Is U.S. Banking the Next U.S. Steel?
Prospects for National Banks as the Shadows Lengthen

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It's an honor to join the EU's Sharon Bowles and Cam Fine to wrap up this conference with a look at the future of finance. Con Hurley has asked me to focus on the broad – but critical – question of the future of financial intermediation now that so many powerful non-bank competitors are getting into the business. There's a lot of talk these days about "shadow banking" – the Financial Stability Board's most recent estimate clocks it at an astounding $71.2 trillion worldwide. Even so, this number underestimates non-bank finance because it largely omits non-banks in traditional financial intermediation – gathering deposits and making loans even though non-banks are exponentially becoming major players at both ends of the basic-banking spectrum. Given that the FSB also finds that non-banks hold 174 percent of the limited categories of bank assets as it calculates them in the U.S., we have a profound paradigm shift with immediate implications for both bank strategy and regulatory policy.

What are these implications? I'll turn to them in detail in a moment, but the most important I see are:

- For banks – especially big ones – it is critical to realign strategic planning to recognize that the monopoly-franchise model on which many companies are based is under heavy attack. The rules driving this change won't go away and, indeed, they may well get even tougher. Thus, regulatory barriers that once kept competition out now choke banks within ever more confined profit opportunities. Combined with technology and other market changes, this creates a once-in-a-generation challenge to redesign the business model. U.S. steel manufacturers ruled the world, until they didn't. The same is true for auto manufacturers and other U.S. companies that were category killers in the 1970s. Are the biggest U.S. banks any more invincible? I don't think so and current market data support this analysis.

- From a policy and regulatory perspective, if it's only bankers and big-bank shareholders that suffer as new financial-intermediation channels are opened, so be it. That's why they are private companies, supposed to live or die as markets dictate. But, if new prudential risks result because new competitors are providing bank-like services at comparable or even greater consumer or market risk, then vulnerable investors and consumers will be harmed and markets will be subject to systemic risk largely unaddressed in any of the Dodd-Frank regulation and resolution standards. At present, the U.S. regulatory framework is charter-based – that is, rules are based on the sign on the door, not the products and services provided. When activities are uneconomic under bank rules and otherwise profitable, they will flee to non-banks along with all their risks. Regulators must thus work quickly to use the tools they have in current law – more than enough for meaningful action – to capture risk and ensure orderly resolution when any activity or institution – not just big banks – poses risk.

My worries here do not just stem from a read of relevant academic literature and policy documents, although I believe both substantiate these concerns. Rather, they result from my hands-on strategic-advisory practice.

We are often asked to advise boards and senior management on the policy context of key business lines. When we do, we draw up a "landscape "that puts the activity in the context of applicable U.S. and, where appropriate, global rules and policies. Importantly, we do this not just by a look in the current rulebook, but also by a forecast of likely policy action on a five-year horizon. We try to do this objectively – it's not what one wants the rules to be, but rather what they are and could be that drives M&A, product, and related advice. In the past year or so, I've been stunned by how many of these landscapes across so many "traditional" banking services show a sharp decrease in comparative advantage and looming strategic realignment of business lines often at the heart of a bank's franchise value.

The Global Context

In the presence of so distinguished a Member of the European Parliament, I would be remiss if I failed first to put my key points in a more global context. The FSB's calculation that shadow banking is 174% of U.S. bank assets flips to 52% in the EU. This difference does not make European policy-makers less worried about shadow finance – indeed, I think they are a lot more worried than their U.S. colleagues, although policy ebbs and flows in favor of or against shadow finance.

Commissioner Barnier has recently laid out a major initiative designed to shrink the shadows. He would do so by choking off non-banks through an array of barriers to banking services. This might work – at least with regard to curtailing non-banks – in the EU precisely because it's far more bank-centric than the U.S. However, these choke-points will further concentrate EU finance in the hands of banks – good for them, but not necessarily for reducing too-big-to-fail or even too-big-to-save concerns, let alone for promoting innovation.

The Barnier initiative is also contradicted by a new, final EU one just announced last week: a program to promote long-term investment that in part depends on side-stepping banking to develop new infrastructure financing vehicles in securitization and similarly shadowy venues.

Thus, regulation-by-charter will have a different impact in the EU than the U.S. because, if it moves quickly, the EU may be able to prevent transformation of finance into non-banking enterprises except in segments where policy objectives facilitate shadow entry. Importantly, the EU may be better able to tolerate some shadows because its framework is far more functional than the U.S.-based charter approach. In the EU, the Basel capital rules apply not just to banks but also to broker-dealers and asset managers in sharp contrast to their charter-specific impact here. Going beyond capital to other critical prudential rules would be helpful not just to the EU, but also to showing the U.S. how better to develop our functional-regulatory framework.

Importantly, the FSB has proposed resolution frameworks not just for systemic banks, but also for insurers, financial-market infrastructure providers, and firms like broker-dealers and asset managers that hold other people's money. The EU has not advanced this framework, perhaps exhausted by work on the bank-resolution and sovereign-support system. Unfortunately, the FDIC's single-point-of entry resolution proposal is not only far away from finalization, but also wholly bank-centric.

Is Shadow Finance Just a Big-Bank Worry?

Are these issues germane just to big banks? With so distinguished a community banker on the panel, let me turn to this question. The sectors most regulators now call shadow banking are mostly not of concern to community banks because they are largely confined to wholesale activities like securities financing, repurchase agreements, money-market funds, and non-traditional insurance. But, the shadows as defined so far also include asset securitization – and, as the battle right now over the future of Fannie Mae and Freddie Mac make clear, community banks must have a place in the secondary market if they are to maintain a role as originators in any sector where securitization calls the shots. But, with this significant exception, some might say that community bankers can sit by and, to the extent the shadow players nibble big banks down to size, good riddance.

I think so sanguine a strategy will prove self-defeating for smaller banks. The reason is because shadow banking is in fact not confined to the largely-wholesale sectors so far subsumed within not just the FSB's work, but also that of the Federal Reserve, Financial Stability Board, Office of Financial Research, and other key U.S. policy-makers.

Where the Shadows Lie

The critical assumption on which I base both my strategic analysis and policy recommendations is the presence of non-banks as ever more formidable players in critical financial-intermediation functions long the province of traditional banks. Take, for example:

- *Small-Business Lending*: This is the lifeblood of traditional banking. Large banks in the 1990s largely – and much to their regret – gobbled up old-style finance companies like The Money Store that once held a lot of sway in this sector, leaving small-business lending to large and community banks for about a decade or so. Now, though, new players like PayPal are revving up in tandem with crowd-funding, P2P lending, and other vehicles with potentially major market clout.

- *Payment Products*: The *American Banker* recently highlighted a survey in which about half of "millennial" respondents said that they think new entrants will restructure traditional retail-payment products, with about a third saying that they would rather bank with Google, PayPal, and other non-banks. These players aren't totally ready for prime time, but they are revving up fast and clearly have a very attractive base of clients in banking's next-generation base.

- *Corporate Finance*: For the biggest companies, big banks were always the home port. This, though, is no longer the case – private-equity firms like KKR, Carlyle, Blackstone, and Apollo are now major players in this sector. Apollo, for example, now has a credit book of about $100 billion compared to $4 billion before the financial crisis. Why the difference? In part, it's because it's a darn sight easier to make commercial loans without having to hold the capital to absorb losses on them. Some say not to worry because these firms don't engage in maturity mis-matches because they pair long-term loans with long-term funding. But, without liquidity rules, who knows?

- *Consumer Lending*: The mortgage business is rapidly changing as non-bank servicers buy not just the servicing rights banks think no longer economic due to capital rules, but also origination and securitization operations fueled again by the lack of capital and related prudential requirements. The CFPB's qualified-mortgage and servicing rules apply across the spectrum, but non-banks have yet to build a compliance infrastructure, not only

> because their private-equity business model doesn't favor long-term infrastructure build-out, but also because there's little capital that needs the protection of robust internal controls. Similar non-bank subprime installment and auto lenders are also ramping up with astonishing rapidity, many also premising operations on the "get-out-of-Dodge" mentality that characterized non-bank finance before the crisis.

To be sure, banks have two remaining monopoly franchises: taking insured deposits and custody services. Even these bulwarks are, though, under attack from without. Over time, customer demand for non-deposit liability-like products has sky-rocketed – after all, what are money-market funds if not cash-equivalent holdings that, especially if paired with transaction-account capability, mimic traditional bank deposits. Big banks have of course become major MMF players, but a can't-beat'em/join 'em strategy does not bely the point that traditional bank services – even the most standard of them – have become complex product offerings as easy – indeed, often easier – to provide outside of bank regulation. Bitcoin is an important alarm on the early warning radar: customers are seeking virtual currencies in large part because they don't want to deal with banks anymore. Even if Bitcoin goes bye-bye and no digital currency replaces it, the enthusiasm of both users and financial-system enablers is a critical strategic development.

Asset custody may be the sole bastion of traditional banking because no non-bank has yet figured out how to hold trillions of assets under management solely for safekeeping. Again, though, the business model is increasingly very different. Big custody banks now make ends meet by boosting return on this low-risk, low-profit business by offering their own asset-management products and by large-scale securities-financing operations. In short, they look a lot like BlackRock – except, of course, for all the rules.

Policy Conclusion

I hope I've made clear that traditional banking is redefining itself with a rapidity not seen since upstarts like Apple and Google dared to challenge IBM. That fight was bare-knuckles because few rules in the technology arena dictate comparative advantage. This is of course very much not the case in finance, meaning not only that banks start the fight with one hand tightly tied behind their backs, but also that regulators should quickly become referees to ensure the fight becomes a more fair one.

What bothers me perhaps most of all in the policy arena is all the talk about shadow banking even as – especially in the U.S. – remarkably little is being done about it. Based on the longstanding U.S. focus of regulating financial services by charter, not function, we are quickly building out a bank-centric regulatory framework that often reaches down to BHCs holding as little as $50 billion in assets even though these low-level regional banking organizations pose no systemic risk. The FSOC is haltingly – very haltingly – naming one or another non-bank a systemically-important financial institution (SIFI), but its count to date is negligible and – even then – the FRB makes no bones about the fact that it hasn't a clue about how actually to regulate these very different SIFIs, let alone any subsequent designees.

The Dodd-Frank Act includes a little-noticed provision that permits U.S. regulators to break through this myopic, charter-by-charter approach and instead to determine which financial-intermediation functions pose systemic risk and then to regulate the function in like-kind fashion regardless of who offers it. This power is to be found in Section 120 of the law, which allows FSOC to designate systemic activities or practices not only as systemic, but also if any pose serious risks to vulnerable consumers or investors.

To be sure, FSOC can't impose its will on recalcitrant or conflicted primary regulators – the SEC over FSOC's MMF rules comes immediately to mind. However, it can make its demands clear, pressure primary regulators, alert markets to emerging risk, and by acting forcefully at the least start a meaningful US. response to regulatory arbitrage and the systemic risk it sows.

One more recommendation: because systemic risk arises by function, not charter, resolving troubled institutions cannot focus only on the very biggest banks. I mentioned earlier that the FDIC's concept release on the single-point-of-entry protocol makes no mention of non-banks nor, indeed, is it at all clear how it would work even in big banks since many house large broker-dealer and similar non-banking operations. Regulation by function requires also resolution by function, not form, and – like FSOC – the FDIC has ample authority under current law to get cracking.

Conclusion

In conclusion, the future of national banks over the next 150 years will be driven, at least for the next ten or so, by the sharp realignment in competitive power resulting from the post-crisis rulebook, most of which has so far fallen exclusively on insured depositories and their holding companies. I am not saying that the rulebook is wrong – much in it is urgently needed. I am saying that banks – even the biggest of the big – aren't the only sources of consumer harm and systemic risk. Regulating them solely because they are banks and leaving non-banks in the free and clear is already realigning core financial-intermediation activities in ways I urge the OCC and other policy-makers quickly to recognize and, then, to address by refocusing rules on critical financial function, not accidents of charter birth.