The Case for Regulating the Shadow Banking System

Morgan Ricks
Harvard Law School

October 14, 2011

What Is "Shadow Banking"?

- *Maturity transformation* outside the depository banking sector

- "Maturity transformation" = issuance of <u>very short-term, fixed principal IOUs</u> to finance *longer-term* financial assets

- (This definition has no *necessary* connection to (i) securitization or (ii) collateralization)

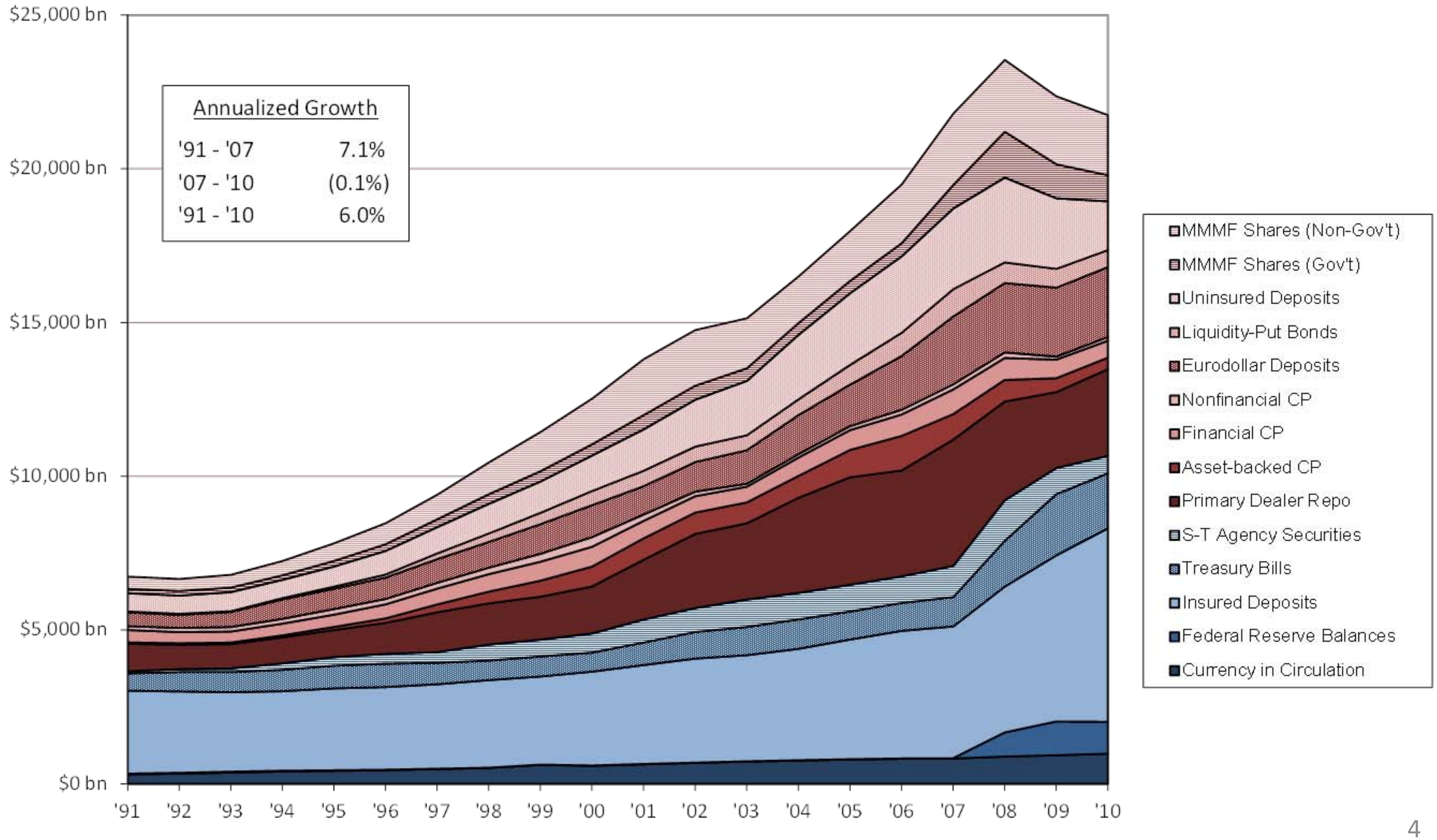
What Is “Regulating”?

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

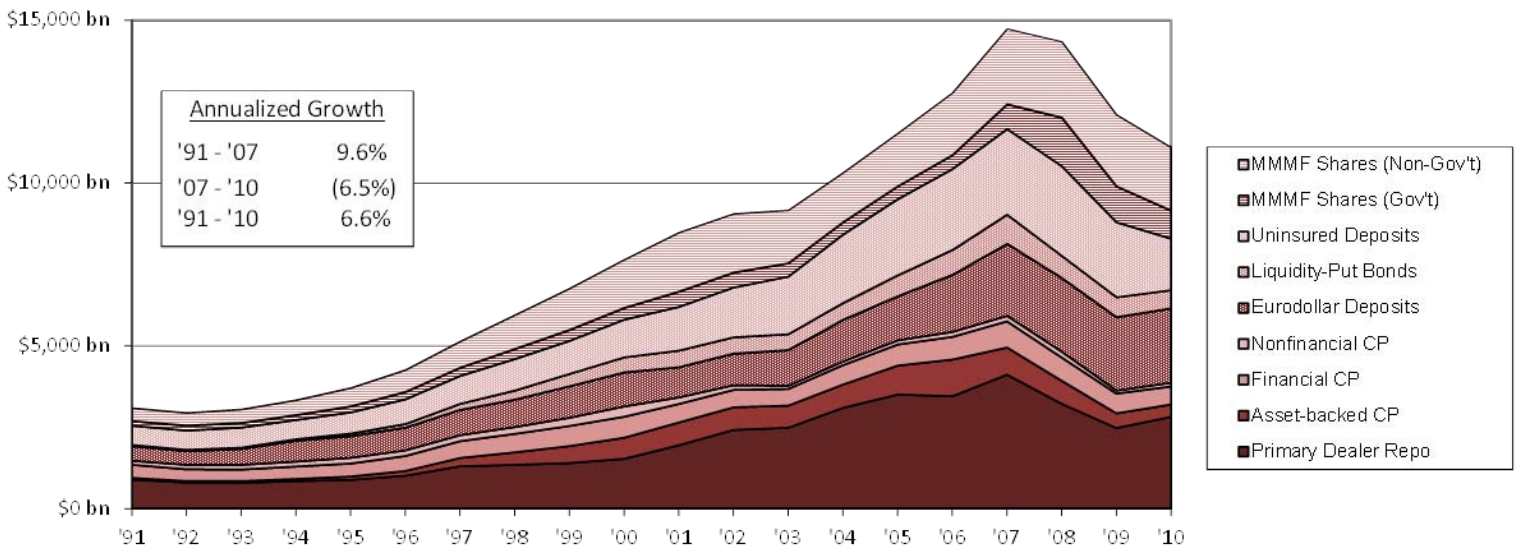
- explicit portfolio and activity restrictions
- capital requirements
- cash reserve requirements
- restrictions on affiliations and affiliate transactions
- access to central bank liquidity
- access to deposit insurance
- a special receivership regime in the event of failure
- a special supervisory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

Gross "Money-Claims" Outstanding

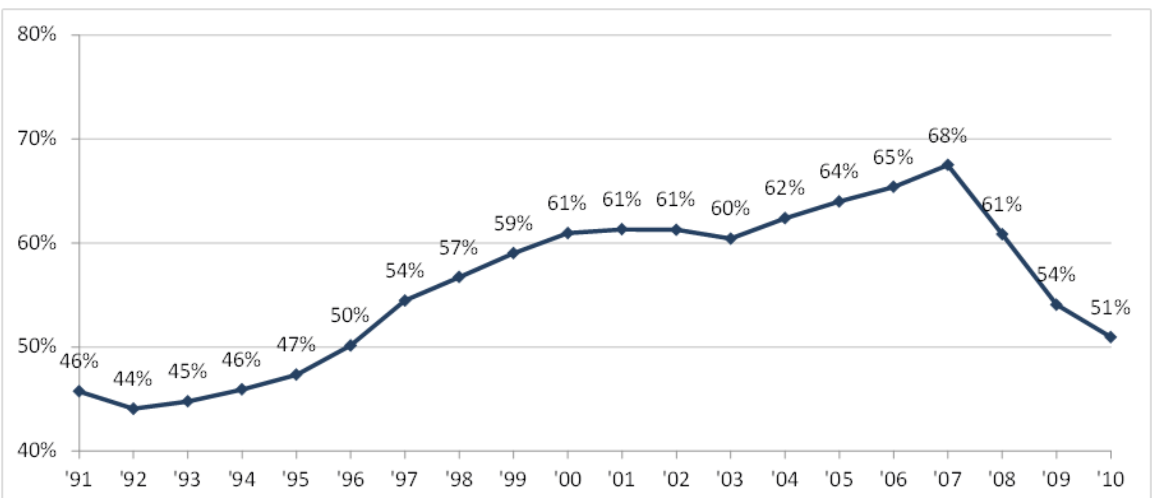
- Very short-term, fixed principal IOUs



Gross Private "Money-Claims" Outstanding



Private / Total Outstanding



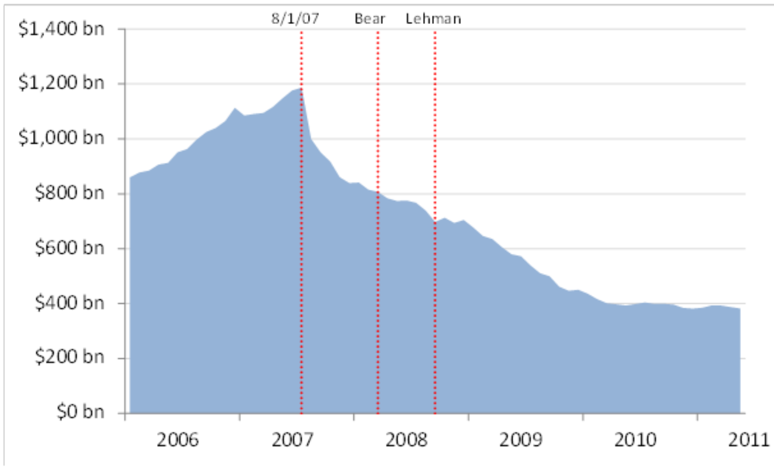
Policy Response to the Crisis

Private Money-Claim Category		*Emergency Policy Measures*
Money market mutual fund "shares"	▶	MMMF Guarantee (Treasury) Money Market Investor Funding Facility (Fed)
Uninsured Deposits	▶	Transaction Account Guarantee (FDIC) Term Auction Facility (Fed) Deposit insurance limit increase (EESA[1])
Liquidity-Put Bonds	▶	N/A
Eurodollar Deposits	▶	Central Bank Liquidity Swaps (Fed)
Financial Commercial Paper Nonfinancial Commercial Paper	▶	Temporary Liquidity Guarantee Program (FDIC) Commercial Paper Funding Facility (Fed)
Asset-Backed Commercial Paper	▶	ABCP MMMF Liquidity Facility (Fed)
Primary Dealer Repo	▶	Primary Dealer Credit Facility (Fed) Term Securities Lending Facility (Fed)

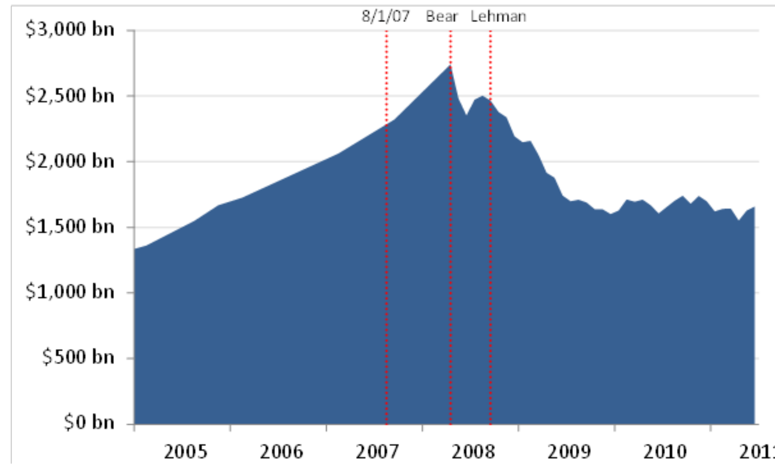
- Practically the entire policy response was about stabilizing private money-claims

Is there a Market Failure?: The Liquidity Events

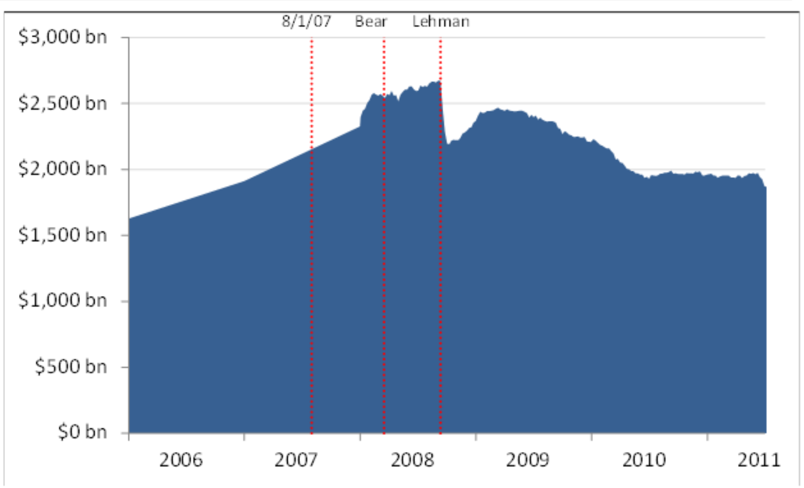
A) U.S. Asset-Backed Commercial Paper Outstanding



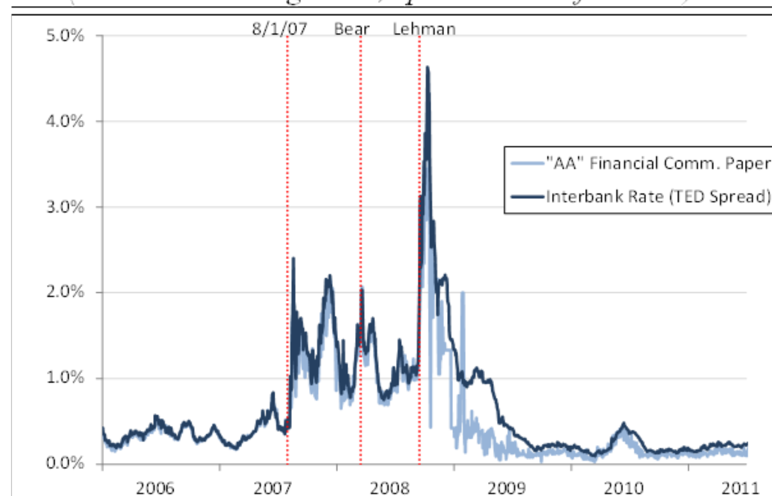
B) Short-Term Repo Outstanding
(Broker-dealer "tri-party" repo)



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

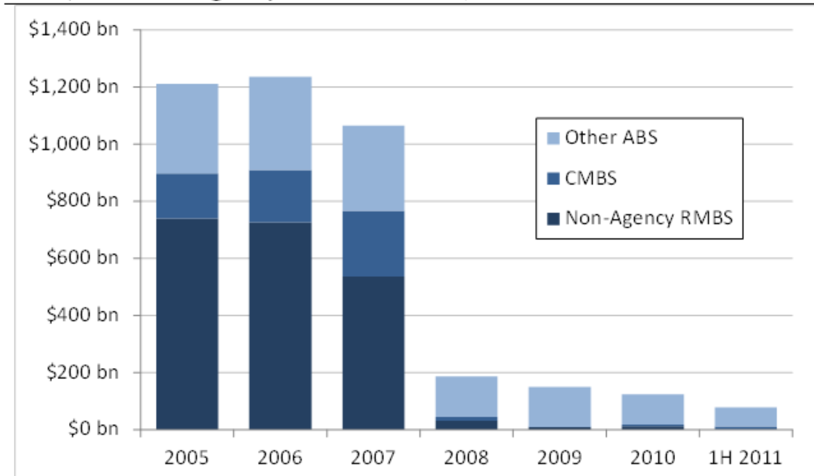


D) Short-Term Funding Spreads
(three-month obligations; spread to risk-free rate)

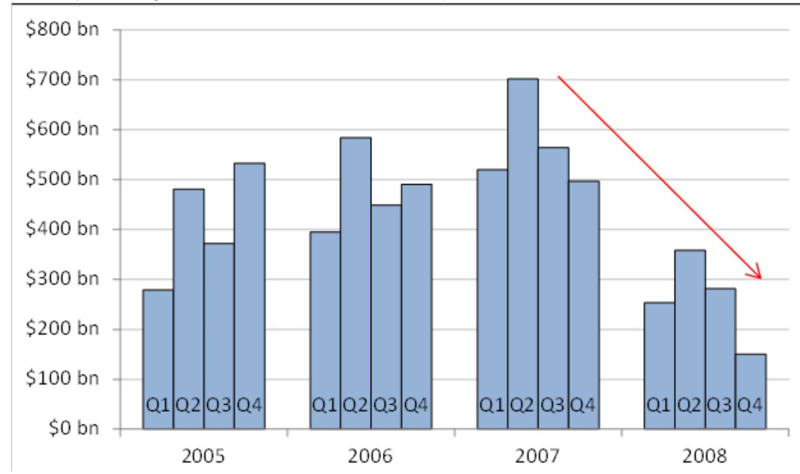


Is There a Market Failure?: The Credit Crunch

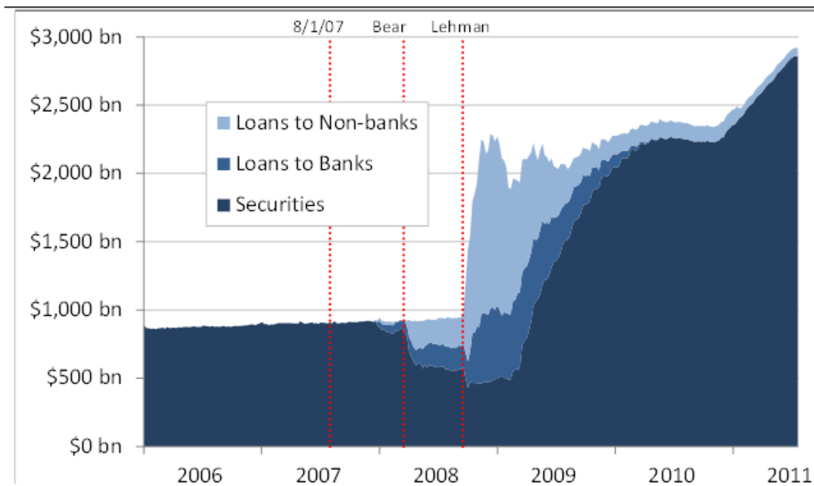
A) U.S. Securitization Issuance
(excludes agency securitization)



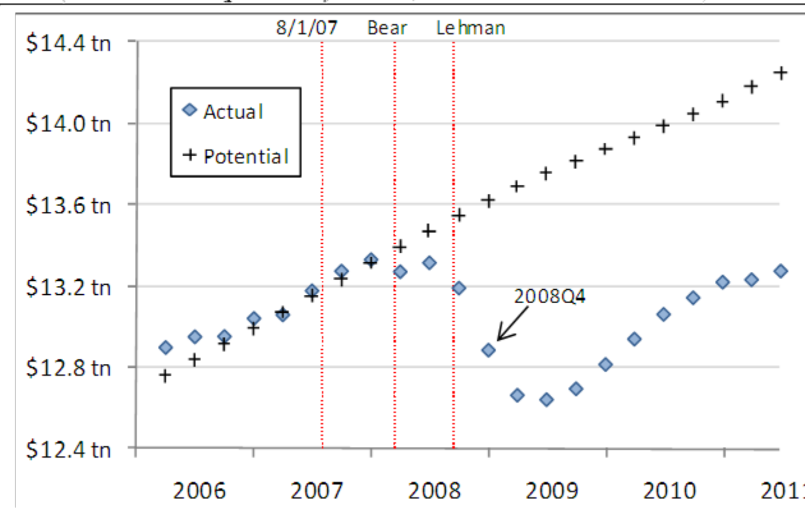
B) New Corporate Lending
(U.S. syndicated loan market)



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 (<u>prohibit</u> 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

Dollars in billions	2006 - 2008 (Total) Balance	Interest	Rate
Short-term borrowings	**$294**	**$38**	**4.3%**
Long-term borrowings*	**$164**	**$38**	**7.6%**
Term spread (long-term less short-term)			**3.3%**
Funding benefit (term spread * S-T borrowings)			**$29 bn**
Pretax earnings			**$35 bn**
Funding benefit / pretax earnings			**85%**

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

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