Financial Regulation Seminar

Title: *Information Gaps and Shadow Banking*
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About Kathryn Judge:
Kathryn Judge is an Associate Professor of Law and the Milton Handler Fellow at Columbia Law School, New York. Her research examines financial institutions, financial innovation, systemic risk, the Federal Reserve, and the role of intermediaries in the financial markets. She has published numerous articles in journals including the University of Chicago Law Review and Stanford Law Review.

Abstract:
A financial system is fragile when small shocks can trigger large effects. The 2007-2009 financial crisis revealed the shadow banking system to be exceptionally fragile and capable of bringing down the rest of the financial system, yet the reasons for this fragility remain incompletely understood. This paper provides new insights into the mechanisms through which small shocks can trigger significant market dysfunction in the shadow banking system and the challenges impeding efforts to design a regulatory regime capable of supporting shadow banking.
This paper argues that information gaps—pockets of pertinent and knowable information that is not actually known to any party, private or public—contribute to fragility and help to explain the systemic risk posed by shadow banking.It makes two claims. First, there are structural reasons to expect sizeable information gaps in the shadow banking system. Second, those information gaps make panics more likely and exacerbate the magnitude of market dysfunction likely to arise from a panic.

In undertaking the structural analysis required to identify information gaps, the paper also sheds light on why attempts to reform the shadow banking system have been so contentious and unproductive thus far. The shadow banking system is a true hybrid. It earns its “shadow” status because it operates in the capital markets, and therefore outside the prudential regulatory regime that governs banks. Yet it also merits its status as a “banking system” because it

performs many of the economic functions historically fulfilled by the banking system and poses similar threats to systemic stability. In situating the shadow banking system at the nexus of these two historically distinct regimes, the analysis helps explain why policymakers and other experts often come to the table with different, and sometimes contradictory, assumptions about how markets work and how regulation can most effectively promote market functioning. By laying this foundation, clarifying how shadow banking contributes to fragility, and identifying ways to reduce that fragility, the paper also forges the beginnings of a more productive path forward.