A Beginners Guide to Shadow Banking

Financial Crisis and Repo

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"What if I told you that the financial crisis could be explained in just two words? Would you believe me?

It's true, and oddly enough, neither of the words is "subprime".

So, what are the words?

Bank run. The financial crisis was actually a run on the banking system. Only it wasn't a run in the usual sense of the word where jittery depositors line up on the street waiting to withdraw their savings, but a run on the shadow banking system where traditional banks get their funding via short-term loans in what's called the "repo market". (short for "repurchase agreement") The shadow banking system has become a critical part of the infrastructure of the modern financial system. It provides a way for banks to move credit risk off their balance sheets, thus reducing the amount of capital they need to support their operations. The banks argue that this new system has made credit cheaper for borrowers which, in turn, generates more activity and growth in the economy. But, of course, the risks are much greater too, as we can see from trillions of dollars that were lost following the meltdown of 2008. These risks cannot be contained as long as shadow banks remain unregulated.

So, when did the crisis actually begin?

Well, most people would point to September 15, 2008, the day that Lehman Brothers defaulted and markets went into freefall. But that's not when the trouble actually started. The trouble began a full year earlier on August 9, 2007, as Pimco's Paul McCulley recalls in his comments at the 19th Annual Hyman Minsky Conference. Here's an excerpt from the speech:

"On August 9, 2007, game over. If you have to pick a day for the Minsky Moment, it was August 9. And, actually, it didn't happen here in the United States. It happened in France, when Paribas Bank (BNP) said that it could not value the toxic mortgage assets in three of its off-balance sheet vehicles, and that, therefore, the liability holders, who thought they could get out at any time, were frozen. I remember the day like my son's birthday. And that happens every year. Because the unraveling started on that day. In fact, it was later that month that I actually coined the term "Shadow Banking System" at the Fed's annual symposium in Jackson Hole.

...while the run commenced on August 9th of 2007, it was pretty much an orderly run up until September 15, 2008. And it was orderly primarily because the Fed.... evoked Section 13-3 of the Federal Reserve Act in March of 2008 in order to facilitate the merger of under-a-run Bear Stearns into JPMorgan. Concurrently, the Fed opened its balance sheet to the biggest shadow banks of all, the investment banks that were primary dealers, including most important, the big five. It was called the Primary Dealer Credit Facility….

The Fed created a whole host of facilities to stop the run. In fact, they expanded the Primary Dealer Credit Facility to what are known as Schedule 2 assets, which meant that dealers could rediscount anything at the Fed that they could borrow against in the tri-party repo market.

Concurrently, the FDIC stepped up to the plate, doing two incredibly important things. Number one, they totally uncapped deposit insurance on transaction accounts, which meant that the notion of uninsured depositors in transaction accounts became an oxymoron. If you were in a transaction account, there was no reason to run. And then the FDIC effectively became a monoline insurer to nonbank financials with its Temporary Liquidity Guarantee Program (TGLP) allowing both banks and shadow banks to issue unsecured debt with the full faith and credit of Uncle Sam for a 75 basis points fee. No surprise some $300 billion was issued.

So, bottom line, you had the Fed step up and provide its public good to the Shadow Banking System. You had the FDIC step up and do the same thing with its public good. And as Paul Volcker was noting this afternoon, you had the Treasury step up and provide a similar public good for the money market mutual funds, using the Foreign Exchange Stabilization Fund." (After the Crisis: Planning a New Financial Structure, Paul McCulley, 19th Annual Hyman Minsky Conference, Zero Hedge)

This is a great description of what happened, but McCulley is a Managing Director at the country's biggest bond fund, so naturally his perspective is different than yours or mine. From a working man's point of view, this is what happened: The banks had been creating dodgy loans that they knew would never be repaid because the mortgage applicants weren't truly qualified to borrow as much money as they did. (Many of the applicants were called Ninjas…aka–"No income, no job, no assets") But the regulators and ratings agencies looked the other way because there was a lot of money involved and everyone was getting very rich. The dodgy loans were chopped up into securitized bonds (mainly Mortgage-Backed Securities) and sold to insurance companies, retirement funds and foreign investors. Then, on August 9, 2007, the Merry-go-round ground to a halt when Paribas Bank (BNP) stopped redemptions on assets that no one really knew how to value. (So, the crisis wasn't really a "panic" as much as it was a repricing event. The market had not yet repriced these toxic assets which were plunging in value on the ABX index.)

The problem was that the banks had been using these toxic assets to secure funding in the repo market. Now that their value was plunging, the banks were becoming increasingly less liquid and less inclined to deal with other banks that they knew were also in trouble. Keep in mind, that "according to Thomson Reuters, nearly $14 trillion worth of complex-securitized products were created," through this process which put the entire global financial system at risk. So, it wasn't just subprime mortgages (which only amounted to $1.5 trillion) that caused the meltdown, but the trillions of dollars in complex securitized bonds that had been traded through shadow intermediaries. As Anat R. Admati, Professor of Finance and Economics, Graduate School of Business at Stanford University said, "Housing policies alone, however, would not have led to the near insolvency of many banks and to the credit-market freeze. The key to these effects was the excessive leverage that pervaded, and continues to pervade, the financial industry." ("Fed scholars: A run on the repurchase market caused the financial crisis and will probably happen again", Repowatch)

Understanding how the repo market works is crucial, but it's also hard to grasp. So, let's use an analogy.

Let's say I need some cash to finance some other business operations I have going. So, I go down to the local pawn shop with my custom-built Maserati, my original Chagall oil painting, and my collection of Renaissance gold coins. The pawnbroker takes one look at my trove and says he can lend me $25,000 for a week, but I'll have to pay him $26,000 to get my stuff back. I say, "Okay", and borrow the money. This allows me to keep my other business operations running. Then, a week later, I return to the pawn shop and repay the money I borrowed.

Okay, so far?

So, next week I go back to the pawn shop and try to get the same deal. Only this time, the dealer has done a little research and discovered that my custom Maserati is actually a late-model Yugo with a flashy paint job; my original Chagall is actually a paint-by-numbers fake I picked up at a flea market, and my collection of Renaissance gold coins, is actually a scattering of slot-machine slugs with a pyrite finish. So the dealer gets all huffy and says he'll only lend me half of what he had before, ($12,500) But that's a big problem for me, because now I don't have the money to fund my other operations or pay my employees. So I have to dig into savings (bank capital), which makes it harder for me to lend money to anyone else. As time goes on, I am forced to sell more of my personal belongings (assets) just to stay afloat.

This is precisely what happened to the banks during the financial crisis. Financial firms that had been providing full-value for securitized bonds (my Maserati) got worried that those bonds might contain toxic subprime loans (my Yugo). So they reduced the amount of money they would lend on the bonds. These so-called "haircuts" set-off a slow-motion panic that lasted for over a year, draining nearly $4 trillion from the shadow banking system. The problem was compounded by the fact that no one knew which bundles held the worst mortgages or which banks had the biggest pile of bonds. So, interbank lending slowed to a crawl, LIBOR skyrocketed, and the credit markets went into a deep-freeze. When Lehman Brothers defaulted on September 15, 2008, the downward spiral accelerated and the entire financial system crashed. That's why Fed chairman Ben Bernanke stepped in and provided blanket guarantees on the financial assets of banks and shadow banks alike.

The essential problem with shadow banking is that it allows private industry (financial institutions) to generate as much credit as they want, thus, adding to the money supply, increasing economic activity, inflating gigantic asset-price bubbles, and setting the stage for a catastrophic meltdown. Economist James Hamilton explains how this works in a recent post titled "Follow The Money". Here's an excerpt:

"If you buy a mortgage-backed security (or collateralized debt obligation constructed from assorted MBS), you could then issue commercial paper against it to get most of your money back, essentially making the purchase self-financing. This was the idea behind the notorious off-balance sheet structured investment vehicles or conduits, which basically used money borrowed on the commercial paper market to buy various pieces of the mortgage securities created by the loan aggregators. The dollar value of outstanding asset-backed commercial paper nearly doubled between 2004 and 2007.

"Yale Professor Gary Gorton has also emphasized the importance of repo operations involving mortgage-related securities. If I buy a security, I can then pledge it as collateral to obtain a repo loan, again getting most of my money back and allowing the purchase to be mostly self-financing as long as I keep rolling over repos. Although I have not been able to find numbers on the volume of such transactions, it appears to have been quite substantial.

"The question of how the house price run-up was funded thus has a pretty clear answer: Other People's Money. Because of so much money pouring into house purchases, the price was driven up." ("Follow The Money", James Hamilton, Econbrowser)

This is how Wall Street pumped up leverage to ungodly levels and steered the financial system off the cliff. The debt-instruments and repo market were used to create a humongous debt pyramid balanced precariously atop a few crumbs of capital.

Consider this, from an article titled "Liquidity Crises – Understanding sources and limiting consequences: A theoretical framework," by Robert E. Lucas, Jr. and Nancy L. Stokey:

"In August of 2008, the entire banking system held about $50 billion in actual cash reserves while clearing trades of $2,996 trillion per day. Yet every one of these trades involved an uncontingent promise to pay someone hard cash whenever he asked for it. If ever a system was "runnable," this was it." (RepoWatch)

Are you kidding me? "$2,996 trillion" in daily trading was propped up an a paltry $50 billion in cash reserves!?! No wonder the system crashed. Even the slightest trace of doubt in the quality of the collateral being exchanged in the repo market, would automatically set off alarms and trigger a panic. And it did!

So, what is the likelihood of that happening again? Are we still in danger?

Yes, we are. In fact, another crisis is probably unavoidable since congress has done nothing to address the repo problem or to make the necessary changes in regulation.

Policymakers need to raise capital requirements, toughen lending standards, and ensure that trading takes place on public platforms that can be monitored by government regulators. Also, financial institutions that function like banks must be regulated like banks. Otherwise, the banks will create more structured instruments that will (eventually) spark another bank run forcing the public to bail out the system once more.

As economics professors T. Sabri Öncü and Viral V. Acharya, professors say, "Leaving the repo market as it currently functions is not an alternative; if this market is not reformed and their participants not made to internalize the liquidity risk, runs on the repo will occur in the future, potentially leading to systemic crises." (RepoWatch)

The only way to prevent another financial crisis is to fix repo, but Dodd-Frank doesn't do that.

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