Shadow Banking, Macroprudential Regulation and Financial Stability

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Introduction and Motivation

- Shadow banking has grown in importance to rival traditional banking
  - Shadow banking provides a valuable alternative to bank funding and helps support real economic activity
  - However, it can become a source of systemic risk
- Current macroprudential requirements mainly apply to bank credit => Activities and risks may migrate to the non-regulated sector => What to do??

URGENT NEED OF MODELS FOR POLICY RECOMMENDATIONS!!!

Contribution

- I build a DSGE model with shadow banking for policy evaluation
- I study shadow banking effects on the macroeconomy, welfare, and financial stability => It increases consumption at the expense of risks to financial stability
- I analyze how macroprudential regulation interacts with shadow banking
  - Should macropru be extended beyond the traditional banking system?
  - Some limits in the shadow banking LTV should be imposed
  - Not to be applied to the whole banking system, some shadow banking is beneficial

Model Overview

- DSGE model with housing, collateral constraints and a shadow banking sector
- Two types of agents; borrowers and savers
  - Borrowers can either borrow from private lenders (shadow banking) or regulated banks
- Financial regulation: LTV, capital requirements (Basel III)
  - Private lenders are not be subject to the same banking regulation as traditional banks

Key Lessons from the Model

- Credit volatility increases with the presence of shadow banking
  - Shadow banking increases risks to financial stability
  - Shadow banking increases credit flow in the economy and thus welfare
  - However, after a certain threshold, these benefits do not compensate the increase in financial volatility and welfare decreases
  - The proportion of shadow banking that maximizes households’ welfare is around 30%