How does Banking Union affect Shadow Banking?

Matthias Thiemann

Goethe Universitaet, Frankfurt am Main, SAFE

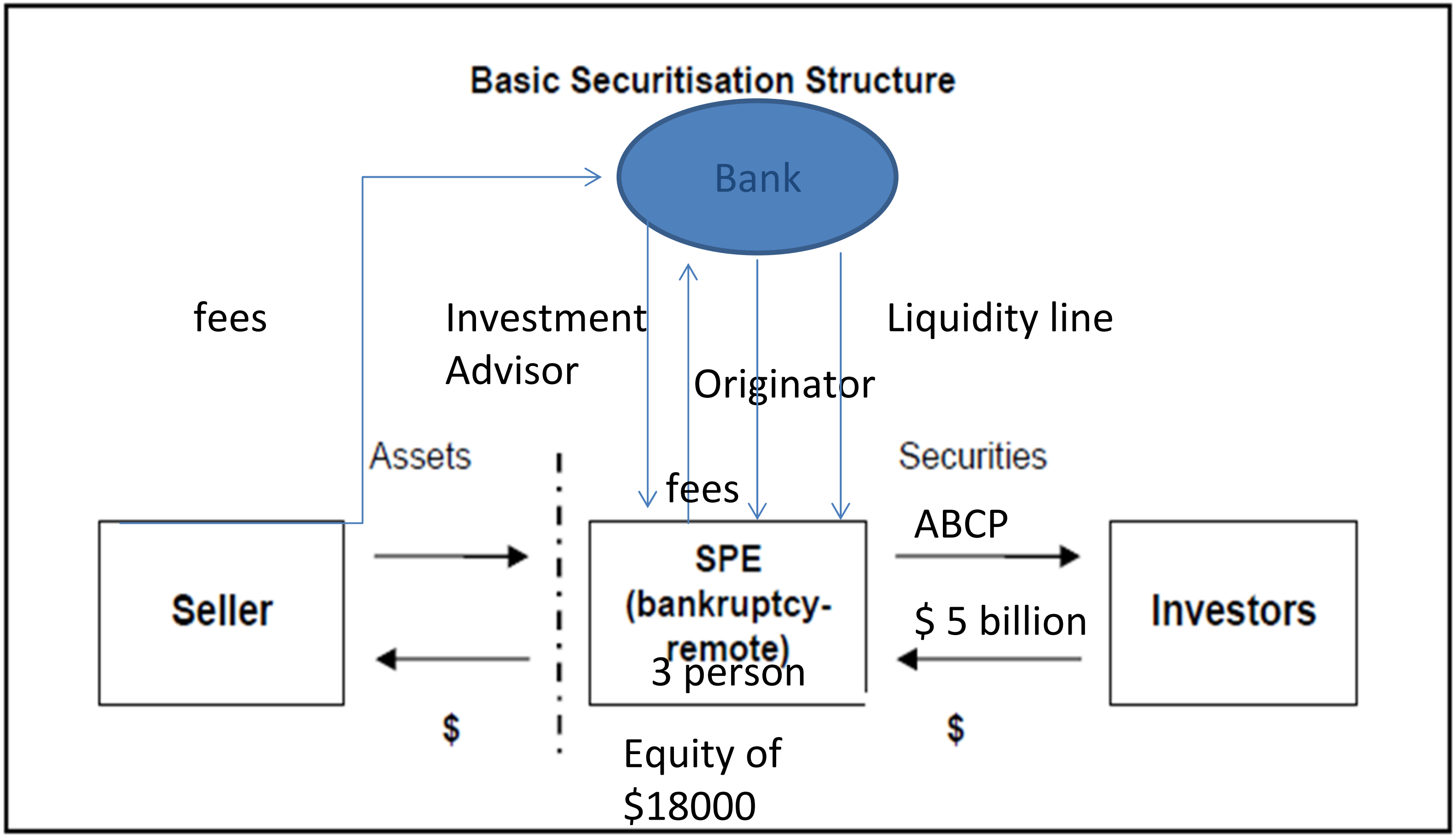
Shadow Banking

- Shadow banking: credit intermediation outside of banking regulation (FSB)
- Entities that in a chain engage in Risk transformation (credit, liquidity and maturity): high scale, risk diversification techniques, low margins (high sensitivity to regulatory costs) and little equity
- that requires a credit or liquidity back-stop (Stijn Claessens and Lev Ratnovski, 'What is Shadow Banking?' (2014), IMF Working Paper 14/25, 4-5)→ linked to banks

Two different systems

- Internal shadow banking activities: Financial Holding Companies organize credit intermediation to minimize regulatory costs/ increase leverage (Pozsar et al 2010)
- E.g. ABCP conduits
- External Shadow Banking Activities: Broker-Dealers, Hedge Funds etc., which receive liquidity through repos

Regulatory Arbitrage in ABCP market: Perimeter Problem



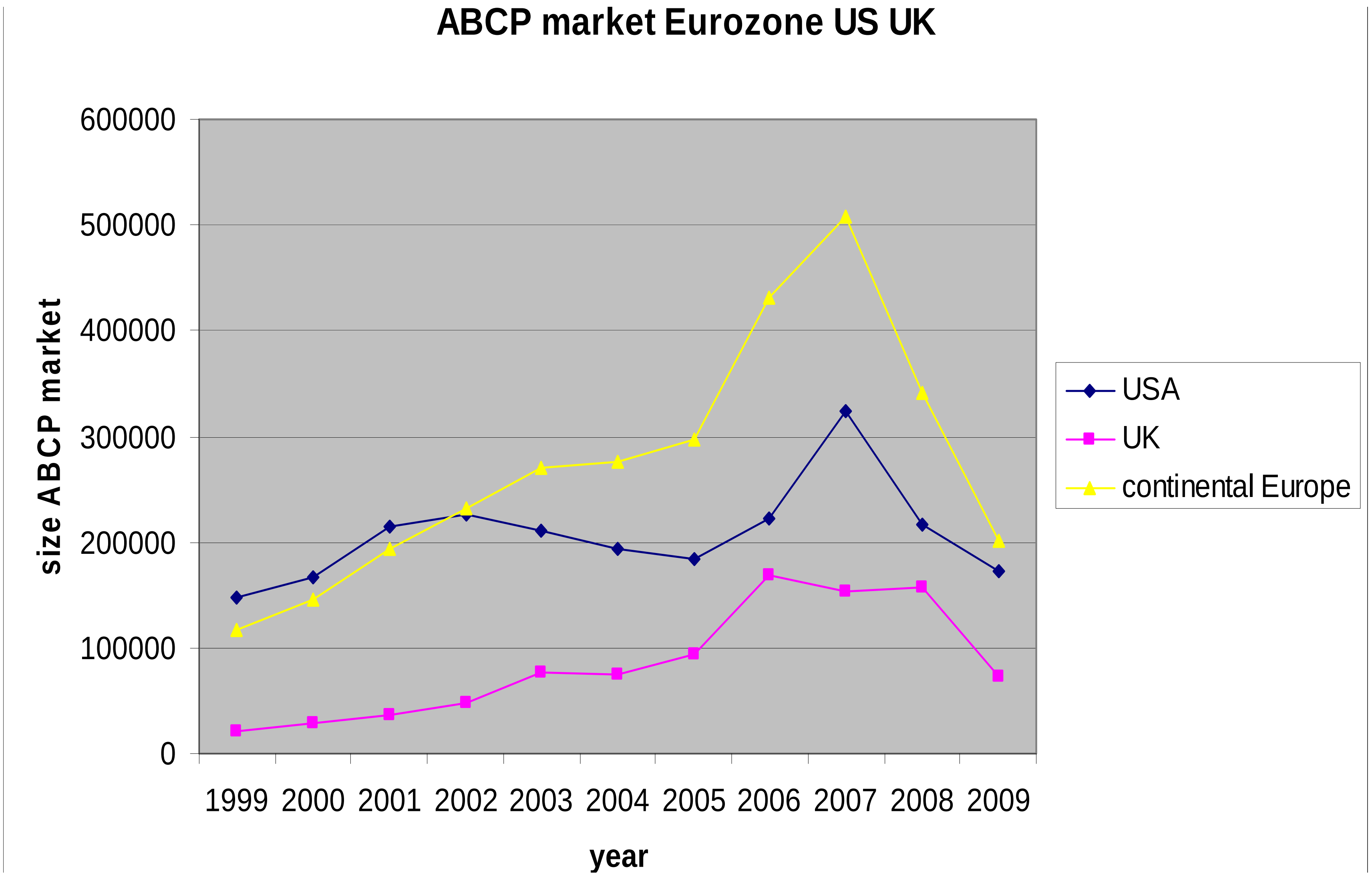
Source Basel Committee 2009

Franchise Value of Banks

- As Triparty repo agents, or as the provider of liquidity and credit lines, banks provide their franchise value as a backstop for these shadow banking activities
- They thereby take the systemic risk upon themselves, for which they receive fee income, but they thus engage in risk-shifting upon the tax payer: Should systemic risks materialize, everybody will bear it

Banking Nationalism and Internal Shadow Banking pre-crisis

- Banking nationalism and the official agreement to European Treaties lead to regulatory leniency: support national champions with limited return on equity
- Regulators did a lot of work nationally to exempt their banks from capital regulation for internal shadow banking activities (e.g. ABCP conduits) in order to increase their fee income
- When crisis hit, a extra-proportionally large part was in Europe

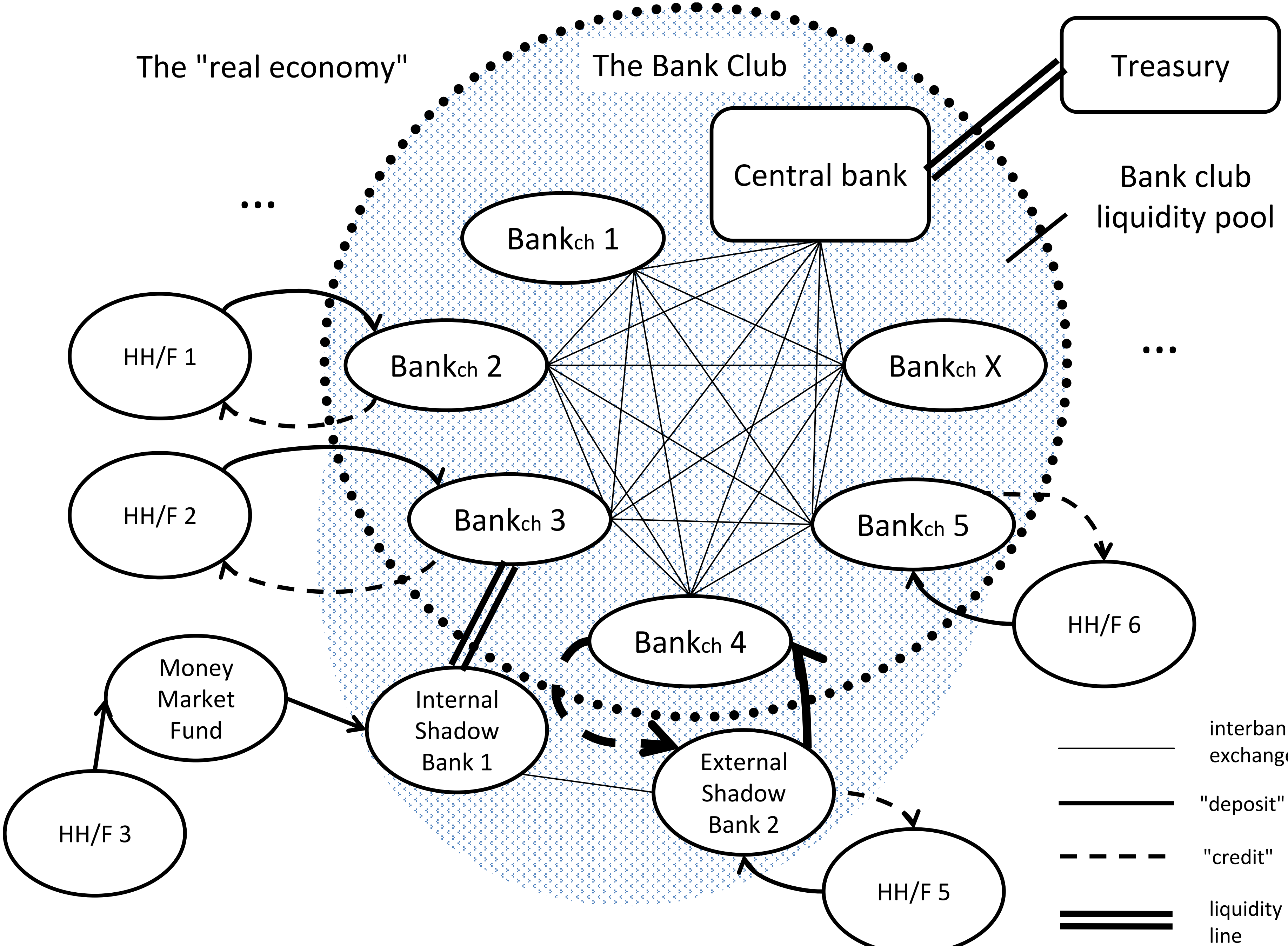

ABCP market Eurozone US UK
size ABCP market
600000
500000
400000
300000
200000
100000
0
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
year
USA
UK
continental Europe

Banking Union and internal shadow banking system

- Does answer to the problem of regulatory competition in Europe by installing a single supervisor in the European Space
- But: Problem of Accounting and Auditing Divergences in Europe (Veron 2014)
- But: Problem of Regulatory Competition with British and American banks in shadow banking

Banking Union and Shadow banking II

- Need to dynamically adjust the perimeter of supervision
- SSM: can Europe benchmark its supervisory practices?
- Need to engage regulated in a dialogue regarding financial innovations and their use, how do they work and why do they work
- Is the franchise value of banks used?



The "real economy"
The Bank Club
Treasury
Central bank
Bank club liquidity pool
...
Bankch 1
Bankch 2
Bankch X
...
HH/F 1
HH/F 2
Bankch 3
Bankch 5
HH/F 6
Bankch 4
Money Market Fund
Internal Shadow Bank 1
External Shadow Bank 2
HH/F 3
HH/F 5
interbank exchange
"deposit"
"credit"
liquidity line

Fringe Banks 2: External Shadow banking system

- Banks provide liquidity to external shadow banking system (directed by broker-dealers): they act as tri-partite repo dealers
- In moment of crisis of external shadow banking system, they hold the assets of the external system as collateral for repos
- If crisis is caused by assets held by the fringe banks, the assets of the external fringe banking system are transferred to the banking system

Banking Union and the External Shadow Banking System

- ECB will intervene in markets to stabilize the collateral value of repos
- ECB thus becomes a dealer of last resort, just like the FED (Mehrling 2011)
- What does this mean in terms of risk-sharing?
- Which are the means to discipline the repo-market?

Shirking and regulation

- A bank-charter is a permission to accept the IOUs of other members of society, and to refinance them with IOU’s a bank issues on itself: this allows a bank to play the yield curve (borrow short, lend long)
- At the same time, a bank charter is costly as banks have to comply with regulation
- Incentive for banks to evade regulation and still play the yield curve

Banks, fringe banks and « new financial practices and usages »

- How can they do that: by taking the position of liquidity provider for fringe banks, defined as « entities which engage in banking business without being under the supervision of the central banks » (Minsky 1986) in good times (repo-business) and lender of last resort in times of crisis
- By lending money to fringe banks, which engage in banking business: banks and fringe banks share as profits the regulatory costs that they have avoided
- « New financial usages and practices » (Minsky) are often motivated by the attempt to facilitate this rule circumvention
- Problem: the financial fragility of the system increases, as banking system and fringe banking system become interwoven

Fringe Banks 1: Internal Shadow banking system

- Internal: banks are the direct back-stop of the system in times of crisis: credit lines/liquidity lines are granted to fringe banks: the IOUs these entities issue will be bought up by the banks in times of crisis, they become « covert liabilities of the banking system » (Minsky 1986)
- Problem grows if fringe banks and banks hold the same assets and these decline in value (Minsky 1986)