The Challenge of Shadow Banking

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How Did We Go From This...

Savers – households, non-financial business

Intermediary Banks

Borrowers – household purchases, business investment
To This?
And what should we do about it?
The Growth of Shadow Banking

• In 1970: 80 percent of financial sector liabilities were ‘traditional’ regulated liabilities like bank deposits, checking accounts, and insurance company reserves.

• By 2007: only 40 percent of financial sector liabilities were ‘traditional’.
Differences From Commercial Banking

• Just like commercial banking, shadow banking converts illiquid, risky, long-term assets into ‘safe’, liquid assets convertible to cash on short notice.

• But does it through market mediated credit.
  – From risks that are held to risks that are sold.

• Much longer, more complex credit chains.
  – Many unregulated non-banks, but banks play key role.
Key ‘Shadow Banking’ Markets

• Securitization markets >> real economy credit.
• Securities lending markets >> within financial sector flows.
  – Replacing unsecured interbank, Fed lending.
• Derivatives markets >> risk transfer.
• Commercial paper.
Shadow Banking: Why Worry?

• Market mediated credit is just as old and just as traditional as commercial banking.

• Spreads risk and allows fine-tuning of assets to investor preferences, increasing credit availability.

• Government-supported secondary mortgage markets date from Depression.
  – Bear certain similarities to ‘shadow banking’ and worked well for many years.
Shadow Banking: Why To Worry

• Extended credit intermediation chains multiply opportunities for fraud, deception.
  – Complexity undermines market discipline.
• Complexity conceals and heightens leverage.
• Pro-cyclical linkage to market prices.
• Result: financial fragility, boom-bust cycles.
Shadow Banking And the Safety Net

• Risk conversion relies on private guarantees.
  – Guarantees from ‘too big to fail’ institutions.

• Private safety net is systemically unreliable.

• Systemic event creates major pressure on government to back private guarantees.

• Private sector expansion of implicit safety net undermines market discipline.
The Challenge To Regulation

- Measurement and oversight of risk.

- Ease of arbitrage when risks move between regulated and unregulated sector.

- Difficulty defining bounds of the safety net.
The Dodd Frank Act Does Not Fully Address These Issues

• Important areas of shadow banking completely omitted from DFA.
  – Regulatory efforts on securities lending, money market funds, slow and inadequate so far.
  – Division between market and prudential regulators a problem.
• Dodd Frank Act ambivalent on the safety net.
• Capital rules still permit extensive risk transfer.
Some Key Questions

• How far will regulation of the large dealer banks take us?
  – TBTF banks were at the center of the shadow banking system, but other central dealers and guarantors could emerge.
• Designation of non-banks – asset managers?
• How to ensure private market discipline?
Some Broader Thoughts

• Need to end the complexity bias in our regulatory system. Lean against forms of ‘financial innovation’ that promise risk transfer benefits but increase fragility.

• Examine increased support for commercial banking model of on-book lending.