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# Banking and Shadow Banking

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## Abstract

This paper incorporates shadow banking modeled as off-balance-sheet financing in a continuous-time macro-finance framework. Regular banks pursue regulatory arbitrage via shadow banking, and they support their shadow banks with implicit guarantees. We show that an enforcement problem with implicit guarantees gives rise to an endogenous constraint on leverage for shadow banking. Our model captures that shadow banking is pro-cyclical and that shadow banking increases endogenous risk. Tightening bank regulation in our model increases the borrowing capacity of shadow banking and financial instability. Furthermore, we show that a limited degree of aggregate risk sharing does not improve financial stability in the presence of shadow banking.

*Keywords:* shadow banking; implicit guarantee; bank regulation; endogenous risk

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