The Challenge of Shadow Banking

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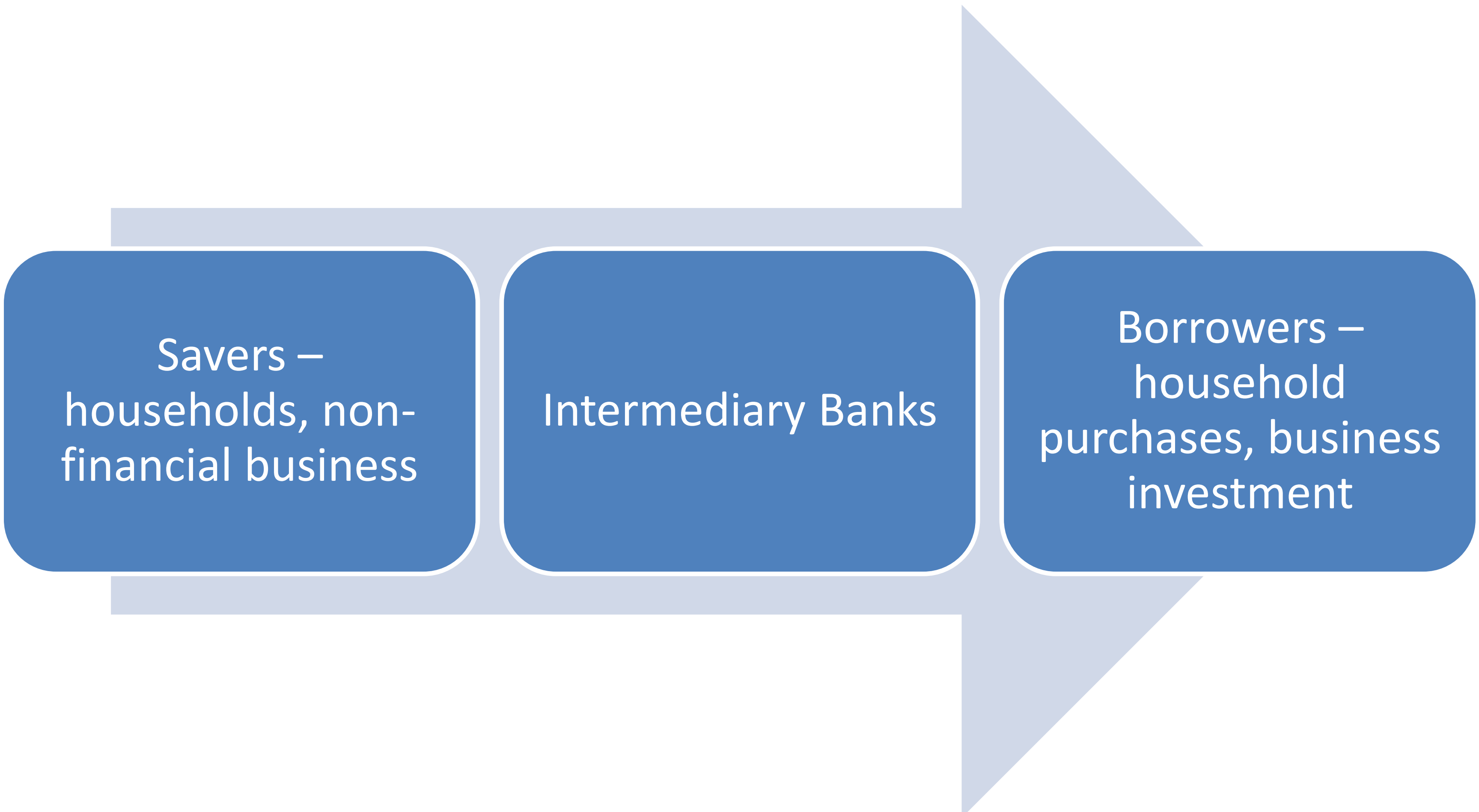
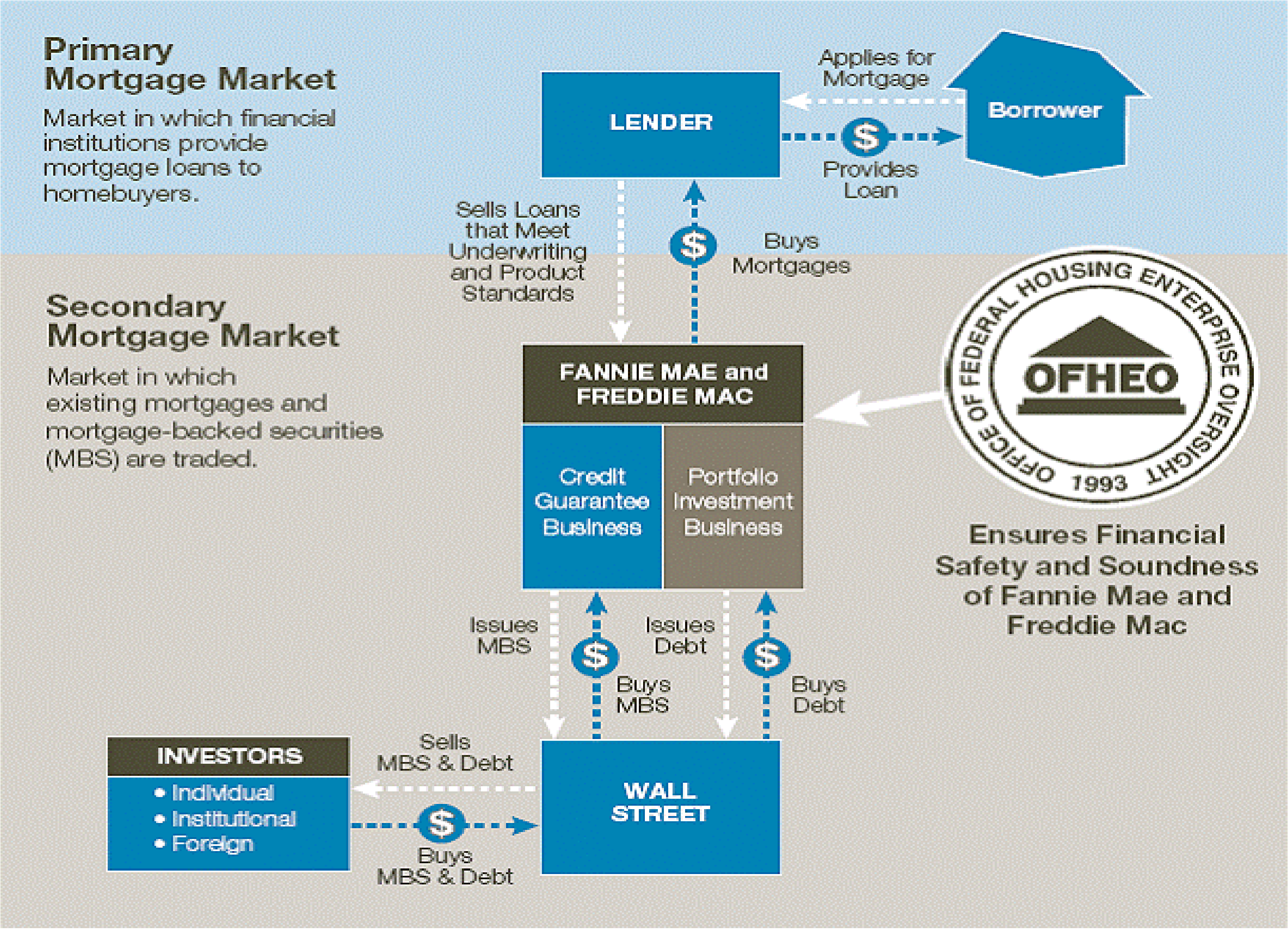
How Did We Go From This…

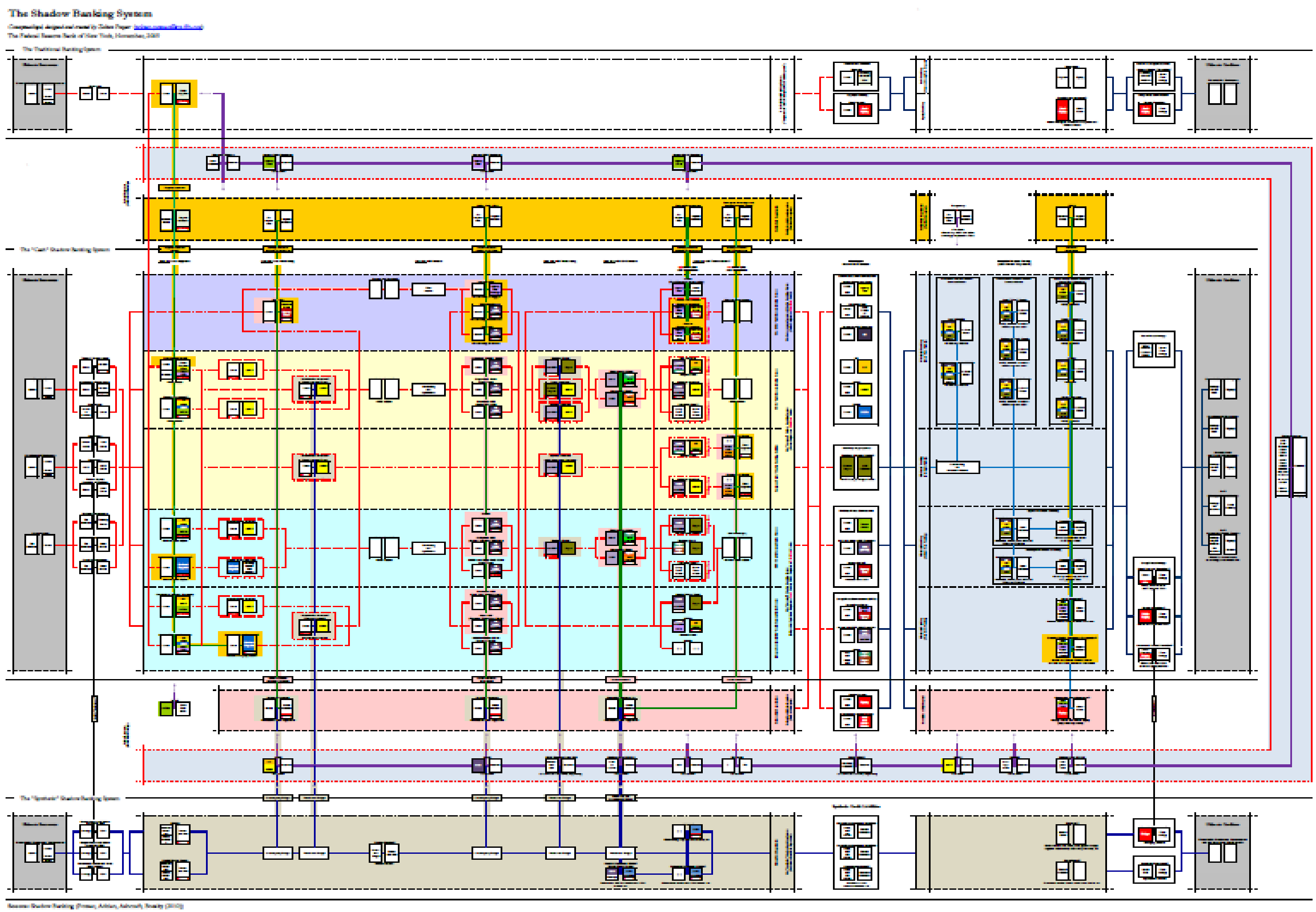


And This…



Primary Mortgage Market
Market in which financial institutions provide mortgage loans to homebuyers.
LENDER
Applies for Mortgage
Borrower
$
Provides Loan
Sells Loans that Meet Underwriting and Product Standards
$
Buys Mortgages
Secondary Mortgage Market
Market in which existing mortgages and mortgage-backed securities (MBS) are traded.
FANNIE MAE and FREDDIE MAC
Credit Guarantee Business
Portfolio Investment Business
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
OFHEO
1993
Ensures Financial Safety and Soundness of Fannie Mae and Freddie Mac
Issues MBS
$
Buys MBS
Issues Debt
$
Buys Debt
INVESTORS
• Individual
• Institutional
• Foreign
Sells MBS & Debt
$
Buys MBS & Debt
WALL STREET

To This?



And what should we do about it?

The Growth of Shadow Banking

- In 1970: 80 percent of financial sector liabilities were 'traditional' regulated liabilities like bank deposits, checking accounts, and insurance company reserves.

- By 2007: only 40 percent of financial sector liabilities were 'traditional'.

Differences From Commercial Banking

- Just like commercial banking, shadow banking converts illiquid, risky, long-term assets into ‘safe’, liquid assets convertible to cash on short notice.
- But does it through market mediated credit.
  - From risks that are held to risks that are sold.
- Much longer, more complex credit chains.
  - Many unregulated non-banks, but banks play key role.

Key ‘Shadow Banking’ Markets

- Securitization markets >> real economy credit.
  - Replacing own-book commercial bank lending.
- Securities lending markets >> within financial sector flows.
  - Replacing unsecured interbank, Fed lending.
- Derivatives markets >> risk transfer.
- Commercial paper.

Shadow Banking: Why Worry?

- Market mediated credit is just as old and just as traditional as commercial banking.

- Spreads risk and allows fine-tuning of assets to investor preferences, increasing credit availability.

- Government-supported secondary mortgage markets date from Depression.
  - Bear certain similarities to ‘shadow banking’ and worked well for many years.

Shadow Banking: Why To Worry

- Extended credit intermediation chains multiply opportunities for fraud, deception.
  - Complexity undermines market discipline.
- Complexity conceals and heightens leverage.
- Pro-cyclical linkage to market prices.
- Result: financial fragility, boom-bust cycles.

Shadow Banking And the Safety Net

- Risk conversion relies on private guarantees.
  - Guarantees from ‘too big to fail’ institutions.
  - Supposedly ‘safe’ collateral. Subordination.
- Private safety net is systemically unreliable.
- Systemic event creates major pressure on government to back private guarantees.
- Private sector expansion of <u>implicit</u> safety net undermines market discipline.

The Challenge To Regulation

- Measurement and oversight of risk.
- Ease of arbitrage when risks move between regulated and unregulated sector.
- Difficulty defining bounds of the safety net.

The Dodd Frank Act Does Not Fully Address These Issues

- Important areas of shadow banking completely omitted from DFA.
  - Regulatory efforts on securities lending, money market funds, slow and inadequate so far.
  - Division between market and prudential regulators a problem.
- Dodd Frank Act ambivalent on the safety net.
- Capital rules still permit extensive risk transfer.
- Office of Financial Research – a mixed record.

Some Key Questions

- How far will regulation of the large dealer banks take us?
  - TBTF banks were at the center of the shadow banking system, but other central dealers and guarantors could emerge.
- Designation of non-banks – asset managers?
- How to ensure private market discipline?

Some Broader Thoughts

- Need to end the complexity bias in our regulatory system. Lean against forms of 'financial innovation' that promise risk transfer benefits but increase fragility.

- Examine increased support for commercial banking model of on-book lending.