Banking Competition Revisited:
Shadow Banks vs. Commercial Banks

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Date Written: June 2017

Abstract

In this paper, I first propose a novel and under-studied deposit competition from shadow banking sector that induces traditional commercial banks to offer higher deposit rates and hold riskier portfolios. The mechanism is through increased bankruptcy likelihood from higher deposit rates and it exacerbates the moral hazard problem. Then I show that through this channel of deposit competition, government could regulate both commercial banks' and shadow banks' risk by either a deposit ceiling regulation or an equity ratio requirement, even though shadow banks are not directly regulated. A panel data from 1987 to 2015 of 63 countries' 1811 banks confirm that higher deposit rates by shadow banks will cause commercial banks to increase their deposit rates and risk portfolios, especially in countries with generous deposit insurance, loose banking regulation, or weak supervisor power.