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Time to Stamp Out the Confusion Around 'Shadow Banking'

In the United States, money market funds are governed by tight risk-limiting rules, rules that have become considerably tighter since 2008. The Securities and Exchange Commission (SEC) has indicated further changes are forthcoming.

Yet some recent commentary and reporting on money market funds misses this fact, substituting instead the vague notion that these funds lurk in a seemingly unregulated world of "shadow banking," an epithet used to debase a large group of nonbank financial intermediaries and activities. A recent Wall Street Journal column, for example, characterized money market funds as "one of the riskiest participants in shadow banking." Last May, a Reuters story described shadow banking as "a network of loosely regulated private equity, hedge, and money funds that together are large enough to topple the global financial system."

Money market funds can be characterized in many ways, but "loosely regulated" is not one of them. These funds are among the most strictly regulated financial products offered to American investors. In fact, one of the SEC's most significant actions in 2010 was a comprehensive set of changes to the rule governing money market funds, raising standards for credit quality and transparency, shortening the average maturities of their portfolios, and requiring significant minimum levels of liquidity.

Such misperceptions can lead in turn to outright mistakes regarding money market funds and other nonbank financial institutions. The Wall Street Journal story cited above, for example, erroneously states that money market funds have "had outsize exposure to European sovereign debt." Yet because of the risk-limiting rules that money market funds follow, they do not invest in securities denominated in foreign currencies. Money market funds thus do not hold European sovereign debt.

So how are these misperceptions arising? A major source of confusion is a paper, "Shadow Banking: Scoping the Issues," issued by the Financial Stability Board (FSB), a global consultative body that brings together financial authorities from around the world. This paper defines shadow banking broadly as "the system of credit intermediation that involves entities and activities outside the regular banking system."

While we salute the FSB's search for ways to strengthen the global financial system, its analysis and the reporting and commentary that flow out of it discuss the issues in broad generalizations. For example, the FSB's most recent paper provides no details on how they define or measure the “shadow banking system,” precluding outside researchers from verifying its analysis.

Indeed, the FSB’s very use of the term “shadow bank” implies that investing and lending outside of the banking system is inherently destabilizing and should regulated more like banks. As ICI discussed in detailed comments to the FSB, here’s why this thinking is wrong.

- Banking and capital markets are both highly regulated and have successfully coexisted for centuries. In the United States, both have played critical roles in gathering funds from savers and lending them to borrowers. Capital markets provide an important supply of credit to governments, businesses, and individuals. And direct lending from the capital markets has increased the availability and reduced the cost of credit for these borrowers.
- Robust capital markets add resiliency to the financial system, because the capital markets sometimes weather times of crisis better than banks. At a SEC roundtable in May, former Federal Reserve Chairman Paul A. Volcker unwittingly underscored this point when he suggested the 650 U.S. money market funds should be turned into banks. “This country could use 650 more banks,” Mr. Volcker exclaimed. “We just lost about 1,000 during the crisis!”
- Moving more financial activity into the banking system will concentrate risks and make the financial system more vulnerable. As the record of the last four years has shown, and as argued forcefully in a recent commentary by Peter Wallison of the American Enterprise Institute, banks following a common set of regulations tend to end up with portfolios carrying a common set of risks—mortgage-backed securities, for example, or European sovereign debt. When those borrowers are hit by an economic shock, banks’ concentration in those assets puts the entire financial system at risk. Credit intermediation through the capital markets diversifies risks and reduces system-wide threats. Regulating more institutions like banks will only increase the amplitude of future crises when shocks occur.

Regulators who miss or ignore these realities risk sowing confusion that undermines public understanding of the vital roles that different institutions play in the financial markets. And that confusion can cause problems as it seeps into the public discourse.

This confusion also detracts from financial reform efforts. Bodies like the FSB will always need to find ways to make markets and market participants better able to withstand shocks. That task is a tough one, and it demands the ability to focus precisely on key areas of concern. The term “shadow banking” falls short of this precision.
