

European Central Bank official sounds warning on growth of private credit

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Another warning has been issued about the dangers posed to the stability of the financial system by the explosive growth of the private credit system, this time from an official of the European Central Bank (ECB).

In an interview with the *Financial Times* (FT) earlier this week, Elizabeth McCaul, a member of the ECB's supervisory board, said the "remarkable" growth of private funds, which are a growing source of finance outside the regulated banks, was the biggest threat to Europe's financial system.

Her remarks echoed similar warnings made earlier by the International Monetary Fund (IMF) and others.

McCaul told the FT there were "certainly caution lights in front of us."

"The most prevalent one, the area into which we have the least visibility and where things can move faster than... the normal credit dynamics—is the non-bank financial intermediaries (NBFIs) market," she said.

In its *Global Financial Stability* report of April 2023, charting the growth of NBFIs since the crisis of 2008, the IMF said investors and institutions had used leverage (debt) to boost expected returns.

"However, vulnerabilities from leverage can sometimes be unknown to both authorities and market participants because they are difficult to measure or because the leverage is hidden."

As a result, the IMF said, financial authorities have no real idea of the relationships of NBFIs in the broader financial system and, while there was some data, "large gaps remain" with "roughly half of aggregate NBFI domestic funding sources unaccounted for."

In Europe, according to McCaul, the NBFIs, or shadow banks as they are often called, held assets worth €42.9 trillion (\$US46.9 trillion) in the third quarter of 2023 as compared to €38 trillion (\$US41.5 trillion) held by traditional lenders.

She told the FT that growth in this area of the financial system since the global financial crisis of 2008 was "remarkable" and "something that always worries us."

Not the least of those worries is that this rapidly expanding area of the European, US and global financial system is "outside of the banking supervisory and regulatory perimeter."

McCaul acknowledged that the opaque links between the NBFIs and banks, which involved repurchase agreements, derivatives and lines of credit, raised concerns about what this "translates into for systemic risks."

According to McCaul: "Some of these funds, especially certain hedge funds, are becoming so big that they can partially move the market by themselves and are not likely to act as shock absorbers in the same way banks have sometimes."

Rather than acting as stabilisers of the market, the major funds, which largely operate with the same algorithms, can exacerbate market movements. If there is a rush for the exits by one, others quickly follow, hoping they can get out the door quickly enough and cut their losses.

An example of how risks can materialise, seemingly out of the blue, was provided by the collapse of the family office company Archegos Capital Management three years ago. Its demise led to losses for investment banks, including Credit Suisse and Nomura, of around \$10 billion.

McCaul said the bond market crisis in the UK in September 2022, which involved the use of derivatives by pension funds, was "another warning light."

She did not go into details, but financial authorities were blind-sided by what took place and had in some cases advocated the use of the strategies used by the

funds.

Only the intervention by the Bank of England to prop up the bond market and the reversal of the mini budget of the short-lived Liz Truss Tory government, which attempted to find major tax cuts for corporations and wealthy individuals with increased debt, prevented a meltdown of the British financial system.

Going back further into financial history, McCaul said the rise of the shadow banks reminded her of the demise of Long-Term Capital Management (LTCM) in 1998, when she was superintendent of banks in New York. In what was a preview of the crisis to come ten years later, LTCM had to be bailed out in a \$3 billion operation organised through the New York Fed out of fear that the entire system could crash.

Some private equity executives have defended their activities saying they reduce risks and make markets more efficient. But McCaul said those claims reminded her of what was said about the packaging of sub-prime mortgages which triggered the 2008 global financial crisis.

The growth of the private equity market is an example of how attempts by authorities to “reform” one area of the financial system does not overcome its inherent contradictions but merely moves them to another area.

The rise of shadow banking is at least in part an attempt by finance capital to get around regulations introduced after the 2008 crisis in order to provide new avenues for profit-making.

The extent of what has taken place in the past decade and half is revealed in figures provided by the Financial Stability Board, an international watchdog formed after the crash. It has estimated that the shadow banking sector, comprising money market funds, private equity funds, insurers, and hedge funds among others, has compiled financial assets totalling \$218 trillion. This is nearly half the global total.

In addition to the IMF, others have been warning about the potential for shadow banking to set off a crisis.

The chair of the US Securities and Exchange Commission, Gary Gensler, said in a recent interview that risks could build up in the world of private funds.

“They are risks that I’ve witnessed personally, like during the Long-Term Capital Management spillovers in 1998.”

Last month the CEO of JPMorgan Chase, Jamie Dimon, said there could be “hell to pay” because of problems in the shadow banking area. He warned that some of the ratings given by ratings agencies to deals financed in the shadow banking area reminded him of those provided to sub-primes in the lead up to the 2008 crisis.



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