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Corporate Law: If It Acts Like a Bank, Regulate It Like a Bank

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If It Acts Like a Bank, Regulate It Like a Bank

John Crawford[1]

A central lesson of last decade's financial crisis is that firms behaving like banks should be regulated like banks. Nonbanks that perform the same economic function as banks create the same risk and demand the same regulatory response as depository institutions with bank charters. This lesson provides immense clarity as one evaluates financial regulatory reforms and their implications for systemic stability. It suggests that certain reforms currently under consideration are unlikely to promote stability.

Banks, "Shadow Banks," and the Financial Crisis

Banks bring enormous economic benefits but also pose singular risks. The primary risk is that depositors will "run," deciding to withdraw their money *en masse*. The problem with a run is that banks do not keep most deposited funds in a vault but rather lend them out.[2]

A run can lead a bank to suspend redemptions or to engage in "fire sales" of assets in order to obtain the cash needed to meet withdrawal demands; either route can have deeply pernicious knock-on effects. Furthermore, a run on one bank often triggers runs on sister banks—a sort of "contagion by simile"—as depositors, seeing the demise of the bank across town, and unsure of whether their own bank is in better condition, decide it is better to be safe than sorry and rush to withdraw. A "panic" ensues if there are widespread runs on banks. Panics and the negative externalities they spawn constitute the essence of a financial crisis. Indeed, the bursting of an asset bubble is generally not "systemic" *unless* it triggers such panics. For example, the decline in stock-market wealth following the dot-com crash was as great as the decline in housing wealth during the recent crisis and recession, but because the dot-com crash did not trigger a financial crisis—that is, widespread

1. Summarized and excerpted from John Crawford, *Lesson Unlearned? Regulatory Reform and Financial Stability in the Trump Administration*, 117 COLUM. L. REV. ONLINE 127 (2017).

2. Thus, as George Bailey (played by Jimmy Stewart) staves off a run in the 1946 classic movie *It's a Wonderful Life*, he explains to his bank customers, "[Y]ou . . . you . . . you're thinking of this place all wrong. As if I had the money back in a safe. The, the money's not here. Well, your money's in Joe's house. . . . That's right next to yours. And in the Kennedy house, and in Mrs. Macklin's house, and in a hundred others."

runs—it was comparatively benign. The damage to the real economy that the financial recession of 2008 wrought, on the other hand, was severe and enduring.

The American banking system suffered many similarly destabilizing, and often devastating, financial crises in the nineteenth and early twentieth centuries. The problem of such crises was largely solved by the creation of the Federal Deposit Insurance Corporation (FDIC). With the introduction of insurance for depositors' principal, along with a special resolution regime to ensure depositors could access their money without delay in the event their bank failed, the incentive to run was removed. The moral hazard that arose with deposit insurance was addressed primarily by intrusive supervision, capital requirements, and portfolio and activity restrictions. The system largely worked: It led to an extended "Quiet Period" of financial stability that coincided with robust growth and a moderation of the business cycle.

While banks were subject to this type of "prudential regulation"[3] coupled with a safety net, other financial institutions traditionally did not create the risk of runs and were therefore subjected to a different type of regulation—one focused on protecting investors from fraud and mandating disclosures necessary to inform them of investment risks, rather than protecting them from losses on their investments. This "capital markets" regulatory paradigm characterized the Securities and Exchange Commission's classic approach to regulating broker-dealers and asset managers.[4]

The core dynamic of the crisis might be summarized thus: nonbank financial institutions started acting like banks but without a safety net or prudential oversight. When they suffered heavy losses in housing-linked securities, a panic ensued.

How did this happen? Although nonbanks cannot issue deposits, it turns out they can issue short-term debt that is the functional equivalent of deposits, using the money thus raised to fund investments in longer-term assets. Entities that engage in this bank-like function outside the regulatory framework and safety net applicable to banks are sometimes referred to as "shadow banks." Regulating shadow banks as if they pose no run risk is a recipe for disaster.

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3. This is also sometimes referred to as "safety and soundness" regulation.

4. Somewhat confusingly, prior to 2008, the classic Wall Street "investment banks," such as Goldman Sachs, Morgan Stanley, Bear Stearns, Lehman Brothers, and Merrill Lynch, were actually broker-dealers (or, more precisely, holding companies with broker-dealer subsidiaries), *not* "banks"—i.e., deposit-taking intermediaries—as the term is used here.

In the two decades leading up to the crisis, shadow banking grew until it was as large as or larger than the chartered-banking system. Prominent examples of shadow banks include money market funds and broker-dealers funding themselves with commercial paper and overnight "repo" loans. Just as depository institutions were vulnerable to crises prior to the establishment of the federal safety net, so shadow banks, without that safety net, proved similarly vulnerable. Previous financial crises in the United States were characterized by runs on banks; the crisis in 2007 and 2008 was at core a run on shadow banks. Structurally, it was like the earlier bank runs, but it manifested itself in a different institutional setting: Instead of depositors lining up to make withdrawals from banks, as during the early 1930s, large institutional investors decided *en masse* not to roll over their short-term loans to broker-dealers, such as Bear Stearns and Lehman Brothers, and redeemed their "shares" in money-market funds.

Ultimately, regulators were able to halt the panic only by (among other measures) extending the safety net to shadow banks. Of course, part of the deal with true commercial banks is that while they benefit from the safety net, they must submit to prudential rules and supervision to control the moral hazard of deposit insurance. The fact that shadow banks received safety-net support without submitting to similar regulation and supervision is problematic, as it may encourage excessive risk-taking going forward. The best way to mitigate that problem is to apply as much of the banking regulatory approach to shadow banks as possible.[5]

Post-Crisis Reforms

Post-crisis reforms have been a mixed bag in addressing shadow banks. On the one hand, Congress limited or removed regulators' authority to extend the safety net outside the traditional banking system. On the other hand, the largest broker-dealers, a major locus of shadow banking activity, are all now housed within bank holding companies (BHCs). While these broker-dealers continue to be regulated by the SEC under a primarily "capital markets" approach, the Federal Reserve regulates holding companies on a consolidated basis, so there is a degree of prudential regulation that applies to the broker-dealers as well. Furthermore, the Dodd-Frank Act established a special "liquidation

5. Another approach would be to try to stamp out shadow banking entirely. *See, e.g.*, MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION (2015).

authority" to try to facilitate winding down a giant nondepository financial institution (such as a bank holding company) without creating significant negative systemic externalities. In sum, as former Treasury Secretary Timothy Geithner has argued, there is less "dry tinder" in the system, but the tools available to regulators to respond to a crisis have, on net, been diminished. This should be a source of concern, as shadow banking still thrives. Even if capital levels are higher and short-term funding levels have declined slightly since 2008, there are still trillions of dollars of uninsured deposit-like claims on institutions, such as broker-dealers and money-market funds, that remain outside the safety net and that are subject to varying degrees of prudential regulation (if any).

The Path Ahead

Some recent proposals for further financial-regulatory reform, such as parts of the Financial CHOICE Act,[6] are motivated by a belief that applying prudential regulation to firms without a formal banking charter represents an unjustified interference in the market. This view mistakenly fails to grasp the functional equivalence of banks and shadow banks. This, in turn, leads to a failure to appreciate the negative externalities that shadow banks can create—externalities that are devastating when they materialize and are impervious to market solutions. I will highlight here two provisions of the CHOICE Act that rely on this dangerous and mistaken view.

First, the CHOICE Act would repeal the authority of the Dodd-Frank-created "Financial Stability Oversight Council," chaired by the Treasury Secretary and composed of the heads of the various federal financial regulatory bodies, to designate nonbank financial firms as "systemically important" and therefore subject to prudential oversight and regulation by the Federal Reserve. This repeal would make it impossible to subject shadow banks that are not already part of BHCs to safety-and-soundness regulation that could forestall a further crisis.

Second, the CHOICE Act would further weaken regulators' emergency-response tools of emergency lending and guarantee authorities—a move that would enable any future panic to cause significantly more damage than might otherwise be the case. The concern of the provision's sponsors is moral hazard: if firms know regulators can prevent catastrophe, they will be less careful to avoid it themselves. But as the history of the nineteenth-century banking system

6. Financial CHOICE Act of 2017, H.R. 10, 115th Cong. (2017).

in the U.S. shows, the lack of a safety net is not necessarily effective at preventing panics and crises. As Secretary Geithner has observed, such an approach is like "[t]aking away the fire department's equipment"—it "ensures that the equipment won't be used but it isn't much of a strategy for reducing fire damage."[7] A much better approach—the one that finally saved us from repeated panics among chartered banks—is to couple emergency response tools with heightened *ex ante* prudential oversight.

Conclusion

The United States remains vulnerable to financial crises and the terrible economic damage they cause. The first and most critical step to ameliorating this problem is to grasp that it is banks' *economic function* rather than *legal form* that demands a special regulatory response. That economic function—funding long-term investments with large amounts of short-term debt—is valuable but can impose appalling costs on the financial system and the real economy when left solely to the discipline of market forces. The United States largely solved this problem with respect to legal depositories, allowing banks' valuable economic functions to thrive while containing the risk through the combination of a safety net and prudential regulation. We have extended only pieces of this approach to shadow banks. Greater stability requires either suppressing shadow banks altogether or applying the banking regulatory approach more completely to them. A key criterion for judging financial reform efforts going forward will be whether they move us further from this end or closer to it.

7. TIMOTHY F. GEITHNER, STRESS TEST: REFLECTIONS ON FINANCIAL CRISES 430 (2015).