The Case for Regulating the Shadow Banking System

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What Is “Shadow Banking”?

• *Maturity transformation* outside the depository banking sector

• “Maturity transformation” = issuance of **very short-term, fixed principal** IOUs to finance *longer-term* financial assets

• (This definition has no *necessary* connection to (i) securitization or (ii) collateralization)
What Is “Regulating”? 

U.S. depository regulation includes, *inter alia*:

- explicit portfolio and activity restrictions
- capital requirements
- cash reserve requirements
- restrictions on affiliations and affiliate transactions
- access to central bank liquidity
- access to deposit insurance
- a special receivership regime in the event of failure
- a special supervisory and enforcement regime
- and so on
Gross “Money-Claims” Outstanding

- Very short-term, fixed principal IOUs
Gross Private “Money-Claims” Outstanding

Private / Total Outstanding
### Policy Response to the Crisis

<table>
<thead>
<tr>
<th>Private Money-Claim Category</th>
<th>Emergency Policy Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money market mutual fund “shares”</td>
<td>• MMMF Guarantee (Treasury)</td>
</tr>
<tr>
<td></td>
<td>• Money Market Investor Funding Facility (Fed)</td>
</tr>
<tr>
<td>Uninsured Deposits</td>
<td>• Transaction Account Guarantee (FDIC)</td>
</tr>
<tr>
<td></td>
<td>• Term Auction Facility (Fed)</td>
</tr>
<tr>
<td></td>
<td>• Deposit insurance limit increase (EESA¹)</td>
</tr>
<tr>
<td>Liquidity-Put Bonds</td>
<td>• N/A</td>
</tr>
<tr>
<td>Eurodollar Deposits</td>
<td>• Central Bank Liquidity Swaps (Fed)</td>
</tr>
<tr>
<td>Financial Commercial Paper</td>
<td>• Temporary Liquidity Guarantee Program (FDIC)</td>
</tr>
<tr>
<td>Nonfinancial Commercial Paper</td>
<td>• Commercial Paper Funding Facility (Fed)</td>
</tr>
<tr>
<td>Asset-Backed Commercial Paper</td>
<td>• ABCP MMMF Liquidty Facility (Fed)</td>
</tr>
<tr>
<td>Primary Dealer Repo</td>
<td>• Primary Dealer Credit Facility (Fed)</td>
</tr>
<tr>
<td></td>
<td>• Term Securities Lending Facility (Fed)</td>
</tr>
</tbody>
</table>

- Practically the entire policy response was about stabilizing private money-claims
Is there a Market Failure?: The Liquidity Events

A) U.S. Asset-Backed Commercial Paper Outstanding

B) Short-Term Repo Outstanding
(Broker-dealer “tri-party” repo)

C) U.S. Prime Money Market Fund Shares Outstanding

D) Short-Term Funding Spreads
(three-month obligations; spread to risk-free rate)
Is There a Market Failure?: The Credit Crunch

A) U.S. Securitization Issuance
(excludes agency securitization)

B) New Corporate Lending
(U.S. syndicated loan market)

C) Federal Reserve Assets

D) U.S. Real GDP
(annualized quarterly rates; chained 2005 dollars)
Policy Proposal

1. Establish licensing requirements for money-claim issuance (prohibit unlicensed firms from issuing money-claims)
2. Require licensed issuers to abide by portfolio restrictions and capital requirements
3. Establish public commitment to stand behind money-claims – make them default-free
4. Require issuers to pay risk-based fees for this support

- This is a “public-private partnership” for money creation
- Same as depository banking regime!
Goldman Sachs – Cost of Funds

*Interest rates include the effects of hedging in accordance with SFAS No. 133

<table>
<thead>
<tr>
<th>Dollars in billions</th>
<th>2006 - 2008 (Total)</th>
<th>Balance</th>
<th>Interest</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term borrowings</td>
<td></td>
<td>$294</td>
<td>$38</td>
<td>4.3%</td>
</tr>
<tr>
<td>Long-term borrowings*</td>
<td></td>
<td>$164</td>
<td>$38</td>
<td>7.6%</td>
</tr>
<tr>
<td>Term spread (long-term less short-term)</td>
<td></td>
<td></td>
<td></td>
<td>3.3%</td>
</tr>
<tr>
<td>Funding benefit (term spread * S-T borrowings)</td>
<td></td>
<td></td>
<td></td>
<td>$29 bn</td>
</tr>
<tr>
<td>Pretax earnings</td>
<td></td>
<td></td>
<td></td>
<td>$35 bn</td>
</tr>
<tr>
<td>Funding benefit / pretax earnings</td>
<td></td>
<td></td>
<td></td>
<td>85%</td>
</tr>
</tbody>
</table>
What Direction Has Policy Taken?

- Still no licensing requirements or prohibitions
  - Money-claims, as such, are not a cognizable regulatory category

- Many new risk constraints (Volcker Rule, Basel III, “macroprudential” supervision, etc.)

- Public support less available
  - New lender of last resort (Section 13(3)) restrictions
  - Basically, no more guarantees (TLGP, MMMFs)
What About Orderly Liquidation?

- Depends on what you mean by “orderly”
- **Shadow banking view**: failure isn’t “orderly” if money-claim issuer defaults on its money-claims

- **OLA doesn’t prevent default on money-claims**
  - Treasury must agree to funding
  - Funding limitations (10% / 90% tests)
  - Subject to debt limit!

- FDIC: under OLA, issuers will default on short-term IOUs “in virtually all cases”
Conclusion

• Market failure in shadow banking → prima facie case for government intervention

• Arguably the central problem for financial regulatory policy

• Recent and pending forms not directed toward this problem

• Need for a coherent institutional design

• Public-private partnership has worked in the past