AMERICANS FOR FINANCIAL REFORM

Regulating Shadow Banking: Challenges And Solutions

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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-Steagal 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 <u>activities</u>, 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?