Shadow Banking:
Evolution, Accounting, Context

by Zoltan Pozsar, Senior Adviser, OFR, U.S. Treasury

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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)
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:** (cash for funding)

**Shorting:** (cash as collateral)

**Derivatives:** (cash for margining)

Source: Pozsar (2013)
**The simplified dealer eco-system:**

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


### Risk PM
(cash needs/yield)

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<thead>
<tr>
<th>T-Notes</th>
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**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)
Imbalances (future)

Macro Drivers

Unfunded Negative Promises Carry

Risk PM (cash needs/yield)

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Imbalances (present)

Macro Drivers

Peggers Capital Pooling Pegs Labor "AMX"

CIO "Fund Liabilities"

Hedge Fund "Beat Benchmark"

Treasurer "Don't Lose"

CEO "Grow" 10

Source: Pozsar (2013)
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)