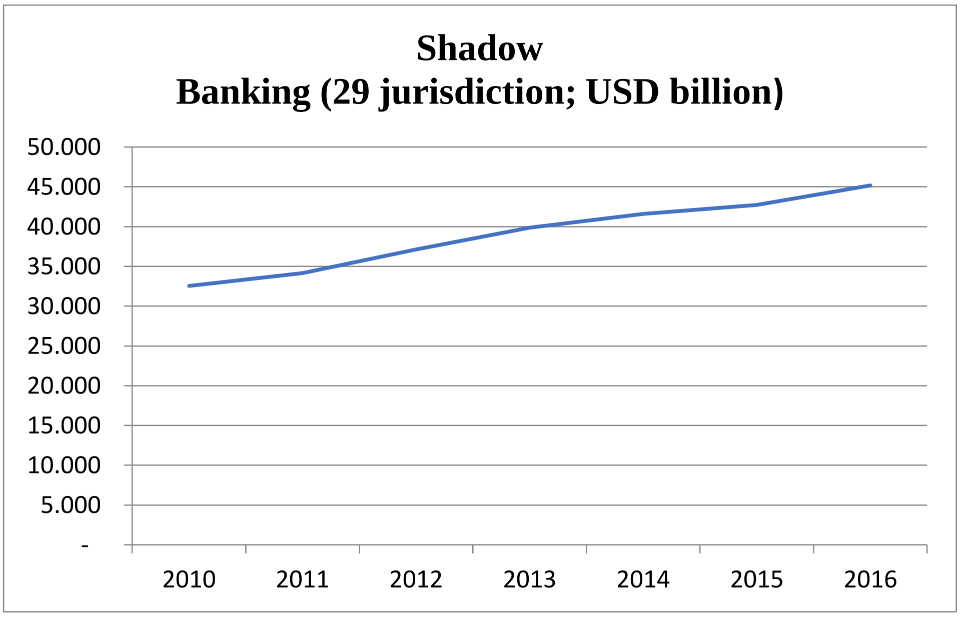
Regulating banks is an easy job respect to the difficult task of building up a global Governance for financial regulation. But as we have seen the divergent compliance to Basel III regulations came from the distinct varieties of financial capitalism between the US and Europe. Global regulations without global Governance, except of the uneven compliance, led also capital movements towards less regulated financial sectors (shadow banks). The banking business has become much more bureaucratic and a barrier to entry that favours large shadow banks, potentially shift activities out of the regulatory regime. Indeed, the risk of activities migrating to less-regulated areas where systemic risk is reproduced always exists. Additionally, given the entrenched global imbalances and the increased leverage, financial capital movement to shadow banks has been facilitated by three specific conditions in the US, Europe and China individually: (a) the post-crisis regulatory burden of traditional banks generating a regulatory arbitrage towards shadow banks in the US and in Europe; (b) the impact of FinTech on traditional banking; more evidently in the US financial market; (c) the specific macro environment -especially in the Eurozone as well as in China- accelerated non-bank lending.

A decade after the global financial crisis, many expected to see a wave of deleveraging; it never came. Public debt was mounting in many advanced economies even before 2008 as well as global nonfinancial corporate debt has more than doubled over the past decade to hit $66 trillion in mid-2017 (Lund et al. 2018). Total debt relative to GDP (including household debt, government debt, and non-financial corporate debt) has surged in the UK, US and the Eurozone from around 350% in 2006 to well over 400% last year (and closer to 500% in the UK), according to the Bank for International Settlements. Also, big banks have proved surprisingly resilient. The combined assets of the 1,000 largest banks in the world have increased by more than half in nominal terms to just over $113 trillion since 2006 (Wright & Asimakopoulos 2017: 9).

Moreover, the global non-bank financial sector has expanded its share of financial intermediation. Shadow banking -a network of non-depositary financial institutions such as money market funds, insurance companies, pension funds, collective investment vehicles as well as investment banks, structured investment vehicles (SIVs) and hedge funds- was the big “winner” from the global financial crisis. In general, shadow banks borrow short-term funds in the money markets to buy assets with longer-term maturities. Lending money like regular banks, but nonetheless they are not subject to traditional bank regulation. As a consequence, they cannot borrow in an emergency from the central banks and their funds traditional are not covered by insurance. Problems arose when investors withdrew their funds at once and to repay these. Due to the lack of the central banks’ safety net, shadow banks have to realize “fire sales” reducing thus the asset value.

Leveraged loans and high-yield bonds for non-investment-grade firms that are highly indebted have doubled since the global crisis (Schoenmaker 2010). According to FSB data, the shadow banks’ global financial assets have increased totally, reaching $340 trillion by end-2016. Additionally, at the same period, comparing to $137,8trn asset value of all deposit-taking corporations (banks etc), shadow banking accounted for financial assets of $160trn or 48% of the global total increasing for the fifth consecutive year (Exhibit 1).

Figure 1



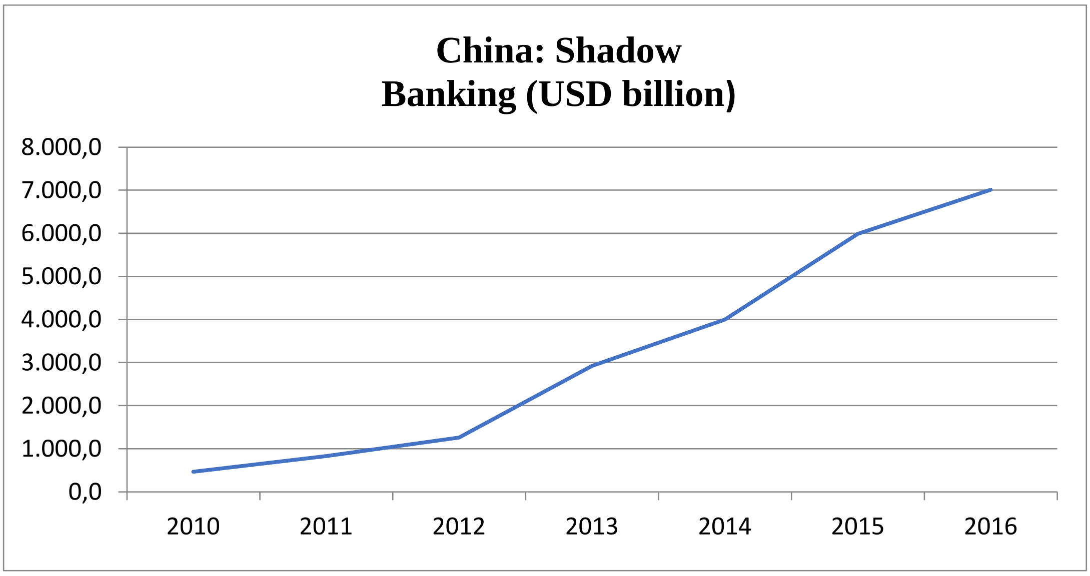
Source FSB

6.1. The macro peculiarities of the rise and the fall (?) of Chinese shadow banking

The rise of Chinese shadow banking was a result of a state driven banking system dominated since 2010. Specifically, private companies account for about two-thirds of the economy, but receive only about a third of net new lending. After the subprime crisis in the US, China decided to spend 4 trillion yuan to preserve a growth downturn. But domestic banks were not able to handle that much liquidity at once. Provincial governments set up local investment funds, namely Trusts to do so. Trusts had $200 billion in outstanding loans in 2008, and by 2013 was more than $1.8 trillion. Moreover, the share of shadow banks credit surged from about 10 percent of the system in 2008 to almost 40 percent in 2013 (Collier 2017:5,6).

In the late 2018, China threatened to exhaust its credit-driven growth model. Thus, China Banking and Insurance Regulatory Commission (CBIRC) announced that "the subsidiary shall operate independently, be responsible for its own profits and losses, and effectively prevent business risks from infecting the parent bank" (Jia & Wildau 2018). These regulations followed a broad new regulatory framework for shadow banking aiming to eliminate implicit guarantees on "wealth management products" (Exhibit 2). As a result, Chinese credit growth has continued to decelerate, despite nine months of significant central bank easing. In other words, in the past year, banking-system liquidity has risen by about a fifth, but net credit growth has fallen by about a third due to the fall of shadow banking assets by a 10% in 2018 (Taplin 2019). Consequently, "many middle class investors made the painful discovery that their money has been swallowed up by the recurring defaults in China's shadow banking market" (Hornby & Zhang 2018). Authorities, therefore, have feared that not compensating financial victims risks social unrest.

Figure 2

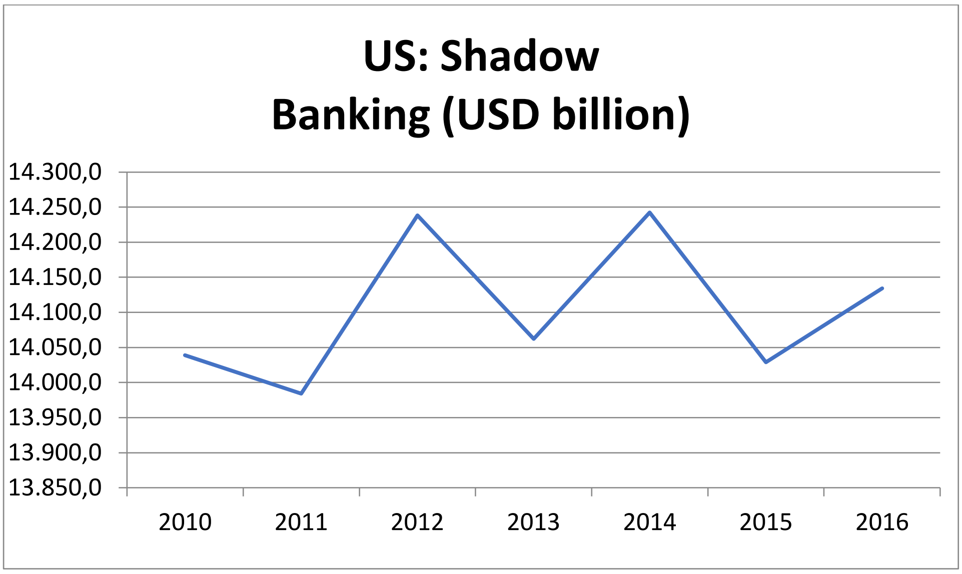


Source: FSB

6.2. Regulatory burden and FinTech in the US financial system

From 2007 to 2015, the surge of the US shadow banking rests both on the increased regulatory burden on traditional banks and the use of financial technology (Exhibit 3). The former explains about 60% of shadow bank growth and that 30% of this dynamic is explained by the use of financial technology. Specifically, shadow banks' market share in mortgage origination has almost doubled from roughly 30% in 2007 to 50% in 2015 (Buchak et al. 2017). Moreover, implicit government guarantees in the Federal Housing Administration (FHA) have advantaged shadow banks. According to the Financial Stability Board, FinTech is defined as technology-enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on the provision of financial services (FSB 2018).

Figure 3



Source: FSB

In the first nine months of 2016, global investment in FinTech reached $21 billion, marking a five-fold increase over 2013. Amazon, for example, offers loans to small businesses for an amount exceeding 3 billion dollars; a subsidiary of Alibaba has a monetary fund with assets of more than $ 160 billion. FinTech, therefore, poses crucial questions to regulatory authorities. What is the role of central banks in promoting and guaranteeing the reliability of payments in the era of digital transformation? What are the appropriate regulations in relation to the new payment instruments? And how can we guarantee the speed and convenience of payments with the stability of the financial system? (Bocciarelli 2017)

6.3. The macro environment as a source of the European shadow banking

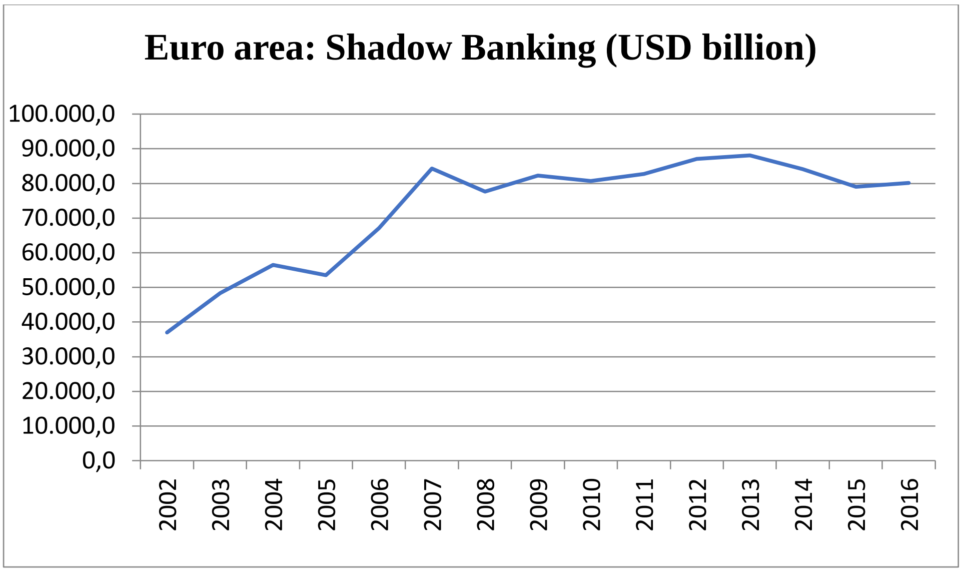
The size of the EU shadow banking system accounted for over €42 trillion total assets at the end of 2017, representing 40% of the EU financial system; almost double the at the beginning of the 2000s (Exhibit 4). The rising share of shadow financial intermediation in the euro area since the global financial crisis lies in the interaction of several factors; low interest rates resulting from the ECB's monetary policy, as well as longer-term structural factors, including demographic trends and population ageing. On the side of euro area banks, shrinking bank lending has been a byproduct of drying up the American wholesale market and the euro area sovereign debt crisis. Firms, therefore, turned to other financing sources other than bank credit, such as equity and corporate debt issuance. At the same time, the rise of shadow banking has been favored by the low level of interest rates in the wake of the financial crisis such as lower returns on bank deposits, falling risk premia and a recovery in a range of asset markets. (ECB Economic Bulletin, Issue 4 / 2016). Insurance companies and pension funds (ICPFs) represent the broadest and fastest growing funding base for investment funds. They held around €3,3 trillion in investment funds at the end of 2017, equal to 34% of pension fund and insurance business, compared to €2,0 trillion at the end of 2012.

In sort, the shadow banking system arose to fill the vacuum between the institutional cash pools preference to avoid unsecured exposure to banks even through insured deposits and on the other side the insufficient supply of short-term government guaranteed securities. In this vein, it's important to highlight the ongoing investment transition from risk aversion positions during the first years after the financial meltdown to more risky investments. In particular, due to lack of a single European deposit insurance scheme, institutional investors turned to high-quality short-term debt, rated by AAA rating agencies. Since 2013 the share of riskier corporate bonds, both financial and non-financial, in the total portfolio of pension funds, insurance and investment funds has increased, while it has decreased for banks (Exhibit 5).

An additional particularity of the EU shadow banking is a "double face" interconnectness. The "internal" one means that European banks remain highly interconnected with entities engaged in shadow banking activities. The share of euro area bank assets (loans and debt securities) for which the counterparty is a euro area entity included in the shadow banking rose steadily from 5.6% in 2006 to 8% in 2017. The other part of the "internal" interconnectedness is related to the wholesale funding provided to euro area banks by shadow financial entities. In 2017, wholesale funding provided to euro area banks by such entities grew by 2% compared with end-2016, reaching €2.2 trillion and marking the highest rate of growth since 2012 (European Systemic Risk Board 2018).

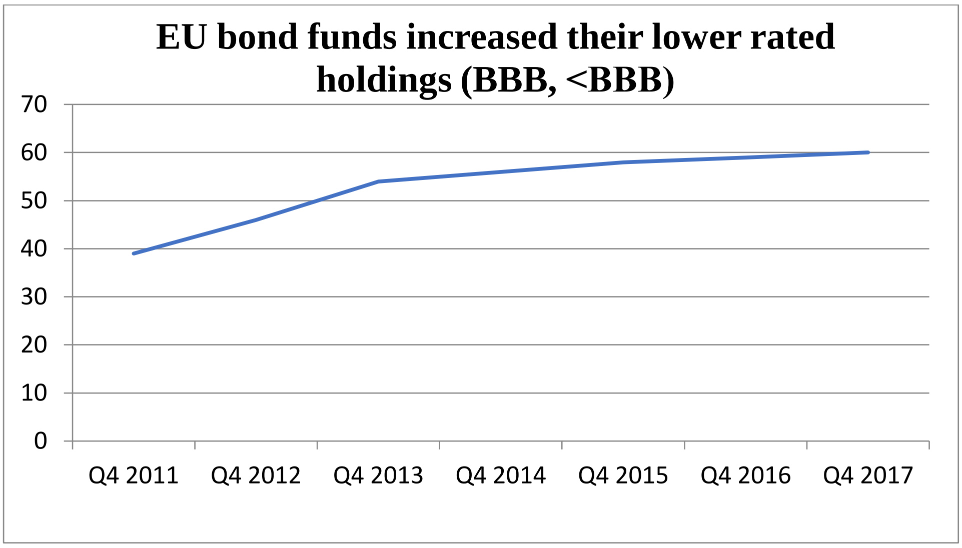
As far as the "external" interconectness, EU banks are most heavily exposed to finance companies US-domiciled shadow banking entities. During the course of 2015, the interest rate rise in the US with the introduction of a large asset-purchase programme in the Eurozone increased domestic and foreign demand for US assets. At the end 2015, 60% of EU banks' total exposures to shadow banking entities were towards non-EU domiciled entities (Adad et al. 2017).

Figure 4



Source: FSB

Figure 5



Source: FSB

7. Conclusion

The post-crisis regulatory burden for banks led shadow banking into expansion, despite an extensive regulatory interventionism by the governments due to the public sentiment against "deregulated capitalism". This trade-off effect raises serious questions on the effectiveness of the global regulations (Basel III). The central conclusion of this paper focuses on the global governance loopholes allowing financial capital to move towards less regulated areas. On the one side, cross border capital flows, reflecting global imbalances and taking advantage of the interest differential, contribute to the shadow banks expansion. That's the case of the interconectness between the US and European financial sectors. On the other side, specific domestic factors in each economy individually reinforce non-banking credit. In the US, the regulatory banking burden and the FinTech increase shadow lending. In Europe, specific macroeconomic conditions limit bank's credit channel. The Chinese state-driven model of financial capitalism has left also room for shadow credit into the private economy. These national diversities tell us that neither one size global regulations fits all nor is desirable. However, it is deniable that unregulated shadow banking development puts once again at risk domestic and global financial resilience.

Being so, a minimum of a multilateral cooperation is a crucial determinant for effective financial policies, guaranteeing not only financial stability, but also protection of the national diversities. Therefore, the aim of a "flexSecure" governance should be to immune domestic regulations from external pressure derived from the uncontrollable movement of the global capital cycle. In this vein, a multilateral cooperation needs to be applied system-wide to avoid regulatory leakages in order to enable supervisors to implement a mixture of quantitative and qualitative guidance on the credit direction. Thus, smoothing out the global financial cycles, a multilateral cooperation could prevent surges, entrenchments in capital flows, booms and busts in asset prices and crises. In this manner, we can achieve a well monitored macro-environment into which the national discretions could regulate flexibly the financial systems, according to their own political priorities, specific economic conditions, models of financial capitalism etc. Finally, a multilateral governance could be a satisfied condition to increase potential benefits of financial integration, without unilateral protectionist measures taken.

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