Regulating Shadow Banking: Challenges And Solutions

Marcus Stanley
Policy Director
Americans for Financial Reform
Market-mediated banking

- Banking services:
  - Maturity, liquidity, and risk transformation.
- Performed through long, complex credit intermediation chains, not single institutions.
- Links in chains are often market trades.
- Transformation relies on supposed ‘safety’.
  - Guarantees from institutions.
  - Collateralization.
  - Subordination.
The Challenges To Regulation

- The safety net vs. market discipline.
- Integration of markets and institutions.
- Complex market-based intermediation chains.
- Ease of risk transfer and activity migration.
  - Key question: will bank-centered regulation work?
Shadow Banking And the Safety Net

• Shadow banking relies on private guarantees.
• Private safety net is systemically unreliable.
• Systemic event creates pressure on government to back private guarantees.
• Private sector expansion of implicit safety net.
• And even the explicit safety net is unclear.
• 2007-09 bailout: violated LOLR principles.
• Can market discipline work?
The Safety Net Post Dodd Frank

• Deposit Insurance
  – May be more limited – swaps push out?
• Federal Reserve 13(3) authority.
  – Nominally more limited, but in practice?
• Treasury liquidity line for resolution.
• Liquidity support for clearinghouses.
• Exchange stabilization fund, FDIC guarantees.
  – Clearly better controls here.
Integration of Markets and Institutions

• Can our fragmented regulatory system handle it?
  – Glass-Steagagel regulation in a new financial world.

• Market vs. prudential regulators.
  – Round 1: Money market funds.
  – Round 2: Asset managers?
  – Round 3: Wholesale funding markets?

• Can the FSOC mediate these divisions?

• Will the Federal Reserve emerge as de facto global regulator?
Complex Market-Based Intermediation

• Complexity multiplies opportunities for deception of counterparties and regulators.
  – Limited progress at Office of Financial Research?

• Leverage can ‘hide’.
  – Collateral chains, embedded leverage.

• Market linkages increase fragility.
  – Procyclicality, link to unstable market prices.
  – Hard to trace market connections – fire sales.
Will Bank-Centered Regulation Work?

• Banks were central but not only guarantors in the shadow banking system.

• Ease of risk transfer outside regulated banks.
  – Basel still permits risk transfer from banks to outside guarantors -- ‘eligible risk guarantors’.
  – Derivatives markets.

• Competition from market-mediated banking.

• Again: market discipline and the safety net.
Solutions That Are ‘On The Table’

• Solution #1: Leverage/risk management at major banks and designated SIFIs.
• Solution #2: Leverage/risk management in funding, risk transfer markets.
  – Margin, collateral, haircuts, clearing.
• Solution #3: Activity limitations, but maintain connections between banks and traded markets.
• Issue #1: Will market discipline + oversight ‘work’ to address migration in response to controls?
• Issue #2: Hidden leverage and exposures?
Solutions That Are NOT ‘On The Table,’ But Should Be

• Address complexity bias in regulation.
• Clearer, more strategic safety net.
  – Protect key activities, minimize moral hazard.
• Greater public role in financial system.
  – Infrastructure and/or services.
• Restore favored role of banking vs. trading.
• Change culture of risk transfer – fiduciary.
• What is finance for?