# DEVELOPMENT OF THE SHADOW BANKING SYSTEM IN ZIMBABWE: A BLESSING FROM THE SHADOWS?

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**Abstract**

The rising of shadow banking institutions in Zimbabwe has been very quick for formal banking institutions and regulators to strategise against the threats that came with their development. This study applied qualitative data analysis and find that, the growth of a shadow banking system was market driven. Lack of confidence and financial innovation on the mainstream banking system to structure financial products that improve intermediation gave space for shadow banking growth. In response to this development, the researcher recommended that regulatory focus should be on the functions of shadow banks rather than institutions; this will be more inclusive and efficient in avoiding innovative creation of new entities that perform the same shadow banking functions. Also, the Zimbabwean formal banking system should be innovative in-line with the development of the international banking models.

**Key Words:** Shadow Banking, Intermediation, Regulators, Monetary Aggregates

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## Introduction

The shadow banking sector has fast become an integral part of the global financial system. This research sought to explore the development of shadow banking and how its growth has affected the operations of the traditional banking system. The architects of the shadow banking system are constantly seeking new avenues to evade regulatory oversight and controls. It is vital therefore, that regulators ascertain the driving forces behind the development of shadow banking and its implications to the formal banking system. Professional bankers, finance geeks and lawyers have been devising banking products and transactions that easily bypass any new rules and regulations passed. This shows the magnitude of the challenges faced by regulators and policy-makers in regulating the shadow banking sector. To this background, shadow banking has become a burning issue that should be pro-actively addressed to avoid regulators coming up with post-crisis policy reforms, because the shadow bankers are likely to have found a way to bypass them.

The recent shift in the banking paradigm in Zimbabwe has seen a sudden boom in shadow banking entities. These have been characterized by lack of disclosure of information about the nature and value of their assets, ownership structures and their opaque governance. Shadow banks offer bank-like products which have threatened the operations of the traditional banking system. Since they have been subjected to little or no prudential regulatory and supervisory authorities, there have been a number of policy initiative to improve monitoring and regulation. The coming of shadow banking institutions has been very quick in Zimbabwe, leaving formal institutions with little time to strategise for the threats that this development comes with. It was therefore imperative to assess and analyse the threats and the possible strategic response measures that the formal banks will have to adopt.

The general objective of this study was to examine the threats posed by the shadow banks to the formal banking system. In pursuit of this general objective, the following specific objectives were drawn; firstly, to determine the drivers behind the development of shadow banking over the years; secondly, to examine the strategic response measures by the formal banking institutions to the development of shadow banking; and lastly, to evaluate regulatory responses to the development of shadow banking.

## Literature Review

The activities, institutions and vehicles that compose the shadow banking system constantly evolve over time and from one economy to another. The shadow banking intermediation process involves huge networks of investment banks, finance companies, money market funds, hedge funds, credit rating agencies, pawnbrokers and micro-credit.

The birth of the shadow banking system can be trace back to the development of money market funds in the 1970s, when the money market accounts functioned largely as bank deposits whilst they were not regulated as banks (Schwarcz, 2012). Shadow banks first caught the attention of many experts because of their growing role in turning home mortgages into securities in the USA prior to the Global Financial Crisis (GFC). The securitization chains which started with the origination of a mortgage that were then bought and sold by one or more financial entities revealed the how complicated shadow banking institutions could be (Rick, 2010). Almost all the stages, from creation of the mortgages to sale of the securities took place outside the direct view of regulators.

The term ‘shadow banking’ is believed to have been coined by economist, Paul McCulley in his 2007 Annual Financial Symposium speech hosted by the Kansas City Federal Reserve Bank in Jackson Hole, Wyoming (Pozsar, 2010). However shadow banking elements has always been existent both locally and globally. According to Pozsar (2010), the shadow banking system is a web of specialized unregulated institutions that channel funding from savers to investors through a range of securitization and unsecured funding techniques. Although shadow banks and all the institutions that constitute the shadow banking system conduct credit and maturity transformation similar to that of traditional banks, they do so without the direct and explicit public sources of liquidity and risk insurance available through the central bank (Pozsar and Adrian, 2010).

These definitions are infact relative and subjective because the composition of the shadow banking system tends to differ depending on the banking environment of an economy. Pozsar’s shadow banking definition included mutual funds, stock exchanges, hedged funds, broker-dealers, microfinances and any other institution that securitise assets. In this study, any financial institution that is formally registered and monitored by a regulatory authority is excluded from the shadow banking bracket.

Goodenough (2012) pointed that shadow banks are regarded as non-depository institutions, they have been subject to less prudential regulation than traditional banks, therefore there was no guarantee whether they kept high financial reserves relative to their market exposure or not. Shleifer and Vishny (2013) argues that, lack of prudence in these institutions left them with very high level of financial leverage and a high ratio of debt relative to the liquid assets available to pay immediate claims. High leverage magnified profits during boom periods and losses during downturns. This high leverage would not be visible to investors which meant shadow institutions would be able to create the appearance of superior performance during boom times by simply taking greater pro-cyclical risks. Though money market funds had zero leverage, they did not pose this risk feature of shadow banks.

The European Central Bank (2013) stated that, since these unregulated institutions use a lot of short-term deposit-like funding but did not have deposit insurance like mainstream banks; their downside exposure to loss of confidence could lead to extreme runs which might destabilise the whole financial system. Krugman (2013) support this view, further citing that a run on shadow banks was the core cause of the global financial crisis of the late 2000s. Shadow banks' collateralized funding was also considered a risk because it could also lead to high levels of financial leverage. By transforming the maturity of credit, such as from long-term to short term, shadow banks fuelled real estate bubbles in the mid 2000s that caused the global financial crisis when they burst.

Ghosh (2012) asserts that shadow institutions were being sponsored and guaranteed by commercial banks who borrowed from investors in short-term, liquid markets so that they would have to repay and borrow again at frequent intervals. On the other hand, they used the funds to lend to corporations or to invest in longer-term, less liquid and toxic assets. Gorton (2010) present evidence that shadow banking assets declined significantly in value as housing prices declined and foreclosures increased in all developed economies during the 2007–2009 crisis.

The literature envisages that risks in the shadow banking system are unavoidable and highly contagious. It can quickly spread to regular banks, which are linked to shadow banks in several ways in the ownership and provision of credit lines. In other instances, it is evident that some banks are dependent on the shadow banking system for their own funding requirements. For example, Dutch banks resort to the financial markets to finance their loan portfolios, as the volume of Dutch savings is too small to meet traditional mortgage funding (FSB report, 2013). The development of securitised complex shadow structured products becomes inevitable to enable loans to be sold or used as collateral for alternative financing structures.

## Research Methodology

To achieve the aim of this study, a broad range of data was required which could possibly be gathered through a survey. The study adopted a cross sectional descriptive survey research method; interviews and questionnaires. All unclear and hanging issues in the questionnaires were clarified in interviews. Since the research was centered on analysing threats of shadow banks, the research had statistical analysis of the monetary aggregates and total formal bank loan-to-deposits balances.

The researcher targeted shadow banking participants such as unregistered moneylending companies, well known loan sharks, unregistered lending clubs and pawn brokers who directly affected formal banks in their daily trading. Hence they were in a position to comprehend and appreciate the level of financial market dynamics. Economic consultants and analysts were also targeted because they had knowledge about the banking system and were likely to provide informed views and opinions. A number of finance scholars were also consulted since many of them could comprehend how the shadow banking system operates.

Considering that there was limited comprehension of the shadow banking by the general masses, a sample of knowledgeable individuals was randomly drawn. Amongst them were; twenty economic analysts, twenty finance and credit analysts, ten pawnbrokers, ten lending club members, five unregistered moneylending managers and ten other knowledgeable scholars was used in this analysis. On the distribution of research questionnaires, greater consideration was put on how active they were in the shadow banking market. A total of ten interviews were held; four commercial bank analysts, four shadow banks clients and two shadow bank managers. The same questionnaire with nine short, precise and skilfully designed questions was used as interview guide.

## Results

Results of the qualitative study show that there was no particular pattern or trend in the growth of shadow banking system. However interpreting the fundamental elements of shadow banks, their development have no negative impact on amounts held by the institutions save for the slow growth noticeable in virgin money activities during this period. The slow growth in traditional banks could not be attributed to shadow banking boom but rather to depletion of disposable income in Zimbabwe's economic downturn.

Unregistered moneylenders became very popular due to lack of feasible alternative investment options for the working class with surplus funds wanting inflation indexed investments. This could be the evidence of the 95% boom in virgin money coming into the shadows. Lending clubs remained popular during this period as they proved to be a better option to raise capital for new or struggling small businesses. They also proved to be a safe way to earn some secured interests for members with surplus cash. The high interest rates charged by shadow banks averaging 25 % per month attracted more investors into the shadow banking market to fund these lucrative businesses. However the short term loan durations means high risk as borrowers had high chances of defaulting on repayments.

Evidence from Zimbabwe showed that regulatory arbitrage and formal banks deposits growth was irrelevant to the growth of shadow banks. Attention could be drawn to the need for small business capital to people viewed to have insufficient creditworthiness and negative credit history. This researcher found out that the majority of shadow banking clients were financially illiteracy and were often unable to analyse the real cost of borrowing and the default risk parameters associated with borrowing as well as lending funds to shadow banks. They were also unable to quantify non-monetary costs, putting into consideration only literal rates presented to them by shadow bankers.

The study also found out that a number of shadow bankers were formal banks' customers which shows that the formal banking system has been a victim of its own child. They borrowed from the banks for onboard lending. Since they had knowledge of the bank lending process and also with the assistance of insiders, they borrowed large sums of capital from the bank at subsidized rates and lend for a profit. The most cited example was the owner of Hamilton Finance Pvt Ltd, Mr. Frank Buyanga, who received a US$100 million from a local bank to kick-start his micro lending business.

## Conclusion

The development of shadow banking was made possible due to the banking market conditions in Zimbabwe. The interrelation between the supply and demand in banking markets facilitated the price formation using the information available from both sides of the market participants. The financially excluded; small businesses and individuals with negative credit history who were viewed as insufficiently creditworthy, were the major drivers of shadow banking. Their product invention techniques have been one driving force behind their growth. Shadow banks have served well the banking niche, making them a necessary element of the banking system. Also lack of confidence in the traditional banking system has led to deposit flight into the thriving shadow banks.

Formal banks responded to the growth of shadow banks through establishing their own divisions that offer banking services to the previously unbanked markets. They were also lobbying for the introduction of laws to govern the shadow banking operations in order to control systemic risk in times of banking crisis. A number of foreign oriented banks have also been innovative to attract deposits and to gain lost confidence in the traditional banking system again after the 2003 banking crisis.

The growth of an alternative banking system signaled problems and lack of financial innovation on the mainstream banking system to structure financial products to improve intermediation. Qualitative analysis in this research showed that shadow banks were directly a result of poor services offered by mainline banks. The fact that shadow banks remained favored regardless of high interests they charge borrowers and high risk profiles on savers shows that there was something that formal banks were missing. The shadow banking system continued to structure financial products from thin airs for which regulatory controls on them has failed; this means the formal banking system was also prone to systemic risk that can destabilize the whole financial system.

## Recommendations for Further Study

Further research may evaluate the threats of shadow banking across borders since the financial markets are globalised; there are financial ties among countries. When the one country's financial environment becomes risky and less profitable, speculative savings fly to other havens. Therefore, regulation of the shadow banking sector in each country should be concerned about harmonizing regulatory measures across borders. Also, further research can consider financial strategies to adapt to new challenges, responses to new developments in the financial market, designing mechanisms of assessment and evaluating the effectiveness of adopted models of regulation and actions. Systemic risk across the borders occurred in 2008 when the US investment bank, Lehman Brothers collapsed, triggering the financial crisis which developed and spilled over to the entire global economy.

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