Shadow banking

Prof. Daniela Gabor
UWE Bristol

Recognized For Premier Structuring & Distribution Capabilities by Issuers and Investors

ABS – United States Survey 2004

Market Penetration

- 1st – tied – for trading relationships among all investors.

ABS Sales

- 1st – for all categories

Relationship Quality

- 1st – for all categories

- #1 ranked in market share by Moody's in ABCP
- "World's Best ABS House" for 2004 by Euromoney
- "North American Securitization House of the Year" for 2004 by IFR

IFR

INTERNATIONAL FINANCING REVIEW

2004
North American
Securitization
House of the Year

Three points

1. a *macrofinance* approach to shadow banking

2. shadow money and credit

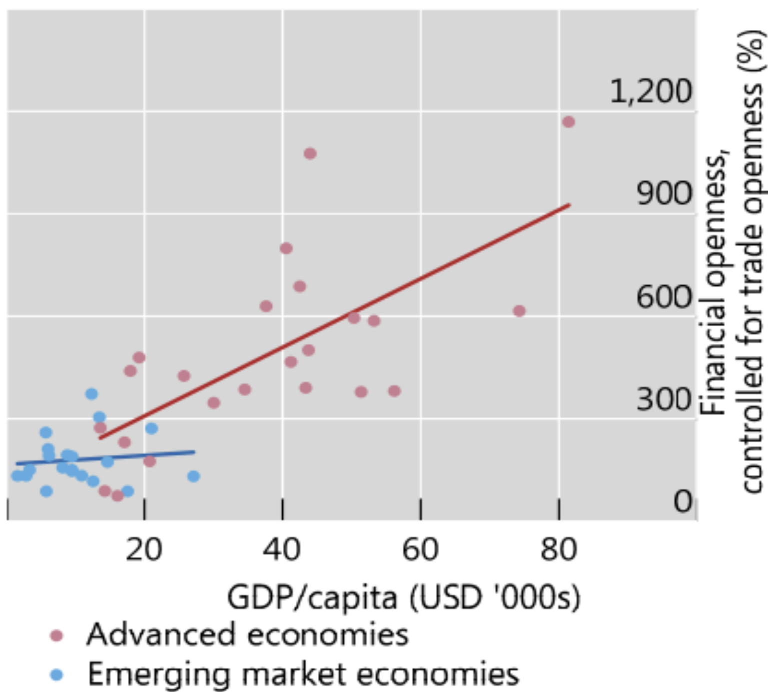
3. shadow banking = financialisation of development

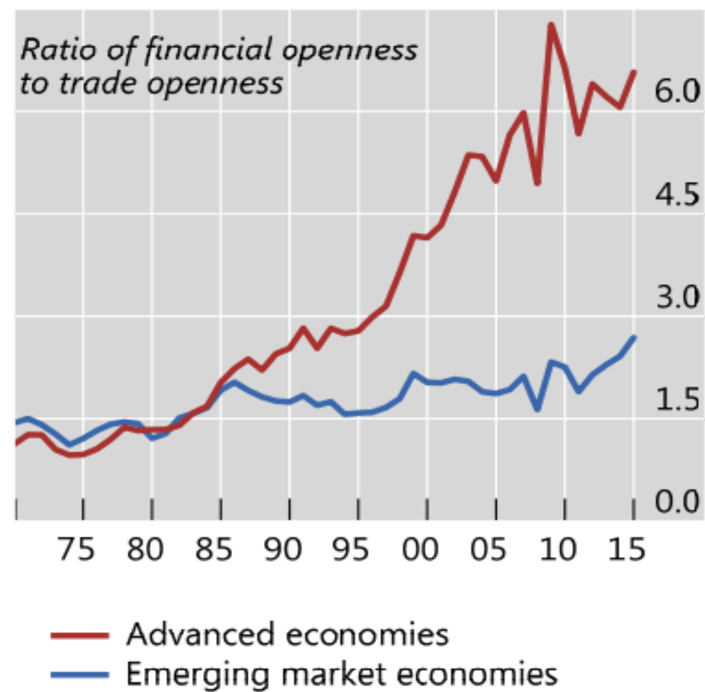
1. Macrofinance

- Close understanding of finance
- *balance sheets* - money, credit, macroeconomics of growth, poverty, inequality, financial crises.
- shadow banking = financial globalisation

A new starting point

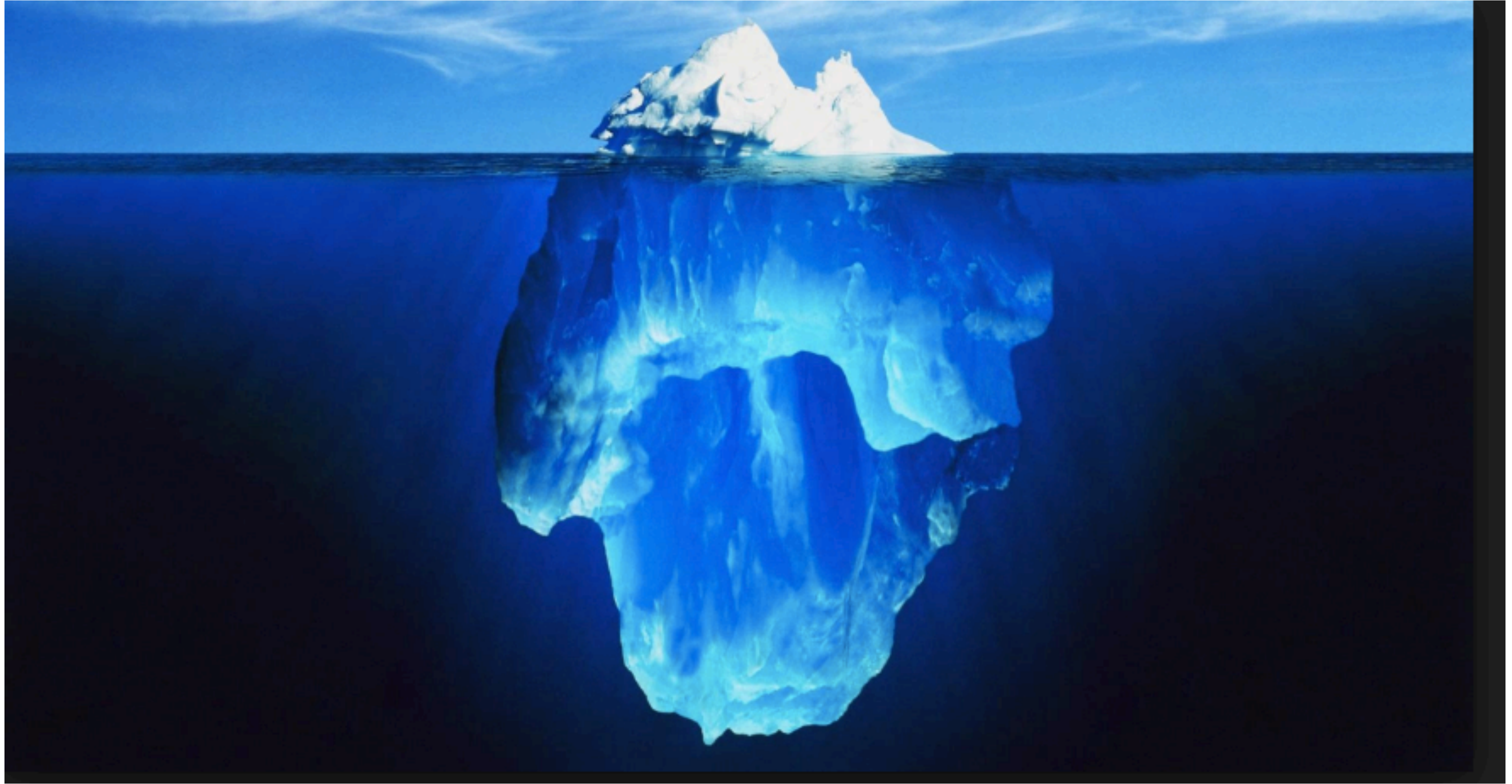
Advanced economies have higher financial openness beyond GDP per capita or trade





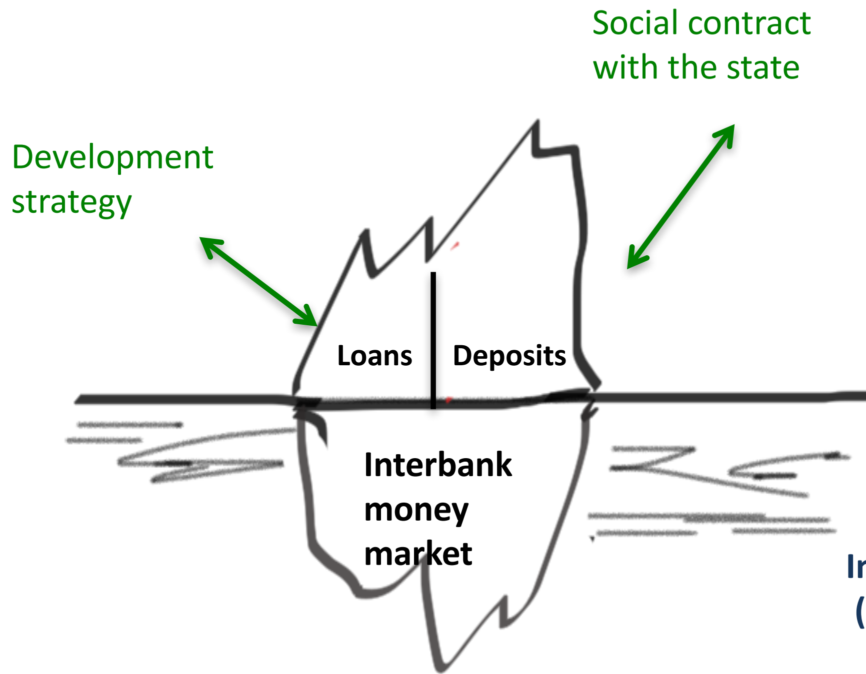
Financial globalisation

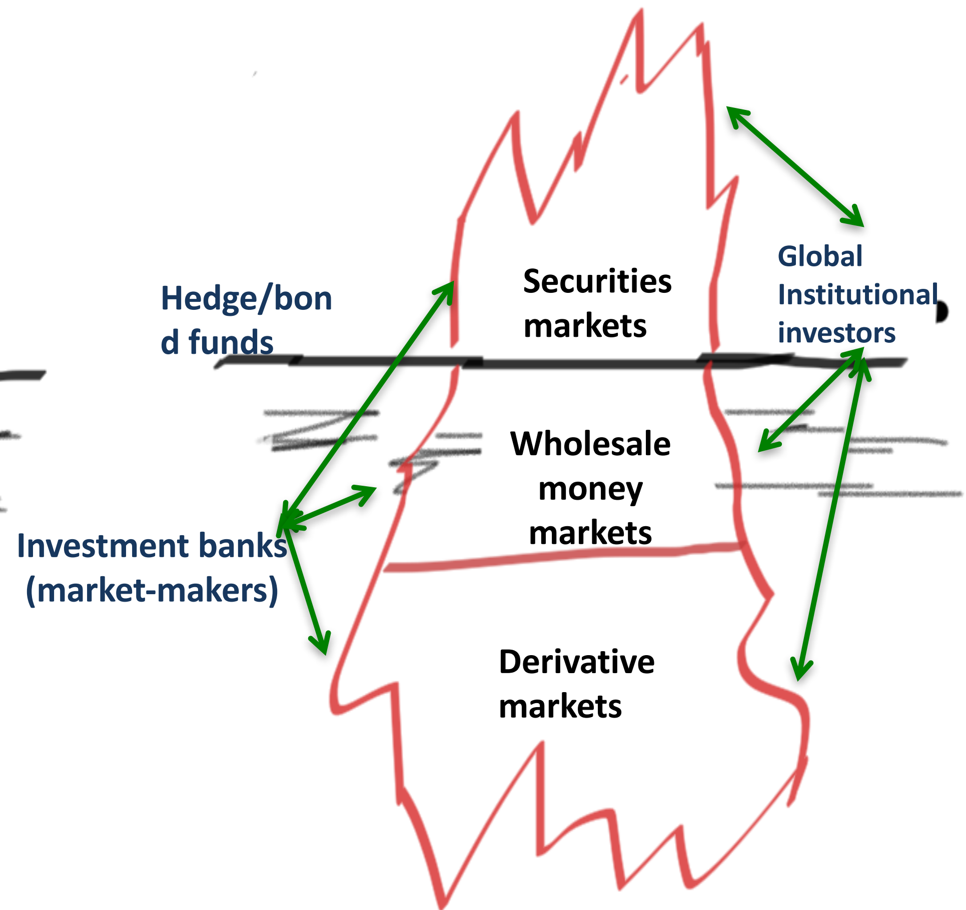
- Financial system organised around securities & derivative markets:
  - Business model anchored in daily variation in price of securities: market-based banking
- Shadow banking: pulling institutional investors to provide financing via wholesale money markets



Bank- based financial systems

Securities markets-based financial systems

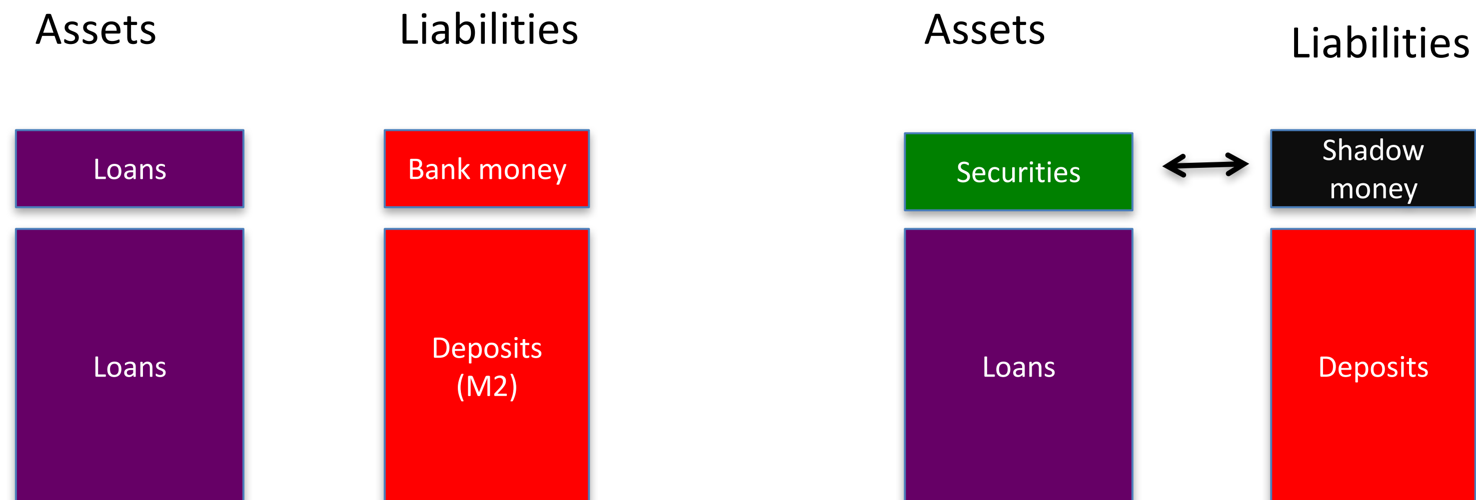




2. Shadow money

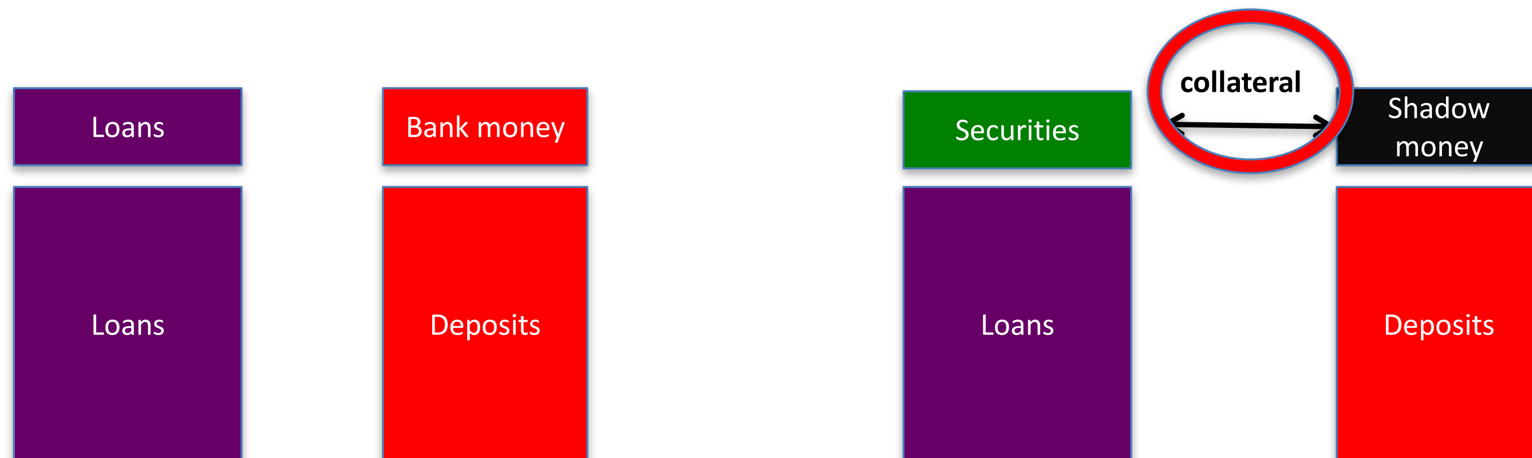
- Money in financial capitalism is different to money in industrial capitalism
- ‘bank money is debt of banks, brought into being as banks finance business’ (Minsky, 1967)
- shadow money is debt of securities traders (banks, asset managers, bond funds, brokers) brought into being to finance securities, debt collateralised by those very securities

Bank money vs shadow money



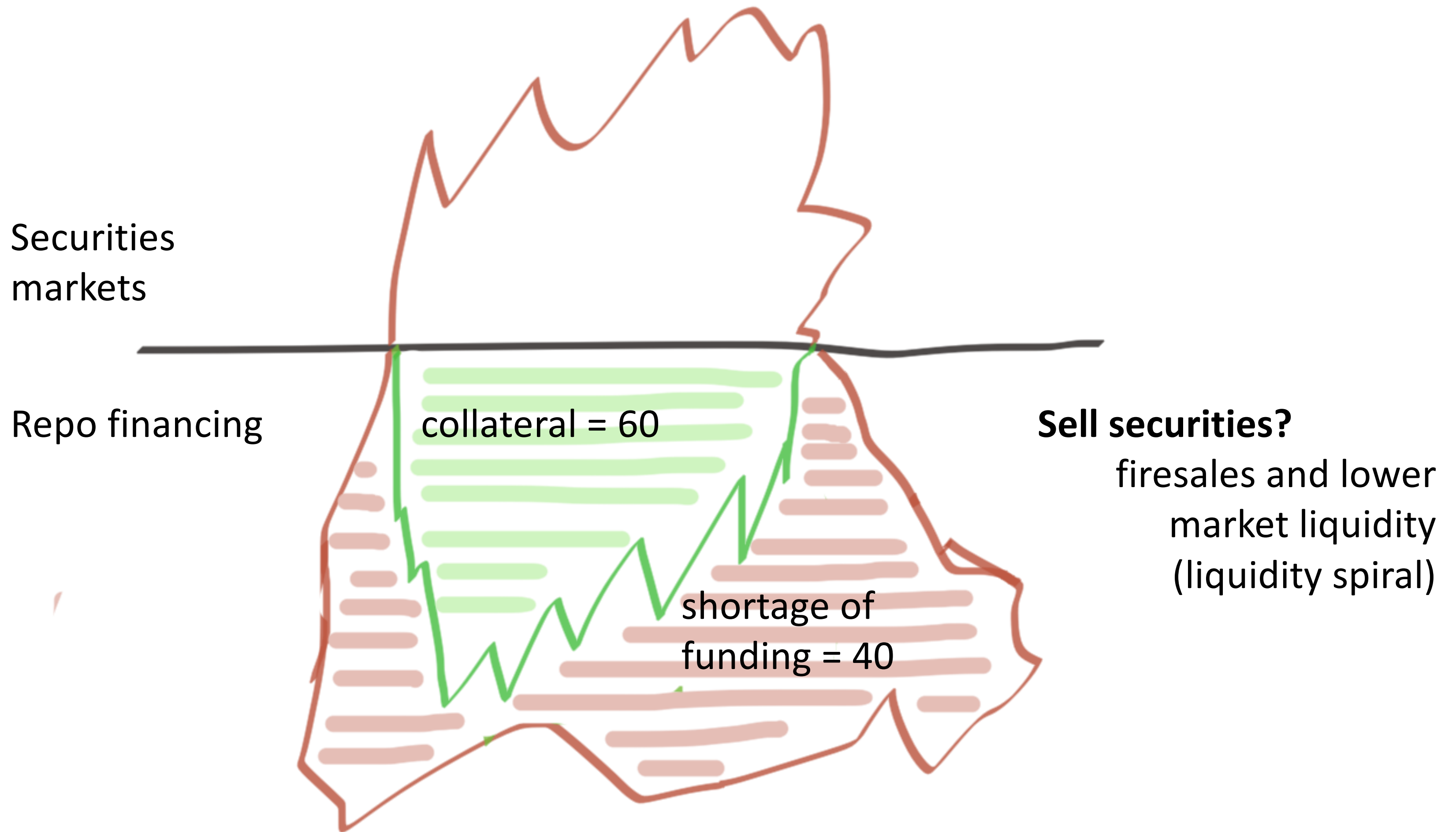
'Shadow money begins where M2 ends' (Pozsar 2014)

How is shadow money created – a question of moneyness

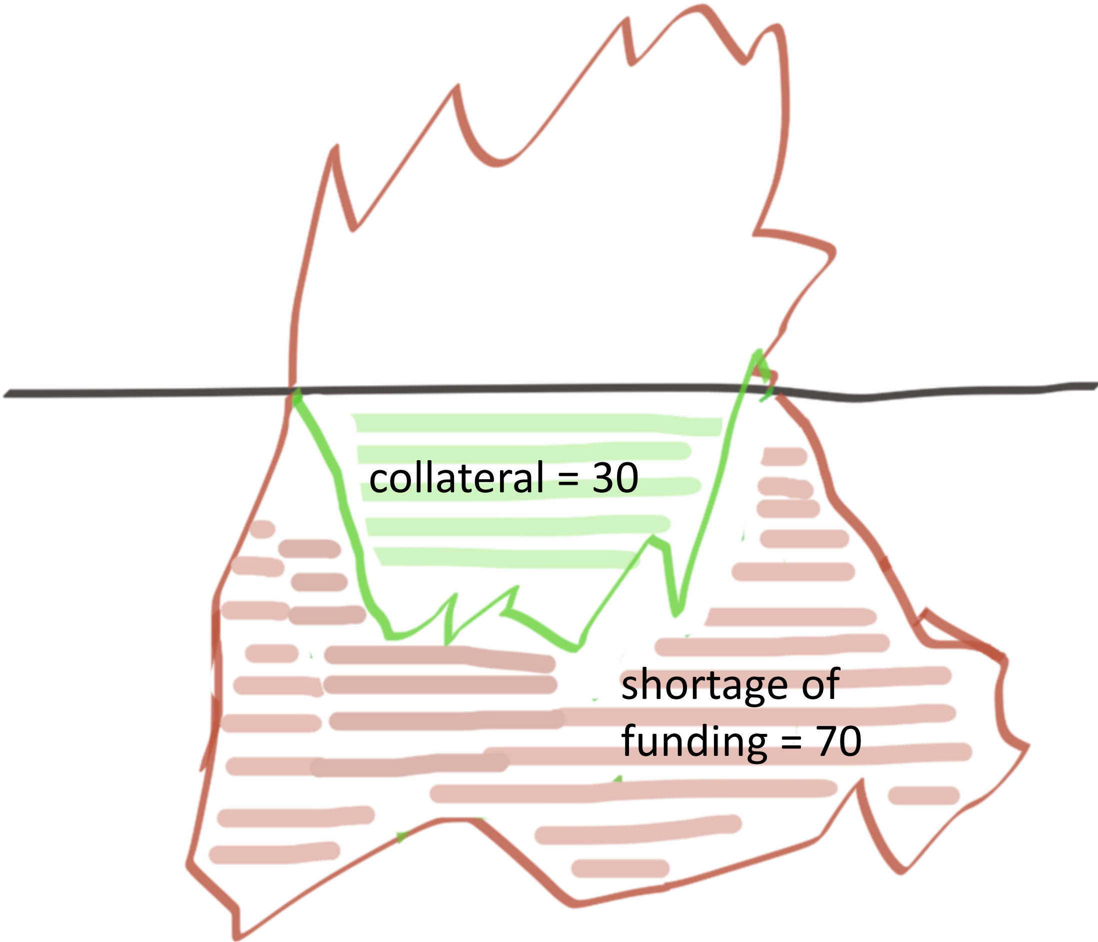


Moneyness – ability to convert *bank money* into *cash* at par on demand, and *shadow money* into *bank money* at par on demand

securities fall in market price from 100 to 60



Corporate bonds fall in market price to 40



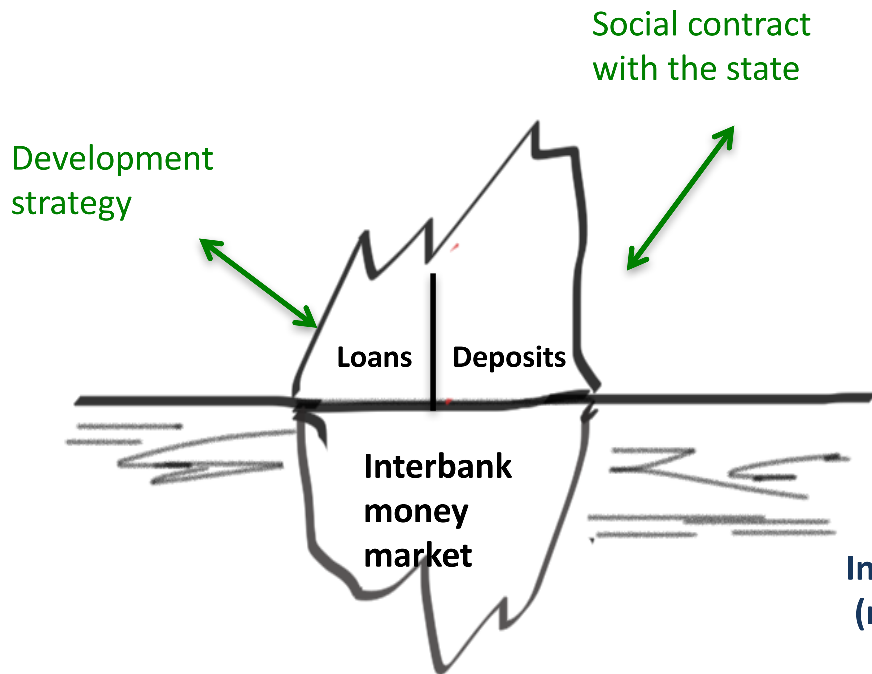
Shadow money issued by a hedge fund

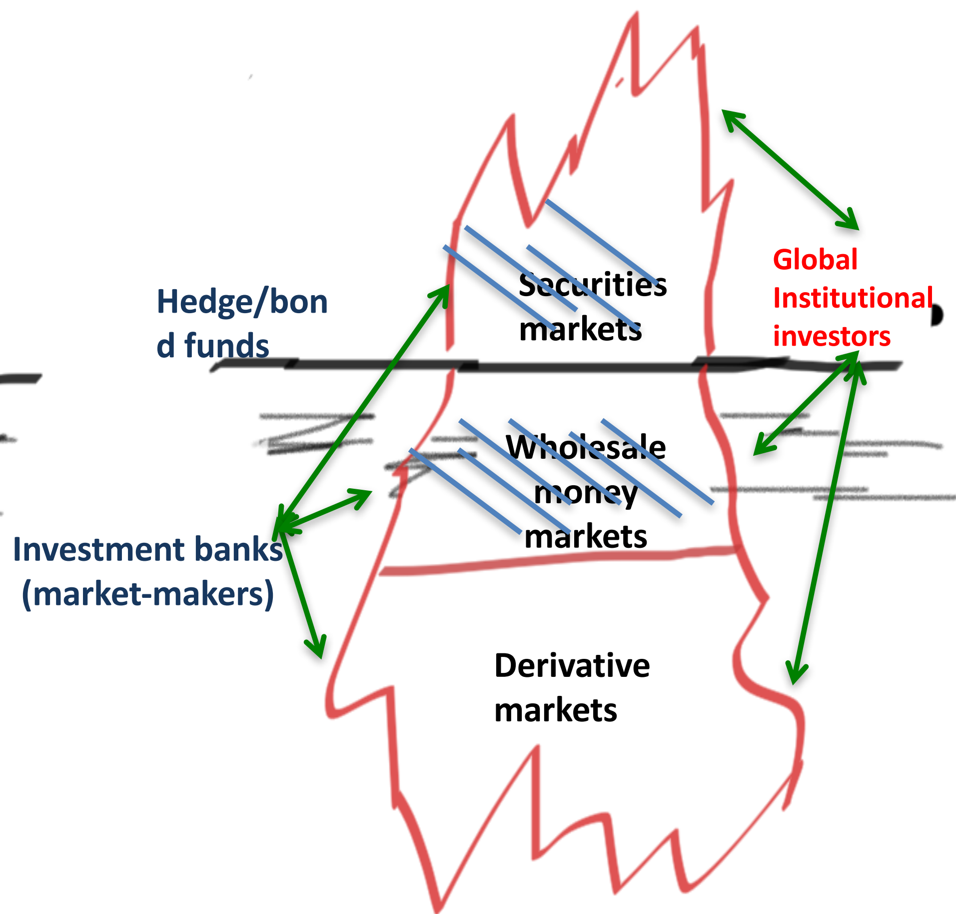
Figure 3 Assets and liabilities for a patient investor

Repo financing	Assets under management (equity)
Securities	
Derivatives (off balance sheet exposure)	

Figure 4 Assets and liabilities for an impatient (speculative) investor

Cash	Repos
Margin	
Securities	
	Assets under management
Derivatives (off balance sheet exposure)	


Bank- based financial systems
Social contract with the state
Development strategy
Loans
Deposits
Interbank money market

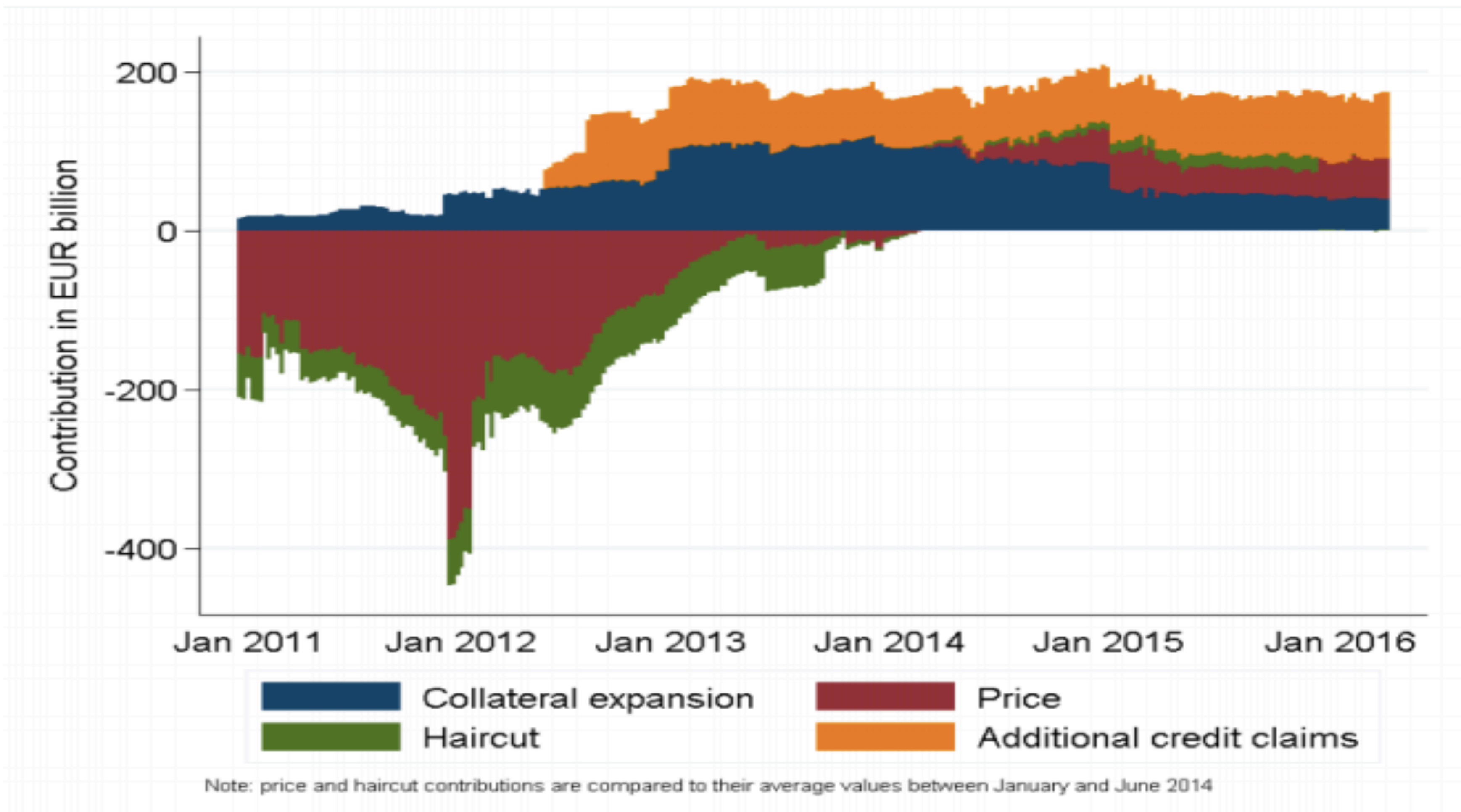

Securities markets-based financial systems
Securities markets
Global Institutional investors
Hedge/bond funds
Wholesale money markets
Investment banks (market-makers)
Derivative markets

The new macrofinance

Table 1 Interactions between monetary/fiscal policies and collateral-based finance

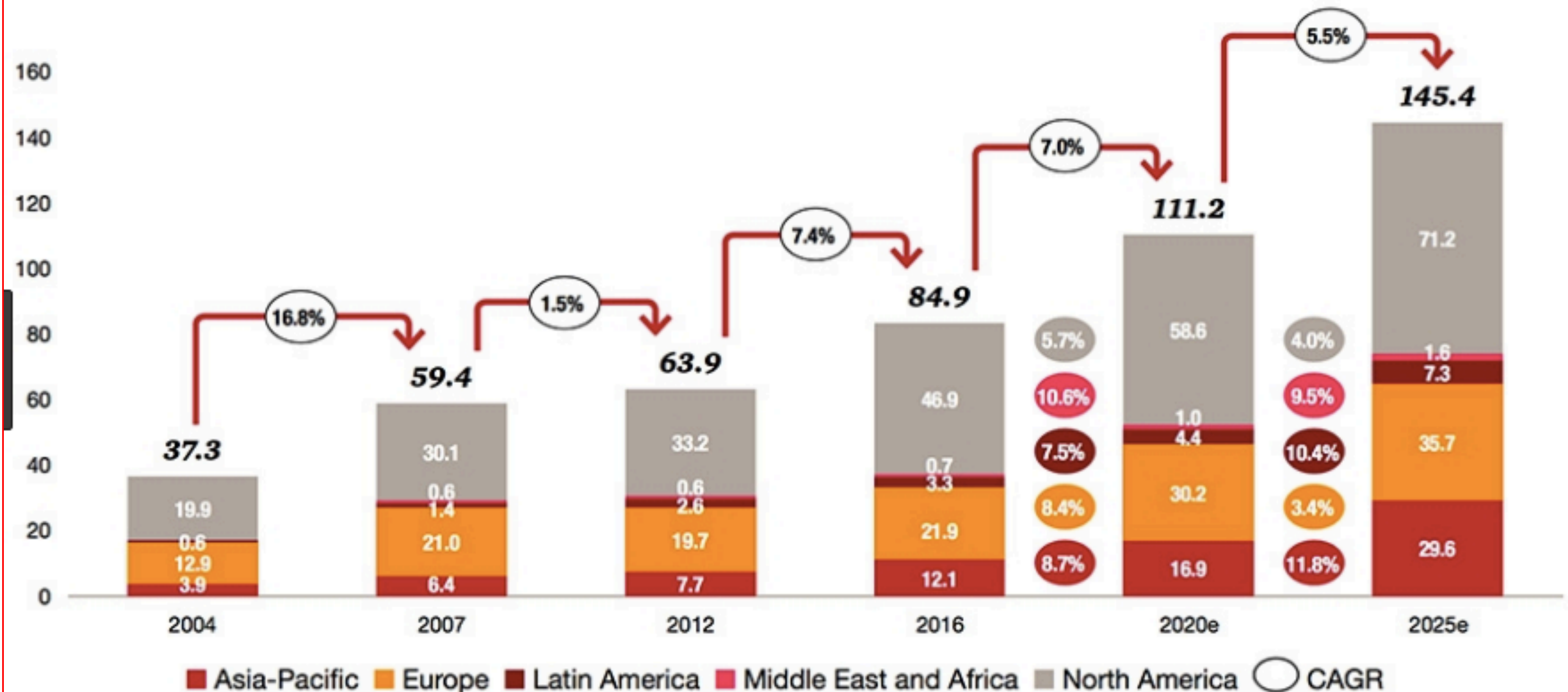
		To collateral-based finance	*From collateral-based finance*
Monetary policy	Normal times	Repo rate targeting Collateral framework	*New money – liquidity and velocity of collateral* *Financial fragility (valuations, leverage, haircuts)*
	Crisis	Procyclical LOLR vs. MMLR (supporting liquidity in collateral markets) Ratio good/bad collateral (QE)	*Liquidity spirals – collateral crises*
Fiscal policy	Normal times	Issuer of collateral for private and central bank repos	*Liquidity for sovereign bond market* *Securitization as response to shortage of government debt*
	Crisis	Financial stability (market liquidity)	*Collateral fragility*
		Coordination monetary / fiscal policy	

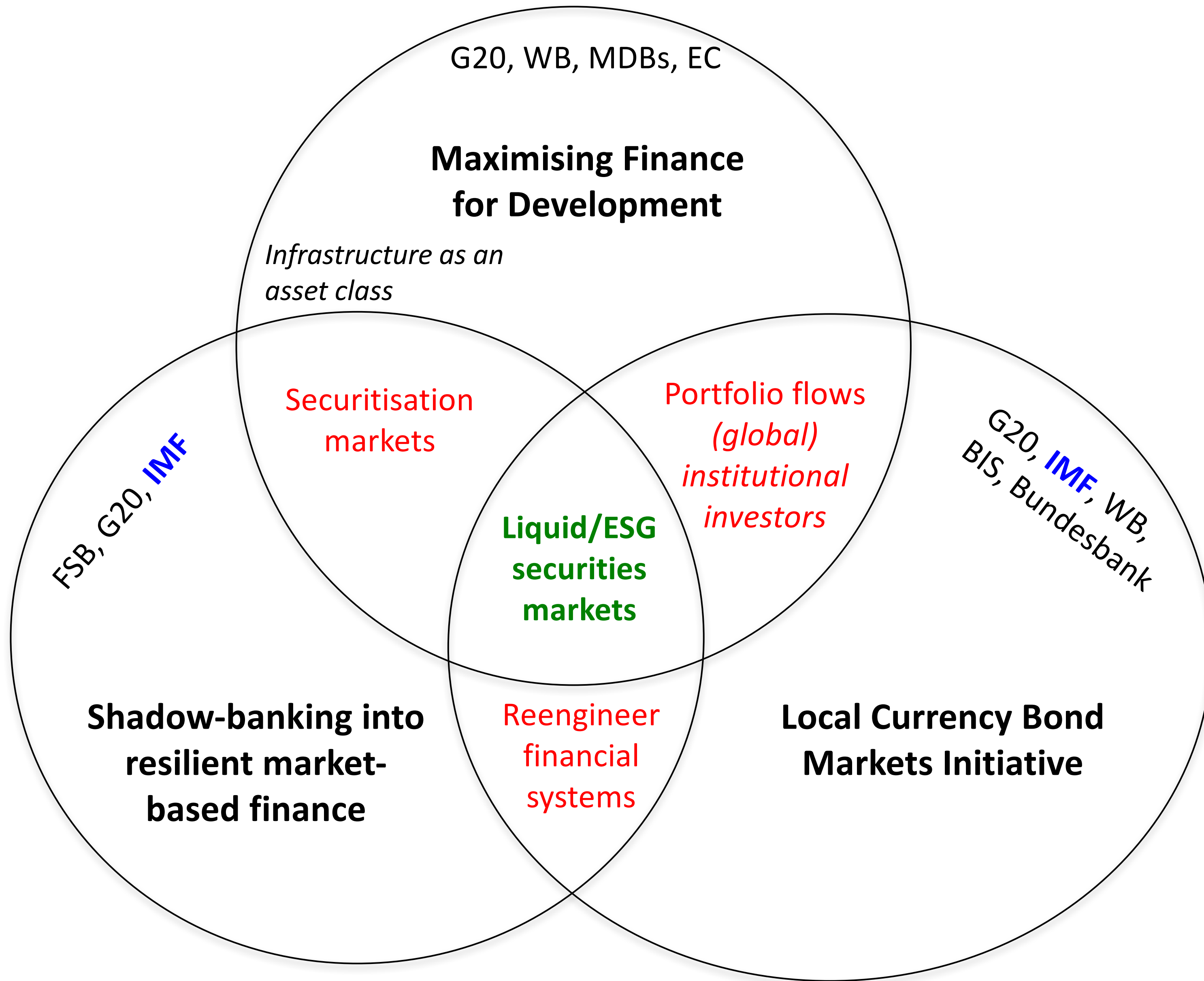
ECB's LOLR vs MMLR



3. Shadow banking in DECs

The age of asset management



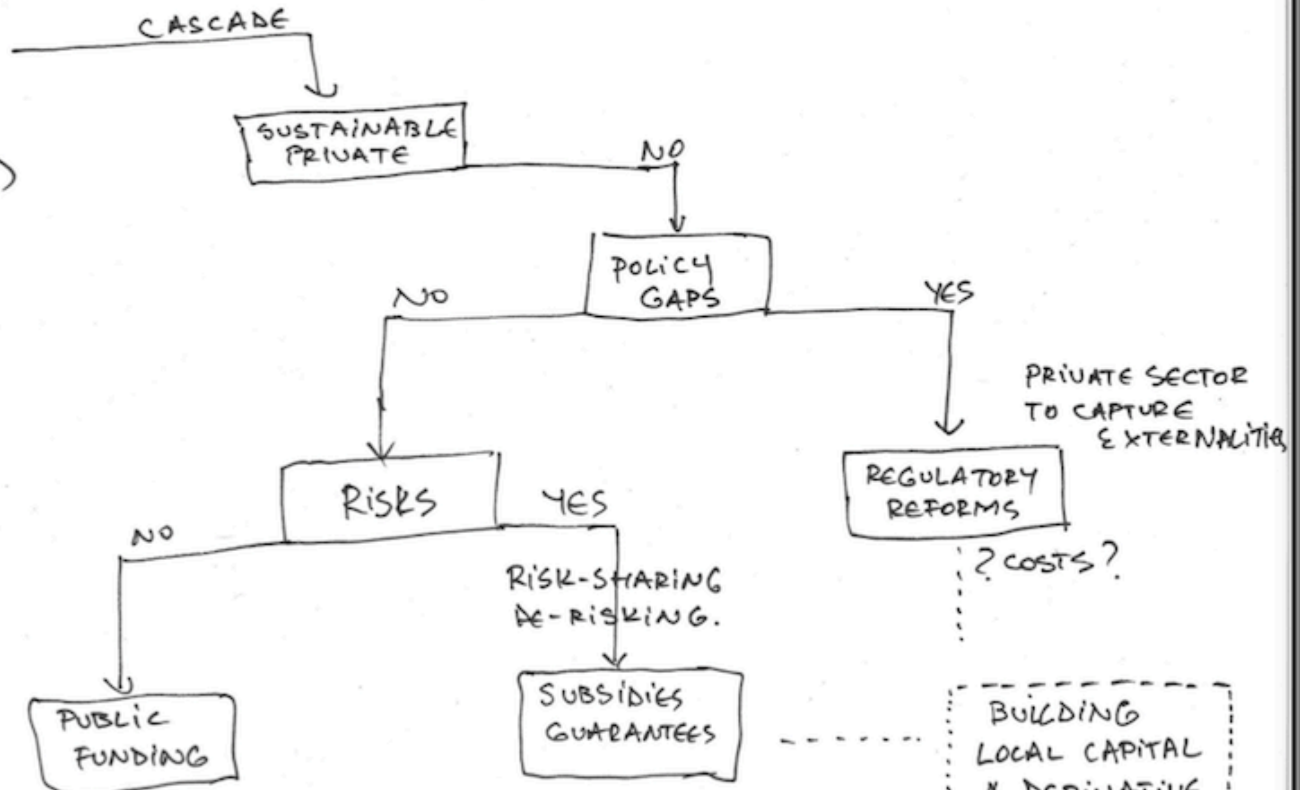


G20, WB, MDBs, EC
Maximising Finance for Development
Infrastructure as an asset class
Securitisation markets
Portfolio flows (global) institutional investors
FSB, G20, IMF
G20, IMF, WB, BIS, Bundesbank
Liquid/ESG securities markets
Shadow-banking into resilient market-based finance
Reengineer financial systems
Local Currency Bond Markets Initiative

CORDELLA (2018): OPTIMIZING FINANCE FOR DEVELOPMENT

3 POTENTIALLY OPTIMAL SEQUENCES

1. REFORMS, SUBSIDIES, PUBLIC (RSP)
2. SUBSIDIES, REFORM, PUBLIC (SRP)
3. PUBLIC, SUBSIDIES, REFORMS (PSR)



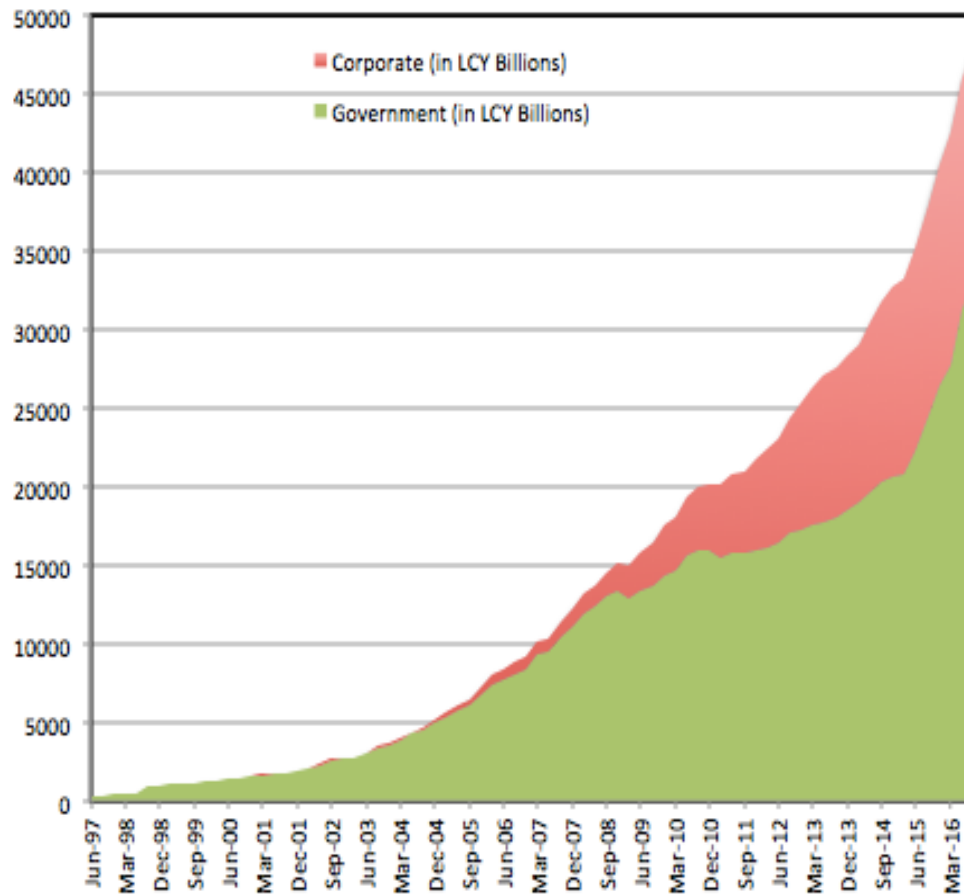
MODEL
- COST OF FUNDING = FOR PUBLIC & PRIVATE
- NO PRIVATE PROFITS FROM EXTERNALITIES
- NO NEGATIVE EXTERNALITIES (SYSTEMIC RISK)

Box 1: Indian bond markets – a view from the Association of Securities and Financial Markets in Asia.

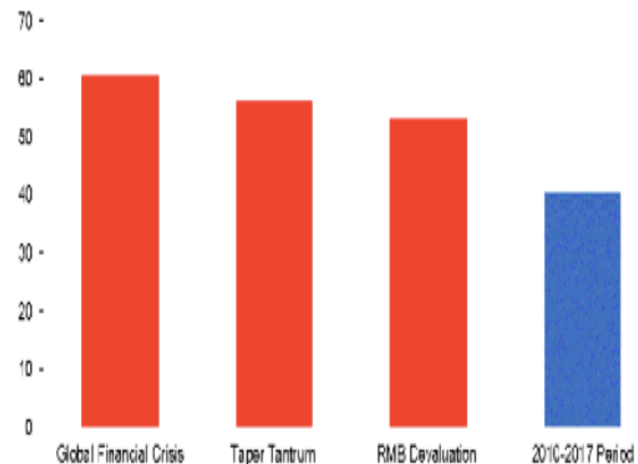
In a 2013 report, ASIFMA identified several bottlenecks in the rapid development of local bond markets, bottlenecks that reduced significantly the interest of foreign investors.

1. *Hold to maturity bias*: local banks held around 80% of government bonds in hold-to-maturity portfolios. This 'patient' strategy, strongly influenced by liquidity regulations, reduced the volume of bonds available for trading in secondary markets, and therefore market liquidity.
   The finance lobby recommended the removal of prudential regulations.
2. *Liquid repo market:* market-makers cannot short securities, and thus provide secondary market liquidity, because the legal framework does not allow for the legal title of collateral to be transferred in a repo. Collateral securities cannot be re-used.
   The finance lobby recommended aligning the legal framework with European/US standards.
3. *Active liquid derivative markets:* foreign investors can only hedge the currency exposure resulting from ownership of local currency securities through non-deliverable swaps outside India (NDSs).
   The finance lobby recommended the development of onshore derivative markets that would increase the liquidity of securities markets.

China & financial globalisation



IMF 2018: domestic financial conditions determined by **global financial cycle**



The downsides of MDBs new financing model

- influence, if not altogether shape, the terms on which DECs join the global supply of securities - he preferences of global banks and global institutional investors.
- MDBs will shape the definition of what is a 'bankable' project - prioritise large infrastructure projects at the expense of smaller projects with more developmental potential.
- MDBs plan to pioneer the securitisation infrastructures that will transform bankable projects into tradable securities - significant revenues & domination for globally systemic financial institutions,
- MDBs co-design the 'de-risking'/subsidies measures and persuading DEC governments to finance the associated costs, as guarantor of private financial profits.
- MDBs may push for DEC pension systems to converge on the US model of private pensions in order to create local institutional investors dependent on global asset managers

Preparing better for the next crisis

- Manage financial globalisation: capital controls and managed exchange rates for Global South
- Defend and revive the welfare state if rentiers to be euthanised (FTT)
- Reclaim the developmental state: **politicians reign, technocrats rule, businesses comply**
  - highly-capable, development-oriented bureaucracy focused on productivity growth &industrial upgrading