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FEDERAL RESERVE BANK *of* NEW YORK

Regulation of shadow banking

Adam B Ashcraft
Senior Vice President and Head of Funding Liquidity and Interest Rate Risk Management

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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

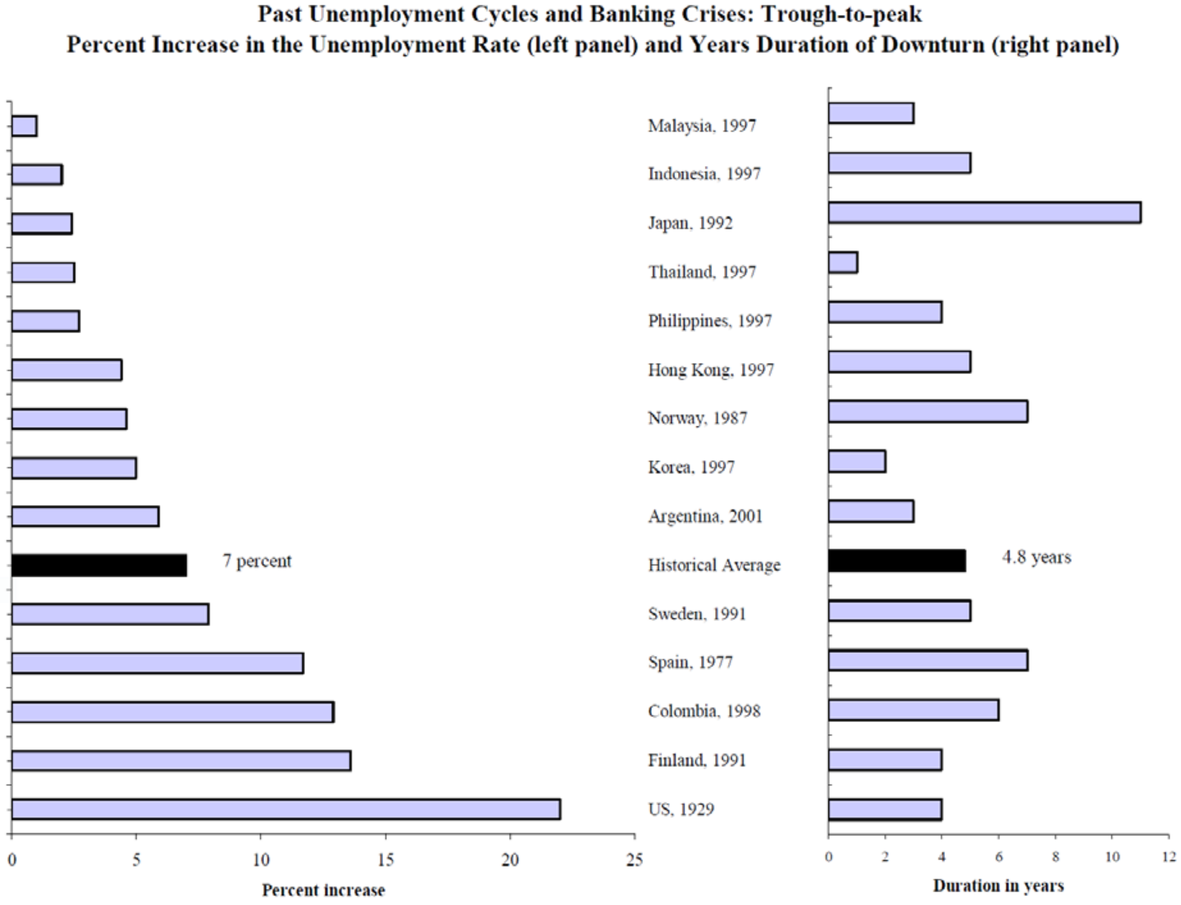
- Money is a unit of exchange, unit of account, and store of value
- Money has no intrinsic value; it is as valuable as the holders of money believe
- There is a close empirical connection between public confidence in money and economic activity
- Fragility of public confidence in the value of money 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

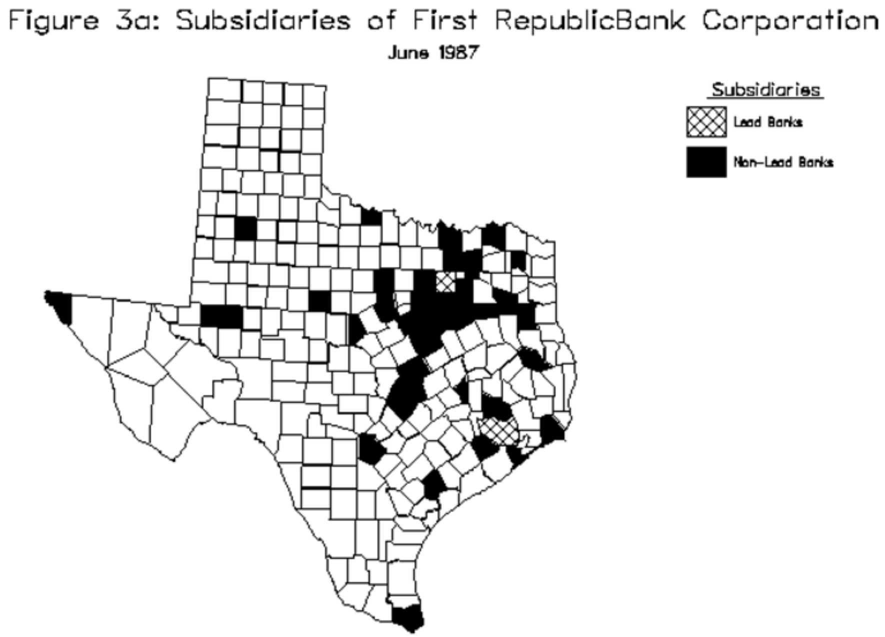
Banking crises are followed by large declines in economic activity

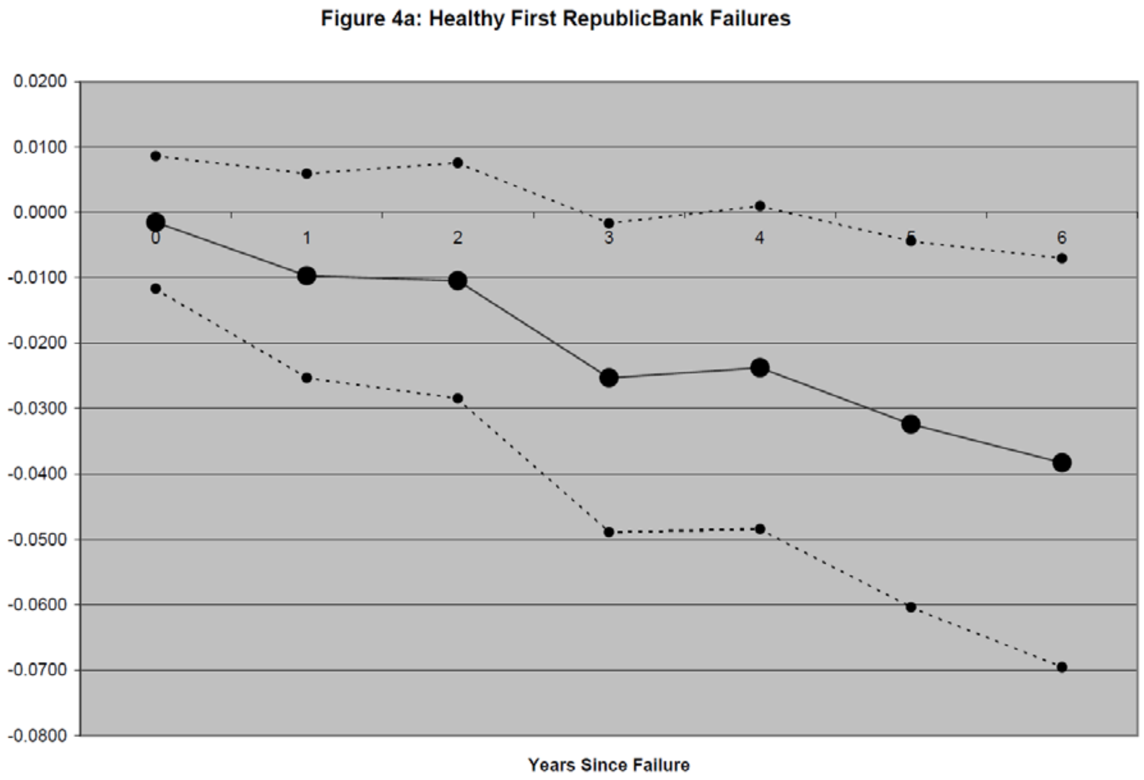
Retail depositor run at Northern Rock, 9/2007



Reinhart and Rogoff (2009): “The Aftermath of Financial Crises,” NBER working paper 14656

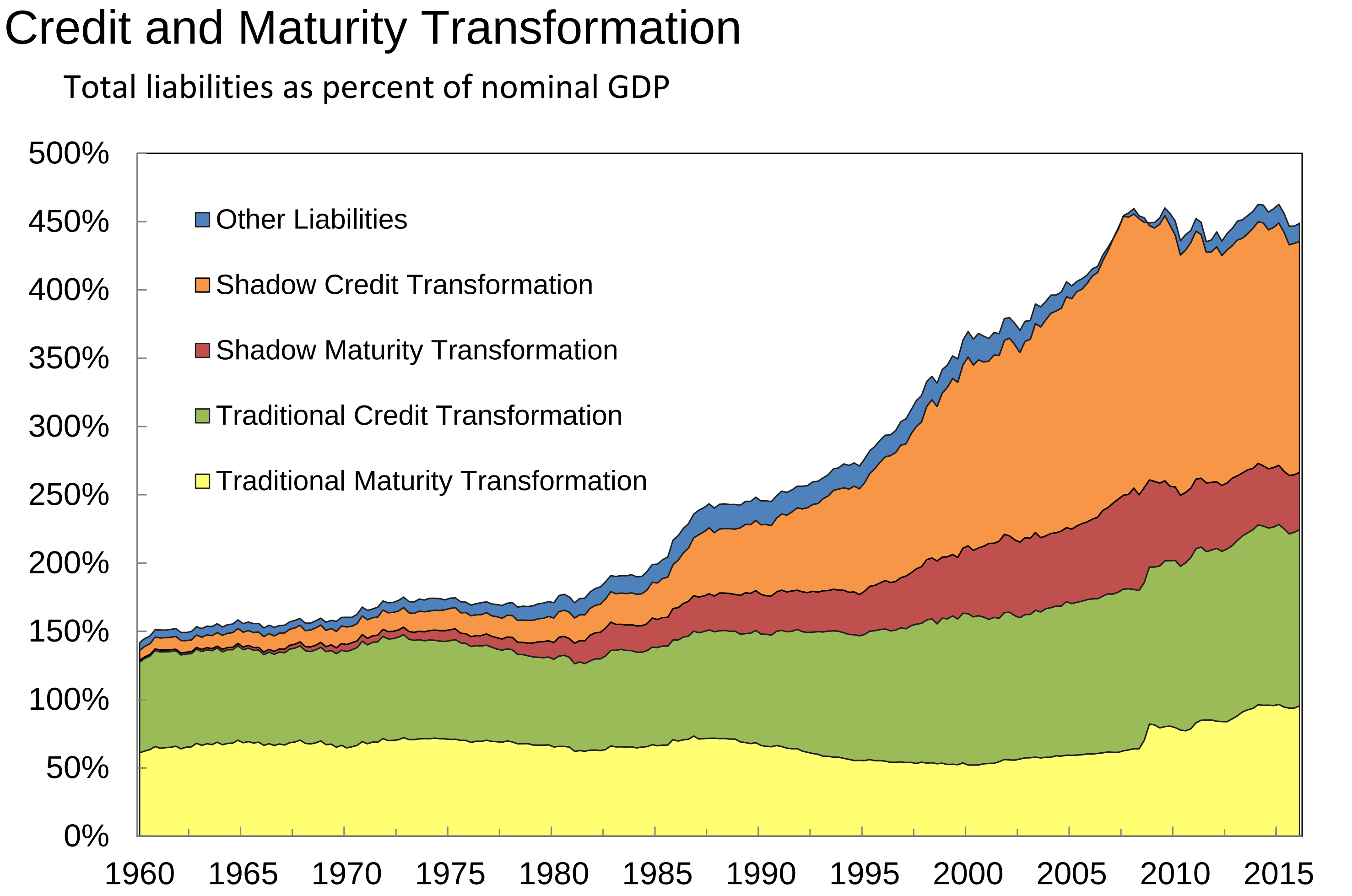
Even healthy bank failures have permanent real economic effects





Ashcraft (2005): “Are Banks Really Special? New Evidence from the FDIC-induced Failure of Healthy Banks,” American Economic Review, Volume 5, Issue No 5 (December).

Historical perspective on importance of shadow banking



Source: FR Financial Accounts of the US

Cite ass: Adrian, Tobias, Adam B. Ashcraft (2012) Shadow Banking: A Review of the Literature, Federal Reserve of New York Staff Report 580

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

Financial crisis experience of shadow banking

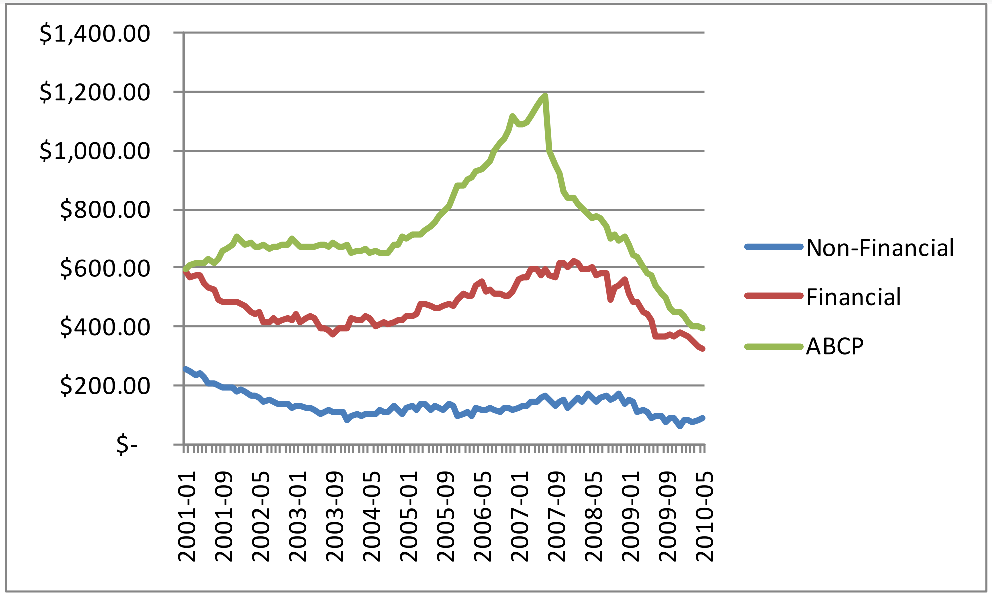
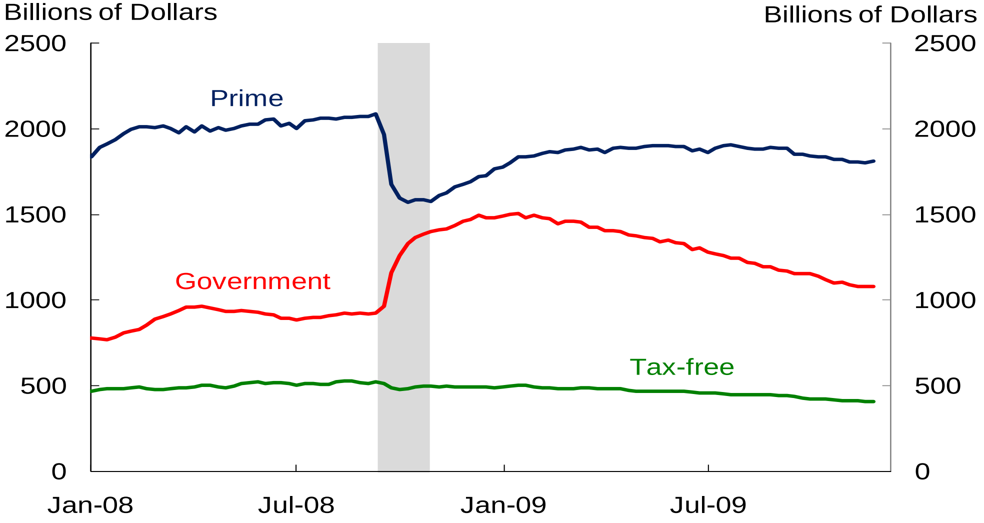
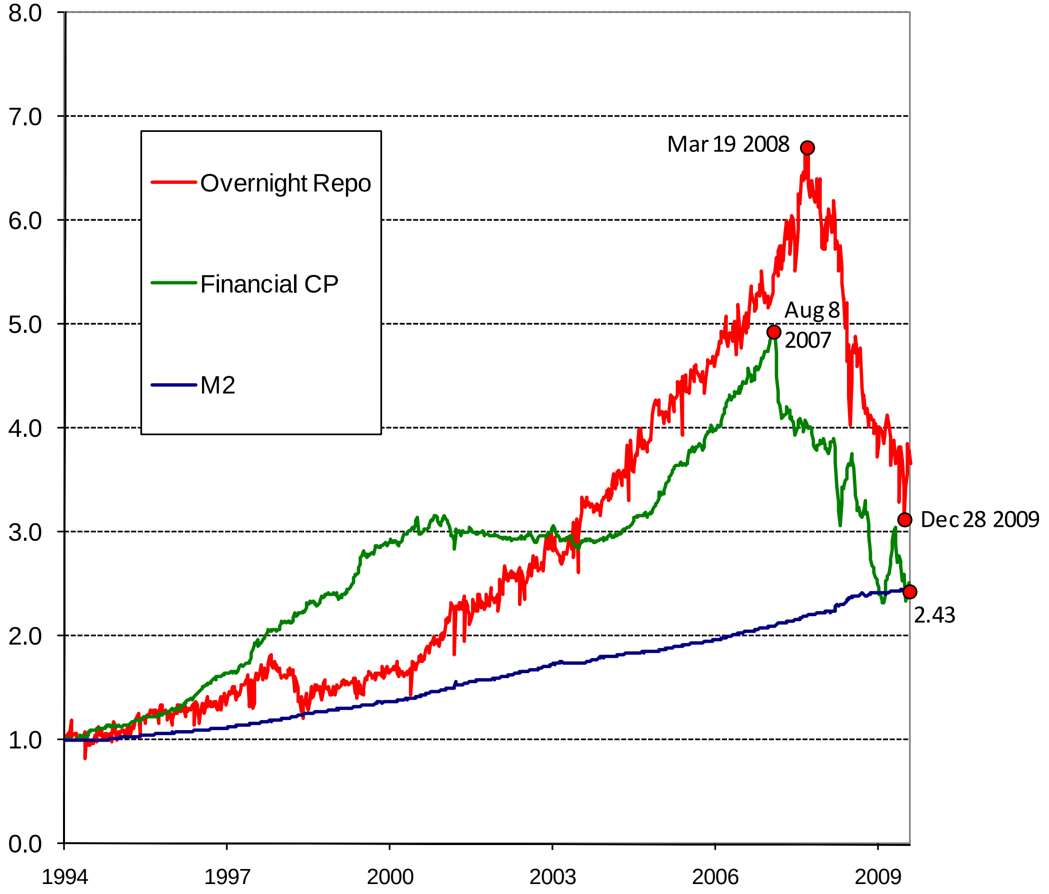


Figure 5: U.S. Money Market Fund Assets by Fund Type



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

(4) Prudential market regulation

(2) Interactions between traditional and shadow banking

Asset Quality

Funding Liquidity

Leverage

Traditional banking

Asset Quality

Funding Liquidity

Leverage

Shadow banking

(3) Boundary between traditional and shadow banking

Financial Stability Oversight Council (FSOC)

Recent uses of the regulatory toolbox