FEDERAL RESERVE BANK *of* NEW YORK

Hybrid Intermediaries

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Much talk about bank complexity

- For the right reasons:
  - Does it brew risk?
  - Inefficient?
  - Hard to resolve?
  - Externalities?

- Possible solutions:
  - break ups, size capping, altogether activity restrictions.

“Static” approach

- Observe reality today, acknowledge existence of large and complex firms, take measures.
- Less emphasis on dynamic considerations
- How did we get to these realities? How do large and complex financial institutions today become such? Why?

Focus on organizational complexity

- Focus on number/types of subsidiaries under common ownership and control
- Natural policy implications
  - Resolution
  - Externalities
  - Complexity of regulation. Gauging effectiveness of oversight

Evolution on the banking side

- Geographic deregulation allowed banks to consolidate and acquire sufficient scale
- Scale allows potential expansion of organizational footprint
- Financial Modernization Act of 1999 sanctions the expansion
- But repeal of Glass-Steagall brewing for a long time well before GLB
- Proxmire Financial Modernization Act of ***1988*** !

Complementary explanation

- Transformation in the “technology” of financial intermediation (Cetorelli, Mandel and Mollineaux, 2012).
- In a traditional model, the intermediary is a central broker providing liquidity services to its fund suppliers and efficient, long term credit allocation to those demanding funds.

Complementary explanation

- Deposit taking, loan making operations defines traditional “boundaries” of the banking firm
- The balance sheet of this broker is the *locus* of intermediation activity
- Its risks and the associated, well-known externalities also stem from banks' balance sheet.
- Justifies a system of monitoring and regulation focused on banks’ balance sheets

The emergence of shadow banking

- Significant financial innovation in recent times, independent of and driven by existing regulation
- Significant migration of financial intermediation activity away from banks' balance sheet
- Evolution of more complex “credit intermediation chains” (Poszar, Adrian, Ashcraft and Boesky, 2013)

The emergence of shadow banking

- Emergence and growth of specialized nonbank entities catering to the process of shadow intermediation
- Example from asset securitization “chains”: growing importance of **specialty lenders**, **underwriters**, **broker dealers**, **guarantors**, **asset managers**, …

Importance of these innovations well understood and anticipated

- “Congress [should not] ignore the technological, economic, and competitive forces shifting the financial markets away from traditional banking channels toward increased use of the securities markets for financial intermediation. . . .The securitization of assets has reduced the need for bank loans even further.” (**Isaac and Fein 1988**).

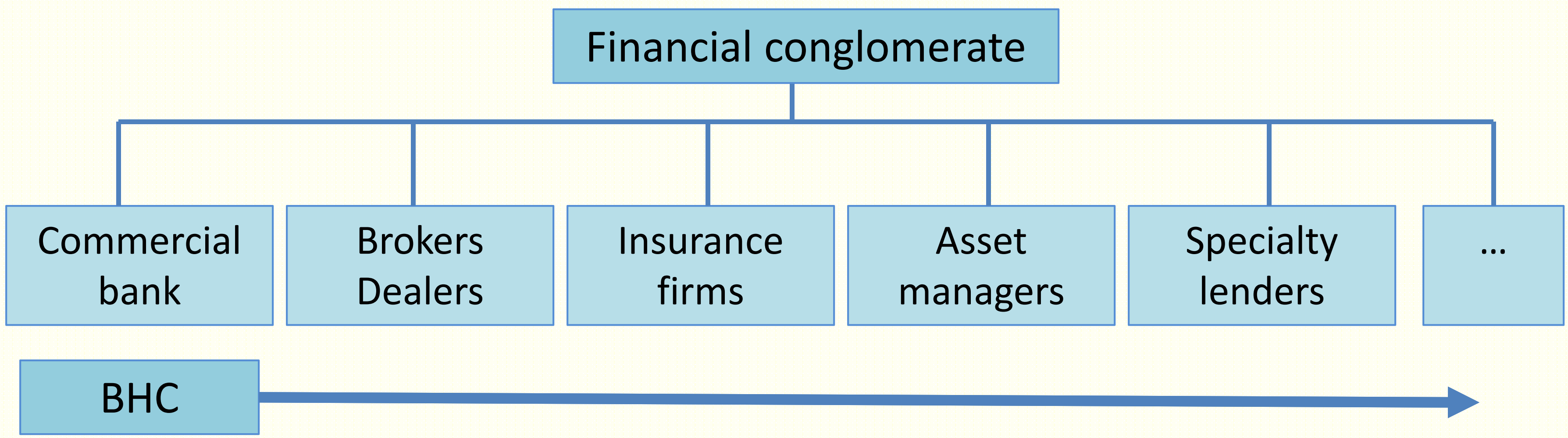
- “if securitization were to continue to spread rapidly to other types of credit, the historic role of the deposit-based credit intermediation process could be seriously jeopardized” (**Federal Reserve Bank of New York 1986**)

Back to the banks

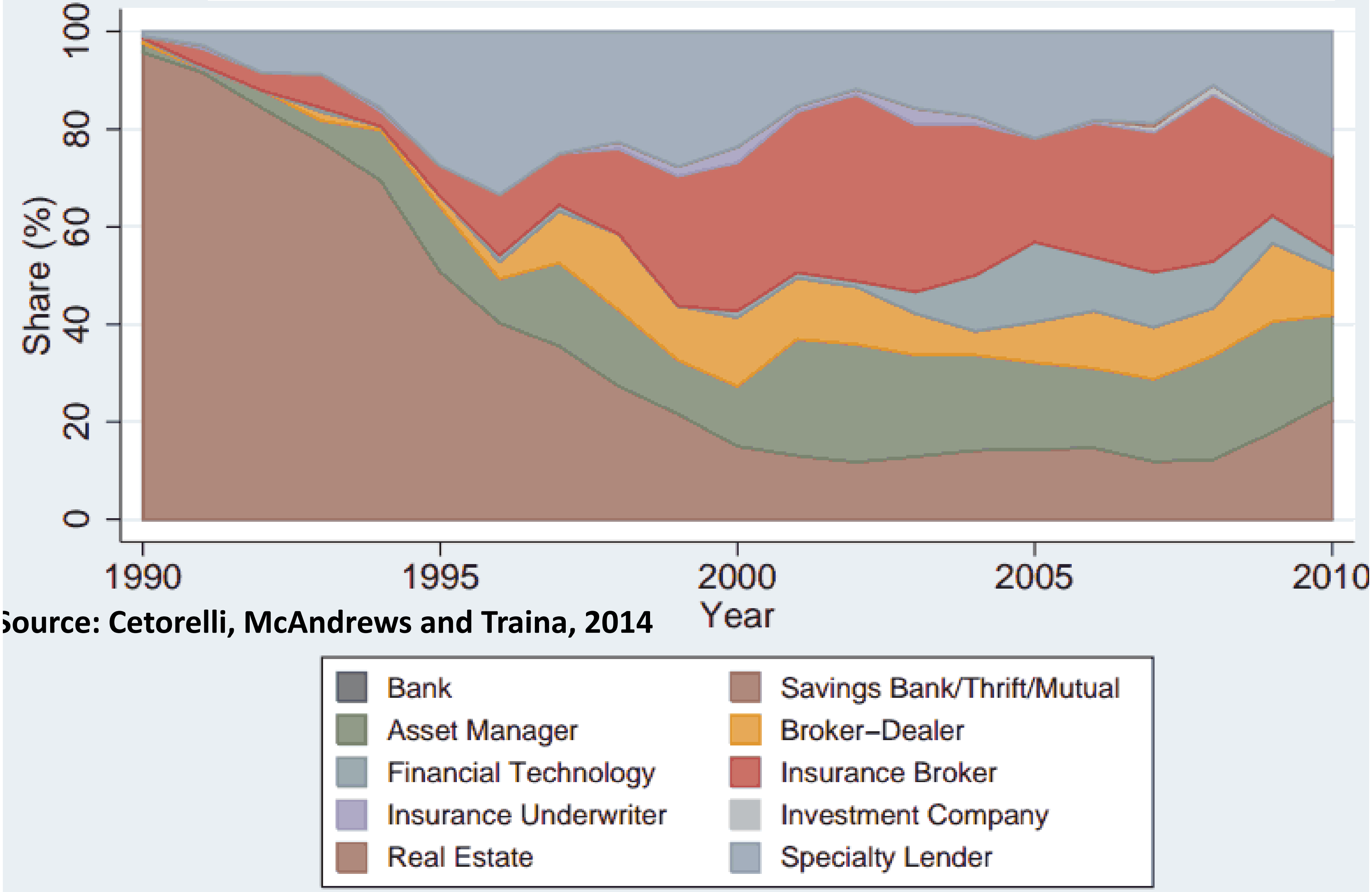
- Banks do not sit still observing this evolution
- Transformation into conglomerates
- Expansion of the “boundaries” of the baking firm

Organizational adaptation

- Conglomeration is the organizational “solution” to integrate intermediation chains



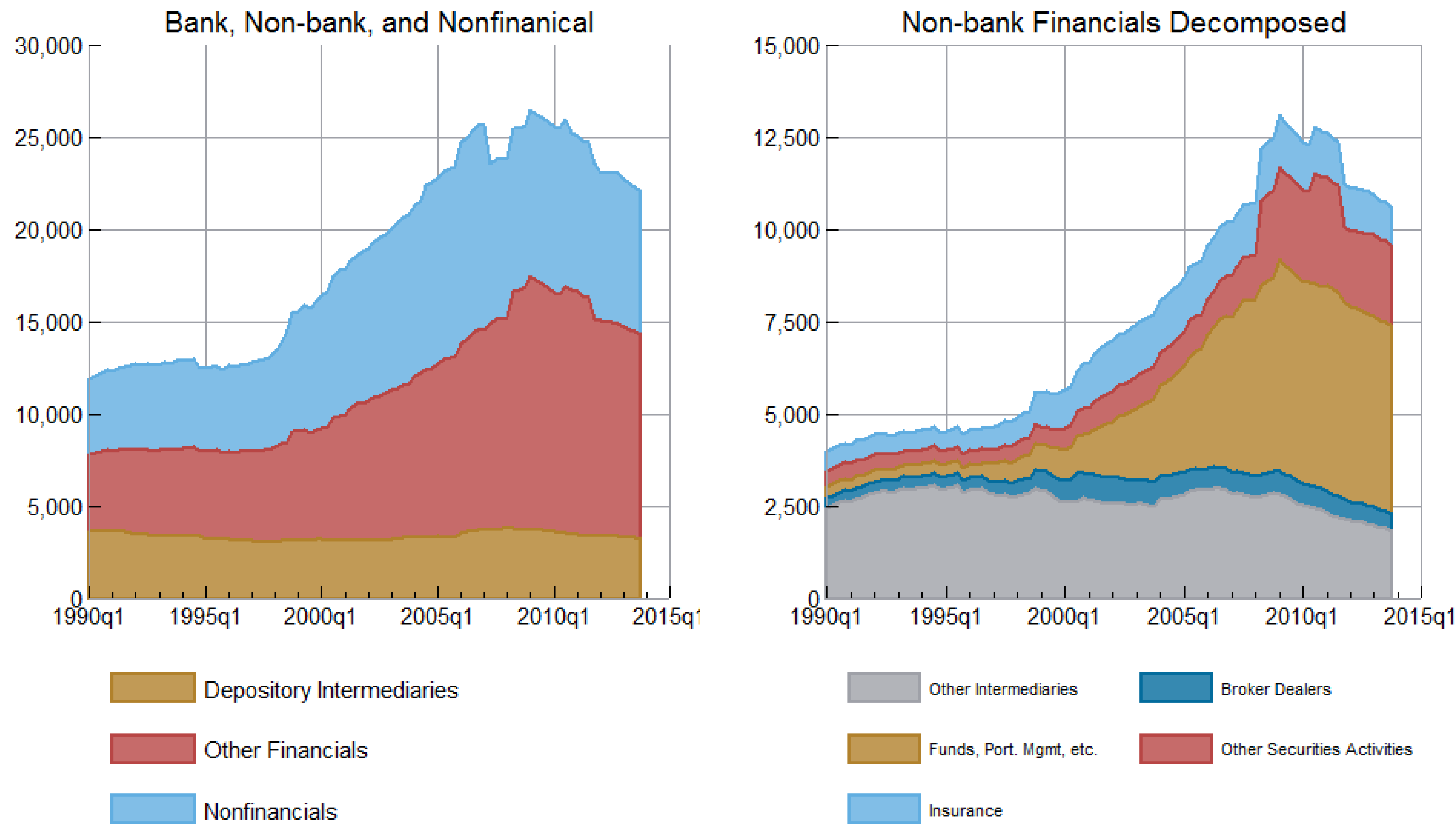
Banks broad acquisition of nonbank entities



Source: Cetorelli, McAndrews and Traina, 2014

Subsidiary Composition

Number of BHC Subsidiaries, by type



Excludes Goldman Sachs, Morgan Stanley, American Express, and CIT Group
Source: FR Y-10, FR Y-9C, CALL Reports; Authors' Calculations

Implications

- Little shadow intermediation truly “in the shadow”
- Still, challenges for prudential monitoring
- Externalities not necessarily from banks’ balance sheet. Or at least not necessarily through traditional banking activities
- Revisiting supervisory “boundaries” for effective oversight
- Regulatory adaptation as well

But reality even more complex

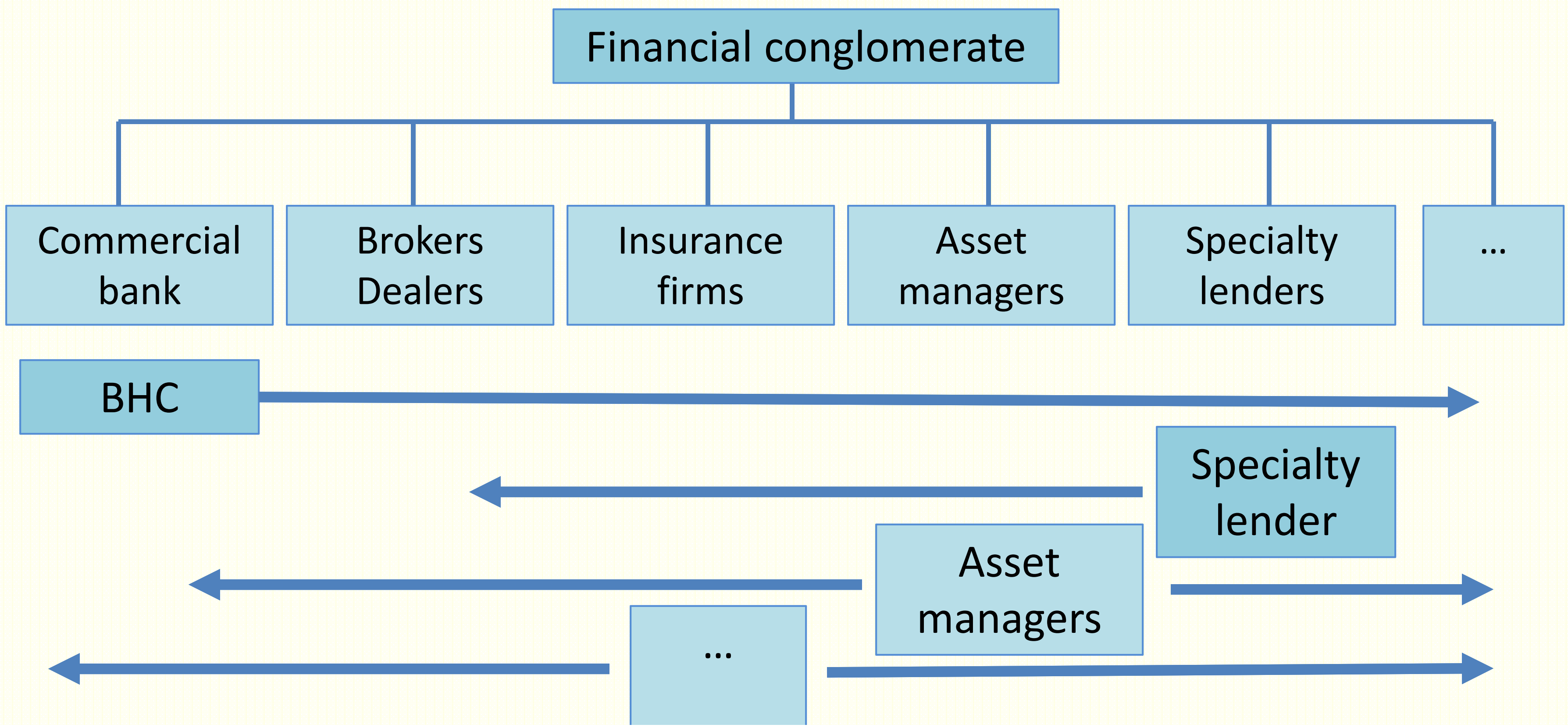
- A **hybrid** is an offspring of two species that in a new environment is better suited for survival than its own parents
- Evolution in the financial “ecosystem” have driven the emergence of ***hybrid intermediaries***

A world with *hybrid intermediaries*

- The modern BHC just described is the quintessential hybrid intermediary
- But no reason for ***nonbank*** financial firms to turn into hybrid intermediaries as well

Organizational adaptation

- Conglomeration is the organizational "solution" to integrate intermediation chains



Buyer/Target Industry Types

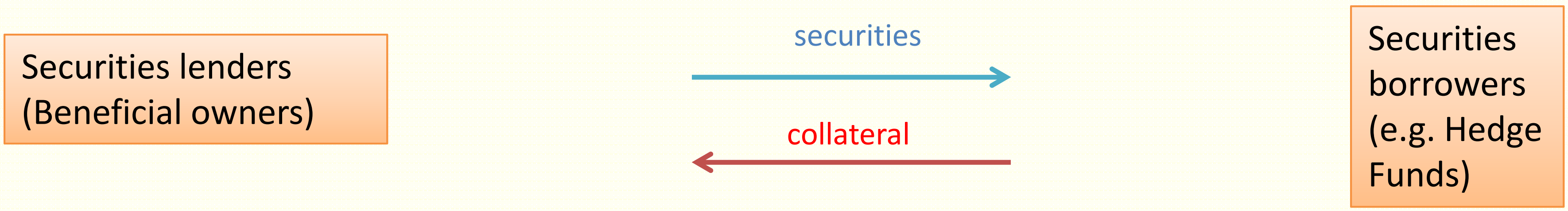
	Target Industry										
Buyer Industry	Bank	Asset Manager	Broker-Deal	Financial Tech.	Insurance Broker	Insurance UW	Invest. Company	Real Estate	Savings Bank/T/M	Specialty Lender	Total
Bank	6,076	519	292	164	759	38	3	1	1,305	653	9,810
Asset Manager	2	459	38	110	27	24	6	17	1	51	735
Broker-Deal	6	127	613	78	59	9	4	9	6	42	953
Financial Tech.	2	13	23	1,123	60	8				13	1,242
Insurance Broker	4	31	12	35	1,762	18			1	6	1,869
Insurance UW	14	138	55	126	533	1,451		4	18	54	2,393
Invest. Company	2	19	4	4	4	2	11	4	1	42	93
Real Estate	1	3	3			1		111	1	10	130
Savings Bank/T/M	359	45	28	8	115	21		2	705	138	1,421
Specialty Lender	19	10	26	20	11	5	3	2	21	769	886
Total	6,485	1,364	1,094	1,668	3,330	1,577	27	150	2,059	1,778	19,532

Significant "off-diagonal" mergers and acquisitions in nonbank sectors as well

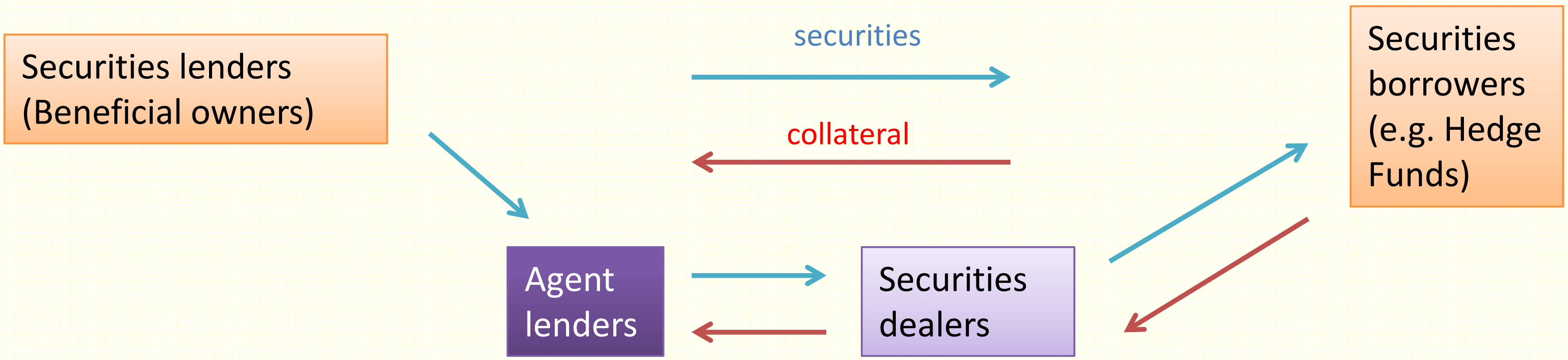
Nonbank hybrid intermediaries. An example

- Focus on **securities lending**
- An example of a modern credit intermediation chain
- Multiplicity of entities and markets involved
- Provision of intermediation services required
- Emergence of nonbank hybrid intermediaries possible

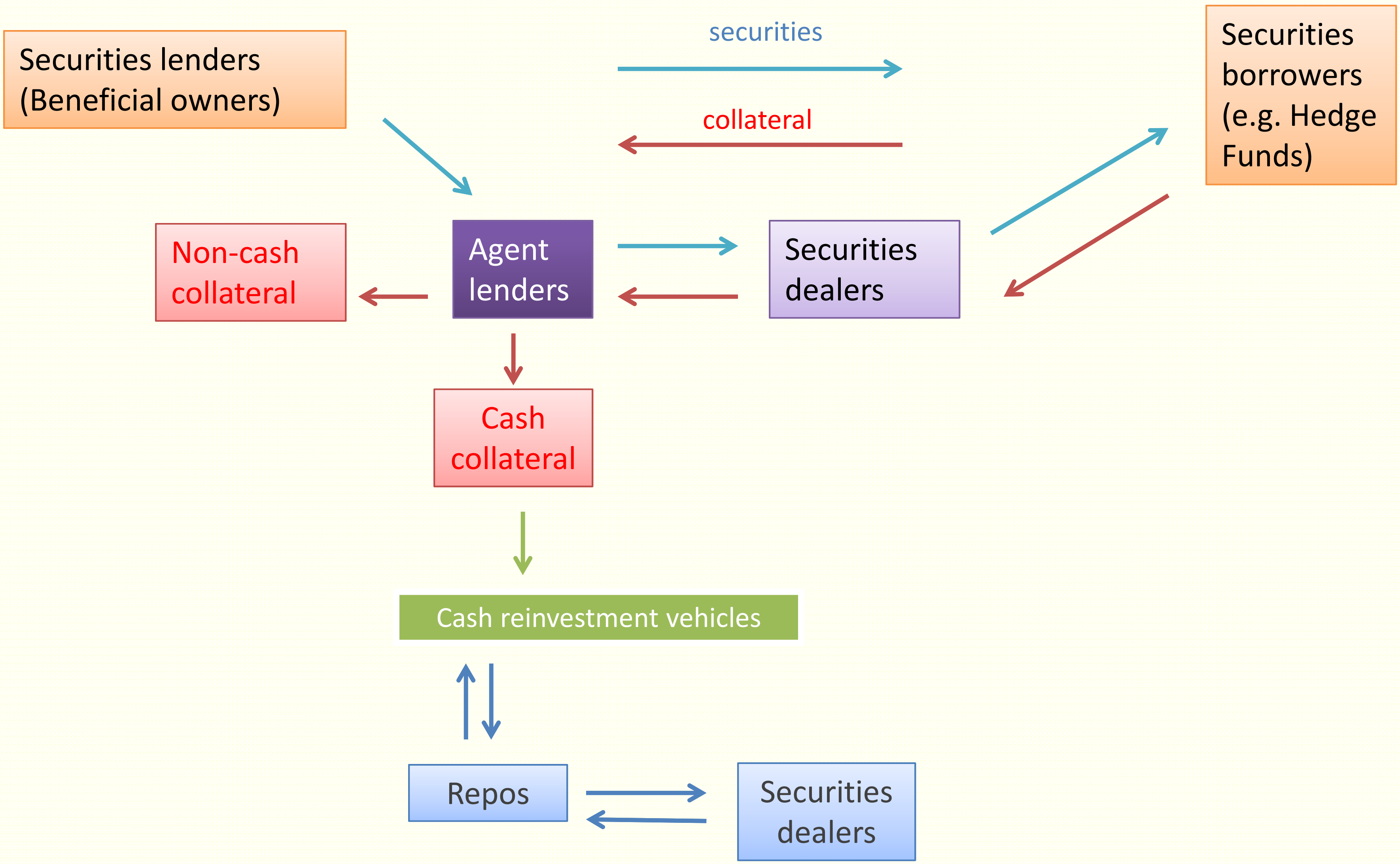
Securities lending intermediation chain



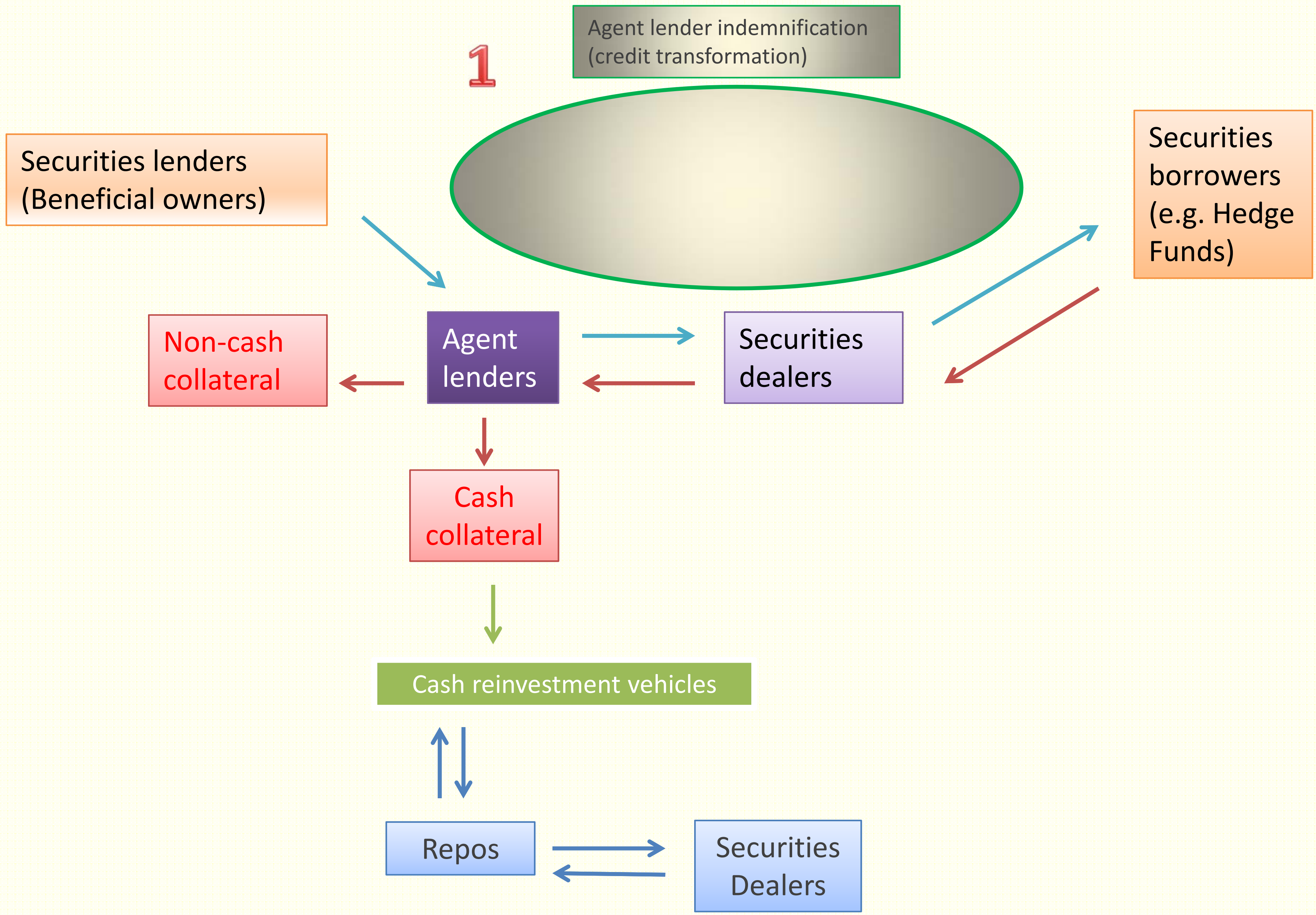
Securities lending intermediation chain



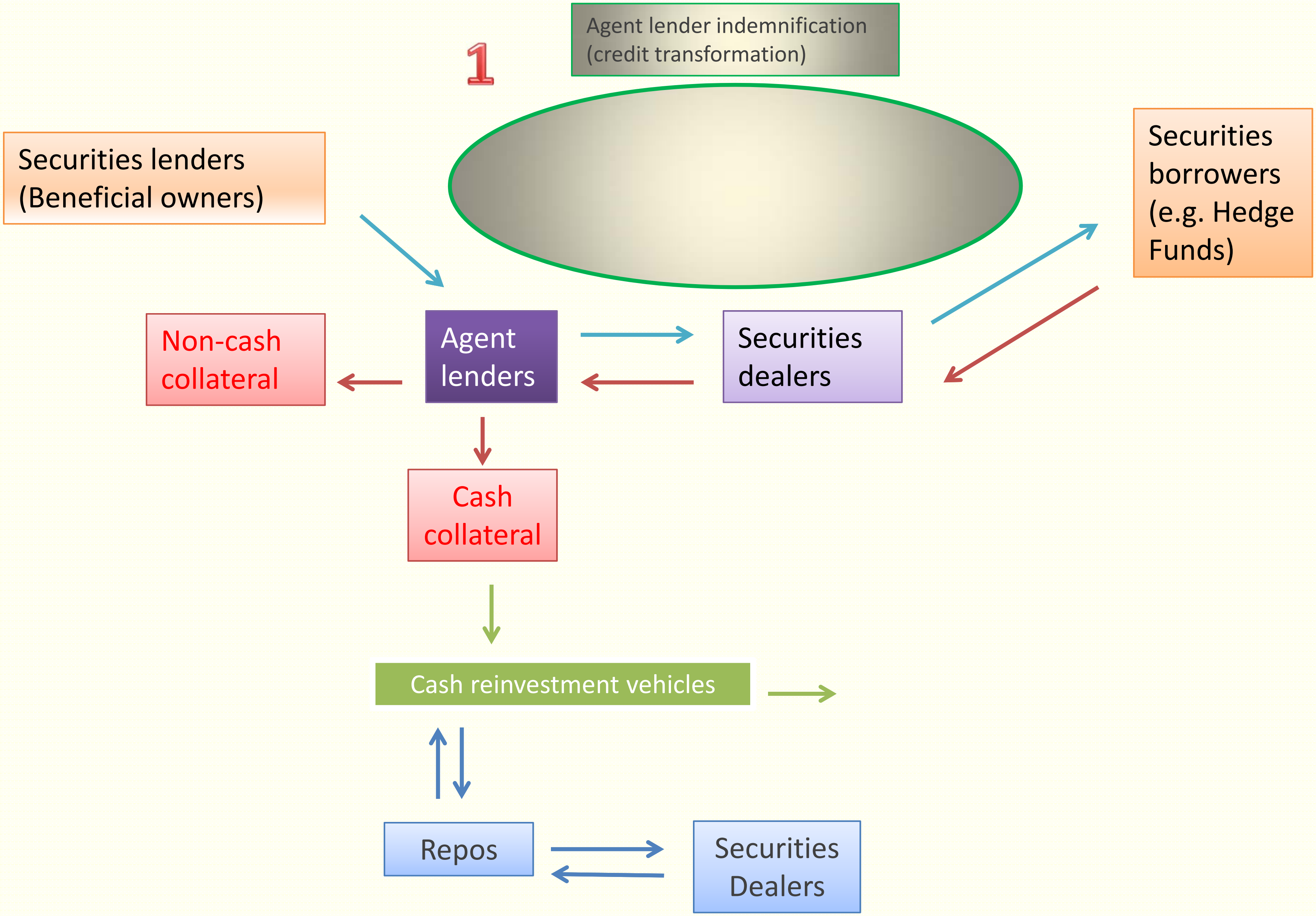
Securities lending intermediation chain



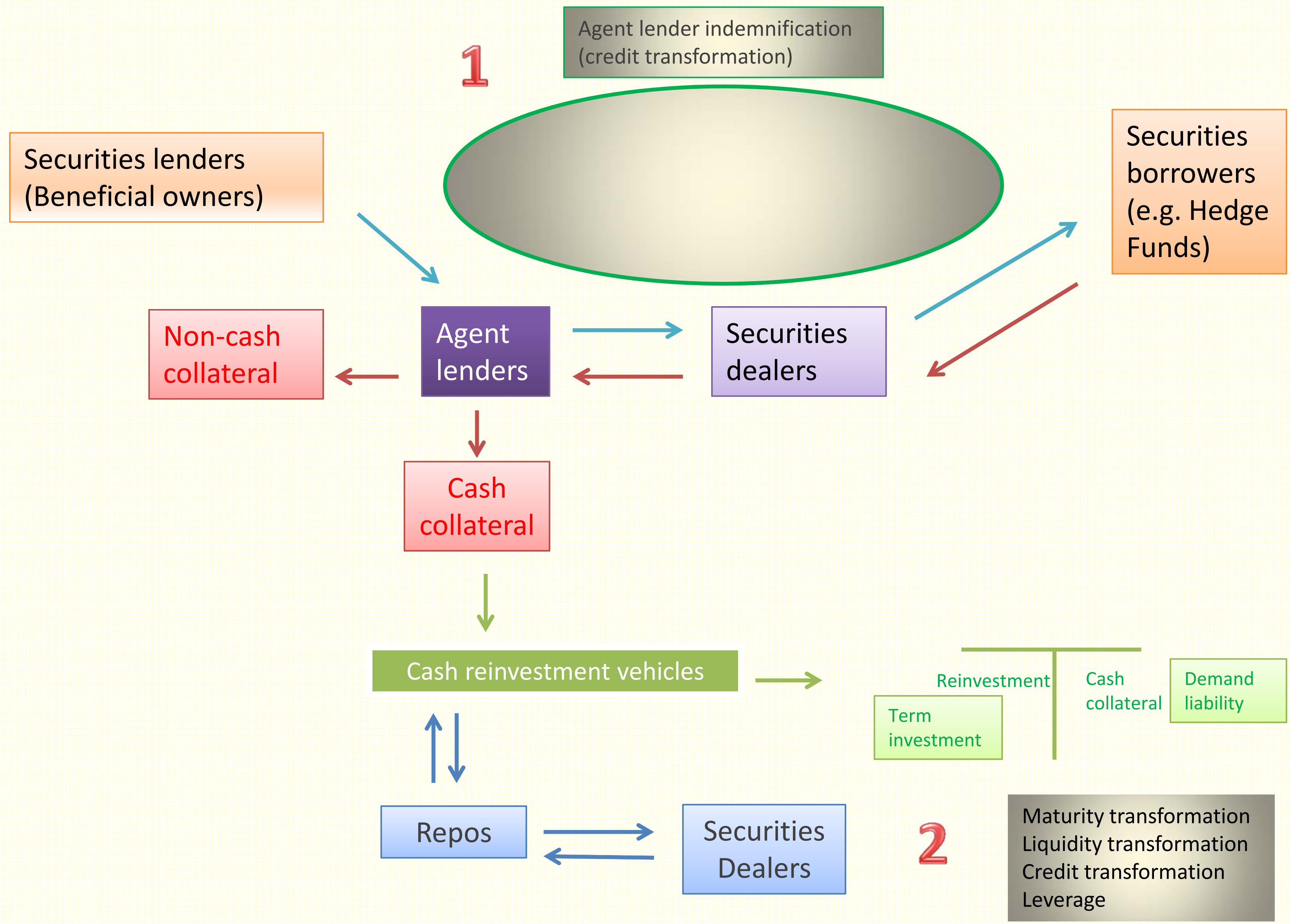
Financial intermediation risks in securities lending



Financial intermediation risks in securities lending



Financial intermediation risks in securities lending



Who are the dominant intermediaries in sec lending?

- The largest intermediaries are, in fact, BHCs.
- But growing role from *non*-BHCs as well
- Both BHCs and non-BHCs providing intermediaries services in securities lending have conglomerate structures with entities along the entire securities lending intermediation chain
- They are, in this space, examples of hybrid intermediaries

Summary

- Insights in the organizational dynamics within the financial industry
- Suggested the emergence and growth of *hybrid intermediaries* as a natural adaptation to an evolving system of intermediation
- Transformation from the bank side (into complex BHCs)
- But transformation from the *nonbank* side of the industry as well

Implications

- New challenges for an effective monitoring and regulation of financial intermediation activity
- Activities spanning multiple products, markets and processes. Constantly changing
- Challenges for effective coordination across regulatory agencies, with separate authority over different entity types
- And harder international coordination as well

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