

Shadow Banking

Abstract

The rapid growth of the market-based financial system since the mid-1980s changed the nature of financial intermediation in the United States profoundly. Within the market-based financial system, “shadow banks” are particularly important institutions. Shadow banks are financial intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector credit guarantees. Examples of shadow banks include finance companies, asset backed commercial paper (ABCP) conduits, limited purpose finance companies (LPFCs), structured investment vehicles (SIVs), credit hedge funds, money market mutual funds, securities lenders and the government-sponsored enterprises (GSEs).

Shadow banks are interconnected along a vertically integrated, long intermediation chain, which intermediates credit through a wide range of securitization and secured funding techniques such as ABCP, ABS, CDOs and repo. This intermediation chain binds shadow banks into a network, which is the shadow banking system. The shadow banking system rivals the traditional banking system in the intermediation of credit to households and businesses. Over the past decade, the shadow banking system provided sources of inexpensive funding for credit by converting opaque, risky, long-term assets into money-like and seemingly riskless, short-term liabilities. Maturity and credit transformation in the shadow banking system thus contributed significantly to asset bubbles in residential and commercial real estate markets prior to the financial crisis.

We document that the shadow banking system became severely strained during the financial crisis because, like traditional banks, shadow banks conduct credit, maturity and liquidity transformation, but unlike traditional financial intermediaries, they lack access to public sources of liquidity such as the Federal Reserve’s discount window, or public sources of insurance, such as federal deposit insurance. The liquidity facilities of the Federal Reserve, and other government agencies’ guarantee schemes were a direct response to the liquidity and capital shortfalls of shadow banks and, effectively, provided either a backstop to credit intermediation by the shadow banking system, or to traditional banks for their exposure to shadow banks. Our paper documents the institutional features of shadow banks, discuss their economic roles, and analyze their relation to the traditional banking system.