Financialization and the Three Utopias of Shadow Banking

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The shadow banking system has been identified as a central cause of the current economic crisis. In this article we clarify how the concept of shadow banking is used in public reports to inform current debates about its regulation. We argue that the debate on the regulation of shadow banking is based upon three utopias: the search for a homogenization of different regulatory spaces; the focus on a temporality based on always present availability of data; and the assumption of static configurations of actors within the financial system. Finally, we propose an alternative reading of shadow banking based on the concept of financialization. Financialization allows us to link shadow banking to questions of authority and legitimacy in financial markets. The politics of financialization in general and shadow banking in particular are linked to the stabilization of interpretations and fixation of meaning.

Keywords shadow banking, financialization, financial regulation, epistemic authority

Introduction

Comparing the current economic crisis with the Great Depression of the 1930s has become a common theme (see, for example Allen & Moessner, 2011). This comparison is convincing insofar as the worst economic crisis of the last 80 years is being experienced. Nevertheless, this comparison underestimates the extent to which the current crisis was made possible by the transformative dynamics of the last 30 years broadly known as financialization. Financialization is commonly associated with the advent of the current dominance of financial rationality up to the point where it is legitimate to talk about a decoupling of financial from real markets (Engelen, 2008; French et al., 2011). This discussion concerned with the processes and concepts of financialization has widened substantially over recent years (Engelen et al., 2011;
Epstein, 2005; Ertürk et al., 2008; Krippner, 2005, 2011). Financialization, however, not only denotes a complete transformation of economic relations but also highlights a reorganization of financial markets themselves. From this perspective, the crisis was made possible by a new network of banks, rating agencies and non-bank actors such as hedge funds or money market mutual funds that were linked through practices of securitization. Even though these transformations were widely known, it was only after 2007 that these specific practices of securitization were associated with the shadow banking system (see Munteanu, 2010; Pakravan, 2011; Pozsar, 2008).\(^1\) Shadow banking is predominantly defined as a ‘functional’ equivalent to the traditional banking system as it practically offers the same ‘services’ but lacks access to public funding and stabilization mechanisms (FSB, 2012c: 2).

Before the crisis, regulators made little reference to shadow banking, but it has subsequently become the subject of heated debate. In addition to the role of volatile investment streams, the innovation of financial practices and the dynamic reconfiguration of the global financial system, shadow banking is a crucial aspect in understanding the current debacle. This has stimulated new demand for regulatory measures (Ojo, 2011; Pozsar & Singh, 2011; Weber, 2011), which are reflected in documents by monetary authorities such as the International Monetary Fund (IMF, 2010, 2011), the Bank for International Settlements (BIS, 2011) and the Financial Stability Board (FSB, 2011a, 2011b, 2012a, 2012b).\(^2\)

One interpretation of this sudden visibility of the shadow banking system is to call it a case of myopia (Cohen, 2009): it must have been myopia indeed if the emergence remained unnoticed of a system that, according to recent estimates by the Financial Stability Board, in 2007 held US$62 trillion in assets — 27 per cent of all financial assets in major industrialized countries (FSB, 2012c: 3). Or, as Pozsar et al. (2012: 9) show for the US in the same year, the shadow banking system accounted for US$22 trillion — US$8 trillion more than the traditional banking sector. Another interpretation is to see the debate on shadow banking as an attempt to extend a regulatory rationality to this new field (Kessler, 2012; Sinclair, 2005). Driven by the quest to provide technical fixes to functional problems, global monetary authorities seek to provide blueprints for a specific approach to regulating the shadow banking system. In this article, we show that this search for technical fixes will not solve any problems associated with shadow banking. In fact, we argue that the current attempt is driven by a utopian ideal on the basis of a homogeneous space, the absence of time and perfect transparency. The logic of this argument is that the imperfect reality needs to be blamed rather than the basic conceptual framework that formulates this ‘utopia’ in the first place.

The argument in this article is presented in three sections. The first section provides a reconstruction of the current debate on shadow banking. This reconstruction highlights how the regulatory debate by main regulatory institutions, such as the BIS, FSB and IMF, refers to a particular reading of shadow banking as a market-based credit system that is juxtaposed with the traditional banking system, which in contrast is backed by a deposit insurance scheme. The second section shows how this reading and the regulatory consequences it identifies are based upon three utopian projects of the spatial, temporal and actor-based constitution of shadow banking. The implications of these projects are that every financial crisis-to-come can be framed, evaluated and understood as further evidence of the necessity of moving closer towards these
utopian ideals. The third section explores how the concept of financialization enables a different understanding of shadow banking that goes beyond the search for technical fixes. This section, in particular, seeks to contribute to the financialization literature more generally by pointing to what concept of ‘the political’ appears adequate for understanding current changes — as, for instance, that which is manifested in the debate on shadow banking.

The rise of shadow banking

The concept of shadow banking is an innovation of the current crisis (Adrian & Shin, 2009, 2010; McCulley, 2007; Pozsar, 2008, 2011) and is understood here as a system of credit intermediation based on informal mechanisms and processes. The emerging literature on shadow banking understands it as a functional equivalent to the traditional system in that they both perform the same function of credit, maturity and liquidity transformation (Pozsar et al., 2012). However, there are two differences that can be distinguished. First, in the traditional banking system, financial intermediation is visible in banks’ balance sheets and banks provide information and monitoring services to their customers. In contrast, in the shadow banking system financial intermediation occurs through a chain of different agencies and actors (see Figure 1 for a more detailed overview; also see Pozsar et al., 2012). Second, while the traditional banking system is stabilized by and linked to public funding (especially by the Federal Reserve System in the US), it is the private sector that has to provide for sufficient liquidity and stability in the shadow banking system (Luttrell et al., 2012).

Figure 1: Off-balance sheet intermediation (Gorton/Metrick 2010: 264).
Although these two differences may appear to be of only minor significance, they help to frame shadow banking as playing a distinct role in bringing about the financial crisis. Private liquidity provision through new practices of securitization led to an originate-to-distribute model, which was widely seen as a better way of allocating risks across financial markets than government-based deposit insurance schemes (for a discussion on financial innovation, see Engelen et al., 2011). The intermediary position of banks associated with the risk taking involved in maturity transformation had been outsourced to a market-based credit system (Mehrling, 2012). In particular, financial innovations were heralded as important for the efficiency of financial markets and access to credit. The recent crisis has made clear that what was intended to increase the availability of credit and allocate risks efficiently, in reality brought the entire banking sector to the brink of collapse (Adrian & Shin, 2009). This did not, however, lead to a general reassessment of financialization by key international financial institutions, which continue to believe in the efficiency of financial markets. For example, the IMF (2012: 75) points to the ‘benefit of financial globalization’ once the right regulation is finally in place. The FSB also supports this view when it states that: ‘The objective of the FSB’s work is to ensure that shadow banking is subject to appropriate oversight and regulation to address bank-like risks to financial stability emerging outside the regular banking system while not inhibiting sustainable non-bank financing models that do not pose such risks’ (2012d: ii).

So far, we have argued that more critical assessments of the shadow banking system (Palan & Nesvetailova, 2013) notwithstanding, the regulatory reports assume that shadow banking could work efficiently and generate efficiency gains as well as social benefits for the wider economy. In addition to allowing the market-based dispersion of risks and thus making credit cheaper, it also broadens the credit market and facilitates access to credit (Aitken & Singh, 2010; FSB, 2012e: 1). The way in which their view of shadow banking is framed is exemplified by the following quotation from Pozsar et al.:

> The securitization-based credit intermediation process has the potential to increase the efficiency of credit intermediation. However, securitization-based credit intermediation also creates agency problems which do not exist when these activities are conducted within a bank. (2012: 3)

This highlights the potential benefits that a securitization-based intermediation process could deliver, but also refers to agency problems. In addition, concepts such as ‘information asymmetries’ and ‘wrong incentives’ (e.g. FSB, 2012f: 23; Tereanu et al., 2010: 15), deriving from modern (micro-economic) game and contract theory, are given as reasons for the malfunctioning of markets. However, to frame shadow banking in terms of ‘moral hazard’ problems and the misalignment of incentives and insufficient transparency (Gorton & Metrick, 2010) defines the problem as market failure and thus also defines the scope and limits of future regulatory reforms. If the instability of the system is attributed to agency problems, regulatory failures or false incentives, then the history of the shadow banking system is ultimately a history of different regulations that failed to solve these ‘objective’ problems.

So far, the story of the evolution of shadow banking can be traced back approximately 80 years, when the US introduced government-sponsored enterprises (GSEs). The presence of GSEs impacted the way in which banks funded themselves and ‘were
cradles of the originate-to-distribute model of securitised credit intermediation’ (Pozsar et al., 2012: 13). The next step towards the shadow banking system was in 1968, when the US government privatized these GSEs. In the 1970s, regulation on interest rate ceilings led banks to circumvent regulations through money market mutual funds (MMMFs). The floodgates to shadow banking were opened when the Clinton administration (1993–2001) abandoned the Glass–Steagall Act in 1999, which formerly separated commercial from investment banks. This provided further investment possibilities and, in line with this, the broader engagement of banks in securitized financial products quintupled the market for mortgage-backed securities (Seabrooke, 2010). The low interest policy of the Federal Reserve during the time of the Bush administration (2001–2008), as well as policies in favour of the ‘homeownership society’, provided further incentives to engage in financial innovation (Deutschmann, 2011). This created demand for structured financial products such as, for example, collateralized debt obligations (CDOs). Gorton and Metrick suggest that ‘a series of innovations and regulatory changes eroded the competitive advantage of banks and bank deposits’ (2010: 3). Summing up the discussion above, the history of shadow banking is not a story of wrong financial innovations or the endogenous instability of financial markets, but one of regulatory reforms and failures.

We have argued that the problematique of shadow banking is its framing by economic concepts derived from microeconomic game and contract theory, which focus the debate on functional solutions geared toward efficiency, incentives and transparency. The next section shows that this strategy is based on specific utopias where the politics of financial markets, and any serious regulation, are seen as a hindrance to fulfilling the conditions necessary for a sound market system.

Three utopian projects

The previous section argued that the current debates on shadow banking focus on a particular set of assumptions. The common narrative frames the crisis as one of market failure where microeconomic models can help us understand what is needed to make finance workable, efficient and stable. This section suggests that such a reading leads to three utopian projects based on spatial configurations, temporal orders and agency formations. Spatially, it assumes that all legal jurisdictions dealing with finance can be harmonized; temporally, it assumes that time can be squeezed into one instant where all information is available in the present; and it assumes that all actors and their connections and the complexity of the financial system can be fully known, new developments, innovations and regulatory arbitrage notwithstanding.

Shadow banking as a particular space

Shadow banking is understood and framed as a specific space that is separated from traditional banking, with each system being subject to different regulations (or constituted by the lack thereof). Reports on the shadow banking system point out that shadow banks are not connected to deposit insurance schemes or central banks’ liquidity measures and therefore it follows that the supervision of shadow banks is significantly more difficult (Adrian & Shin, 2010; FSB 2012g, 2011a). This difficulty is multiplied when it is taken into consideration that shadow banking is closely
related to securitization practices (collateralized debt obligations (CDOs), for example) that are not confined to nation states (Gorton et al., 2012; Kessler, 2009) and therefore require global cooperation.

For the IMF (2011), however, nation states are the primary focus in taking responsibility for their banking systems and therefore, it argues, if countries stabilize their domestic banking system this should also reduce systemic risks. However, nationally-based political frameworks do not provide the means to ‘address systemic risks’ or to secure ‘too-important-to-fail institutions’ (IMF, 2010: 9) or, as Cerutti et al. suggest: ‘Much of the data needed for identifying and tracking international linkages, even at a rudimentary level, is not (yet) available, and the institutional infrastructure for global systemic risk management is inadequate or simply non-existent’ (2011: 3).

The complexities of cross-country relations and monetary flows cannot be tracked and measured adequately because of a lack of information (IMF/FSB, 2011). The collection of more comprehensive and accurate data would require the establishment of new structures to exchange information about the global shadow banking system and its evolution (FSB, 2011). This turns the problem of data collection into a utopian project. As long as there are regulatory borders and jurisdictional differences, the quest for information leads to global coordination problems that imply a global regulatory framework into which national, regional and transnational regulatory measures could be inserted. Therefore as long as there are different jurisdictions, information gathering will necessarily be insufficient and financial actors will suffer from information asymmetries.

**Shadow banking as a specific temporal order**

Financial intermediations regulate time by providing liquidity today in exchange for future revenues. Within the shadow banking system and through securitization, non-bank financial intermediaries were increasingly able to provide the transformation of long-term maturity assets into short-term financial products (FSB, 2012a). This shift was supported and unintentionally accompanied by regulatory measures of the Basel Accords (du Plessis, 2011). Shadow banking allowed for maturity transformation beyond national supervision and created such money-like short-term liabilities in the form of (synthetically) constructed commercial papers, as the BIS confirms:

Shadow banks have the potential to generate substantial systemic risk because they can be highly leveraged and engage in significant amounts of maturity transformation while being closely linked to commercial banks. And, as the name suggests, the shadow banks can do all of this in ways that are less than completely transparent. (2011: 15)

This led to a highly liquid financial market based on the exchange of commercial papers. The exchange value of such papers could be sustained because the risk associated with these financial products could be hedged through the provision of market-based insurance schemes (credit default swaps, or CDSs).

This combination of commercial papers and insurance implies a distinctive temporality of shadow banking. High frequency trading with money-like assets was now possible within the shadow banking system. As a market-based valuation system it is not bound to individual currencies and, hence, spatial restrictions. These commercial papers (in combination with tailored default insurances) could be seen ‘as money-like’
assets because everybody believed — or assumed — that all information would be readily taken into consideration and, accordingly, the price of these commercial papers would be adjusted. Eventually, when all available information is (believed to be) included in the price, then speed is only limited by the technical restrictions of glass fibre and calculation capacities.

This temporal utopia refers to the notion that all future developments, changes and uncertainties can be reduced to the current price. When information has already been stored in ratings and hedged through insurances, then there is no future uncertainty or change that could impact on the current price and all future developments and uncertainties are already taken into consideration. This means that shadow banking generates ‘money-like’ assets through the creation of — in theory — a highly liquid market-based credit system. Every attempt to regulate the shadow banking system thus needs to ‘fix’ the future in order to sustain the liquidity of these markets. A crisis within the shadow banking system is then the crisis of something unforeseen, not included in current prices.

This stretches back to a longer debate in economics about the role of radical uncertainty. As Kessler (2008) shows, modern economic models are built on the belief that there is no distinction necessary between uncertainty and risk. Therefore, uncertainty and risk are subject to the same logic and are ‘manageable’ through calculative practices. Denying the existence of radical uncertainty implies that all possible future states of the world can be known. This theoretical manoeuvre of excluding radical uncertainty (and thus denying its distinct rationality) constitutes — in its practical consequence — this temporal utopia: the utopia suggesting that time can be squeezed into the ‘present’. Secure knowledge about the future then becomes the rationale for regulation.

**Shadow banking as a set of actors**

Demand for regulation of the shadow banking system focuses not only on control over cross-border transactions and maturity transformations, but also on the transparency and visibility of agency positions within the shadow banking system (Adrian & Ashcroft, 2012). In the context of the shadow banking system, this is important in two ways. First, the necessity of identifying ‘systemically relevant banks’; that is, to identify those institutions that are so deeply connected with the global financial system that their financial position needs to be made known to regulators. Second, and more importantly for this discussion, financial markets are not constituted by a given set of actors, rather, there is a continuous entry and exist of specific types of actors within financial markets, as the evolution of special purpose entities across different jurisdictions indicates (Thiemann, 2012). The Basel Committee for Banking Supervision described special purpose entities (SPEs) but could not foresee how they would actually perform in operating financial markets (BCBS, 2006: 122–30). From this perspective, shadow banking is associated with a new level of complexity and new chains of actors. Proposals to fix and make visible the set of actors experience two main difficulties. First, even though regulatory measures want ‘to extend the regulatory perimeter beyond traditional financial institutions to cover shadow banks’ (BIS, 2011: 15), it is also acknowledged that processes of shadow banking can, potentially, stabilize the traditional banking system (FSB, 2012b). From this perspective, the
existence of the shadow banking system might not be a bad thing and therefore the ‘transformation’ of shadow banking into ‘traditional’ banking is counterproductive. Second, in order to stabilize the shadow banking system, supervision requires information about and risk assessments of all the actors involved (Caruana, 2012; Fontaine & Garcia, 2012). One expression of this is the call for global legislation of financial regulation (FSB/IMF/BIS, 2011: 6). This requires a common definition of categories by which these agencies can be distinguished and regulated accordingly. However, these categories are not passive descriptions, but alter the field they want to describe: the regulatory demands perceive the shadow banking system to be a static relation between specific actors. Yet, even if at a given point in time all actors were known, there would still be a utopian project underpinning this attempt, as it would neglect innovations and the emergence of new actors. For example, the attempt to define the capital ratios of specific agents via the Basel Accords did not succeed in stabilizing the financial system. To the contrary, these regulatory measures were involved in the creation of new entities (as SPVs) and connections (indicated by new trading practices and new financial instruments) within the shadow banking system. Global regulation, then, would not just require the exclusion of loopholes, but would also have to assume that actors within financial markets are not fixed entities associated with prescribed sets of financial practices. Therefore, although it might, in principle, be possible to identify current actors, it is hard to monitor all evolving links and connections in the context of dynamic changes.

Taken together, all three aspects of incomplete information — space, time and agency relations — focus on the basic conditions for attaining a state of complete knowledge in order to facilitate the stability of the financial system. What becomes clear is that this is a task that can never be achieved. In order to leave the confines of this utopian project, it is necessary to challenge the very problem that current regulations seek to solve. We have argued that the current description of the shadow banking system and the regulatory endeavour it formulates are based upon the idea of perfect information rather than information asymmetries. An alternative to this perspective focuses on the reconstruction of data and its location in specific social contexts. In order to capture these social contexts, we turn to the concept of financialization.

Financialization and shadow banking

The preceding sections argued that the current discussion on the shadow banking system is based upon a specific episteme, by which we mean a specific perspective on things, and in particular the specific conditions of knowledge construction. This episteme of the dominant financial institutions (especially the BIS, FSB and IMF) is characterized by the pursuit of perfect, objective knowledge that constitutes three utopian projects. Hence, we suggested that current initiatives represent ‘more of the same’ measures which led to the financial crisis rather than new measures designed to help resolve present recessionary dynamics.

However, this does not mean that current initiatives will not leave a lasting imprint on shadow banking (see Adrian & Ashcraft, 2012). Their shortcoming is based on the idea that one can regulate shadow banking by making each institution subject to
tighter regulation. What is omitted is the notion that the system is able to reproduce itself and that the regulation and complexity of shadow banking represents a ‘dialectical’ relationship rather than simply one of ‘transfer’. By dialectical we mean that regulation changes the complexity of shadow banking and that this complexity then creates new regulatory demands. Shadow banking can thus not simply be transferred into the realm of sound regulation, rather attempts at incremental change will induce changes, new practices and new contingencies within the shadow banking system. This means that the shadow banking system is a product of the dialectic relationship and not a designed outcome of regulation. Hence, we want to point out that the current approach (as outlined above) to regulating shadow banking focuses on given entities or ‘things’ and presupposes given actors, jurisdictions, regulations or specific practices. What is underestimated is the way in which connections between those entities change continuously. In other words, this approach underestimates the extent to which new regulations will merely induce a reorganization of connections and lead to new or further complexity of financial markets. In order to decrease the complexity without increasing the instability of financial markets the solution is not to abandon regulatory measures but to concentrate on evolving connections between practices, regulation and actors. This might mean, then, de-connecting (i.e. forbidding) certain procedures rather than incorporating them into the regulatory framework.

To step beyond the current confines, it is therefore necessary not only to point out the shortcomings inherent in the vocabulary in which shadow banking is discussed, but also to develop a different conceptual framework that allows the capture of this inter-subjective constitution of space, time and agency. By exploring the connections and inter-subjectivity, we intend to show that financialization is irremediably linked to reified notions of authority (Fuller, 1959: 10; and more recently, Herborth, 2012: 245).

Hence, when it comes to the politics of financialization, the point is less to refer to nation states, regulatory bodies or interests and more to focus on politics, which is linked to the creation, manifestation and stabilization of frames and interpretations. At the same time, politics and the stabilization of frames and interpretation are irremediably linked to the operation and rationality of financial markets. Hence, an alternative conceptual framework needs to be able to do three things: (1) provide an explanation of financialization itself; (2) show how financialization leads to questions of authority; and (3) indicate how authority (as the capacity to interpret data) constitutes and stabilizes frames. Without criticizing other alternatives, in the remainder of this article we want to pursue this quest for an alternative by looking at prices.

Financialization and prices
Financialization captures the transformation from production-led to finance-led economies. The exact dynamics that led to financialization and the consequences that followed are widely contested by authors from different perspectives such as the French Regulation School (Aglietta, 2000), cultural political economy (Langley, 2008) or the ‘bricolage’ approach (Engelen et al., 2010). Additionally, financialization also emphasizes social (Carruthers & Kim, 2011), political (Polillo, 2011) and economic reconfigurations (van Treeck, 2009). Thus, at its core, the concept of financialization analyses the way in which financial markets became detached from real markets, how they outgrew given confines and set out to transform social, economic, political and
cultural relations (for an overview, see especially Ertürk et al., 2008). Although these developments are crucial for understanding contemporary capitalism, we try to reconstruct how financialization has led to a reorganization of financial markets themselves — and thus to provide an explanation of how financialization relates to shadow banking as an alternative to the economic interpretation fostered by the ISB, IMF, FSB and BIS. Here, we encounter a conceptual problem. The reconstruction of the internal dimension of financial markets, through indicators of financialization such as profits, which predominantly map the changes between financial and real markets, do not provide an understanding of the dynamic operation of financial markets (see Ertürk et al., 2008: Chapter 1; Krippner, 2005: 174; Stockhammer, 2007; van Treek, 2009: 908). A focus on the relative weight of profits generated by financial transactions versus, for instance, manufacturing certainly points to the dominance of financial markets vis-à-vis real markets, with crucial repercussions for the organization of the (global) political economy. In order to understand shadow banking, however, we have to base our analysis on an alternative description of financialization.

Regarding definitions of shadow banking, a consensus exists that shadow banking is constituted by the private provision of liquidity and its de-coupling from public funding. Even if one wants to depart from this definition, it shows that shadow banking is based on its own internal sources of authority and legitimacy. Without ratings by credit rating agencies, practices of securitization would not be possible, as they have the power to define the meaning of data and promote their interpretation. Similarly, like any social order, shadow banking developed internally constituted notions of what is legitimate; that is, what practices are seen as normal. Thus, the debate on shadow banking is not simply a technical debate on how to regulate these institutions and financial instruments; rather, it also opens up a debate about authority, the boundary of state authority and the rationality of markets. It is here that the autonomy and power of financial markets are renegotiated. However, it is not a debate that includes the wider public or public authorities; rather, it is a debate whereby economic models and concepts define the terms and content of financial reforms. These concepts include incentive misalignments, transparency, market failure, asymmetric information (predominantly in the form of moral hazard) and have exclusionary powers by defining the horizon of possible reform by constituting a technical debate and a functional logic. The primary question in the debate on how to reform financial markets, then, focuses on ‘how best to fix financial markets’. If, however, the reform of financial markets is a technical question to begin with, it is de-politicized right from the start. Financial experts with their disciplinary knowledge are then ultimately in the right position to ‘speak’ and to ‘define’ the ‘common good’ and how reforms should look. The politics of financialization in the case of shadow banking are not simply related to what states do, but how a group of experts related to central banks and international financial institutions (in particular the IMF, BIS and FSB) can, based on disciplinarily defined knowledge, advance a specific perspective on shadow banking to such an extent that the definition of key problems, the meaning of shadow banking and reforms, are already framed by their analysis.

In order to make this point more specific, we argue in two stages. First, it is suggested that a more conceptual discussion is needed on the continuous operation of financial markets and how actors, models and instruments are connected. Therefore it is vital that we reconceptualize authority in financial markets as it is not ‘delegated’
or given qua ‘status’ (that is: being ‘in’ authority), but linked to the operation of financial markets themselves (being ‘an’ authority). Hence, we need to think about status, authority and expertise as ‘arising’ from within financial markets. What constitutes authority in finance is not the same as what constitutes authority in law or sports or any other social sphere. This discussion allows us, then, to understand the meaning of economic authority, its scope and its enabling ‘role’.

To capture the operations of financial markets, how financial markets are reproduced and their boundaries, it is thus not sufficient to look at actors or specific practices. Rather, we argue that financial markets are continuously reproduced, and limited by prices; in other words, financial markets make things (companies, the future, weather, food, pollution or climate change) priceable. Through financial markets things are linked to prices and prices connect to other prices.

Before we continue with this argument, two caveats are necessary. On the one hand, this concept of prices differs from the story of prices told in neoclassical economics where prices result from supply and demand and change in accordance to them. However, in order to provide a different narrative and challenge such theory, it is necessary to change the vocabulary, whereby prices are understood not in economic terms, but from a social perspective and understood as a ‘media of communication’ (see Kessler, 2012; Albert et al., 2008). On the other hand, one could argue that economists have already pointed out that prices serve as communication devices. However, the only strand that could claim to be interested in prices as media of communication have been Austrian economists, who, in fact, lack a theory of communication (Kessler, 2012). Mainstream economists put emphasis on rational expectations and equilibria conditions, not on social practices of communication.

Second, we start from the presumption that prices are never just a mirror of demand and supply; they are never apolitical or neutral. Rather, they result from and are based upon a specific constellation of institutions, actors, calculative practices or regulatory frameworks that all leave their imprint on how prices are constituted. Prices, in other words, are formed by stabilizing specific connectivities of communication. After each communication, there is a plurality of possible arguments or responses that carry communication further. However, in every situation there is only a limited set of possible responses that connect in a meaningful way. Asked on the phone, the question ‘is Jim there?’ cannot be answered by ‘tomorrow there is a snowstorm in California’. Further, answering with a ‘yes’ and then hanging up might indicate that one has not understood the question (Kratochwil, 1989: 18). Rather, one would expect a ‘yes’ or ‘no’ and, in the case of the former, that the person to whom one is speaking will then get Jim. The same holds true for economic or legal spheres: within legal proceedings there is only one certain set of possible arguments which are structurally different and which follow a different rationality to arguments in the economic sphere. The set of arguments that ‘make sense’ in economic relations can be structured around ‘prices’. In short, we need to ask what is already presupposed in the formation of prices, what are the consequences of these prices and what are the implications for the meaning of their associated objects?

Even though this may sound abstract, this focus on prices helps to tackle several conceptual problems that we indicated above. First, we can now provide an alternative account for financialization exemplified by the shadow banking system: without the specific configuration of actors, without ratings, without derivatives, practices of
securitization and without the financial innovations of the last 20 years, it would hardly be possible to form a price for specific tranches of mortgage-backed securities. Questions regarding over-the-counter products, structured investment vehicles, value-at-risk calculations, evaluations by rating agencies and hedge fund operations all play a role in forming a picture. Whether we look at Enron, LTCM or Lehman — their new business models and their interrelations within financial markets point to new ways of making prices possible. Second, now we can also take seriously the proposition that shadow banking is not simply a distinct field set apart from the traditional banking system, but that the system emerged ‘dialectically’ as a result of intended and unintended consequences. Its emergence was intended insofar as the deregulation of financial markets and support for financial innovations are important pre-conditions for shadow banking. However, its emergence is also unintended, as traditional banks and other financial actors (money market mutual funds or hedge funds) used the loopholes to circumvent Basel II regulations. Hence, we do not need to locate the sources of instability outside of regulated financial practices, but understand crises as linked to the very operation of financial markets. During (financial) crises, the ‘normal’ stabilization of price connectivities and narratives, which constitute the meaning of data, collapse with the consequence that crises produce radical uncertainty because it becomes no longer possible to ‘make’ a price. Instead of focusing on better data, higher disclosure requirements and measurements of risks, this perspective suggests that we need a discussion on the negative effects of mathematical models in financial markets, the limits of their use, their boundaries and their produced ‘risks’. We need a discussion on how Wall Street has been redefined by the entry of the ‘Quants’ — as Patterson (2011) named mathematicians or physicists working in financial markets — and how computer models de-legitimize practical reasoning. The next section pursues the question of how financialization thus understood allows us to grasp the importance of authority in contemporary financial markets.

**Financialization and the question of authority in finance**

While in real markets prices refer to tangible objects (cars, bread or butter), in financial markets prices are only formed through their operation. For instance, if prices of derivatives refer to future expectations of other financial products, this process requires an already present operation of trading procedures within financial markets which then enable a financialization of expectations (see Aspers, 2009). Financialization implies not only an expansion of ‘prices’, in the sense that more relations, things and issues are understood in terms of price, but also suggests a different rationality of how prices are formed and interlinked.

Through this perspective we can reconsider crucial implications for questions of authority. In real markets, there are qualitative and quality differences in the properties of goods in that one could say that a car from company A is of better quality than the car from company B because of its physical properties. This holds true for diamonds, real estate or sausages. Even if the categories according to which these goods are divided in terms of their different qualities are arbitrary and conventional, in real markets, it is good enough to know the categories and be aware of the quality differences. In the context of financial markets, this procedure is different in that there are no existing physical properties that could legitimize differences in quality. Different tranches of CDOs are legal constructs referring to future events, but not to
present physical entities. Nevertheless, there are differences in quality in financial markets, where differences inevitably refer back to those who propagate these categories (Aspers, 2009). Here, financial expertise is taken to be a legitimate authority; what is said is less important. It is the logic of a statement that has to comply with a prerogative financial knowledge. This allows, then, the statement’s integration into financial communication. In other words prices in financial markets refer back to epistemic authority (Adler & Haas, 2009: 368; Widmaier & Park, 2012: 128). In the field of shadow banking, authority relates to the possibility of defining how knowledge can be defined as such and through which mechanisms knowledge can be created as an ‘objectivist epistemic illusion’ (Hamati-Ataya, 2012: 640). It enables, for instance, understanding the position of rating agencies: they have ‘moved from a more persuasive role into that of epistemic authority, or embedded knowledge network’ (Sinclair, 2005: 64–65).

Credit rating agencies are one of the most prominent epistemic authorities in financial markets. The evaluation of shadow banking and its impact on the crisis is surprisingly silent on these — despite the widespread public debate about their power and authority before the crisis. However, this public debate is nurtured by the belief that credit rating agencies are to be blamed for their conflicts of interest and their business models (for a discussion, see Kessler, 2012; Sinclair, 2005). They are blamed for wanting to secure future profits with their ratings. Even though we do not dispute this problem, we want to indicate another dimension. If we take away their ratings, we take away modern finance, that is, financial innovations enabling a large-scale market-based credit system. Credit rating agencies are part of the social matrix of finance in that they form a basic part of the chain, which enables prices to connect to other prices and therefore facilitate communication within financial markets. Thus, the problem is not one of making a trade-off between different regulatory goals; rather, it is how the political discourse refers to legitimacy and authority. The implications of this are that the communicative position of credit rating agencies structures the field of possible connectivities. For instance, if they categorize a political decision of Greek politicians as a problem in the context of the debt crisis, then it reduces Greece’s ability to ‘find’ a price for their bonds. This means that the government of Greece cannot refinance its budget and obligations of the past because of logics represented, for instance, by debt to GDP ratios (for a critical discussion, see Herndon et al., 2013). Political decisions therefore have to take ‘interpretations’ by credit rating agencies into consideration in terms of policy responses and proposals. Therefore, the point is less whether their evaluations are accurate and more whether credit rating agencies possess such an authoritative position. In other words, are they able to reproduce the economic and economistic reading of crises. They reiterate a particular reading of the crisis informed by a particular framework. Through this process certain discourses become stabilized and others are excluded. What is needed, therefore, is an alternative vocabulary to challenge processes of financialization and thereby conceptions of authority within the financial markets.

**Conclusion**

This article has focused on the concept of financialization as a means of analysing the regulatory discourse of shadow banking. We suggested that the shadow banking system is framed, understood and analysed in terms of agency problems, government
failures or information problems that derive from economic theory in general and asymmetric information models in particular. This perpetuates the efficient market hypothesis and it frames the current crisis as resulting from ‘failures’ in the past. It follows that this perspective is positive about the new possibilities that the shadow banking system generates in terms of financial innovation, the efficient dispersion of risks and new forms of liquidity transformations. However, this reasoning operates in utopic contexts. If there are no boundaries, no time, no ‘loopholes’, then the promises of a free market shadow banking system will finally materialize. Hence, shadow banking is defined as a specific space, time or constellation of actors that gives rise to specific regulatory tasks that can never be successful.

In order to provide an alternative description of shadow banking, the final part of this article suggests that the concept of financialization can help us to side-step the three utopian projects. It allows us to re-construct the way in which financial innovation and financial practices continuously ‘generate’ new uncertainties, new spaces and new constellations of actors. It provides a framework whereby we can reconstruct the interdependencies and continuous changes of space, time and agency. We drew conclusions for the regulation of shadow banking by pointing to the case of credit rating agencies. It is suggested that regulation will not correct failures, but that stability and crises have to be seen together: regulation needs to take into consideration the formation of prices and it poses the question of how prices are (dis)connected within the shadow banking system. We suggested that the ‘politics’ of financialization relate to how a specific group of actors can determine and fix a certain interpretation of events. In other words, the politics direct us to the question of how certain interpretations are stabilized and how crises are ‘rationalized’. We have shown how the current interpretation of shadow banking is stabilized through specific economic concepts deriving from modern microeconomics put in place to structure the problems and define the regulatory demands that shadow banking generates. Hence, we propose to focus in particular on how authority is generated in order to open up this ‘closure’ and to produce a space for ‘critique’ and alternative interpretations. This will then allow us to see how other forms of knowledge and authority are silenced and how the public is systematically excluded from reform debates through the functionalist dreams of a stable financial market.

Notes

1 The term shadow banking is said to have been coined by Paul McCulley. For a more detailed explanation of his views on what shadow banking means, see the interview in McCulley (2013).

2 There are sub-committees such as the Macroeconomic Assessment Group (MAG, 2010), the Basel Committee on Banking Supervision (BCBS, 2010), the Working Paper series of the BIS and the IMF, and reports by joint groups (IMF/BIS/FSB, 2011; IMF/FSB, 2011)

3 Models of asymmetric information are usually separated between models of moral hazard (asymmetry after signing of the contract) and adverse selection (asymmetry before the signing of a contract). For a discussion, see Kessler (2012).

4 Commercial papers (CPs) are traditionally simple securities. The shadow banking system, however, was (and still is) based on more complex securities, which had been structured and sliced (e.g. collateralized debt obligations, or CDOs). The next step was to construct synthetic commercial papers, which were not backed by real assets or portfolios of them. In contrast, these synthetic commercial papers were structured commercial papers relating to credit default swaps (CDSs), which in turn referred to the performance of asset-backed commercial papers (ABCPs), for instance mortgage-backed securities (MBSs).

5 For theoretical discussions that come close to this approach, see Latour (2005) and Luhmann (1997: 42).
References


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