

2017

# Lesson Unlearned?: Regulatory Reform and Financial Stability in the Trump Administration

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## Recommended Citation

John Crawford, *Lesson Unlearned?: Regulatory Reform and Financial Stability in the Trump Administration*, 117 *Colum. L. Rev. Online* 127 (2017).

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LESSON UNLEARNED?: REGULATORY REFORM AND  
FINANCIAL STABILITY IN THE TRUMP ADMINISTRATION*John Crawford\**

## INTRODUCTION

A central lesson of the financial crisis of 2007–2008 was that firms behaving like banks should be regulated like banks. Nonbanks that perform the same economic function as banks—so-called “shadow banks”—create the same risks and demand the same regulatory response as depository institutions with bank charters.<sup>1</sup> The principal legislative reform passed in the wake of the crisis, the Dodd-Frank Act,<sup>2</sup> made several important, albeit incomplete, advances in applying elements of the banking regulatory regime to shadow banks. These achievements are now at risk, as President Trump has promised to “do a big number on Dodd-Frank.”<sup>3</sup> In what has been interpreted as a first salvo in the effort to dismantle Dodd-Frank,<sup>4</sup> he issued an executive order directing the Secretary of the Treasury to conduct a wholesale review of the current financial regulatory landscape.<sup>5</sup> While executive and agency action can

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1. As discussed in more detail below, the term “shadow banking” refers in this Piece not to unregulated financial activities writ large but rather to one specific activity: funding a portfolio of financial assets with lots of short-term debt. See *infra* note 36 and accompanying text. For an excellent account of the different *legal* entities that have been defined as “banks” under the Bank Holding Company Act, see generally Saule T. Omarova & Margaret E. Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States*, 31 *Rev. Banking & Fin. L.* 113 (2011).

2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3. Glenn Thrush, *Trump Vows to Dismantle Dodd-Frank “Disaster,”* *N.Y. Times* (Jan. 30, 2017), <http://www.nytimes.com/2017/01/30/us/politics/trump-dodd-frank-regulations.html> (on file with the *Columbia Law Review*).

4. See, e.g., Michael C. Bender & Damian Paletta, *Donald Trump Plans to Undo Dodd-Frank Law, Fiduciary Rule*, *Wall St. J.* (Feb. 3, 2017), <http://www.wsj.com/articles/trump-moves-to-undo-dodd-frank-law-1486101602> (on file with the *Columbia Law Review*).

5. Exec. Order No. 13,772, 82 Fed. Reg. 9965 (Feb. 8, 2017). The Executive Order lays out six *prima facie* unobjectionable principles, such as “empower[ing] Americans to make independent financial decisions and informed choices in the marketplace,” “advanc[ing] American interests in international financial regulatory negotiations and meetings,” and directing the Treasury Secretary to review current laws and regulations to see if they conform to these principles. *Id.*

roll back some of Dodd-Frank's reforms, durable structural reversals will require legislation.<sup>6</sup> The precise contours of such legislation are hard to predict, but most commentators believe the best starting point for considering what it might look like is the Financial CHOICE Act<sup>7</sup> (CHOICE Act) sponsored by Representative Jeb Hensarling, chairman of the House Committee on Financial Services.<sup>8</sup> This Piece argues that several key provisions from the CHOICE Act evince a fundamental conceptual mistake that threatens to undermine the financial stability of the United States.<sup>9</sup> It is important to articulate this argument now so that it can inform the debate prior to the enactment of any new law, rather

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6. In addition to the fact that policy can be reversed again under a future administration, most financial regulatory agencies are independent and can occasionally prove refractory under White House pressure. See, e.g., Damian Paletta & Deborah Solomon, Geithner Vents at Regulators as Overhaul Stumbles, *Wall St. J.* (Aug. 4, 2009), <http://online.wsj.com/articles/SB124934399007303077> (on file with the *Columbia Law Review*) (describing tensions between the Treasury Secretary and various agency heads over the direction of reform in 2009).

7. CHOICE is an acronym for Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs. See U.S. House of Representatives Fin. Servs. Comm., The Financial CHOICE Act, Executive Summary, [http://financialservices.house.gov/uploadedfiles/financial\\_choice\\_act\\_executive\\_summary.pdf](http://financialservices.house.gov/uploadedfiles/financial_choice_act_executive_summary.pdf) [<http://perma.cc/PNK5-LFT7>] (last visited Feb. 26, 2017); see also Financial CHOICE Act of 2016, H.R. 5983, 114th Cong. (2016).

A revised version of the CHOICE Act was released on April 19, 2017. See Discussion Draft of the Financial Choice Act, H.R. \_\_, 115th Cong. (2017), [http://financialservices.house.gov/uploadedfiles/choice\\_2.0\\_discussion\\_draft.pdf](http://financialservices.house.gov/uploadedfiles/choice_2.0_discussion_draft.pdf) [<http://perma.cc/HR9F-AFLL>]. The key provisions discussed in this Piece remain substantively unchanged in the new version of the Act.

8. See, e.g., Davis Polk & Wardwell LLP, The Trump Transition and Possible Directions for Financial Regulatory Reform 1 (Nov. 17, 2016), <http://www.davispolk.com/sites/default/files/2016-11-17-trump-transition-financial-choice-act-only-the-beginning.pdf> [<http://perma.cc/4R4M-W34D>] (identifying the CHOICE Act as “a starting point that signals a potential general direction of travel for financial reform”); Debevoise & Plimpton, The Outlook for Financial Regulatory Reform Under President Trump 2 (Nov. 30, 2016), [http://www.debevoise.com/~media/files/insights/publications/2016/11/20161130b\\_the\\_outlook\\_for\\_financial\\_regulatory\\_reform\\_under\\_president\\_trump.pdf](http://www.debevoise.com/~media/files/insights/publications/2016/11/20161130b_the_outlook_for_financial_regulatory_reform_under_president_trump.pdf) [<http://perma.cc/GN4B-AGAN>] (explaining the CHOICE Act as “a blueprint for the types of [financial] reforms that a Republican-controlled House and Senate may pursue”); Ryan Tracy, How a Financial Council Republicans Loathe Could Work in Their Favor, *Wall St. J.* (Jan. 17, 2017), <http://www.wsj.com/articles/how-a-financial-council-republicans-loath-could-work-in-their-favor-1484581368> (on file with the *Columbia Law Review*) [hereinafter Tracy, A Financial Council Republicans Loathe] (stating that Representative Hensarling's bill “is expected to serve as a starting point for a debate on changing Dodd-Frank this year”).

9. The analysis is consistent with the patriotism and good faith of the provisions' sponsors. The error is conceptual and not (necessarily) born of conflict or misaligned incentives. It is important to emphasize, as well, that the focus of this Piece is on provisions that most directly implicate financial stability. There are many other provisions of the CHOICE Act—for example, relating to an overhaul of the Consumer Financial Protection Bureau—that, whether good or bad based on other criteria, are unlikely to have a significant effect on financial stability. These (many) other provisions are excluded from the Piece's analysis.

than merely critique the law *ex post*. The mistake boils down to a failure to grasp the functional equivalence of banks and shadow banks. This 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.<sup>10</sup>

This Piece explains the nature of banks and the regulatory response they demand, and why shadow banks require a similar response. Understanding the function and risks posed by shadow banks then serves as a touchstone for critiquing key elements of the CHOICE Act. The Piece argues that the provisions reveal a misguided belief that market discipline is the key to financial stability.<sup>11</sup> Alas, the banking model, by its very nature, is rife with market failures that demand a unique regulatory response. Early indications are that when it comes to financial stability, the new Administration and Congress will move in the wrong direction.

## I. BACKGROUND

### A. *Banks: The Problem and the Solution*

Banks bring enormous economic benefits<sup>12</sup> but pose singular risks as well. The principal risk is that depositors will “run,” deciding to withdraw their money *en masse*.<sup>13</sup> The problem with this is that banks do not keep deposits in a vault.<sup>14</sup> A run can lead a bank to suspend redemptions or to

10. The arguments about shadow banking and the response it demands are well established, if not universally understood or embraced. See, e.g., Morgan Ricks, *The Money Problem: Rethinking Financial Regulation 2* (2016) [hereinafter Ricks, *The Money Problem*] (arguing shadow banking was “at the center of the recent financial crisis”); Volcker All., *Unfinished Business: Banking in the Shadows 9–12* (2016) [hereinafter Volcker Alliance Report], [http://www.volckeralliance.org/sites/default/files/attachments/VolckerAlliance\\_UnfinishedBusinessBankingInTheShadows.pdf](http://www.volckeralliance.org/sites/default/files/attachments/VolckerAlliance_UnfinishedBusinessBankingInTheShadows.pdf) [http://perma.cc/7LKE-DUT7] (noting that “the risk of busts and bailouts remains all too real” due to the operation of shadow banks and offering policy solutions). It is important, however, to apply them specifically to the most objectionable reforms under consideration.

11. To be clear, nothing in this analysis is inconsistent with the notion that market discipline is essential to a functioning capitalist economy broadly conceived, nor with the (clearly correct) view that it can play an important, albeit limited, role in bank regulation. See generally John Crawford, *Credible Losers: A Regulatory Design for Market Discipline*, 54 *Am. Bus. L.J.* 107 (2017) [hereinafter Crawford, *Credible Losers*] (describing mechanisms through which market discipline works and presenting a framework for establishing discipline for systemically important financial institutions).

12. Banks not only serve a valuable credit-intermediation role—it is more efficient for the bank to channel deposits to creditworthy consumers and businesses than it would be for depositors to try to make loans directly—but they also provide depositors with an efficient technology for storing and then employing resources for near-term transactional purposes. See, e.g., Richard Scott Carnell et al., *The Law of Banking and Financial Institutions* 39–43 (5th ed. 2013).

13. George G. Kaufman, *Bank Runs*, *Libr. Econ. & Liberty*, <http://www.econlib.org/library/Enc/BankRuns.html> [http://perma.cc/CNQ2-LKUF] (last visited Mar. 3, 2017).

14. As George Bailey (played by Jimmy Stewart) staves off a run in the classic movie *It's a Wonderful Life*, he explains to his bank customers:

engage in fire sales of assets, both of which can have deeply pernicious knock-on effects.<sup>15</sup> Furthermore, a run on one bank often triggers contagious runs on sister banks.<sup>16</sup> A “panic” ensues if there are widespread runs on banks. Panics and the negative externalities they spawn constitute the essence of a financial crisis.<sup>17</sup> Indeed, an asset bubble bursting is generally not “systemic” *unless* it triggers such runs. For example, the decline in stock market wealth after 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 runs—it was comparatively benign.<sup>18</sup> The

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[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.

It’s a Wonderful Life (Liberty Films, Inc. 1946).

15. If depositors lose immediate access to their money, it may lead to consequential losses: “opportunity costs, operational disruption, reputational damage, or even default.” Morgan Ricks, *Regulating Money Creation After the Crisis*, 1 *Harv. Bus. L. Rev.* 75, 83 (2012) [hereinafter Ricks, *Regulating Money Creation After the Crisis*]. On the other hand, if the bank tries to raise cash quickly in order to meet redemption demands by selling relatively illiquid assets (such as mortgages), it will often have to accept a price below the assets’ “fundamental value.” This is a fire sale. Fire sales can have extremely pernicious knock-on effects. See, e.g., Anil K. Kashyap et al., *Rethinking Capital Regulation, in Maintaining Stability in a Changing Financial System* 431, 440–42 (2008), <http://www.kansascityfed.org/~media/files/publicat/sympos/2008/kashyaprajanstein031209.pdf> [<http://perma.cc/BMF4-8JME>]. Furthermore, to the degree the banks facing or even fearing a run will hoard their liquid assets, it can have a serious negative effect on new lending, thus depressing economic activity. See *id.* at 442.

16. This “contagion by simile” describes, for example, what happened to the money market fund industry after the failure of Reserve Primary in September 2008. See Fin. Crisis Inquiry Comm’n, *The Financial Crisis Inquiry Report* 353–56 (2011), <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> [<http://perma.cc/KD9Z-FUK7>]. As described below, money market funds meet the functional definition of “bank.” See *infra* note 40.

17. See Ricks, *The Money Problem*, *supra* note 10, at 102 (“[I]nsofar as financial stability is about avoiding macroeconomic disasters, it should concern itself mostly with *panic-proofing*.”); Timothy F. Geithner, *Are We Safe Yet? How to Manage Financial Crises*, *Foreign Aff.*, Jan./Feb. 2017, <http://www.foreignaffairs.com/articles/united-states/2016-12-12/are-we-safe-yet> [<http://perma.cc/PC3M-A3B4>] [hereinafter Geithner, *Are We Safe Yet?*] (“It’s important to understand why financial systems are so vulnerable to crises. First, and most important, they are inherently prone to panics and runs.”).

18. See, e.g., John H. Cochrane, *Lessons from the Financial Crisis, Regulation*, Winter 2009–2010, at 34, 34, [http://faculty.chicagobooth.edu/john.cochrane/research/papers/cochrane\\_lessons\\_regulation.pdf](http://faculty.chicagobooth.edu/john.cochrane/research/papers/cochrane_lessons_regulation.pdf) [<http://perma.cc/DU6G-FEZJ>] (“The signature event of [the 2008] financial crisis was the ‘run,’ ‘panic,’ [or] ‘flight to quality’ . . . . If that panic had not occurred, it is likely that any economic contraction following the housing bust would have been no worse than the mild 2001 recession that followed the dot-com bust.”); Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., *Some Reflections on the Crisis and the Policy Response* (Apr. 13, 2012), <http://www.federalreserve.gov/newsevents/speech/bernanke20120413a.htm> [<http://perma.cc/NU82-VKFY>] (comparing the housing crash to the dot-com crash and

damage to the real economy that the financial crisis of 2008 wrought has been severe and enduring.<sup>19</sup>

The American banking system suffered many similarly destabilizing, and often devastating, financial crises in the nineteenth and early-twentieth centuries.<sup>20</sup> The problem of such crises was largely “solved” by the creation of the Federal Deposit Insurance Corporation (FDIC) in 1933.<sup>21</sup> With the introduction of deposit insurance to protect depositors’ principal, along with a special resolution regime to ensure depositors could access their money without delay,<sup>22</sup> the incentive to run was removed. The “moral hazard” that arose with deposit insurance<sup>23</sup> was

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arguing that the principal difference lay in the fact that the former was partly caused by the role of shadow banks while the latter was not).

19. See, e.g., Carmen M. Reinhart & Kenneth S. Rogoff, *Recovery from Financial Crises: Evidence from 100 Episodes*, 104 *Am. Econ. Rev.* 50, 54 (2014) (noting the post-2007 crisis was “one of the most severe multi-year crises on record in the advanced economies”); Martin Wolf, *The Long and Painful Journey to World Disorder*, *Fin. Times* (Jan. 5, 2017), <http://www.ft.com/content/ef13e61a-ccec-11e6-b8ce-b9c03770f8b1> (on file with the *Columbia Law Review*) (explaining how the financial crisis and subsequent Eurozone crisis “had devastating economic effects: a sudden jump in unemployment followed by relatively weak recoveries” and noting that the “economies of the advanced countries are roughly a sixth smaller today than they would have been if pre-crisis trends had continued”).

20. See, e.g., Ben S. Bernanke, *The Federal Reserve and the Financial Crisis* 9–10 (2013) (identifying six banking panics between 1873 and 1914); Gary B. Gorton, *Misunderstanding Financial Crises: Why We Don’t See Them Coming* 29 (2012) (quoting a commentator’s claim in 1899 that “[s]ince 1793 panics have occurred [in the United States] in the following years: 1797, 1811, 1813, 1816, 1819, 1825, 1837, 1847, 1857, 1866, 1873, 1884, 1890, and 1893”); Geithner, *Are We Safe Yet?*, *supra* note 17 (“In the five or so decades before the Great Depression, U.S. banks possessed much higher levels of capital, and yet the United States still experienced an appalling number of enormously damaging banking panics.”).

21. It is important to note that the savings and loan (S&L) crisis of the 1980s did *not* involve a panic, precisely because the institutions in question had deposit insurance. The S&L crisis laid bare some significant flaws in the implementation of bank regulation—flaws that were at least partially addressed by the Federal Deposit Insurance Corporation Improvement Act of 1991. See, e.g., Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 *Ann. Rev. Banking L.* 317, 325 (1993). Importantly, however, unlike panics, “the savings and loan debacle was *not* accompanied by a severe macroeconomic disaster . . . [but only] a mild and brief recession.” Morgan Ricks, *Safety First? The Deceptive Allure of Full Reserve Banking*, 83 *U. Chi. L. Rev. Online* 113, 121 (2016) [hereinafter Ricks, *Safety First?*], [http://lawreview.uchicago.edu/sites/lawreview.uchicago.edu/files/uploads/Dialogue/Ricks\\_FINAL.pdf](http://lawreview.uchicago.edu/sites/lawreview.uchicago.edu/files/uploads/Dialogue/Ricks_FINAL.pdf) [<http://perma.cc/J74F-S7JX>].

22. See 12 U.S.C. § 1821(f)(1) (2012).

23. Moral hazard refers to the fact that those who are insured against a bad outcome may take less care in avoiding that outcome. In this context, private actors—depositors and bank shareholders and executives—will not bear the full costs of a bank failure and so may not take as much care as they should to avoid this outcome, particularly since strategies that lead to higher profits in good states of the world increase the likelihood of failure in bad states of the world. See Carnell et al., *supra* note 12, at 282–83. Risky corporate bonds, for example, pay a higher yield than Treasuries but are also likelier to default. See Moody’s Inv’r Serv., *Corporate Default and Recovery Rates 1920–2010* (2011), <http://efinance.org.cn/cn/FEben/Corporate%20Default%20and%20Recovery%20Rates>,

addressed primarily by intrusive supervision, capital requirements, and portfolio and activity constraints.<sup>24</sup> The system worked: It led to an extended “Quiet Period” of financial stability that coincided with robust growth and a moderation in the business cycle.<sup>25</sup>

#### B. *Two Approaches to Financial Regulation*

The regulatory approach just described combines a safety net with risk constraints and intrusive supervision to “solve” the problem of banks. It is important to distinguish this “banking regulatory approach” from what this Piece will refer to as the “capital markets” approach to regulation.<sup>26</sup> The banking regulatory approach, sometimes referred to as prudential regulation, or “safety and soundness” regulation, is distinguished by three features: (i) an emphasis on protecting the principal of a certain class of creditors—namely, depositors; (ii) an emphasis on preventing institutional failure;<sup>27</sup> and (iii) a special resolution regime to prevent systemic spillovers in the event a bank does fail.<sup>28</sup> This characterizes the regulatory approach of the so-called banking regulators, including the Office of the Comptroller of the Currency, the FDIC, and the Federal Reserve.

The “capital markets” approach, in contrast, characterizes traditional regulation by the Securities and Exchange Commission (SEC).<sup>29</sup>

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1920-2010.pdf [<http://perma.cc/89QJ-UWX9>] (providing historical corporate bond default rates); Donald Marron, *The Day the United States Defaulted on Treasury Bills*, *Forbes* (May 26, 2011), <http://www.forbes.com/sites/beltway/2011/05/26/the-day-the-united-states-defaulted-on-treasury-bills/#2f2d9bac30ad> (on file with the *Columbia Law Review*) (explaining that contrary to popular belief that the United States government has never defaulted on its obligations, it has done so once in 1979); *Tracking Bond Benchmarks*, Wall St. J.: Mkt. Data Ctr., [http://online.wsj.com/mdc/public/page/2\\_3022-bondbnchrk.html](http://online.wsj.com/mdc/public/page/2_3022-bondbnchrk.html) [<http://perma.cc/42CM-KFGB>] (last visited Mar. 29, 2017) (providing information on yields for different debt instruments).

24. Lending by the Federal Reserve also played an important role for solvent banks facing temporary liquidity problems. For a good overview of this overarching regulatory approach, see Ricks, *Regulating Money Creation After the Crisis*, *supra* note 15, at 103.

25. See Gary B. Gorton, *Slapped by the Invisible Hand: The Panic of 2007*, at 11 (2010).

26. See, e.g., John Crawford, *The Moral Hazard Paradox of Financial Safety Nets*, 25 *Cornell J.L. & Pub. Pol’y* 95, 113 n.86 (2015) [hereinafter Crawford, *The Moral Hazard Paradox*].

27. This informs the various risk constraints imposed on banks, as well as emergency lending. See *supra* note 24 and accompanying text (examining regulatory reaction to the 2007 financial crisis).

28. See generally FDIC, *Resolutions Handbook* (2014), [http://www.fdic.gov/about/freedom/drr\\_handbook.pdf](http://www.fdic.gov/about/freedom/drr_handbook.pdf) [<http://perma.cc/D8AV-VM6F>]. FDIC resolution prevents contagion from a bank failure in ways the existing Bankruptcy Code cannot. See, e.g., Crawford, *Credible Losers*, *supra* note 11, at 135–36.

29. See, e.g., *What We Do*, SEC, <http://www.sec.gov/about/whatwedo.shtml> [<http://perma.cc/XH6G-FQ8P>] (last visited Feb. 25, 2017) (“The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”).

The SEC regulates a wide variety of nondepository financial institutions, including the classic Wall Street securities firms, sometimes referred to as “broker-dealers,”<sup>30</sup> that specialize in activities such as underwriting securities offerings, “market-making,”<sup>31</sup> offering advisory services, and arranging financing for corporate mergers and takeovers. The SEC has traditionally focused on preventing fraud and manipulation in securities markets; its focus has *not* been on preventing particular firms’ failure.<sup>32</sup> Likewise, while it tries to protect investors from fraud,<sup>33</sup> it does not try to prevent informed risk-taking or to protect investors from principal losses when their bets turn out badly. This approach is much less prescriptive and intrusive than the banking approach and seeks to harness rather than supplant market forces.

The capital markets approach is appropriate when a firm’s failure and investors’ losses do not create significant negative externalities—which is generally the case when firms do not fund their activities with deposits or other short-term borrowings that function as deposit equivalents. Firms that do not fund themselves this way are generally not susceptible to runs and therefore do not pose the threat to financial stability that banks do.<sup>34</sup> Importantly, these distinctions are functional; they turn on the risk different institutions create, which in turn derives from the activities in which those firms engage. They do not depend on legal forms or labels.

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30. Confusingly, the largest of such firms are also sometimes referred to as “investment banks”—but they are *not* banks as it has been understood in this Piece. The term “broker-dealer” encompasses a broader universe of firms than just the large Wall Street investment banks such as Goldman Sachs and Morgan Stanley, but the Piece uses the term because it maps onto the terminology of SEC regulation and avoids confusion with the other definitions of “bank.” See, e.g., Guide to Broker-Dealer Registration, SEC (Apr. 2008), <http://www.sec.gov/divisions/marketreg/bdguide.htm> [<http://perma.cc/C3L5-KYAH>].

31. A “market maker” is “a firm that stands ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price.” Fast Answers: Market Maker, SEC, <http://www.sec.gov/answers/mktmaker.htm> [<http://perma.cc/X3VZ-B4NE>] (last modified Mar. 17, 2000).

32. While preventing individual firm failure has not traditionally been the SEC’s focus, there are nevertheless several rules that the SEC applies to broker-dealers that have a weak prudential flavor to them, most prominently a “net capital” rule, which serves as a (very) rough analogue to bank capital and reserve requirements. 17 C.F.R. § 240.15c3-1 (2016).

33. The SEC seeks to deter fraud directly through its enforcement arm. See generally Division of Enforcement, SEC, <http://www.sec.gov/enforce> [<http://perma.cc/K3NP-DRJA>] (last updated Apr. 14, 2015). It also oversees the Securities Investor Protection Corporation (SIPC), which insures brokerage customers against loss or theft of their cash or securities after the failure of a broker-dealer—but *not* against decline in value due to market movements. See What SIPC Protects, Sec. Inv’r Prot. Corp., <http://www.sipc.org/for-investors/what-sipc-protects> [<http://perma.cc/B69G-CMU8>] (last visited Feb. 25, 2017).

34. It is worth noting that there are other sources of run-like dynamics that may call for more intrusive regulation, such as the collateral calls AIG faced in September 2008. See Fin. Crisis Inquiry Comm’n, *supra* note 16, at 344–45.



C. *Shadow Banks and the Crisis*

Although nonbanks cannot issue deposits, it turns out that they can issue short-term debt that serves as the functional equivalent of deposits,<sup>35</sup> using the money thus raised to fund investments in long-term assets. Entities that engage in this bank-like function outside the regulatory framework and safety net that apply to banks are so-called *shadow banks*.<sup>36</sup> Regulating shadow banks under a capital markets approach is a recipe for crisis.

Shadow banking has a long history<sup>37</sup> but was largely dormant for most of the Quiet Period.<sup>38</sup> In the two decades leading up to the crisis of 2007–2009, however, shadow banking metastasized until it was as large as or larger than the chartered banking system on the eve of the crisis.<sup>39</sup> Prominent examples of shadow banks include money market funds<sup>40</sup> and broker-dealers funding themselves with commercial paper and repo loans.<sup>41</sup> 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

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35. An example of such a deposit substitute is the repurchase agreement, or “repo loan,” in which, for example, a money market fund makes a short-term loan—often overnight—to a broker-dealer and receives collateral in return. The cash lender in this case is the functional equivalent of a depositor, with a daily option not to roll over its loan—that is, to withdraw its funding. Tobias Adrian & Hyun Song Shin, *The Shadow Banking System: Implications for Financial Regulation 8* (Fed. Reserve Bank of N.Y. Staff Report No. 382, 2009), [http://www.newyorkfed.org/research/staff\\_reports/sr382.pdf](http://www.newyorkfed.org/research/staff_reports/sr382.pdf) [<http://perma.cc/Y7WU-XUXY>] (“In a repo, the borrower sells a security today for a price below the current market price on the understanding that it will buy it back in the future at a pre-agreed price.”).

36. See, e.g., Ricks, *The Money Problem*, supra note 10, at ix (“To [the Crisis Response Team at the U.S. Treasury, “shadow banking”] meant something . . . quite specific. When we talked about shadow banking, we were referring to the financial sector’s use of vast amounts of *short-term debt* to fund portfolios of financial assets.”).

37. *Id.* at 230–37.

38. See, e.g., Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, *Brookings Papers on Econ. Activity*, Fall 2010, at 261, 265 fig.3, [http://www.brookings.edu/wp-content/uploads/2010/09/2010b\\_bpea\\_gorton.pdf](http://www.brookings.edu/wp-content/uploads/2010/09/2010b_bpea_gorton.pdf) [<http://perma.cc/A4AH-X8ZZ>].

39. *Id.*; see also Zoltan Pozsar et al., *Shadow Banking 8 fig.1* (Fed. Reserve Bank of N.Y. Staff Report No. 458, 2010), [http://www.newyorkfed.org/medialibrary/media/research/staff\\_reports/sr458.pdf](http://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr458.pdf) [<http://perma.cc/2T2E-JVCX>].

40. A money market fund offers investors “shares” that have traditionally maintained a stable value of \$1.00 and invests in a variety of instruments of short- to medium-term maturity and low credit risk. The shares are redeemable on demand and function as close substitutes for deposits for the money market fund investors. See *Money Market Funds*, SEC, <http://www.sec.gov/answers/mfmmkt.htm> [<http://perma.cc/RK4D-BBXW>] (last updated Jan. 17, 2017).

41. Gorton & Metrick, supra note 38, at 261–62. For a description of repo loans, see supra note 35.

2008 was at core a run on shadow banks.<sup>42</sup> 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.<sup>43</sup>

Ultimately, regulators were able to halt the panic by (among other measures) extending the safety net to shadow banks.<sup>44</sup> Of course, part of the deal with *commercial* banks is that while they benefit from the safety net, they must submit to (often onerous) prudential rules and supervision. The fact that shadow banks received safety-net support without striking such a deal struck many as problematic. In the wake of the crisis and the bailouts, one approach to the problem of shadow banking would have been to try to stamp it out.<sup>45</sup> Indeed, there is reason to believe this would be the best approach, but it has little, if any, political traction. As long as shadow banking exists, then the best way to mitigate the inevitable fragility it creates is to apply as much of the banking regulatory approach to it as possible.

#### D. *Post-Crisis Reforms*

Post-crisis reforms have been a mixed bag in addressing the shadow banking system. On the one hand, Congress limited or removed regulators’ authority to extend the safety net outside the traditional banking system.<sup>46</sup> On the other hand, the largest broker-dealers, a major locus of shadow banking activity, are all now housed within bank holding companies (BHCs).<sup>47</sup> 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-

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42. Gorton & Metrick, *supra* note 38, at 279–80.

43. See Fin. Crisis Inquiry Comm’n, *supra* note 16, at 280, 324, 363. For an explanation of money market fund shares, see *supra* note 40.

44. See Davis Polk & Wardwell LLP, *Financial Crisis Manual: A Guide to the Laws, Regulations and Contracts of the Financial Crisis* 24, 32 (2009), <http://www.davispolk.com/sites/default/files/files/Publication/d1ab7627-e45d-4d35-b6f1-ef356ba686f2/Preview/PublicationAttachment/2a31cab4-3682-420e-926f054c72e3149d/fcm.pdf> [<http://perma.cc/E6Q7-BWCH>].

45. See generally Ricks, *The Money Problem*, *supra* note 10 (arguing short-term funding markets were the central problem to the financial system).

46. See Crawford, *The Moral Hazard Paradox*, *supra* note 26, at 97 n.8, 121.

47. A BHC can own both banks and nonbank subsidiaries, such as broker-dealers or asset managers. At the beginning of 2008, there were five large stand-alone investment banks that were not housed in BHCs. Of these, one (Lehman Brothers) failed, Fin. Crisis Inquiry Comm’n, *supra* note 16, at 324–44, two (Bear Stearns and Merrill Lynch) were bought by large BHCs, *id.* at 353–88, and two (Goldman Sachs and Morgan Stanley) converted into BHCs, *id.*

dealers as well.<sup>48</sup> Furthermore, the Dodd-Frank Act established a special “liquidation authority” to try to facilitate winding down a giant nondepository financial institution (such as a BHC) without creating significant negative systemic externalities.<sup>49</sup> In sum, as former Treasury Secretary Timothy Geithner has argued, there is less “dry tinder” in the system, but the tools available to policymakers to respond to a crisis if one occurs have, on net, been diminished.<sup>50</sup> 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).<sup>51</sup>

## II. THE PATH AHEAD: THE IMPACT OF PROPOSED REFORMS ON FINANCIAL STABILITY

The thesis of this Piece is that the key to financial stability is to apply the banking regulatory approach to institutions and activities that *function* like banks. For those that do not function like banks—that is, for firms that are not vulnerable to runs—the capital markets approach is entirely appropriate. Based on key provisions of the CHOICE Act, however, there is reason to believe that legislative efforts in the coming year(s) will move in the wrong direction on this front.

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48. See generally Div. of Banking Supervision & Regulation, Bd. of Governors of the Fed. Reserve Sys., Bank Holding Company Supervision Manual (2016), <http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc.pdf> [<http://perma.cc/KT3X-YUPF>] (providing guidance for regulating bank holding companies). For example, a BHC has to meet capital requirements not just in its bank subsidiary but on a consolidated basis for the entire holding company family. *Id.* § 4061.0; see also Geithner, Are We Safe Yet?, *supra* note 17 (“Perhaps as important as the fact that capital requirements have grown in size is that they now apply more widely . . . . Today, the largest investment banks are regulated as bank holding companies, subjecting entire institutions to higher capital requirements.”).

It is important to note, however, that the broker-dealer does *not* enjoy automatic access to the federal safety net—emergency lending by the Federal Reserve and deposit insurance—as does the commercial bank that sits in the same holding company family. See 12 U.S.C. § 378 (2012) (prohibiting securities dealers from engaging in banking business); What’s Covered, FDIC, <http://www.fdic.gov/deposit/covered/> [<http://perma.cc/QPM7-DZ9M>] (last updated Jan. 6, 2017); The Federal Reserve Discount Window, <http://www.frbdiscountwindow.org/Pages/General-Information/The-Discount-Window.aspx> [<http://perma.cc/PG9E-R5DZ>] (last updated June 22, 2015).

49. 12 U.S.C. §§ 5381–5394.

50. Geithner, Are We Safe Yet?, *supra* note 17 (describing constraints on fiscal and monetary policy in the current environment as well as a decrease in “fire-fighting” tools).

51. *Id.* (describing higher capital levels and decreased reliance on uninsured short-term funding in the financial system); Volcker Alliance Report, *supra* note 10, at 14 fig.1 (measuring uninsured short-term debt in the financial system).

A. *The Financial Stability Oversight Council*

Two key lessons of the financial crisis were that large gaps existed in our financial regulatory structure and that no entity was responsible for monitoring risks to the stability of the system as a whole. As a result, the Dodd-Frank Act created the Financial Stability Oversight Council (FSOC), composed of the heads of all the federal financial regulatory agencies and chaired by the Treasury Secretary.<sup>52</sup> The FSOC is responsible for monitoring risk throughout the financial system. The principal new authority the FSOC wields is the power to designate financial institutions that are neither banks nor BHCs (both of which are already prudentially regulated) as “systemically important,” thereby subjecting them to prudential oversight by the Federal Reserve.<sup>53</sup>

This is important because some large nonbanks engage in extensive shadow banking activities. For example, MetLife, an insurance company that has been designated as systemically important by the FSOC but that has fought this designation,<sup>54</sup> funds itself with billions of dollars in short-term debt—that is, with deposit substitutes.<sup>55</sup> If MetLife’s short-term creditors refused en masse to roll over their loans, it would be functionally identical to, and create the risk of the same awful externalities as, a traditional bank run. Indeed, if one understands *why* banks demand a special regulatory response, it is hard to justify the *lack* of such a regulatory response to a firm such as MetLife that engages so extensively in shadow banking.

While the number of major firms engaged in shadow banking *outside* of BHCs may be limited today, that can change rapidly, just as it did in the decade or two leading up to the crisis. FSOC designation is the only tool we have to ensure that some measure of prudential regulation is applied to nonbanks engaged in shadow banking.

The FSOC is thus an essential component of post-2008 financial reform and plays a crucial role in maintaining systemic stability, particularly as market actors adjust their activities to try to evade regulation. Yet Republicans have expressed a good deal of hostility to the FSOC,<sup>56</sup> and the CHOICE Act would eliminate the FSOC’s designation

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52. 12 U.S.C. § 5321.

53. *Id.* § 5323.

54. See Ryan Tracy, *MetLife Asks Appeals Court to Uphold Removal of ‘SIFI’ Label*, *Wall St. J.* (Aug. 16, 2016, 10:38 PM), <http://www.wsj.com/articles/metlife-asks-appeals-court-to-uphold-removal-of-sifi-label-1471355267> (on file with the *Columbia Law Review*).

55. See Brief of Professors of Law & Finance as *Amici Curiae* Supporting Defendant at 14–15, *MetLife, Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219 (D.D.C. 2016) (No. 15-cv-00045-RMC), 2015 WL 3422509 (“Even more striking than the aggregate size of MetLife’s debt is that MetLife finances so much of its activities through short-term borrowing that must be repaid or refinanced in the near term.”).

56. See, e.g., Max Abelson & Zachary Tracer, *SEC’s Pivowar Calls FSOC ‘Vast Left-Wing Conspiracy’*, *Bloomberg News* (July 16, 2014, 12:00 AM), <http://www.bloomberg.com/news/2014-07-15/sec-s-piowar-calls-fsoc-vast-left-wing-conspiracy.html> [<http://perma.com/news/2014-07-15/sec-s-piowar-calls-fsoc-vast-left-wing-conspiracy.html>].

authority.<sup>57</sup> Representative Hensarling stated recently that by “empowering the FSOC to designate [systemically important financial institutions], the Dodd-Frank Act allows the Federal Reserve to impose bank-like standards on nonbank institutions; in other words, to move institutions from the non-bailout economy to the bailout economy.”<sup>58</sup> Alas, it is not designation that moves an institution into the “bailout” economy.<sup>59</sup> It is engaging in bank-like activities such that a run on the institution (and/or its failure) creates potentially catastrophic costs for the financial system. Designation does nothing to increase the powers of regulators to “bail out” a firm; it simply empowers regulators to compel shadow banks to operate in a way that makes their failure less likely. The incentive to “bail out” a firm is identical whether or not the firm has been designated.

In short, repeal of the FSOC’s designation authority is high on the priority list of influential Republicans but is grounded in a confused and rigidly formalistic conception about which entities demand a banking regulatory approach. Repealing this authority will have a potentially significant destabilizing effect on the financial system in coming years.

#### B. *Emergency Response Tools: Lending and Guarantee Authorities*

As noted, Congress has already acted to limit regulators’ firefighting tools in the years since the crisis: It has placed restrictions on the Federal Reserve’s emergency lending authorities and eliminated the freestanding guarantee authorities regulators used to limit the financial wildfire in late 2008.<sup>60</sup> The CHOICE Act would further tie regulators’ hands in responding to a crisis.<sup>61</sup> The desire to tie regulators’ hands reflects a view

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cc/KT6J-ZBPD] (reporting Republican SEC Commissioner Michael Piwowar’s comments that the FSOC’s “initials really stand for ‘Firing Squad on Capitalism,’” and that the Council is a “vast left-wing conspiracy to hinder capital formation,” “[t]he Bully Pulpit of Failed Prudential Regulators,” and “[t]he Dodd-Frank Politburo”); Tracy, A Financial Council Republicans Loathe, *supra* note 8 (describing one of the members of President Trump’s FSOC transition team as executive director of “an advocacy group whose website calls FSOC a ‘rogue regulator’ and asks readers to ‘Sock Back at FSOC’ by telling Congress to curtail its power or abolish it”).

57. Financial CHOICE Act, H.R. 5983, 114th Cong. § 211 (2016).

58. Press Release, Fin. Servs. Comm., Chairman Hensarling Once Again Calls on FSOC to ‘Cease and Desist’ Too-Big-to-Fail Designations Until Questions Are Answered (May 20, 2014), <http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=380567> [<http://perma.cc/4NCG-8G8N>].

59. “Bailout” in this context means government support to prevent a firm from defaulting on its debt obligations.

60. See *supra* text accompanying note 46.

61. H.R. 5983 §§ 243, 707. Perhaps most disturbingly, it would eliminate the statutory provision providing a “systemic risk exception” to the requirement that the FDIC adopt the “least cost” approach to resolving a bank. *Id.* § 242. Normally, the “least cost” requirement means that the FDIC cannot protect uninsured creditors of a failed bank. See 12 U.S.C. § 1823(c)(4)(G) (2012). The systemic risk exception provides a way for it to do so anyway if the majority of the FDIC Board *and* of the Board of Governors of the Federal Reserve *and* the Treasury Secretary all concur that doing so is necessary to preserve the

that we should leave shadow banks entirely to the market, that the moral hazard arising out of panic prevention in the shadow banking sector will prove more costly than the fallout from the crises when they occur. Again, this Piece argues that this view is wrong as applied to banks.<sup>62</sup> If one accepts that it is wrong as applied to banks, it is (again) hard to justify adopting such a view with respect to shadow banks. As Secretary Geithner wrote in his memoir, 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.”<sup>63</sup> Of course, it is important to emphasize that emergency response tools and safety nets must be coupled with prudential rules and supervisory authority to mitigate moral hazard: This is the basic logic of the banking approach to regulation.

### C. Resolution

Another key aspect of the CHOICE Act addresses what to do with failing financial behemoths. Putting a bank through bankruptcy would be extremely disruptive, because bankruptcy is slow, and depositors, unlike typical bondholders or equity claimants, need immediate access to their accounts.<sup>64</sup> Without such immediate access, there may be significant consequential damages for the depositors irrespective of any investment losses,<sup>65</sup> and runs are more likely to spread to sister banks—a sort of contagion by simile.<sup>66</sup> A key to the banking approach to regulation, then, is providing a resolution mechanism that allows depositors of a failed bank to get immediate access to their money. One of the reasons the failure of Lehman Brothers in September 2008 was so disruptive is that many of its short-term creditors were treating their claims on it like deposits—

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financial stability of the United States. See *id.* This provision played a critical role in preventing an all-out collapse of the system in late 2008. See Crawford, *The Moral Hazard Paradox*, *supra* note 26, at 114–15. Proposing its elimination evinces what Secretary Geithner has called “moral hazard fundamentalism”—that is, a desire to constrain moral hazard not as a means to an end (a robust financial system and healthy economy) but as an end in itself. Cf. Timothy F. Geithner, *Stress Test: Reflections on Financial Crises* 178 (2015) [hereinafter Geithner, *Stress Test*] (noting the government’s desire not “to bolster the impression that government handouts were available upon request”).

62. Some commentators disagree and believe that the effects of deposit insurance are pernicious. See, e.g., Charles Calomiris & Matthew Jaremski, *Deposit Insurance: Theories and Facts* (Nat’l Bureau of Econ. Research, Working Paper No. 22223, 2016), <http://www.nber.org/papers/w22223> (on file with the *Columbia Law Review*). This Piece argues that this view is wrong, though it has the virtue of being more coherent than the competing view that the banking regulatory approach should be adopted for banks but not shadow banks.

63. Geithner, *Stress Test*, *supra* note 61, at 430.

64. See Crawford, *Credible Losers*, *supra* note 11, at 135–36.

65. See Ricks, *Regulating Money Creation After the Crisis*, *supra* note 15, at 83.

66. See *supra* note 16 and accompanying text.

making Lehman a large shadow bank—but there was no special mechanism available to unwind it.<sup>67</sup>

Title II of the Dodd-Frank Act was crafted to respond to this problem: The “orderly liquidation authority” empowered the FDIC—after an invocation procedure that, like the systemic risk exception discussed above, requires the concurrence of the Board of Governors of the Federal Reserve and the Secretary of the Treasury—to resolve nonbanks in a process intended to mirror the bank resolution process.<sup>68</sup>

The CHOICE Act would repeal Title II of the Dodd-Frank Act and replace it with a new subchapter of the Bankruptcy Code, Chapter 11, Subchapter V (Subchapter V).<sup>69</sup> Many of the provisions of Subchapter V appear to mimic the best features of the Dodd-Frank Act. There are, however, at least two significant disadvantages of Subchapter V vis-à-vis Title II from a financial-stability perspective. First, the CHOICE Act would not permit regulators to trigger a Subchapter V bankruptcy filing.<sup>70</sup> As Professors Mark Roe and David Skeel argue,

If the regulators think that a bankruptcy is needed, but that a bailout or alternative resolution process is not needed, they cannot directly force a filing. . . .

True, regulators can pressure bank managers to reluctantly file, but the regulators may have to concede conditions to bank executives to make them file quickly; if the bank does not file quickly, the regulators may decide that to save the economy, they have to bail the bank out. In the extreme case, bank management may just refuse to file for bankruptcy.<sup>71</sup>

Second, while Title II can be invoked for any nondepository financial company,<sup>72</sup> Subchapter V would be available for a narrower category of firms.<sup>73</sup> This leaves open the possibility that significant shadow banks that do not fit under the narrower definition of “covered financial company” would have only the preexisting provisions of the

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67. Fin. Crisis Inquiry Comm’n, *supra* note 16, at 324–43.

68. 12 U.S.C. §§ 5381–5394 (2012). For an analysis of plans that regulators have developed to implement Title II, see generally Crawford, *Credible Losers*, *supra* note 11, at 137–47.

69. Financial CHOICE Act, H.R. 5983, 114th Cong. §§ 1181–1192 (2016).

70. Id. § 232 (revising Chapter 11 of the Bankruptcy Code).

71. Mark J. Roe & David A. Skeel Jr., *Bankruptcy for Banks: A Sound Concept that Needs Fine-Tuning*, N.Y. Times: DealBook (Aug. 16, 2016), <http://www.nytimes.com/2016/08/17/business/dealbook/bankruptcy-for-banks-a-sound-concept-that-needs-fine-tuning.html> (on file with the *Columbia Law Review*) (critiquing a stand-alone version of this bankruptcy reform that had made its way into an appropriations bill).

72. 12 U.S.C. §§ 5381(a)(8), 5383. Depository institutions are excluded, of course, because they are *already* subject to a special resolution regime.

73. H.R. 5983 § 231(a) (defining “covered financial corporations” as comprising only (i) BHCs or (ii) other large holding companies that “exist[] for the primary purpose of owning, controlling and financing [their] subsidiaries” but excluding stockbrokers and commodity brokers).

Bankruptcy Code as a resolution option going forward, recreating the very problem that Title II of Dodd-Frank was written to solve.<sup>74</sup> Again, then, the CHOICE Act evinces a failure of imagination and understanding in grasping the core problem of financial stability: bank-like functions and risks that lie in the regulatory shadows.

#### D. *Capital*

One of the key ingredients of prudential regulation is capital requirements. Capital is a measure of the difference between what a bank owns (its assets) and what it owes (its debts).<sup>75</sup> The thicker a bank's capital buffer, the more losses it can absorb before tipping into insolvency. Leading up to the crisis, the nation's shadow banks—particularly broker-dealers funding themselves with short-term debt—were operating with capital buffers that were razor thin.<sup>76</sup> One of the more intriguing provisions of the CHOICE Act would permit banks and BHCs that meet a 10% leverage ratio—equivalent to a capital buffer of 10% of a firm's total assets<sup>77</sup>—to be relieved of a wide array of other prudential regulations.<sup>78</sup> The provision seems to hinge on a belief that with higher capital in place, we can relax about the risk of panics and allow a capital markets approach to govern. There are several problems with this view. First, while it is true that higher capital requirements are better for stability if all else is equal, all else is *not* equal here. Because a firm opting into this regime would, for example, be relieved of meeting *risk-based* capital requirements, we should expect such firms to migrate to a much riskier portfolio of assets.<sup>79</sup> It is not clear that a firm with a 10% leverage ratio but holding risky assets is less likely to fail or to create systemic knock-on effects than a firm with a 5% leverage ratio holding primarily “safe” assets.

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74. The problem with the CHOICE Act's definition is not that there are lots of shadow banks that would fail to fit within it *right now* but rather that shadow banking can shift to forms that do not rely on the holding company structures that are Subchapter V's focus.

75. Note that this is distinct from *reserve* requirements, which mandate that banks hold a certain percentage of their deposit base in cash (or as deposits with the Federal Reserve). Capital requirements have nothing to do with how much cash a bank holds; rather, they have to do with how much debt a bank can take on relative to equity. Bank capital requirements are extremely complicated in detail, see 12 C.F.R. § 3.10 (2016), but straightforward conceptually. See Carnell et al., *supra* note 12, at 217–18 (distinguishing different usages of “capital” from the usage in bank regulation). See generally Anat Admati & Martin Hellwig, *The Bankers' New Clothes* (2013) (providing a lucid conceptual account of bank capital).

76. Fin. Crisis Inquiry Comm'n, *supra* note 16, at xix.

77. For every \$10 in assets, then, the firm would have \$1 in capital to absorb losses.

78. H.R. 5983 §§ 101–102.

79. *Id.* § 102. Banks currently have to meet both risk-based requirements and a (lower) leverage ratio that is unadjusted for risk—a sort of belt-and-suspenders approach to capital regulation. 12 U.S.C. § 5371 (2012).



More fundamentally, capital requirements are an extremely clumsy and unreliable tool *on their own* for preventing panics. In the era prior to the development of the federal safety net, bank capital levels were significantly higher than 10%, but runs and panics occurred every decade or two.<sup>80</sup> Although there must be a point at which higher capital would “solve” the problem of financial crises—at the limit, one could force all intermediation to be funded with 100% equity and all deposit-taking institutions to hold 100% reserves<sup>81</sup>—there is no proposal with any political traction that comes close to such a level.<sup>82</sup>

To be sure, the current combination of capital, liquidity, and other prudential standards as applied to BHCs (which house a large portion of the shadow banking industry in their nondeposit subsidiaries) does not “panic-proof” the system, even as it marks an improvement over a *laissez faire* approach.<sup>83</sup> Perhaps trading higher capital for scaled-back regulation in other areas will get us a similar degree of protection for lower cost. Perhaps not. Either way, its effect on financial stability is likely to be small relative to the risks we face, and the provision (again) betrays a fundamental misunderstanding of the nature of those risks.

#### 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 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 cost through the combination of a safety net and safety-and-soundness regulation. We have extended only pieces of this approach to shadow banks. Greater stability requires either suppressing

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80. On bank capital levels in the nineteenth and early-twentieth centuries, see Admati & Hellwig, *supra* note 75, at 30–31. On the frequency of financial crises in this era, see *supra* note 20 and accompanying text.

81. See, e.g., Adam J. Levitin, *Safe Banking: Finance and Democracy*, 83 U. Chi. L. Rev. 357, 360 (2016) (proposing full reserve banking).

82. Professor Anat Admati is perhaps the most prominent advocate for higher capital levels, proposing leverage ratios in the range of 20–30%. See Admati & Hellwig, *supra* note 75, at 179. Even if full reserve banking proposals had political support, it is worth reiterating that such an approach would be inferior to the classic banking regulatory model of the Quiet Period, which combined (lower) capital levels with a safety net and prudential supervision. See generally Ricks, *Safety First?*, *supra* note 21.

83. This is a function of the continuing existence of trillions of dollars in runnable funding outside the safety net. See Volcker Alliance Report, *supra* note 10, at 21; Geithner, *Are We Safe Yet?*, *supra* note 17.

shadow banks altogether or applying the banking regulatory approach more completely to them. A key criterion for judging financial reform efforts in the new Administration will be whether they move us further from this end or closer to it.