Shadow Banking and Financial Stability under Limited Deposit Insurance

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BIS and CEPR

The views expressed are the discussant only and not necessarily those of the BIS
Outline

- The paper in a nutshell
- Three comments
  - Interactions between shadow banks and banks are complex
  - Risks are both on the liability side and the asset side
  - Practical policy considerations
- Conclusions
Financial stability implications of SB should not be analysed separately from the cap on deposit insurance at traditional banks.

Stylised theoretical model derives some policy prescriptions:

- If the cap on insured deposits is high, SB sector is detrimental to financial stability: SB creates systemic instability that would not be present if all deposits were held in commercial banks.

- By contrast, if the cap on insured deposits is low, then the presence of a SB sector is beneficial from a financial stability perspective: shadow banks absorb uninsured deposits from the banking sector, thereby shielding banks from runs.

Set SB sector to the smallest size that is necessary to absorb enough uninsured deposits from commercial banks.
Three comments
I. Interactions between SB and banks are complex

- The relationship between banks and shadow banks are more complex than those described in the model
  - SB and banks may be controlled by the same companies
  - Shadow banks (ie MMFs) provide funds to banks
  - MMFs and banks interactions occur not only via changes in the asset price (secondary market)
  - Run on MMF may also have negative impact on bank funding
Yu’eBao’s importance for bank funding

Yu’eBao’s asset composition

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Maturity of Yu’eBao’s assets

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1 Share of Yu’eBao’s assets (excluding Treasury bonds) as a fraction of total interbank funding. Total interbank funding is calculated as the sum of outstanding amounts in the interbank NCD, the repo collateral, the outright repo and the interbank loans markets.

2 Interbank certificates of deposits.


4 Reverse repos = financial asset held under resale agreements.

Sources: CEIC; WIND; BIS calculations.
II. Assets are also risky

- Instability may be amplified in the presence of risky assets
  - Model claims that in case of a run on a SB, if its size is limited there is a small correction on the “safe” asset price
  - Because the assets in the model have no risk, banks do not have an incentive to sell them if there is no withdrawal
  - But in reality, a decline in the market value of assets could trigger pro-cyclical behavior. This could cause deleveraging, fire sales and run
  - So even if bank liability side is safe, banks may also sell assets
III. Practical policy considerations

- Set **SB sector** to the **smallest size** that is **necessary** to absorb enough uninsured deposits from commercial banks

- Two elements here:
  - Size of the SB sector
  - Deposit insurance cap (exogenous)

- What policy instruments?
  a) Macroprudential policies designed to limit MMFs activities
  b) Deposit insurance cap adjusted to take into account MMFs size
  c) Combination of (a)-(b)
Conclusion

- Very interesting paper
  - Novel model about shadow banking and financial stability
  - Link between cap on insured deposits and SB size

- Need to think more about how model prescriptions could change in the real world and how to apply them
Thank you for your attention

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