Funding the Future

Glossary entry: shadow banking

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In response to a request made on the blog, I published this glossary entry on shadow banking yesterday. I also added one on the related issue of private credit, which is linked at the bottom of the post.

The context for these posts is the contribution that both activities are making to the current financial risk environment, to which the Bank of England has recently referred, creating a situation where a financial crash is now a possibility.

Shadow banking describes financial activity that performs many of the functions of conventional banking, such as creating credit, providing liquidity, financing investment, and enabling speculation, but which takes place outside the regulatory structures applied to licensed banks.

It is called “shadow” banking, not because it is illegal (although some of it can facilitate illicit activity), but because it often operates with less transparency, weaker oversight, and fewer safeguards than conventional banks. It is banking-like activity conducted in the shadows of regulation.

There are several characteristics of shadow banking worth noting.

First, shadow banks are not usually banks at all. They include hedge funds, private equity firms, money market funds, structured investment vehicles, insurance companies, pension funds, and parts of the asset management industry. They may borrow short-term, lend long-term, package debt, speculate on asset prices, and create complex financial products, but they do so without the same capital requirements, deposit insurance rules, or direct central bank oversight faced by commercial banks.

Second, shadow banking grew because regulation was deliberately bypassed. After the deregulation wave associated with neoliberalism, financial institutions sought ways to expand lending and speculation without holding the capital buffers required of banks. If

regulation restricted one activity, the activity was often moved elsewhere. This is a classic example of regulatory arbitrage.

Third, shadow banking played a central role in the Global Financial Crisis of 2008. Mortgage-backed securities, collateralised debt obligations, repo markets, and off-balance-sheet vehicles helped create enormous hidden leverage. When confidence collapsed, governments and central banks had to intervene because institutions that claimed to be outside the state still expected rescue when failure threatened the wider economy.

Fourth, shadow banking increases instability. It often relies on short-term borrowing to fund long-term or risky assets. When confidence disappears, liquidity can vanish rapidly, forcing fire sales and market panic. Because the sector is opaque, regulators may not know where risks are accumulating until a crisis begins.

Fifth, shadow banking encourages rent extraction. Much of its activity is not directed towards productive investment but towards speculation, asset inflation, and fee generation. It can inflate property bubbles, increase corporate debt extraction, and divert capital away from socially useful purposes.

Finally, shadow banking exists because governments have often allowed finance to become too powerful. It reflects the politics of destruction and contributes to the economics of failure by increasing systemic risk while privatising gains and socialising losses.

From a Funding the Future perspective, shadow banking is, therefore, conventional banking without equivalent accountability. It demonstrates what happens when finance escapes democratic oversight: risk rises, transparency falls, and society is left paying the bill when the system fails.

See also: private credit.