Regulation of shadow banking

Adam B Ashcraft
Senior Vice President and Head of Funding Liquidity and Interest Rate Risk Management
7/12/2016

The views expressed here are those of the author exclusively and do not represent those of the Federal Reserve Bank of New York or the Federal Reserve System
**Framing of key issues around shadow banking**

**Traditional banking** is the funding of illiquid assets through money-like instruments which benefit from explicit credit and liquidity support from the official sector

- Money is a unit of exchange, unit of account, and store of value
- Money has no intrinsic value; it is as valuable as the holders of money believe
- There is a close empirical connection between public confidence in money and economic activity
- Fragility of public confidence in the value of money underlies the motivation for official sector credit and liquidity support for bank deposits

**Shadow banking** is the funding of illiquid assets through money-like instruments that do not benefit from explicit credit and liquidity support from the official sector

- Rationale for credit intermediation outside traditional intermediaries includes specialization, financial innovation, and regulatory arbitrage
- Rationale for maturity transformation outside banks, and the creation of private money-like instruments, is largely the pursuit of low-cost and risk-insensitive sources of funding
- Fragility of confidence in value of private money, combined with connection between money and economic activity, underlies official sector concern about shadow banking
Banking crises are followed by large declines in economic activity

Retail depositor run at Northern Rock, 9/2007

Even healthy bank failures have permanent real economic effects

Historical perspective on importance of shadow banking

Credit and Maturity Transformation
Total liabilities as percent of nominal GDP

- **Traditional Credit Transformation**
  - Bank and BHC term debt
  - Pension liabilities
  - Insurance liabilities

- **Traditional Maturity Transformation**
  - Bank deposits
  - Interbank loans

- **Shadow Credit Transformation**
  - Mutual Funds
  - Corporate Bonds
  - GSE debt

- **Shadow Maturity Transformation**
  - Money market shares
  - Security Repos
  - Open Market Paper

Source: FR Financial Accounts of the US

Cite as: Adrian, Tobias, Adam B. Ashcraft (2012) Shadow Banking: A Review of the Literature, Federal Reserve of New York Staff Report 580
Financial crisis experience of shadow banking

Figure 5: U.S. Money Market Fund Assets by Fund Type

- Prime
- Government
- Tax-free

Billions of Dollars

Source: Moneyfundanalyzer
Note: Shaded area September 16 - October 21
Regulating traditional and shadow banking activities

- **(Investor) market discipline**
- **Prudential market regulation**
- **Institution-based prudential regulation**
  1. Resiliency of traditional banking
  2. Interactions between traditional and shadow banking
  3. Boundary between traditional and shadow banking
  4. Prudential market regulation

**Traditional banking**
- Asset Quality
- Funding Liquidity
- Leverage

**Shadow banking**
- Asset Quality
- Funding Liquidity
- Leverage

**Financial Stability Oversight Council (FSOC)**
Recent uses of the regulatory toolbox

1. Resiliency of traditional banking
   (i) Capital
   (ii) Liquidity
   (iii) Resolution

2. Interactions between traditional and shadow banking
   (i) ABCP
   (ii) Tri-party Repo
   (iii) Derivatives
   (iv) Leveraged Lending

3. Boundary between traditional and shadow banking
   (i) GSEs
   (ii) SIFI designation
   (iii) Volcker

4. Prudential market regulation
   (i) NRSROs
   (ii) MMMFs
   (iii) Risk Retention
   (iv) Reg AB
   (v) Secured Financing Haircuts