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INEVITABILITY OF SHADOWY BANKING

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Paul McCulley: A *shadow bank* is an institution or bank-sponsored special-purpose vehicle that has persuaded its customers that its liabilities can be redeemed *de facto* at par without delay (or can be traded *as if* they will be executed at par without fail at maturity) even though they are not *formally* protected by government guarantees.

The “y” and “ing” I add to his term stretches the shadows to include not just firms (like SIVs, money-market funds, and government-sponsored enterprises), but *instruments* such as swaps, repurchase agreements and AAA securitizations that may trade for substantial periods of time as if they carried zero counterparty risk.

THE RESCUE REFLEX

Risky Instruments enjoy shadowy implicit guarantees that eliminate counterparty risk whenever it is believed that top government officials will be afraid **not to let the safety net absorb** all or most of the losses their holders might suffer.

“Shadowy” is meant to encompass opportunistic efforts to play upon this reflex to extract implicit (i.e., confidently conjectured) guarantees from a nation’s financial safety net without informing taxpayers about their exposure to loss and without adequately compensating them for the value of the contingent credit support that authorities’ rescue reflex imbeds in the shadowy entity’s contracting structure.

The value of a protected firm’s side of shadowy govt guarantees increases with the volatility of its asset **quality** and the fragility of its funding structure.

SHADOWY BANKING IS REGULATORY ARBITRAGE

Although macroeconomists conceive of the taxpayer side of financial institutions' shadowy claims as an **externality**, it is more **accurately** a central part of the industry's **implicit contract for regulatory services**: a market-completing **"taxpayer put"** which the industry understands as a government-enforced obligation for taxpayers to rescue large and politically powerful shadowy firms(SFs) and their counterparties when they are in difficult straits.

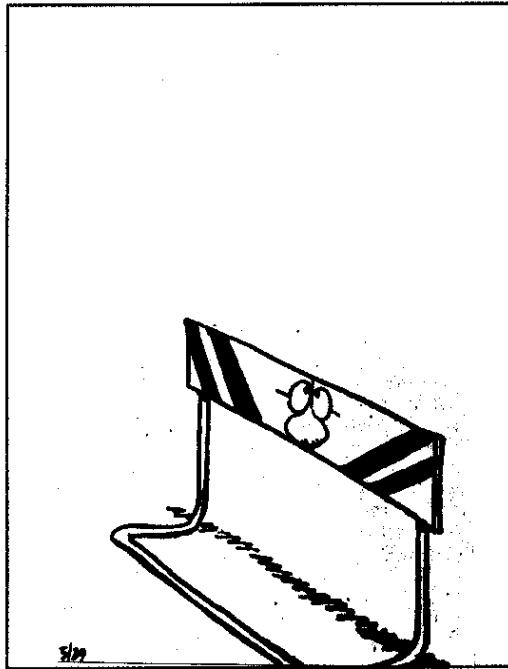
A nation's largest, most complex, and most politically powerful firms believe that, in exchange for accepting loophole-ridden regulatory requirements and paying deposit insurance premia, they are **entitled** to exercise this put whenever investors perceive they might be hiding ruinous losses.

REGULATORY ARBITRAGE IS IRREPRESSIBLE

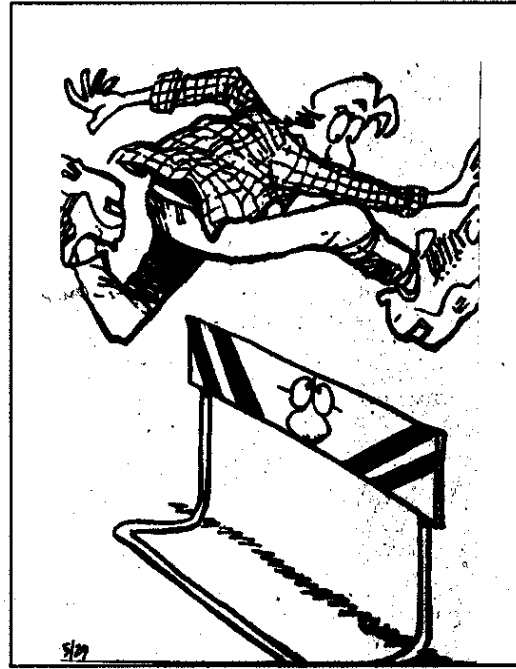
I find it useful to look at regulation from a *Hegelian* perspective so as to **dramatize** the incentive conflicts regulators and regulatees face. **Loophole Mining** and **Money Politics** bombard regulators with conflicting (i.e., Hegelian) political & economic pressures.

- Regulation = **Thesis** (e.g., the DFA)
- Avoidance and Lobbying = **Antithesis**
- Re-Regulation = **Synthesis** (new thesis)

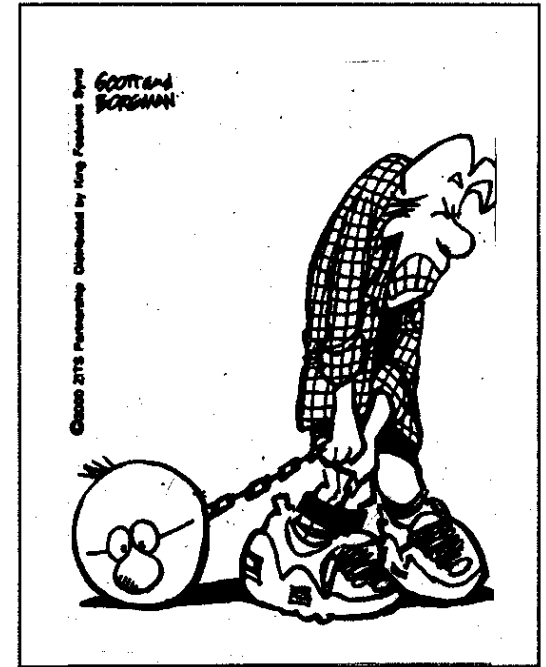
Parent-Child Example



Regulation



Avoidance



Reregulation
(one possibility and
far from the most
likely one)

SHADOWY BANKING: REGULATORY STRATEGIES ARE LESS EFFECTIVE THAN THEY SEEM

- Regulators' **Influence-driven** incentive conflict promotes avoidance and creates a **taxpayer put** for Shadowy Firms: coercing taxpayers to assume the risk of a **disadvantaged equity investor of last resort**. **As such, Taxpayers have a right to the same information and safeguards as formal shareholders.**
- **Failing to account for taxpayers' stake on Shadowy and Federal balance sheets** helps the financial industry to sow misconceptions, nontransparency, and outright loopholes into the capital standards and regulatory definitions of capital and risk that --then and now-- are supposed to keep financial instability in check.

THE SHADOWY NATURE OF THE PUT IMPARTS AN AVERSION TO TRUTH

Costs and benefits of Regulation depend on the mere **appearance** of compliance: Bank Accounting and Risk Management resemble a “Makeover” TV Show (*fashionistas*, cosmeticians, & plastic surgeons artificially improve their looks).

Managers search out loophole ways to **offer post-govt jobs, exercise political clout, adjust & report their asset and funding structures, and choose the jurisdictions** in which they book particular pieces of business so as to lower regulatory burdens that government constraints would otherwise put on their pursuit of firm objectives.

If shadowy bankers were no more devious than teenagers, they might improve **taxpayers’ understanding of the arbitrage process by posting some of the following grafitti on the walls of federal buildings.**

SHERIFFS

Boulder Camera © 3/11/10 creators.com
joberffins@gmail.com
sheriffus.com

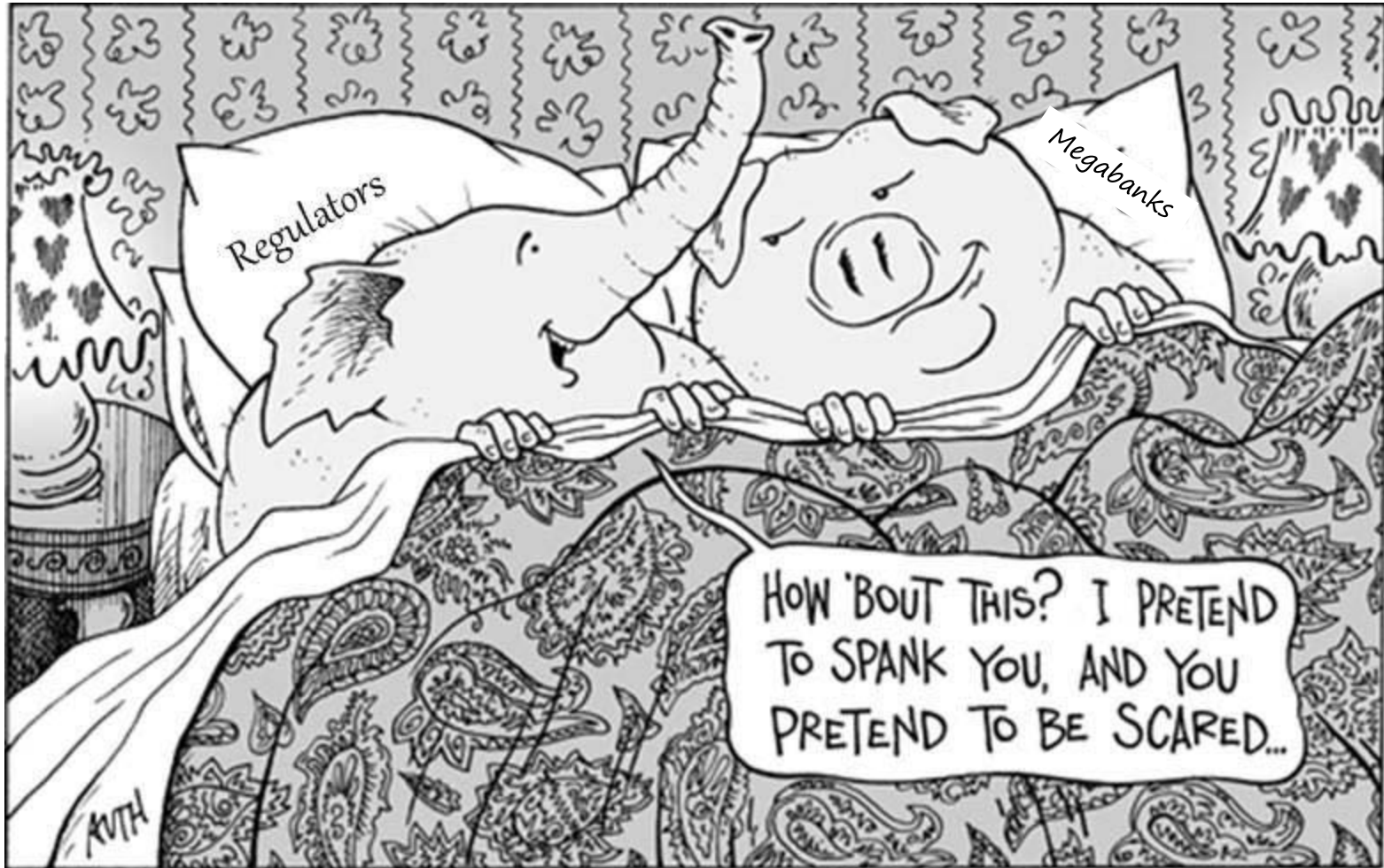
LEAVE THE FREE MARKET ALONE
UNLESS WE NEED ANOTHER BAILOUT
WE DON'T NEED NO STINKIN' REFORM
THE FINANCIAL INDUSTRY RULES
GOVERNMENT REGULATORS CAN GO TO H***
NO CONSUMER FINANCIAL PROTECTION AGENCY
WE DO WHAT WE WANT, WHEN WE WANT
SO WHAT IF AMERICANS ARE HURTING?
WE GAMBLE WITH YOUR MONEY AND KEEP THE PROFITS
THE MORE BONUSES FOR US THE BETTER
HA! WHO'S GOING TO STOP US, CHUMP? YOU?
WE DON'T CARE ABOUT AMERICA'S FUTURE
GREED IS GOOD - DERIVATIVES EVEN BETTER

+ 30
+ 9
- 19
+ 85
- 3
-

The Hegelian Game of Financial Regulation Is an Evolutionary Three-Party Contest

- Principal Players are Regulated Institutions, Regulators(including pols), and Taxpayers.
- Ethically challenged institutions build political clout and **feel entitled to hide salient information** from other players in both time-tested and innovative ways. Have more skill, more information, and fewer scruples than other players.
- Regulators **join in a partial coalition with the Regulated** not only to help them with concealment, but also to cooperate in overstating the effectiveness and fairness of their own play (i.e., express too much confidence in their damage control strategies and enforcement).
- Taxpayers are deceived and are made to play from a poorly informed, **disequilibrium** position; they are unaware of their commitment to a strategy that they would reject if informed.

Post-DFA Rule-Making



4-16-10 THE PHILADELPHIA INQUIRER. UNIVERSAL CLICK.

FUTURE ROUNDS OF SHADOWY INSTRUMENTS ARE APT TO BE CLEVERLY ENGINEERED SWAPS

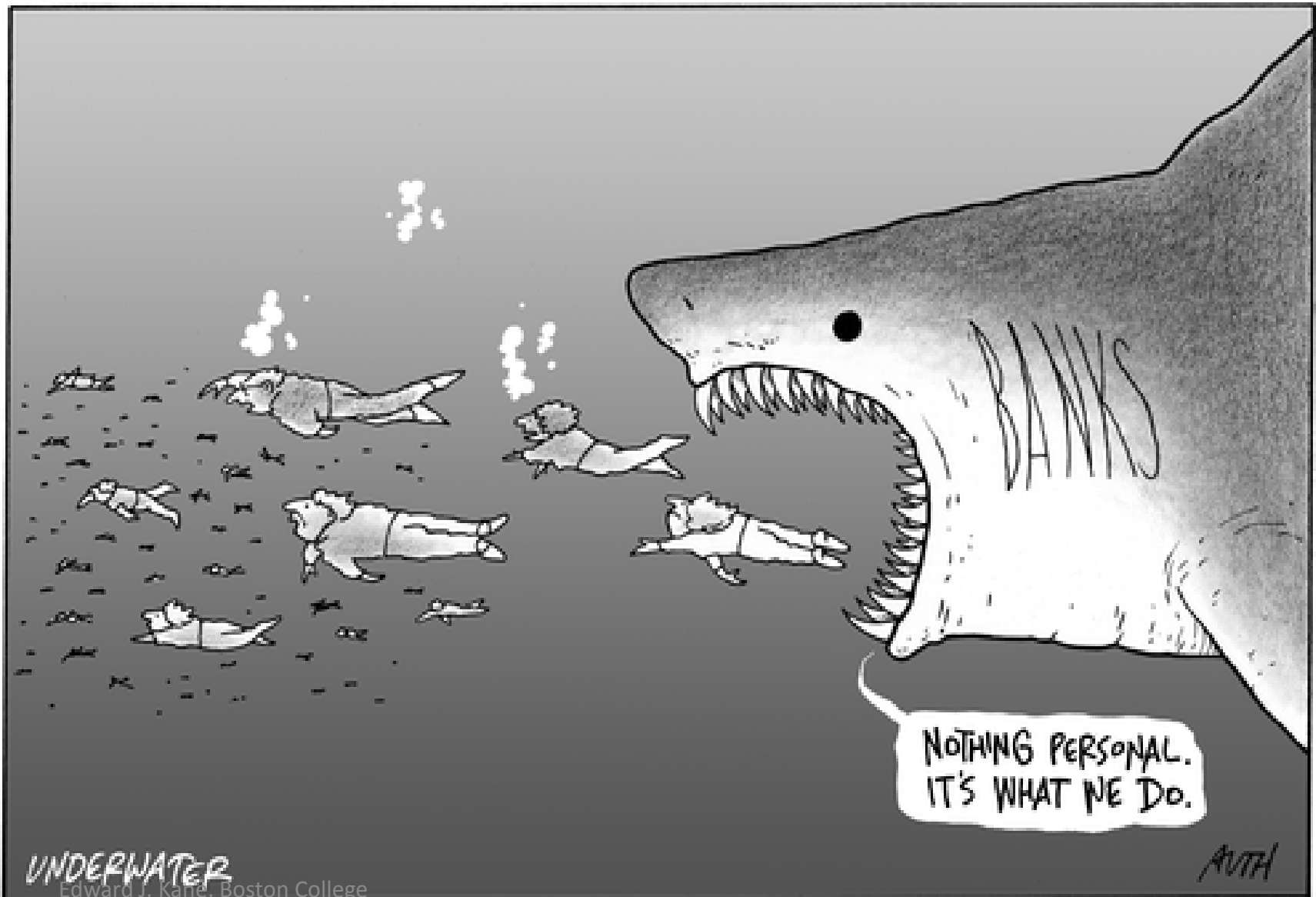
1. Any contract that carries an explicit or implicit guarantee can be swapped in great volume and high volume establishes the equivalent of **squatters' rights** because authorities are reluctant to roll back innovations that achieve widespread use.
2. Swaps that substitute for traditional ways of providing insurance and pension coverages create incremental balance sheets whose Shadowy MARKET-COMPLETING TAXPAYER PUTS are unsupervised and unregulated and probably UNREGULATABLE with existing SEC and CFTC regulatory toolkits and skillsets (Value at Risk, Capital Requirements, Position Netting, Trading Halts, and Margin Calls).

ILLUSTRATIONS OF UNCHECKED EXPANSION IN SWAP-BASED REGULATORY ARBITRAGE

1. Promontory International's "Certificate of Deposit Account Registry Service" (CDARs)
 - a. Over 3,000 member institutions: the FDIC underwrites the overline coverage and Promontory collects the Fees.
 - b. Sadly, Ex-Game Wardens Make the Best Poachers
2. The AIG Debacle (What did its counterparties know? Why didn't they help authorities to see AIG's gigantic risk exposures? Why did they refuse to take haircuts?)

AMORAL DEFENSE OF THE TAXPAYER PUT

10-26-11 THE PARADOXICAL MINDSET. UNIVERSAL PULICK.



1. Regulators need to understand that their team is politically constrained to be outgunned, outcoached, and always playing from behind: Because technological change produces concealment and risk-taking opportunities not contemplated by regulatory procedures, every control strategy loses effectiveness **over time**.
2. To improve accountability for regulatory play, we need to break up the Regulator-Regulated coalition, bring the taxpayer put onto federal and financial-institution **balance sheets and income statements**. This would require a re-orientation of information generation, reporting, and special penalties for fraud in government and in the financial industry (both here and abroad).

Genuine repair would have to reach deep into the machinery of Government. Here is a Headline we might hope for:



The thing that came loose is **TRUST**. Higher Capital is helpful, but no silver-bullet repair for restoring trust. Society Needs to **Incentivize** and **Monitor** Private and Public Managers of National Safety Nets So that INCENTIVE DILEMMAS **DO NOT** Subsidize Firms that actively Expand Their Risk-Taking and Political Clout in Destructive Ways.

No Long-run Cure exists, only some **Remedies**: (1) Start screening financial innovations for dangerous safety-net consequences, and (2) adopt a cocktail of incentive and informational adjustments. Government **Officials and managers of protected institutions** must be made at least as **accountable to taxpayers** for measuring and **honestly** disclosing the equity-like loss exposures that they shift to taxpayers as corporate managers are accountable for disclosing value of operations to stockholders.

- Repair Ethics of Finance and Credit-Rating Process: Replace arrogance and sense of entitlement in industry and government with a delineation of the **duties of disclosure, loyalty, care, and competence** owed to taxpayers as equity investors in Shadowy firms. Regulators must give taxpayers a fair deal.

A critical step must be to strengthen **training and recruitment** procedures for top regulators. Incentive conflict is the problem and placing **political patronage** at the center of the appointment process amplifies incentive conflict. One's ability to handle incentive conflict is shaped in large part by one's personal sense of honor and duty. In many areas of public service, a candidate's sense of honor and duty is honed by specialized training programs. I believe that we need to establish a **specialized academy for training financial regulators** and admit cadets from around the world. This would forge connections between graduates at supervisory agencies in different countries and pave the way for more-effective information flows and cross-border regulatory cooperation. ESE Initiative covers principles of financial engineering, but students need also to be drilled in the duties they owe the citizenry and in how to overcome the political pressures that elite institutions exert when and as they become undercapitalized.

THE ALTERNATIVE: FURTHER ROUNDS OF ETHICALLY CHALLENGED REREGULATION

