Emerging Risks and Shadow Banking

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Shadow banking definitions

• Simple: credit intermediation by non banks (FSB)
• Sharper: credit based on liquidity and maturity transformation based on uninsured market instrument
• Key feature: replicating banks’ inexpensive funding via short term wholesale and secured debt
• Critical to fund the credit boom 2002-2008
• By this definition, no visible growth in shadow banking in recent years in Europe
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How shadow banks manage to resemble banks

• Bank funding is cheap because they offer liquidity on demand
• This construction makes banking unstable and requires regulation
• Shadow banking is about replicating this construction outside the regulated perimeter
• We need to understand the construction to avoid regulatory arbitrage
How shadow banks promise liquidity

• Bank cheap funding rely from deposit insurance, access to central bank refinancing and TBTF.

• How can shadow banks match this?

• One: very short term debt

• Two: extract liquidity guarantees from banks
  • Basel III claims to have stopped this route
Shadow bank direct funding

• Own funding channel: secured financial credit

• This contractual form credibly deliver safety, liquidity thanks to *superior priority and bankruptcy privileges*
  • Unlike short term debt, not well documented
  • Repo funding, derivatives

• But creating absolute safety for some lenders create more risk for others

• **To control risks associated with shadow banking, we need to keep track of this construction**
Examples of shadow banks

• Traditional
  • MMF

• Emerging:
  • Central Clearing Platforms
  • ETF ?
  • Asset Managers ?

• Submerged:
  • Special investment vehicles
  • Large broker dealer non banks
Manage shadow banking risk

• Top priority: make sure shadow banks do not expand in illiquid assets by feeding on liquidity guarantee by banks
• Corollary: avoid creating any expectation that central banks should stabilize shadow banks
  • By intervening in asset markets or lending to non banks
• New challenges: keep track of shadow banking constructions in asset managers, ETF
• Very delicate: security lending, collateral swaps allowing liquidity transformation by unregulated intermediaries relying on banks (eg via swaps and derivatives)
Figure 10. Barclays U.S. Aggregate Bond Index Duration

* Approximate percentage change in price in response to a 1 percentage point change in interest rates.

Source: Bloomberg L.P.
Figure 11. Loss to U.S. Bond Funds After 100-Basis-Point Shock to Interest Rates (Estimated)

Note: Bond funds include mutual funds and exchange-traded funds (representing $3.8 trillion in total assets) that report to the Investment Company Institute.

Sources: Bloomberg L.P., Haver Analytics, OFR analysis