"It takes me about two hours to assemble a team of finance geeks and lawyers to devise a product or a transaction that will bypass any new rule or regulation coming our way," the senior French banker said over dinner. We were in Southern Europe at a conference on financial intermediation, in the midst of the financial crisis in the autumn of 2008.

The comment felt like a confession. Although this banker was visibly concerned about the state of the financial system, his job is to organize a team that will relentlessly move around any new rules or restrictions designed to tame risk.

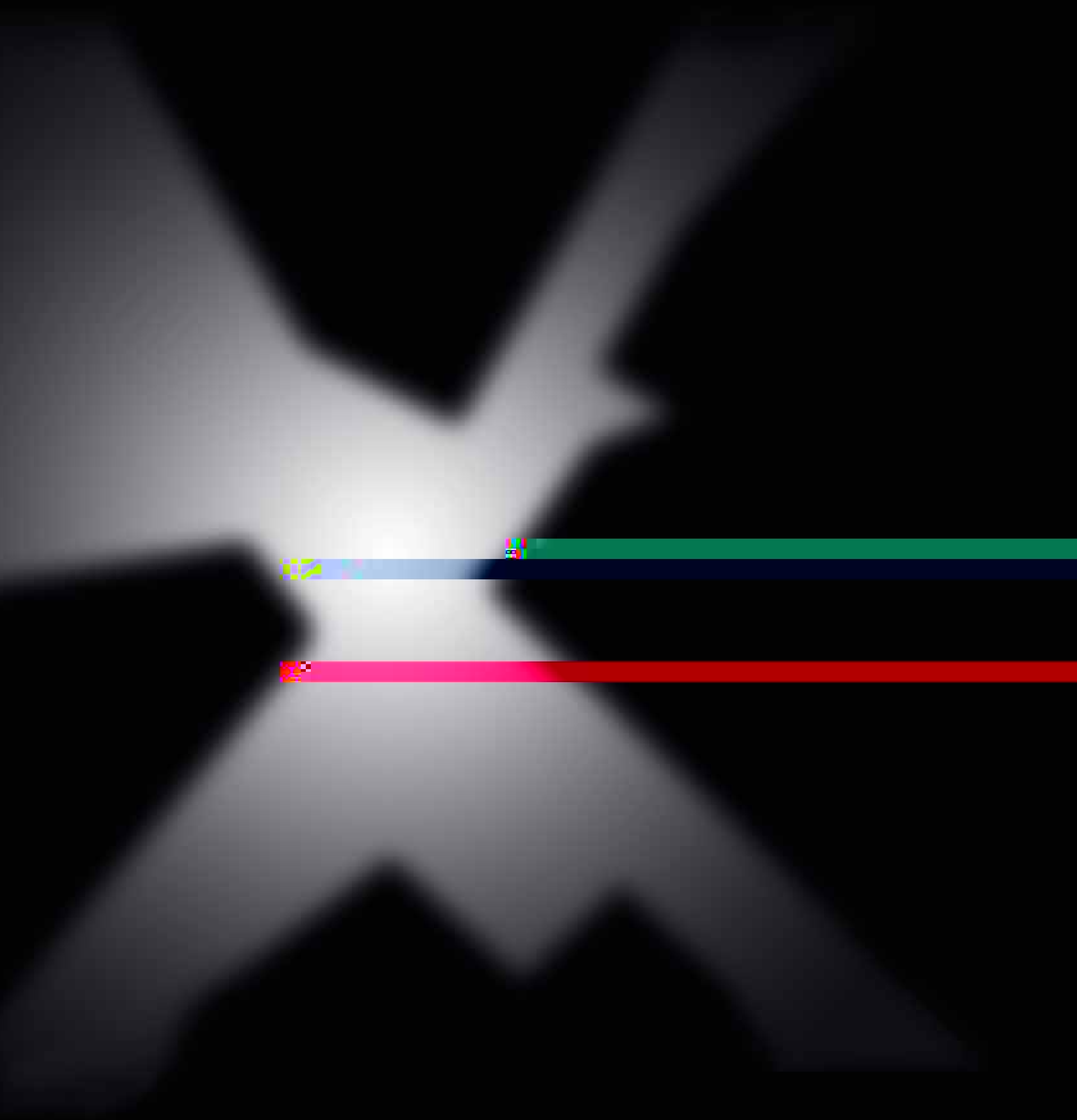
Regulators and policymakers are in a battle against the blunt logic of financial managers who increase the complexity of the financial system each time they respond to new regulation. I call this process "financial evolution", to draw a heuristic connection to living organisms and the old assumption of the natural order of things. In finance, it seems futile to question or criticize innovation, defined as a sign of progress and a good thing. Progress, in turn, implies a form of linear evolution.

"Shadow banking" is the most compelling illustration of how the process of financial evolution actually happens. This term coined by Paul McCulley, then managing director at PIMCO, is both a stroke of genius and an unfortunate choice of words. Unfortunate, because it implies this activity is "shady"; it wrongly ascribes pejorative connotations to an essential part of the financial sector. Genius, because the confusion over which entities should count as "shadow banks" has matured into an important debate among industry experts, regulators, academics and civil society.

Shadow banking started out as a benign force of financial innovation and competition. It has been broadly defined as a complex network of credit intermediation that occurs outside the boundaries of traditional, regulated banks. A more precise definition suggests it is a system of market-based funding, or "money market funding of capital market lending" (Mehrling et al. 2013).

The Financial Stability Board (FSB) puts the global size of the shadow banking system at $71 trillion. This accounts for roughly half of total banking assets globally and a third of the world's financial system. Anglo-Saxon countries predominate, with US and UK accounting for 46 per cent and 13 per cent of the global shadow banking system respectively. Japan and the Netherlands follow closely with 8 per cent each.

The system's international reach is deep. Shadow

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