Shadow Banking:

Evolution, Accounting, Context

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Shadow banking and money:

The types of assets and the types of backstops behind money claims yield four basic categories of money.

Purely public, hybrid and purely private money claims.

Cash vs. **cash equivalents**.

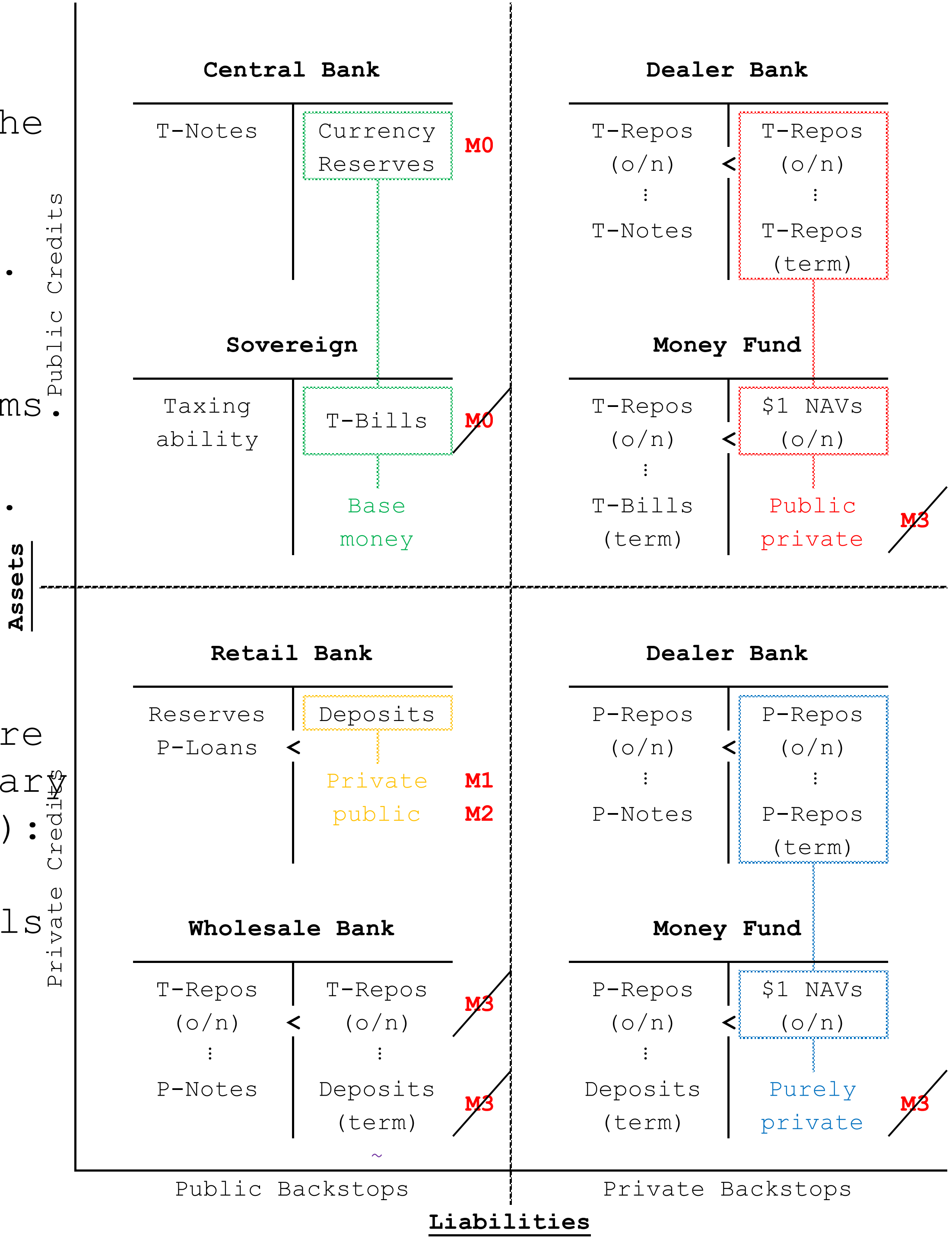
Traditional money supply vs. **shadow money supply**.

Monetary aggregates measure only the tip of the monetary iceberg (see Pozsar, 2011):

M0 does not include T-Bills despite their money-ness.

M3 discontinued in 2005.

Source: Pozsar (2013)



[1] **Purely public money (M0, or base money):**

Ability to tax and money creation at will

[2] **Private-public money (M1 and M2):**

Explicit liquidity puts from the Fed, and explicit credit puts from the sovereign (i.e. the FDIC) on all bank liabilities.

[3] **Public-private money (M3):**

Implicit official liquidity and credit puts via Treasury collateral involved, but no direct puts on the liability side.

[4] **Purely private money (M3):**

No official puts, not even implicitly via the collateral involved. Peripheral money

Cash pools and shadow money:

[1] Cash pools do not have access to M0, M1 or M2.

⇒ For cash pools, money begins where M2 ends.

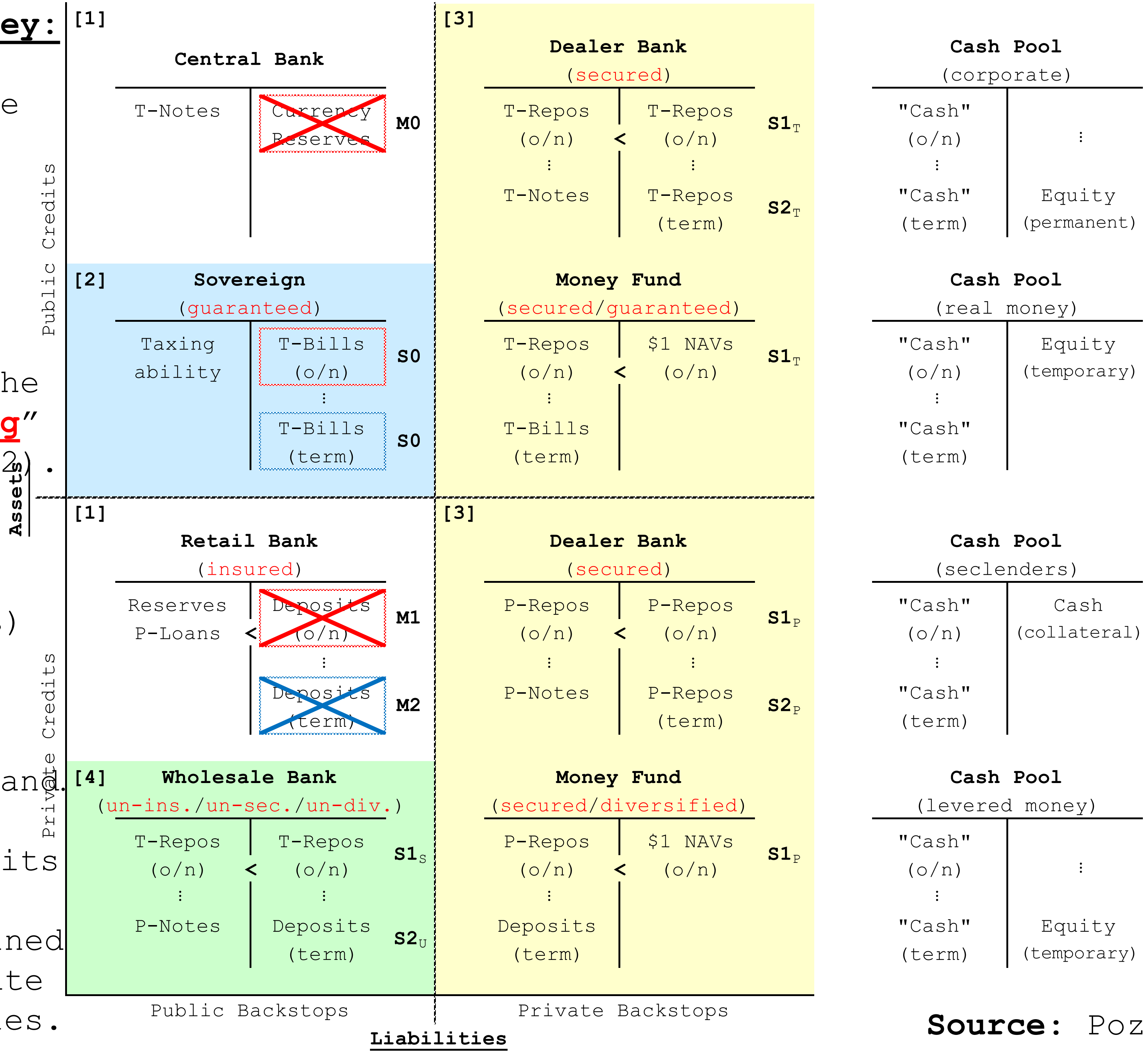
[2] Cash pools can't get enough T-Bills. This is the "**paradox of safe investing**" (see Pozsar, 2011 and 2012).

⇒ This drives demand for **quasi T-bills** (credit-safe, short-term assets) issued by shadow banks.

[3] Cash pools' access is limited to shadow banks, and

[4] un-insured bank deposits

⇒ Cash pools are constrained to holding public-private and private shadow monies.



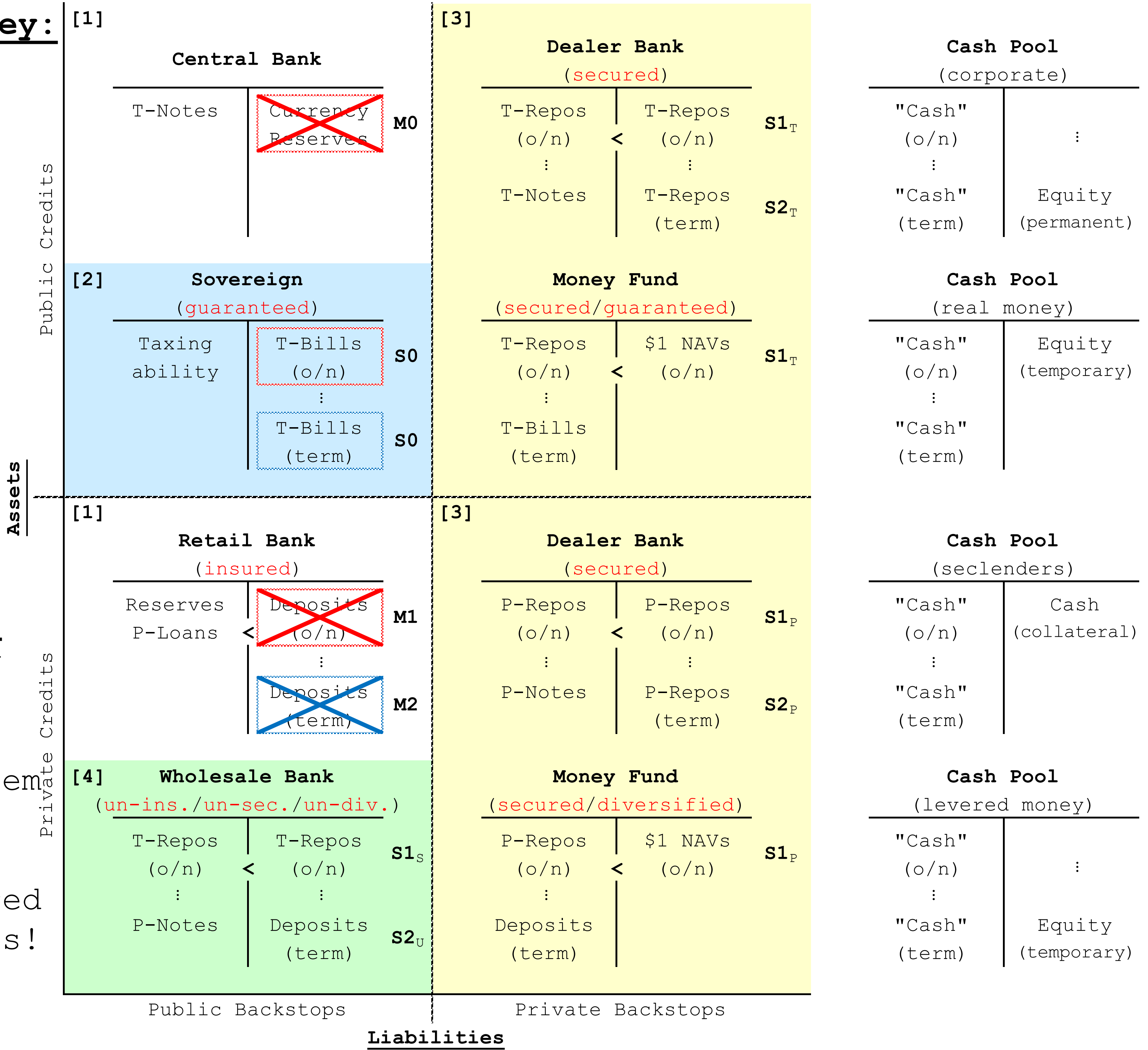
Source: Pozsar (2013)

Cash pools and shadow money:

⇒ Cash pools always face some counterparty risk in a "cash" portfolio.

⇒ How effective is retail deposit insurance and LoLR access to retail and wholesale banks only when cash pools prefer to invest their cash balances elsewhere for reasons of safety?

⇒ **Ineffective safety net:** a system funded by many uninformed, small and insured depositors is more stable than a system funded by a relatively few very well informed, very large and un-insured institutional cash pools!



Source: Pozsar (2013)

Dealers' buy-side customers:

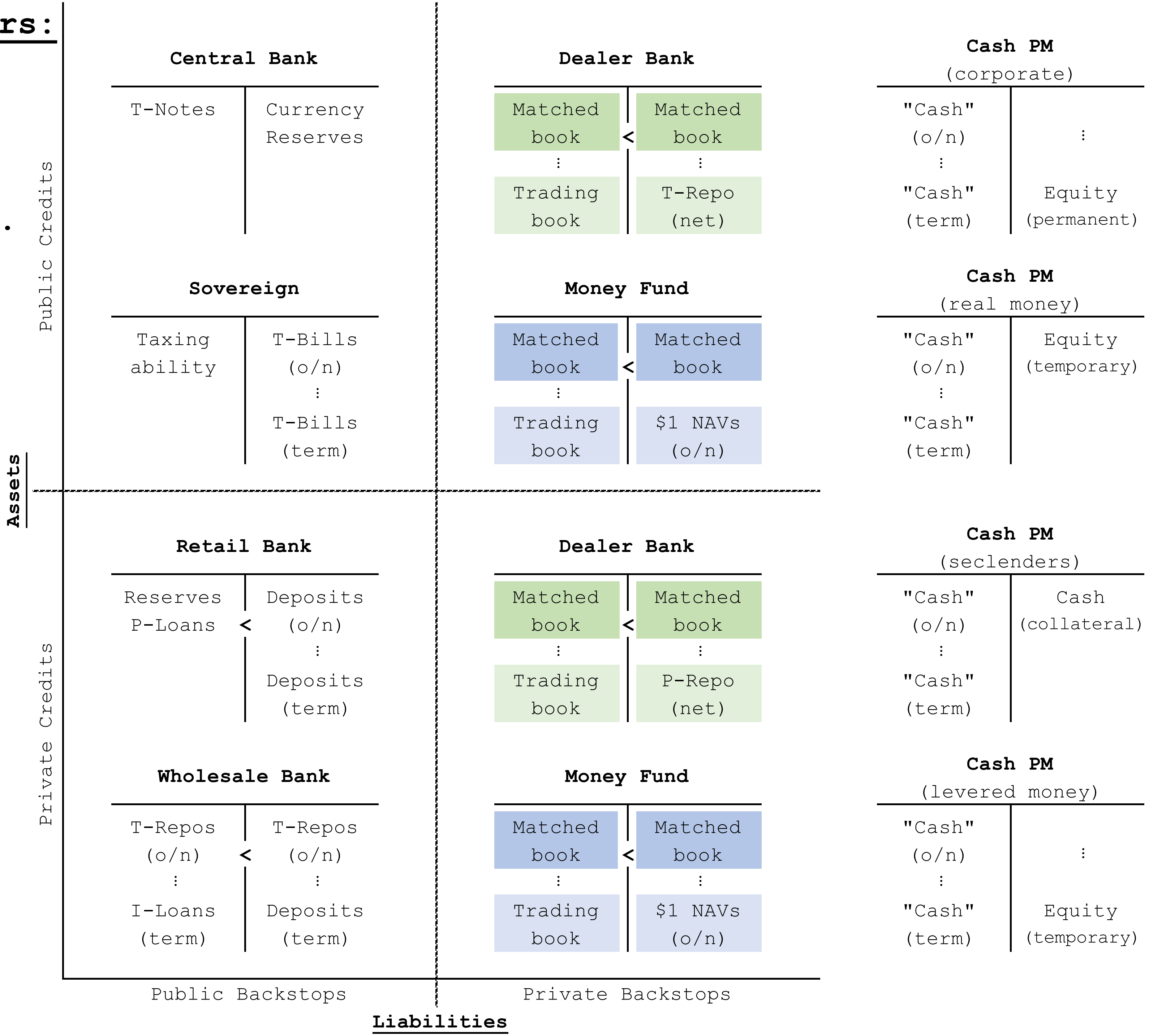
Risk portfolio managers need **leverage**, **shorting** and **derivative exposures**.

Cash plays a role in each.

Leverage: **Risk PM** (cash for funding)

Shorting: **Risk PM** (cash as collateral)

Derivatives: **Risk PM** (cash for margining)



Source: Pozsar (2013)

The simplified dealer eco-system:

[1] Cash and risk PMs, money and risk dealers.

[2] Matched book and net long/short positions.

Risk PM
(cash needs/yield)

T-Notes	T-Repo
P-Notes	P-Repo
CDS	⋮
IRS	Equity
FXS	(temporary)

Money Dealer

Matched book	<	Matched book
		⋮
Trading book		Repo (net)

Cash PM
(cash rich/safety)

"Cash"	CDS
	IRS
	FXS
	Equity
	(temporary)

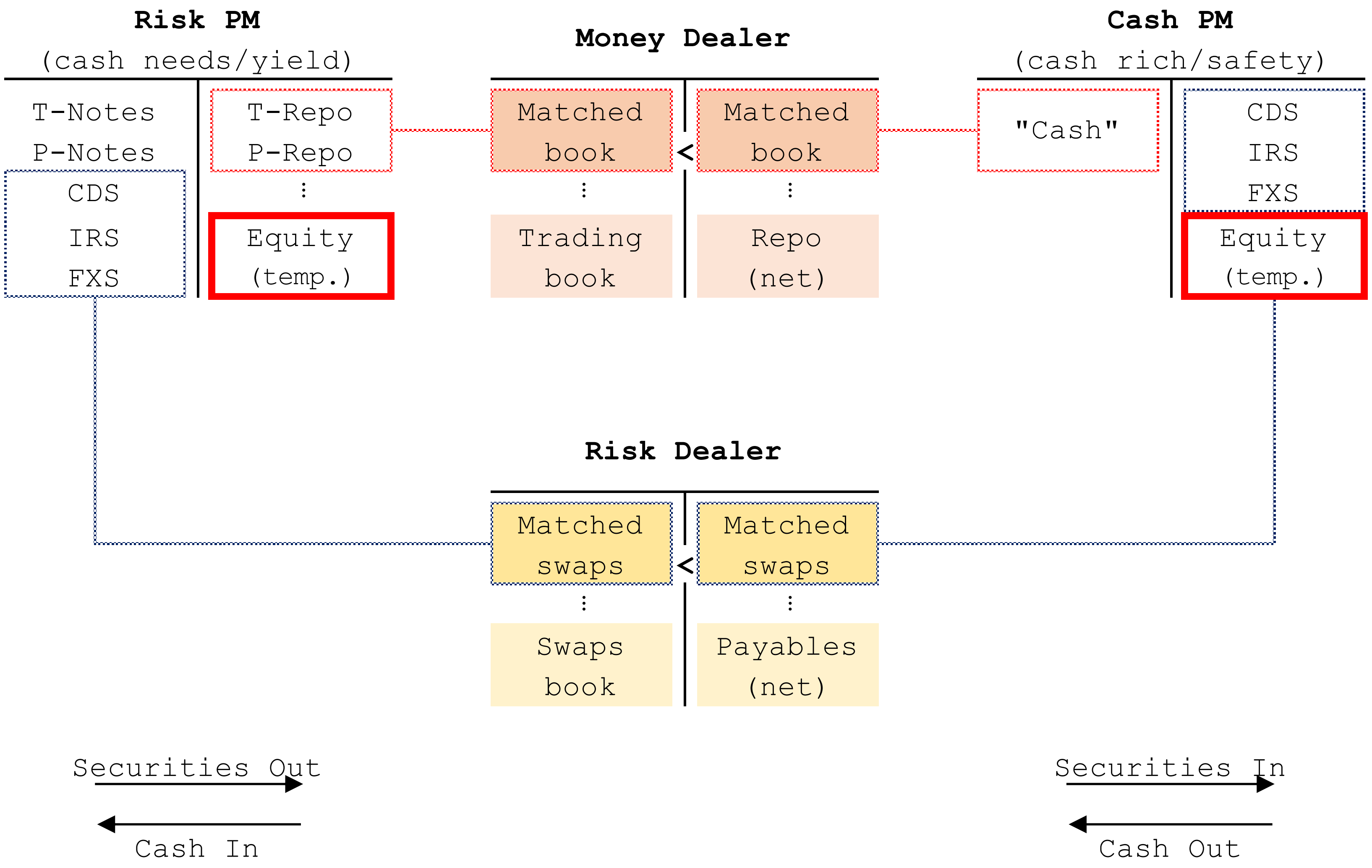
Risk Dealer

Matched swaps	<	Matched swaps
⋮		⋮
Swaps book		Payables (net)

Source: Mehrling et al (2013) – **Bagehot Was a Shadow Banker**

Risk intermediation:

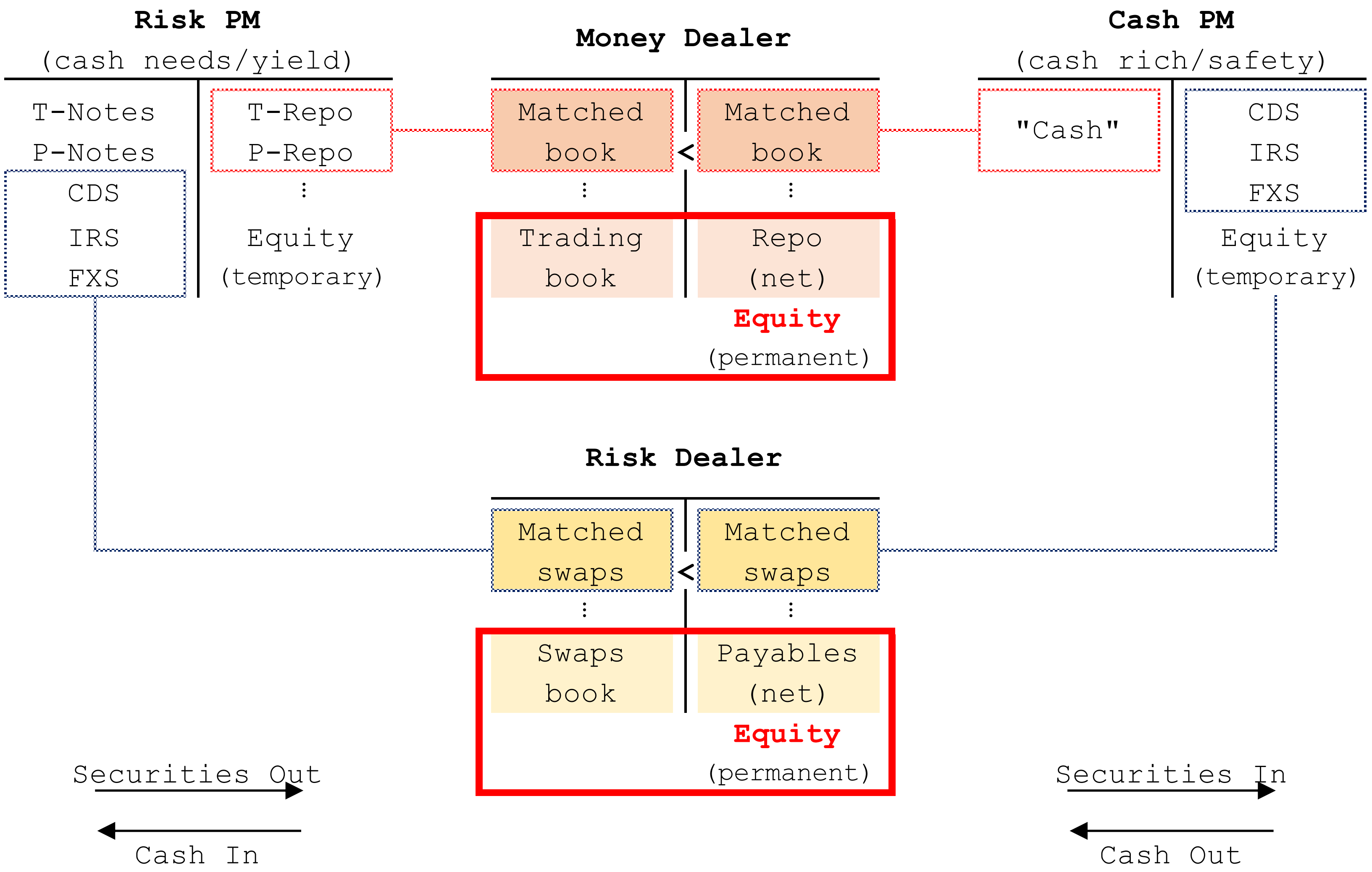
PM's equity is **temporary** equity. Temporary equity is an **asset allocation** decision.
Dealers intermediate temporary equity b/w winning and losing counterparts to a bet.



Source: Mehrling et al (2013) – **Bagehot Was a Shadow Banker**

Risk intermediation:

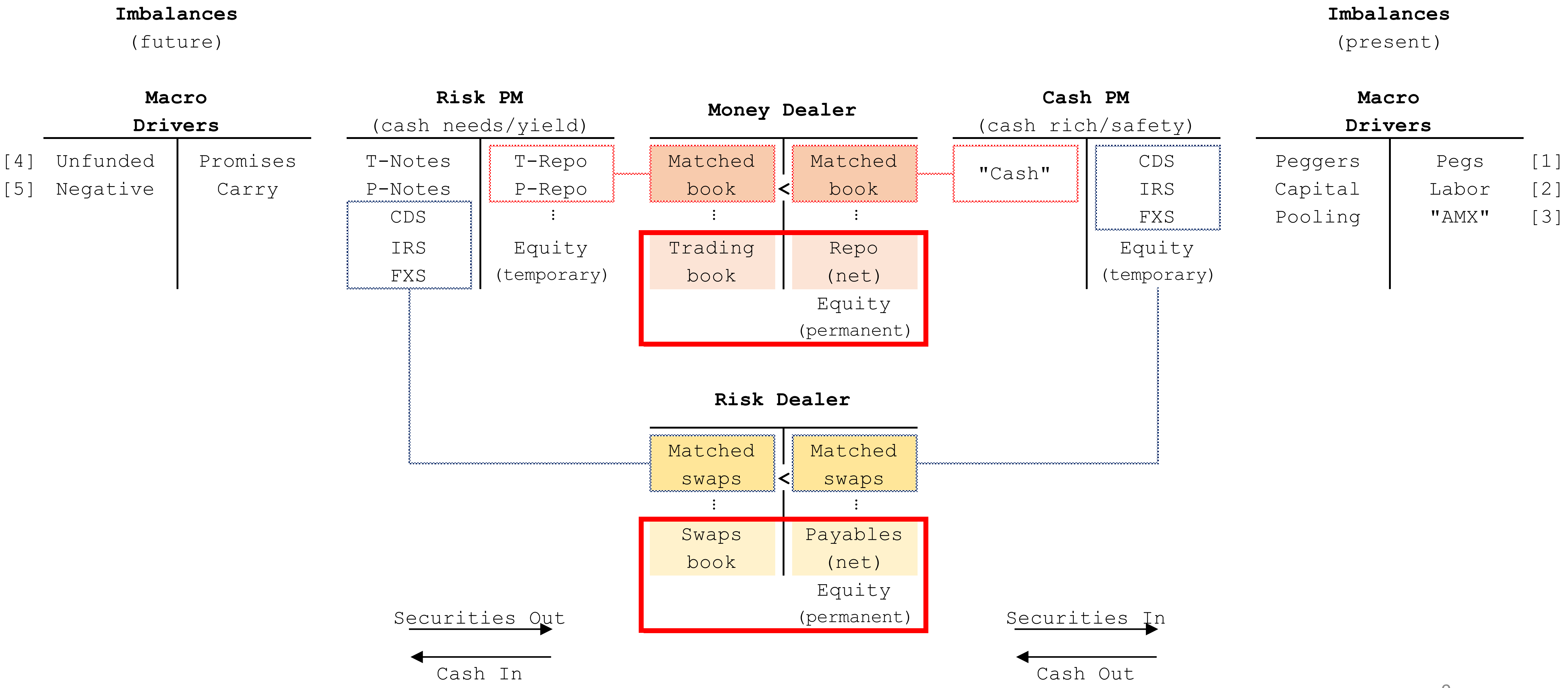
Dealers' equity is **permanent** equity.
For counterparty and inventory risk.



Source: Mehrling et al (2013) – **Bagehot Was a Shadow Banker**

Symptoms vs. Causes

Equity is a solution for symptoms.
What dealers do is a reflection of
the eco-system they inhabit.



Source: Pozsar (2013)

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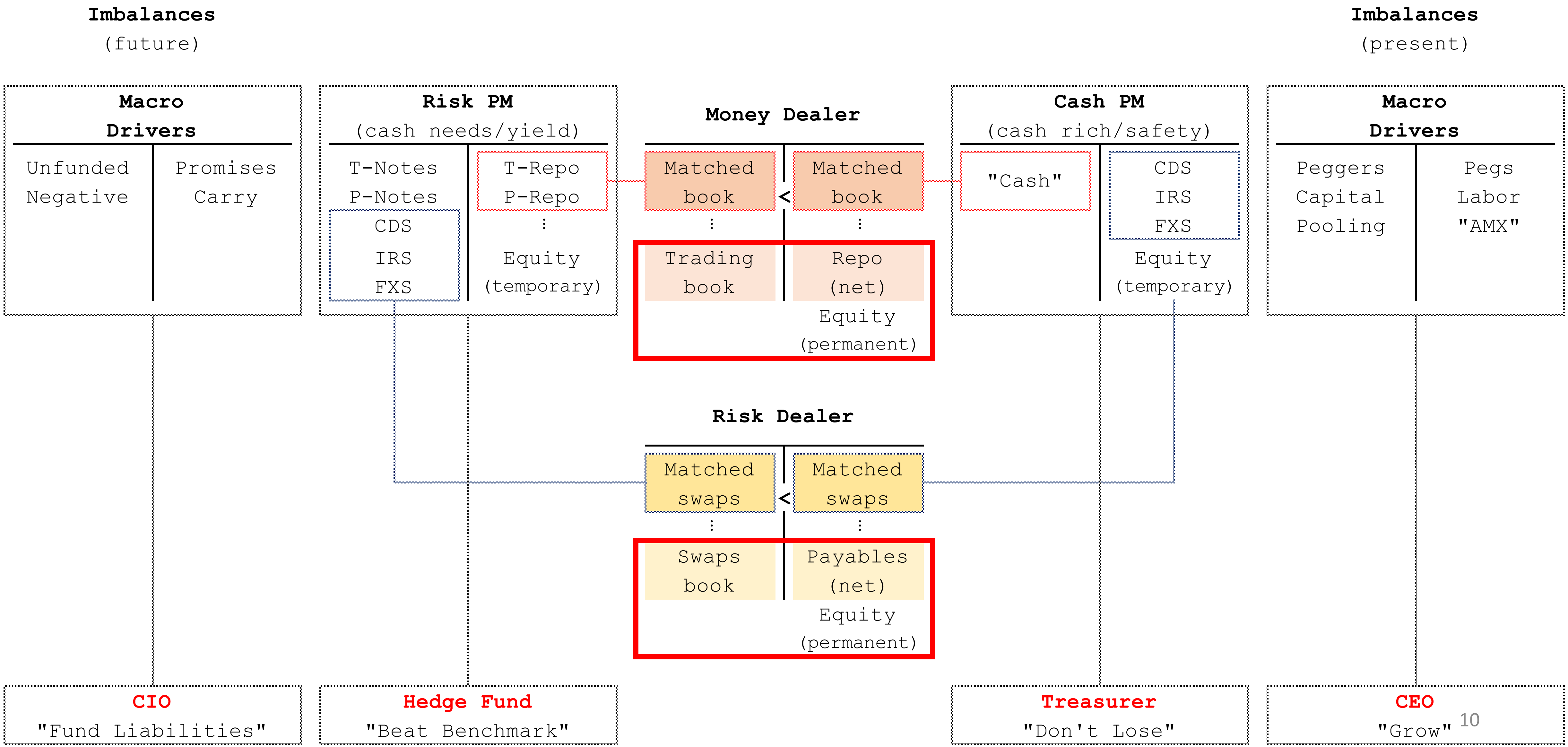

Conclusions:

A Macro View on Shadow Banking

1. Bond portfolios are getting more and more leveraged and bonds are becoming more and more valuable as collateral.

2. Leveraged bond portfolios help asset-liability matching in an ever-lower yield environment and collateral gives cash pools safety in a system w/ an outdated safety net.

3. Credit intermediation is just a **byproduct**. A carry trader goes to work every day not to lend but to generate alpha.

4. Credit, maturity and liquidity transformation is a start, but ask "why": to manage future and present imbalances.

5. Credit transformation ~ bond-like volatility and equity-like returns to help CIOs meet future promises. Maturity and liquidity transformation ~ quasi Treasury bills and quasi money claims for the safekeeping of skewed incomes.

Source: Pozsar (2013)