Shadow Banking—
What are We Really Worried About?

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During the crisis we observed ... runs

Runs on banks from wholesale funding sources:

- Repo funding of U.S. investment banks
- MMMF funding of commercial and universal banks
- ABCP funding (backed by mortgages)

Runs on banks from retail depositors

Runs on MMMFs from corporate cash pools and then retail investors
Recent shadow banking observations (II)

- During the crisis we observed ... leverage
- Risks in non-banks insufficiently backed by “capital”
  - MMMFs
  - Non-traditional insurance activities
  - SIVs/Conduits
- Lately we observe ... leverage and maturity mismatches
  - Wealth management products (“trusts”) in China
  - M-REITs in the United States
Basic typology of systemic risk

- **Time-series component**
  - Buildups of leverage
  - Maturity mismatches between assets and liabilities
  - Procyclicality of margin/collateral valuation

- **Cross-section (interconnectedness) component**
  - Knock-on effects of shocks, potentially through long chains of intermediaries, often leading to runs (or “flight to quality”—types of contagion)
  - Interactions between funding and market liquidity (funding difficulties + fire-sales)
WHAT are we worried about?

- Uncontrolled, or hidden, leverage in non-banks that adversely affect the financial system (and the real economy)
- Non-linear, amplified responses in market prices and quantities
- Bank-like maturity mismatches and deposit-like features that are unsupervised and/or unprotected by a safety net
  - Products where investors expect to be able to make instant withdrawals (often at face value) but assets are longer-term
  - Examples: MMMF, WMP (China), M-RIETs
What are we NOT worried about?

- Growth of market-based financing of credit
- Financial access: savers and borrower using alternative means or institutions to execute utility enhancing transactions.
- Unleveraged transactions and investments (e.g., pass-through mutual fund with variable net asset value)
- “Pure” payment systems with well-constructed infrastructures
How do we know WHEN to be worried?

- Degree of leverage (capital adequacy)
- Degree of maturity mismatch
- Cash holdings for redemptions
- Operational risk measurement;
  - Legal documentation
  - Clearing/settlement/custody security
  - Client disclosures and customer protections
- Other, yet devised, measures in accordance with conceptual advances
Challenges in assessing systemic risks

- Data on size of exposures (not AUM) from non-bank institutions (data collection expanded to include those outside regulatory perimeter)
- Judging what is acceptable risks (how much leverage can shadow banks take on without risking the system)
  - E.g., financial companies
- How to tell if investors understand the risks they have incurred
  - Are disclosures adequate?
  - Are investors “sophisticated”? Able to absorb losses?
- Data/information about interconnectedness
  - Collection of raw data
  - Transparency (To whom? When? How much?)
Sovereign, Bank, Insurance Connections

Graphic from Dale Gray
Sovereign, Bank, Insurance Connections

Blue Insurance
Black Sovereign
Red Bank

Apr09-Mar12

P-Value=0.01
Ex: Yu’E Bao—should we worry or not?

- China’s first on-line investment fund for individuals (automated transfers between bank checking/Alibaba account/Yu’E Bao)
- Connected to Alipay, China’s 3rd largest third-party payment platform with 800 m. customers
- Now largest MMF—RMB 55.7 billion ($9.2 billion)
- 13 million customers at end-Sept (launched in June)
- Interest rate is ~5% (vs 0.35% in bank deposits)
- Redemptions can be made at any time
- Apparently, investments are in government and corporate money markets
What do we do if systemic risk is too high?

- Bring within regulatory perimeter/observe
- Lower leverage (impose “capital requirements”)
- Lower maturity mismatches through regulation or incentives
- Build liquidity (redemption) buffers
- Educate customers
- Make activities too expensive to execute
- Reduce interconnectivity (using?)
- Outlaw activities?
U.S. Private-Label MBS Issuance

Source: Inside Mortgage Finance and IMF staff estimates
Underpinning steps: incentives

- Adjust private sector compensation to cover long-run risks, not just short-run returns
- Ensure empowerment of supervisors and regulators
- Resurrect “incentive compatible regulation”
“These new regulations will fundamentally change the way we get around them.”
Underpinning steps: information

- Provide basic information to prevent panics
  - Provide granular information to supervisors and regulators
  - Remove some types of confidentiality to be able to provide more information to the public

- Balance systemic risk with protection of competition to produce efficient and effective economy
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