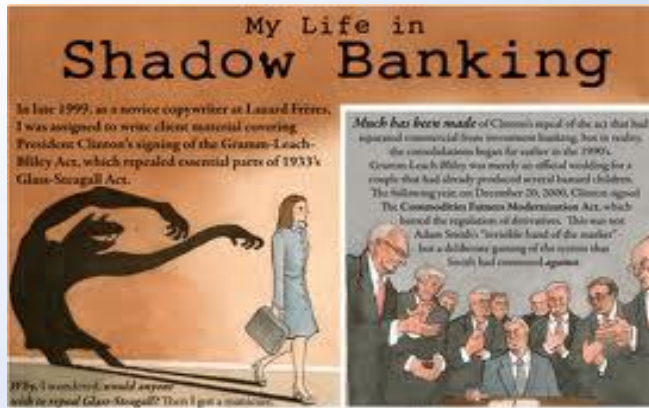




SHADOW BANKING vs SHADOW MARKET



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SHADOW BANKING vs SHADOW MARKET

- In financial regulation, very good intents may lead to catastrophic consequences, the fair value concept and IFRS for banks being a classic example.

Professor Perotti highlights in his work how the provision of specific protections to repo lenders may, in reality, become an ingredient of a recipe for systemic shocks which will affect the whole market place.



- Repo lending is a significant component of shadow banking.

Before the crisis what is now called shadow banking was seen as an excellent alternative (parallel) to banking as a way to finance the economy.

It was agreed it allowed for an efficient distribution (and dispersion) of risks while offering flexible and large funding to investors.

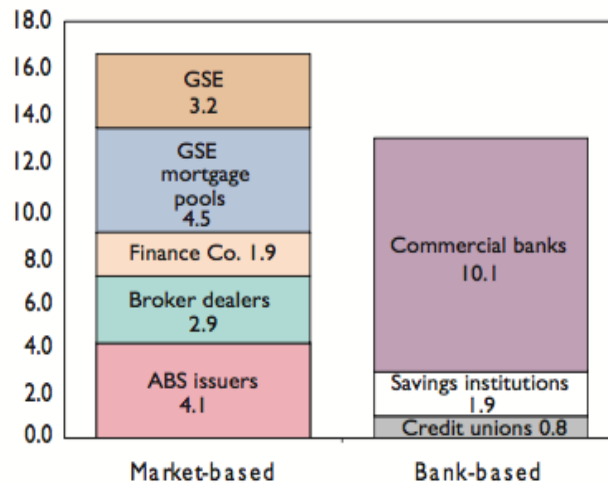
As such, it was a catalyst for secure growth and played a large part in the “Goldilock scenario”



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Chart 1
Total assets at 2007Q2

(USD trillions)

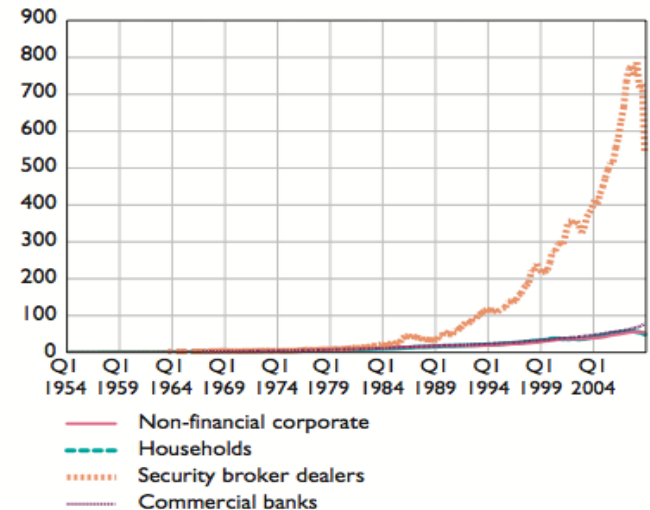


Source: US Flow of Funds, Federal Reserve.

(Published in Bdf, FSR #13)

Chart 2
Growth of assets of four sectors in the United States

(March 1954 = 1)



Source: US Flow of Funds, Federal Reserve.

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- With the crisis (repo 105 being seen as one of the catalysts of the catastrophic demise of Lehman), shadow banking has been identified as a dangerous but still a « must have » system, and solutions must be brought to improve it by retaining its advantages and reducing the risks within the whole financial system.
- As we speak, it is widely recognized that the financing of the economy will be constrained by Basel III, applied to banks. Hence the requirement for a secure disintermediated channel, as this system will be required to finance a larger part of the economy, in particular in Europe.

And precisely, what has to be managed here is a **system**, not a collection of “siloes” or inconsistent rules.



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- Professor Perotti highlights an issue which conveys very significant practical consequences
- ✓ Repo contracts are a significant component of shadow banking. They are seen as a key element of financing lubrication (IMF), which must be protected. All the more so because of worries regarding a shortage of AAA assets, consequences of Basel III liquidity provisions, Dodd-Frank, CCP requirements, owners demand for segregation,....



- ✓ **First class protection for repo lenders**

Not only bankruptcy privilege, but repossession, incentive to sell

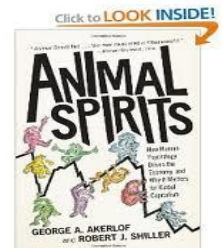
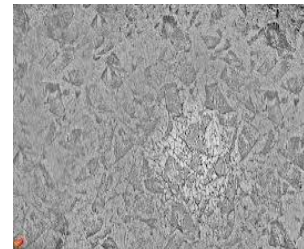
- ✓ Opaque « trades » on opaque asset classes

=> Ingredients for (shadow) bank run

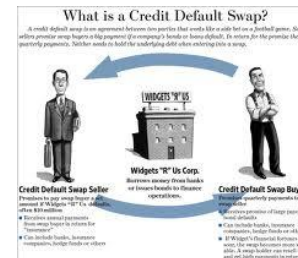


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•What Enrico describes is typical of the worst of all worlds: opacity of banking transactions combined with market animal spirits.



•It is also a metaphor of other « local » rules/protections/behaviours which may create systemic shocks because of inadequate incentives or beliefs, e.g monolines, CDS, IFRS



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A natural conclusion:

- Shadow banking cannot self-stabilize because it is too complex,
- “Local” regulations (UCITS, securitization, hedge funds, repo) do not focus on systemic risk, but on non 100% prudential matters e.g. client protection, market risk, market integrity, etc,



- Hence specific rules should apply to the most toxic trades, where opacity (amplified by long chains of players), leverage, market herd behaviour create a case for shadow bank runs. Transparency should be implemented and wrong incentives should be removed.

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My discussion today will be to spring from Enrico's conclusions, which are well founded and the subject of much debate in the market place, to discuss the notion of "market", because the concept is embedded in the world of shadow banking.

Is not "bad" shadow banking better described by « shadow markets »?



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Back to basics:

- We know from conventional wisdom that the economy is financed by the intermediated channel (banks) and the disintermediated channel (everything else, or « the market »).
- Shadow banking is, as a consequence, part of the disintermediated channel, and as such, is assimilated to « the market ».
- But we should be serious about what a market really is: In 2007, we have been reminded that it is a forum where a **large number of duly diligent participants** trade well **documented** and frequently **third party researched fungible assets**. Which drives liquidity and market depth.



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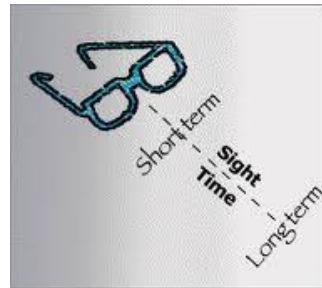
Some parts of shadow banking are part of this league, some are not:

Shadow banking typology (FSB)	Shadow banking as part of "the market"?
ad hoc entities like ABCP, SPV, etc:	if underlying assets are traded on a liquid market
Money market funds:	should only invest in liquid assets if presented as cash harbour
ETF:	if underlying assets are traded on a liquid market
insurance on credit instruments:	?
securitisation:	if underlying assets are traded on a liquid market
securities lending and repo:	if underlying assets are traded on a liquid market
interco lending:	no

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Let's go back to the basics again:

- Shadow banking is the subset of transactions which perform credit by transformation of maturity, liquidity, credit without access to Central bank liquidity or public sector guarantees (Poszar) or “money market funding of capital market lending” (Mehrling)



- The majority of these operations are the usual remit of banks and mimic banking transactions. By nature banking operations are one to one, hence opaque, and leveraged. Hence necessary banking regulation.



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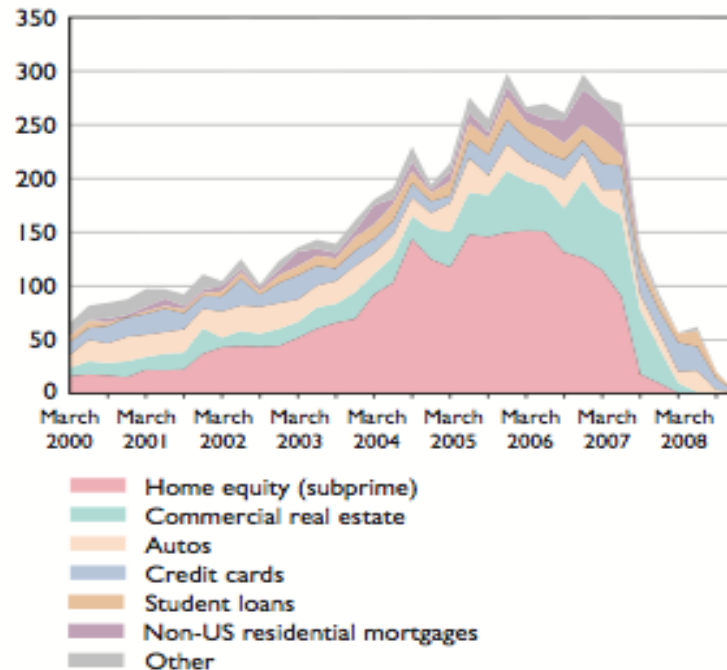
- Whilst this kind of operations are seen as “market trades”, in reality:
 - ✓ they are still opaque,
 - ✓ they can be leveraged and, *in addition*,
 - ✓ they are subject to market herd behaviour
 - ✓ And in frequent cases ...they cannot be traded in a market
- At this point, we enter the systemic risk zone, where shadow banking trades can be seen, in reality, as a hybrid animal, a GMO, with banking features, and market dynamics which can be observed only in adverse period.



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Chart 6
New issuance of asset-backed securities
in previous three months

(USD billions)



Sources: JP Morgan Chase and Adrian and Shin (2009).

Published in BdF FSR #13

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- Reality is that a significant number of these trades were only primary trades, **without secondary market**, even in normal times, for a good reason: assets were very **complex**, **documentation** not easy to understand and products designed to be held to maturity.

Wholesale Loans	Structured & Retail	Structured Retail	Other
<ul style="list-style-type: none">Residential MortgagesCommercial MortgagesConsumer LoansSME & Leveraged Loans	<ul style="list-style-type: none">RMBSCMBSConsumer ABSCDO/CLOEsoteric ABS	<ul style="list-style-type: none">Interest Rate SwapsDigitalSnowballSteepenerIndex LinkedInflation Linked	<ul style="list-style-type: none">Credit Default SwapsTotal Return SwapsCovered BondsAlternative AssetsInfrastructure



- In fact, this type of activity is inherently different from the conventional financial market, the main features of which being liquidity, transparency and limited leverage.

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Liquidity is then essential as a firewall to shadow bank run. But what is liquidity?

- « A market is often said to be liquid when the prevailing structure of transactions provides a prompt and secure link between the demand and supply of assets, thus delivering low transaction costs. » <http://arxiv.org/pdf/1112.6169v1.pdf>
- « So far, there has been only a modest literature analyzing liquidity effects in the fixed-income securitized product market, which mostly focuses on liquidity at the market-wide level » <http://people.stern.nyu.edu/msubrahm/papers/FINRA.pdf>
- Liquidity will always be a variable, echoing fear and greed in the market. **Our point in this discussion is to alert on situations where liquidity DOES NOT exist all. Situations which expose shadow banking to systemic shocks at all times.**
- However, beside existing or still to be published academic work, we may consider the following grid as food for thought

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	EQUITY VANILLA BOND	CDS ABS (sorted by underlying)	CDs and other derivatives	/....
ASSET				
size of the asset market	Green bar			
size of the asset class	Green bar			
porosity within the asset class	Green bar			Large
HOLDERS				
% of long term holders	Green bar			
% of speculators	Green bar			
atomicity of participants	Green bar			
purpose of holders: ALM or portfolio construction	P P			both
MARKET STRUCTURE				
exchange traded	Green bar			
asset rotation	Green bar			
clearing house	Green bar			
OTC predominant		Green bar		
quote or order driven		Q		
magnitude of bid-ask spread	Green bar	variable		
criticality of market making	Green bar			Red bar
depth	Green bar			
resilience	Green bar			
average "stay" in market maker books/inventories	Green bar			forced inventory
INFORMATION				
simplicity, transparency of prospectus	Green bar			
third party research		rating ag.		
availability and user-friendliness of quantitative data	Green bar			
disclosure of prices and volumes	Green bar			rating ag.

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Conclusion:

1) markets that did not exist

- At the peak of the 2007 crisis, problems were made much worse by the faith in the capabilities of what was wrongly seen as a market.
- In this instance, standard loans (e.g. subprime mortgages or other loan contracts) were repackaged as securitised products and then transformed into increasingly complex non transparent financial instruments, such as CLOs, CDOs, square CDOs, etc.

2) contagion

- The systemic aspect stemmed from size, indiscriminate contagion to underlying asset classes (after all, preliminary IMF assessment for subprime losses was only \$ 300bn, small, but not insignificant, in terms of order of magnitude, in relation to US banks aggregate equity) forced sales, and ignorance of who was a good counterparty or was not.
- The panic process was both catalyzed, facilitated and sharply accelerated by prudential and accounting rules, the former encouraging regulatory arbitrage in favour of non transparency (Basel I), and the latter leading to major procyclicality through indiscriminate marking to market of products (due to FAS and IFRS standards) for which there was no real market.

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3) Shadow bank run

- A bank run can happen for many reasons, which are all linked to creditors distrust: opacity, leverage, willingness to get out first from a sinking ship, and catalyst.
- In the case of a shadow bank run, there is an additional feature which is the brutal awareness that products that were thought to be « marketable » did not find any buyer, at any price.
- The market nature of traded assets aggravates the run, and worse, creates contagion to similar instrument or asset classes, which starts the systemic chain reaction.
- In terms of moral hazard, it should be noted that although shadow banking does not enjoy to Central bank liquidity, at least one of its components (MM Funds) have been guaranteed (“don’t break the buck”) by the US government

...

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4) Where do we go from there?

- A few (naïve?) ideas that we may share in the context of this discussion
 - ✓ A huge effort has been made to make banks more secure (Basel 3, Dodd-Frank, Vickers, Liikanen, French and German banking laws, etc). Rightly so because we discovered that instead of dispersing risks in the marketplace, shadow banking transactions actually concentrated them in the banking system. We must *really* believe that these rules (in particular Basel III, which is fairly quantitative and supervised) are serious, otherwise we have a big problem.
 - ✓ In consequence, we should not add to the burden of banks an additional layer of haircuts, capital charges, etc, at the expense of a safe financing of the economy.
 - ✓ Of course society has to be sure that regulators enforce a ban on regulatory arbitrage (as seen in the past with off-balance sheet carry-trade vehicles like SIV, SPV, etc).

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- ✓ Also we should ensure that risk weightings encapsulate genuine liquidity as well as solvency parameters.
- ✓ Regulated Financial institutions must be regulated with rules that specifically control systemic risks, and in particular transactions performed on illiquid markets. We believe that regulators have all means to gauge whether markets are intrinsically liquid or not. We know that liquidity may evolve with market fear. But also know that some markets do NOT exist, at all times.
- ✓ All other institutions involved in shadow banking should demonstrate that they are not engaged in systemic transactions,....
- ✓or they should be regulated (and registered) as banks.

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