

The rise of asset management and capital market-based financing: a cyclical or a structural shift?

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Banks vs. Markets

- “Indirect” vs. “Direct” Financing
(Gurley and Shaw 1960)

Corporation

Intermediary

Household

Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
	Stocks Bonds			Stocks Bonds	
	Loans	Loans	Deposits	Deposits	

- Europe “overbanked”?
- Universal banking + national fragmentation

Varieties of Intermediation

Corporation

Intermediary

Household

Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
	Stocks Bonds			Stocks Bonds	
	Stocks Bonds Loans	Stocks Bonds Loans	Pensions Insurance Deposits	Pensions Insurance Deposits	
	Stocks Bonds CP	Stocks Bonds CP	MF Shares MF Shares MF Shares	MF Shares MF Shares MF Shares	

- Universal banking model combines various

Intermediation and Real Activity

Deficit Agents

Intermediation

Surplus Agents

Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
	Due to	Risky Assets --Business --Household --Gov't	Risk Capital --Business --Household --Gov't	Due from	

- Financial Risk Intermediation
 - Surplus funds Risky Investment (machine, house, road)
 - Surplus funds Risky Dissaving (profits, wages, taxes)
 - Demand for money balances drives intermediation supply
- Global Reach
 - Non-resident deficit and surplus agents
 - Non-resident **intermediation** of various types

Evolution of Intermediation

- Mismatch of corporate liability preference and household asset preference
 - Banks, Pension Funds, Insurance Companies
 - Transformation involves risk-bearing
 - Concentration facilitates creditor oversight
- Diversification and Liquidity
 - Mutual Funds
 - Transformation involves risk-pooling, liquidity risk
 - Transparency facilitates trust

From Bank-based Credit to Market-based Credit

“Traditional” Bank

Assets	Liabilities
Loans Reserves	Deposits Capital

Securitization

“Shadow” Bank

MMMF

Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
RMBS	Hi tranche Mid tranche Lo tranche	Hi tranche IR Swap CD Swap	RP	RP	“deposits”

- Citibank vs. UBS, US vs. European regulation

What is shadow banking?

“**Money market funding**
of
Capital market lending”

- **Global** (dollar) funding of **local** lending
- **Market pricing**, both money and capital
- Key role of **market-making** institutions
- Key role of **central bank as backstop**

“Making” Markets, Money and Risk

Capital Funding Bank

Global Money Dealer

Asset Manager

Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
RMBS CDS IRS	MM funding	MM funding	“deposits”	“deposits”	Capital CDS IRS

Derivative Dealer

Assets	Liabilities
Credit Default Swaps Interest Rate Swaps	Credit Default Swaps Interest Rate Swaps

- Mature Money Dealing System (e.g. MMMF)
- Immature Risk Dealing System (esp. CDS, LOLR)

Financial Globalization and Shadow Banking

- Financialization
 - Post WWII, rise of private capital markets
 - Post Bretton Woods, rise of private money markets
- Globalization of production/consumption
 - Extension across globe
 - Integration across globe
- Shadow Banking
 - From loan-based credit to market-based credit
 - From funding liquidity to market liquidity
 - Quintessential institutional form for modern day
 - Regulatory arbitrage determines where, not whether

Questions for Europe

- Internal
 - Capital Markets Union (given monetary, banking)
 - Financial Services (given social insurance)
 - From universal banking and fragmentation, to specialization and concentration
- External
 - Interface with Global System
 - Capital Inflow/Outflow, Gross and Net
 - From Demand to Supply of Market Liquidity
 - Money markets, Capital Markets, and Shadow Banking

What is at Stake?

- “Capitalism is essentially a financial system, and the peculiar behavioral attributes of a capitalist economy center around the impact of finance upon system behavior.” (Minsky 1967)
- “An effective, smoothly functioning international capital market is itself an instrument of world economic growth, not a nuisance which can be disposed of and the functioning of which can be transferred to new or extended inter-governmental institutions....the main requirement of international monetary reform is to preserve and improve the efficiency of the private capital market while building protection against its performing in a destabilizing fashion.” (Despres, Kindleberger, Salant 1966)

Banking as a Payments System

Deficit Bank

Intermediation

Surplus Bank

Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
	Interbank loan			Interbank loan	
	Target II	Target II	Target II	Target II	

- Banking Union supports (private) direct finance versus (public) indirect finance
- Key role of Money Market Dealer

Banking as a Market-Making System

Deficit State (Central) Bank Asset Manager

Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
	Gov't Bonds			Gov't Bonds	
	Gov't Bonds	Gov't Bonds	€ deposits	€ deposits	

- Capital Union supports (private) direct finance versus (public) indirect finance
- Key Role of Capital Market dealer

A Cyclical or a Structural Shift?

- Evolutionary Process
 - Bank, Non-Bank Finance, Market-based Finance
 - Monetary Union, Banking Union, Capital Union
 - National Market, Federal Market, Global Market
- A model for Europe, not “me-too” US model
 - Social democracy vs. US New Deal
 - Global system is a Dollar system
 - US system itself is in institutional flux