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**

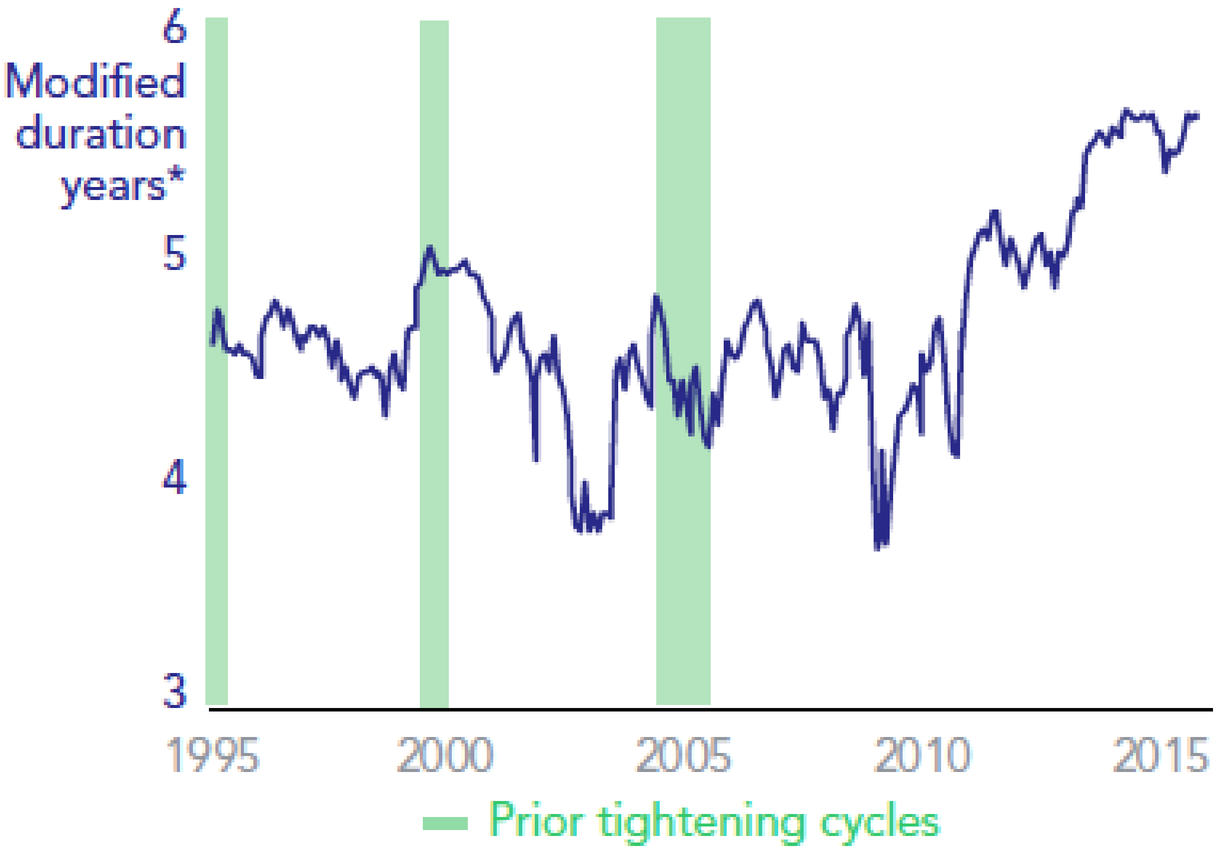
Examples of shadow banks

- 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)

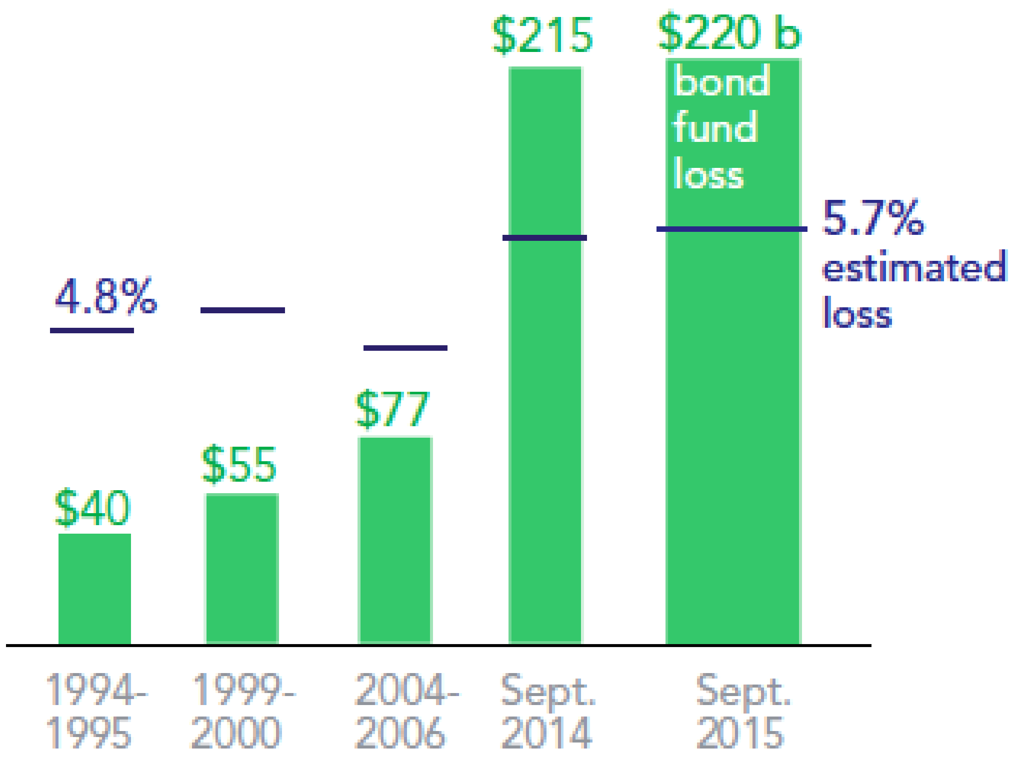
Figure 10. Barclays U.S. Aggregate Bond Index Duration



* 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