De Facto Banking Activities

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Neither Dodd-Frank nor the CHOICE Act addresses the systemic risks arising from de facto banking activities per se. In this essay, we define de facto banking as the transformation of liquidity, maturity and credit by financial intermediaries other than traditional banks. De facto banking becomes a systemic threat when systemically important liabilities (SILs)—that have no government guarantee or insurance and that (like uninsured bank deposits) are subject to a run—are used broadly to finance assets that are less liquid, of longer maturity, or less creditworthy.

The essay highlights the enormous moral hazard created in the U.S. financial system by the combination of the government’s support in the crisis of 2007-2009 and the failure to address de facto banking activities in either the Dodd-Frank or CHOICE Acts. It also discusses alternative approaches to this issue, including that recently proposed in the Minneapolis Plan to End Too Big to Fail: namely, to impose a broad Pigouvian tax on de facto bank liabilities.

Instead of containing the systemic risks within the de facto banking sector, the CHOICE Act would increase the systemic threat by revoking the FSOC’s SIFI authority and by failing to introduce any means to prevent risk migration from the traditional bank sector.