**Thesis Proposal**

**THE IMPACT OF SHADOW BANKING ON TRADITIONAL BANKING; A RESEARCH ON BERLIN COMMERCIAL BANKS**

# Introduction

The purpose of this study is to examine the impact of shadow banking on traditional banking system and its effects on credit expansion and overall financial system. The research focuses on the banks of Berlin, Germany that how and to which extent they are involved in credit expansion through securitization and collateral intermediation which are the two main components of shadow banking. According to general Austian business cycle theory (Mises, 1949), the credit expansion is conducted by commercial banks on the basis of fractional reserve to create a business cycle. It is true but may be viewed as too outdated now as other financial institutions can also expand credit by offering some instruments to have demand deposits. Money market funds are best example of this which were created as a substitute for bank accounts. Over the past few years, banking has shifted away from traditional activities of loan creation and deposits to securitezed banking in which loans were further distributed to other institutes or entities which are known as ‘shadow banks’ (Meeks, 2013).

# Literature Review

Shadow banking most commonly defined as the credit intermediation which involve activities and entitities outside the regular banking system (Financial Stability Board, 2011). These entities are SIV(Structured Instrument Vehicles), SPV( Special Purpose Vehicles), Hedge funds, broker dealers, Money Market funds, and Investment Banks etc. Shadow banking is similar to commercial banking in terms of transforming maturity and risk but rely on wholesale funding and repo market rather than retail deposits. Moreover, they lend against collateral due to lack of accesss to formal central bank reserves which normally acts as a safery net.

Securitization is a process that, via tranching, reusing of cash flows from already existed loans and creates assets that are considered to be fully safe by market participants. While collateral intermediation supports collateral bases activities and opereations within the financial system involving intensive reuse of scarce collateral (Claessens, 2014). This is a very empirically important topic as shadow banking constitute around 25-30% of the total financial system (Financial Stability Board, 2011). Securitization enables banks to transfer credit risk of the loans from balance sheets to the investors via asset backed securities (Gartchev, 2009). So, banks can avoid reserve and capital adequacy requirements bu this ‘reulatory arbitrage’. The importance and role of the shadow banking can be realized be the fact that before crisis, the assets in the shadow banking were increased to 60 trillion dollar in 2007 (Financial Stability Board, 2011). Securitization enables banks to expand their credit creation to even greater extent but is also vulnerable to financial system bcz it expands the balance sheets of banks and makes the profile of intermediaries more similar. Moreover, due to less regulation it reduces screening and increases the financial relation among banks. The net worth of any shadow bank will reduce in case of negative asset price which constrainsts the supply of collateral for the commercial banks leading them to deleverage. The power of monetoay policy decreases due to shadow banking because it is less regulated as compared to the traditional banks and securitization protects banks’ lending activity from the funds from central bank as banks are less dependent on those funds or regulatory requirments and more on capital markets including shadow banking and their demand for securitized assets. Apart from securitization, shadow banks can also expan credit throung collateral intermediation which means multiple reuse of collaterals. According (Manmohan Singh, 2012) to “collateral backs one laon which can be used further as collateral again more loans, so the underlying asset actually ends up securing more loans which are more than its value. This is called rehypothecation which means collateral can be reused many time by counterpart for its own use. For instance, in 2008 hedge funds that pledged collateral to Lehman Brothers were not able retrieve it because Lehamn had it reused as its own collateral and got bankrupt.

The 2007 subprime crisis revealed the existence of parallel funding system outside of regular banking which is called shadow banking system. It is true that all these funding methods were first established in US before it did in Europe but it is really difficult to just apply the analysis of US shadow banking to Europe. In Europe, there was universal banking and the regulatory situations were also different from the US banks. In 1980s, financial deregulation occurred due to some reforms (plihon). Financialization of universal banks in euro area led to “market based banking” corresponding to a new form of financial intermediation. European shadow banking is hybridized by some operations borrowed by US such as securitization but still there is a need to understand the similarities and differences between the shadow banking of Europe and US to have more accurate analysis of the underlying issue. The national banking systems in Europe differs among countries depending on the role of the government. The importance of public involvement is common feature of coordinated capitalisms in Europe. Germany has a rich history of public involvement in its banking sector. Three particular institutions the Sparkassen (savings banks), postal savings institutions, and the German development bank called the Kreditanstalt für Wiederaufbau (KfW), or Bank for Reconstruction. These institutions comprise a large share of the German financial system and they perform a wide range of financial services with a particular focus on building personal wealth and small business financing.

# Research Question

With the initial review of the studies from the past, the central question of the thesis could be broadly defined as:

*Q. How and to which extent berlin commercial banks are involved in Shadow Banking and why it is necessary for the financial system?*

# Research Methodology

**Research Design**: Experiential Qualitative Research

**Research Instrument**: Semi-structured interviews

**Sample Size**: 4-5 different commercial bank managers in Berlin banks will be interviewed to have the better understanding with right approach to the study. Any other financial executive having a rich experience in banking sector or with good grip of the topic can be interviewed depending upon the willingness.

**Data Analysis**: The analysis of the data will be carried out by identifying and creating themes through ***Thematic Analysis***. For this purpose, the researcher will be using purposive sampling technique for interviewing the officials of various banks involved in shadow banking.

# Bibliography

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