De Facto Banking Activities

By Kermit L. Schoenholtz

> *"Important as banking reforms may be, it is worth recalling that the trigger for the acute phase of the financial crisis was the rapid unwinding of large amounts of short-term wholesale funding that had been made available to highly leveraged and/or maturity-transforming financial firms that were not subject to consolidated prudential supervision."* Janet Yellen, **Regulatory Landscapes: A U.S. Perspective**, June 2, 2013.

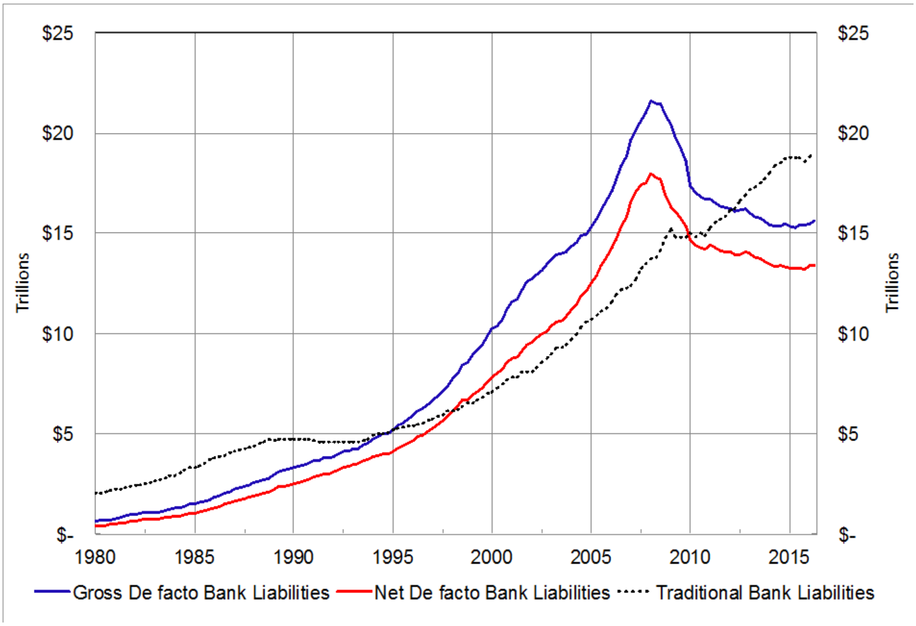
In this paper, we have defined *de facto banking* as the transformation of liquidity, maturity and credit by financial intermediaries other than traditional banks. Dodd-Frank focused on the systemic risks associated with *de facto* banking that arise in the largest, most complex, and most interconnected financial institutions. It provided authority to the Financial Stability Oversight Council (FSOC) to designate nonbanks as systemically important financial institutions (SIFIs) and placed them under the stricter supervisory regime of the Federal Reserve. The same applies to certain clearing, payments and settlements firms, which can be designated as financial market utilities (FMUs) and placed under joint supervision of both their traditional regulator and the Federal Reserve. As we have seen, the Financial CHOICE Act revokes the authority of the FSOC to designate SIFIs and FMUs and rescinds prior designations.

Importantly, neither Dodd-Frank nor the CHOICE Act addresses the systemic risks arising from *de facto banking activities* per se. These activities involve transformations of liquidity, maturity, and credit that "take place without direct and explicit access to public sources of liquidity or credit backstops" (see **Pozsar, Adrian, Ashcraft, and Boesky**, 2013). They are typically financed by systemically important liabilities (SIL) that have no government guarantee or insurance (see **Acharya and Öncü**, 2013) and that (like uninsured bank deposits) are subject to a run. As examples, SILs include repurchase agreements, securities lending, and asset-backed commercial paper (ABCP).

Following Acharya and Öncü, *de facto* banking becomes a systemic threat when SILs are used to finance systemically important assets (SIA). SIAs are either the SILs of other highly leveraged intermediaries (fueling interconnectedness and systemic vulnerability) or high-risk assets that can become illiquid. The latter includes loans to systemic intermediaries, mortgage-backed securities (MBS)—especially when used as collateral for repo or financed through securities lending—ABCP, and the like.

How substantial is *de facto* banking activity today? Updated estimates provided by the Federal Reserve Bank of New York show gross liabilities of *de facto* banks (including those held by other *de facto* banks) totaled $15.6 trillion as of mid-2016, compared with $19.1 trillion for traditional banks (including chartered depositories, foreign banking offices, and bank holding companies). As the following chart highlights, *de facto* banking liabilities have shrunk from the 2008 peak of $21.6 trillion near the height of the financial crisis. Yet, most of this plunge occurred *prior* to the Dodd-Frank Act (in July 2010), reflecting the demise of the business model of wholesale funding for potentially illiquid, high-risk assets, rather than the impact of regulation.

Traditional and *De Facto* Banking Liabilities (Trillions of U.S. dollars)



Source: Update courtesy of Federal Reserve Bank of New York; based on Pozsar, Adrian, Ashcraft, and Boesky, **Shadow Banking**, FRBNY *Economic Policy Review* 19(2) (2013). Underlying data from Financial Accounts of the United States. Shadow banking liabilities include money market mutual funds, open-market paper, agency and GSE-backed securities, mortgages in mortgage pools, asset-backed securities issuers, federal funds and securities repurchase agreements and security RPs of the monetary authority.

Amid the financial crisis of 2007-2009, the Federal Reserve frequently resorted to the use of its emergency facilities to backstop SILs of intermediaries that had paid no *ex ante* premium for this liquidity insurance. For example, the Fed's **Commercial Paper Funding Facility** (CPFF) provided support for ABCP issuance, while the **Primary Dealer Credit Facility** (PDCF) effectively supported the tri-party repo funding of broker dealers. As Pozsar et al (2013) note, "upon the complete rollout of the liquidity facilities and guarantee schemes, the shadow banking system was fully embraced by official credit and liquidity puts and became fully backstopped, just like the traditional banking system."

The combination of the government's support in the crisis of 2007-2009 and the failure to address *de facto* banking activities per se in either the Dodd-Frank or CHOICE Acts creates an enormous moral hazard in the U.S. financial system. Intermediaries outside traditional banking will be inclined to issue SILs and to hold SIAs with the understanding that: (a) there remains no *ex ante* fee for imposing such risks on the financial system; and (b) they can expect that emergency liquidity facilities will be provided to sustain *de facto* banking activities in the face of a financial crisis.

Even worse, the necessary and desirable imposition of higher capital and liquidity requirements on traditional bank activities incentivizes the migration of systemic risk-taking to the world of *de facto* banking. To be sure, traditional banking has expanded in recent years, while *de facto* banking has stagnated, but the continued upward ratcheting of bank capital requirements—as favored by this author—could reverse this pattern unless the incentives for risk migration are contained.

One simple and attractive approach is 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. The Minneapolis Plan estimates that a 15% leverage ratio requirement on the largest, most systemic banks would result in a funding cost increase equivalent to a 1.2% tax on the *de facto* bank liabilities. While that calibration requires careful review, the application of a simple tax on SILs to limit risk migration is consistent with the fundamental principles of effective regulation articulated in an earlier NYU Stern volume, ***Regulating Wall Street*** (2010). And, just as systemic risk is analogous to pollution—both resulting from externalities and poor incentives—a tax on SILs to limit systemic risk corresponds to a carbon tax, the mechanism that many economists favor as a means of limiting environmental risks (see, for example, **Mankiw** (2009)).

Alternative approaches also should be considered, including the outright prohibition of some *de facto* bank activities. For example, it may be more effective to forbid the recipient of high-quality collateral in a securities loan to sell that collateral and invest the proceeds in riskier assets. This form of liquidity, maturity and credit transformation can be difficult to observe (and therefore to tax), and it appears to be an important means by which life insurers engage in *de facto* banking (see **Foley-Fisher, Narajabad, and Verani**, 2016).

To conclude, we believe that the CHOICE Act would increase the systemic threat arising from *de facto* banking by revoking the FSOC's SIFI authority and by failing to introduce any means to prevent risk migration from the traditional bank sector.