Collateral transactions and shadow banking

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As illustrated by the Global Financial Crisis and the more recent Covid-19 pandemic, when asset prices fall, margin levels increase and highly leveraged financial institutions are forced to deleverage, causing market participants to 'run' in advance of other market participants motivated to do exactly the same thing. As a result, a vicious cycle can emerge where lenders raise margin levels thereby demanding more financial collateral, forcing de-leveraging and more asset fire sales, eventually generating a downward leverage and liquidity spiral. The source of this instability is a recurring phenomenon involving the build-up of leverage that makes the economy particularly vulnerable to financial crises.

This dissertation investigates the use of collateral transactions in the shadow banking sector. In particular, it will argue for the introduction of more stringent margin measures to tame financial uncertainty by limiting leverage and dampen procyclicality. One plausible way to restrict leverage is to impose minimum margin regulation, which would ex-ante limit the amount of leverage a financial institution can obtain. This dissertation will therefore propose four complementary measures that would ultimately result in a harmonised legal and regulatory margin framework in the EU shadow banking sector.

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