The Not-So Normal New:

The Assault on Bank Franchise Value and Its Policy Impact

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ABSTRACT

This paper assesses the business and policy ramifications of the realignment in U.S. financial markets accelerating in the wake of new rules largely applicable only to banks, especially those with assets over $50 billion, examining the extent to which non-banks have become potent providers of financial products across the full spectrum of financial services to forecast strategic implications for financial-services firms and the policy impact of a shift to the "shadows."

If non-banking firms gained market share solely due to competitive acuity or technological advantage, then this would be the normal course of an evolving market in which only bank shareholders suffer. However, the new regulatory framework applies very differently to like-kind activities based on a firm's charter. Risk is often regulated by form – i.e., charter – not by function, creating competitive drivers that realign financial-market product offerings based on the most favorable regulatory venue. This clearly has profound shareholder-value ramifications. Further, financial-market realignment has significant policy implications, especially if regulators do not anticipate the shift of activities from regulated banks to "shadow" firms and any risk this poses to consumers or other retail and wholesale financial-market participants or, under stress, to financial-market stability.

This paper argues that the shift of traditional financial-intermediation products from banks to non-banks could pose market-integrity, enforcement, and systemic risk. It does not argue that current and prospective rules, including those for the very largest banks, should be revoked or rewritten. Nor does it argue that bank rules must apply to non-banks. Rather, the analysis forecasts potential market consequences based on current observation, arguing that policy-makers should anticipate market realignment and, where this is found to pose risk, recalibrate their actions to ensure that like-kind activities are subject to like-kind rules regardless of the offering institution.

It is further argued that, financial institutions will need to recalibrate their strategy to maximize shareholder value under applicable rules. Recent technology-driven competitive realignment has demonstrated the franchise-value impact of new business models; where change is empowered or accelerated by regulatory forces, then franchise-value realignment will proceed at even greater speed with still more profound impact on market structure and regulatory policy.

This paper represents solely the views of the author and not necessarily those of any of the clients of Federal Financial Analytics, Inc. A list of these clients may be found on the firm's website (www.fedfin.com). As shall be seen there, they include a diverse group of financial services firms, private-equity firms for whom the firm provides M&A services, hedge funds for which investment and other advisory services are provided, and U.S. and global regulators, who receive analyses of current and prospective U.S. policy in this sector. The firm does not lobby.

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I. Current Policy Developments

A. Global Framework

In recent years, regulators around the world have begun to fear that an unintended consequence of the post-crisis reforms demanded of banks will drive risk into the "shadows," with the Group of Twenty (G-20) heads of state requiring financial regulators to assess this risk beginning in 2009.[1] The Financial Stability Board (FSB) has been charged by the G-20 with leading this effort due to its role as the parent organization of the Basel Committee on Banking Supervision (Basel Committee), the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS). As a result, the FSB has taken on extensive work-streams to define and measure shadow banking, as well as to press its subsidiary organizations to act on resulting risk.

In its most recent assessment of shadow banking, the FSB found that assets housed in firms it defines as shadowy equal $71.2 trillion. In the U.S. the percentage of applicable shadow-to-bank assets is particularly striking, with non-bank financial institutions holding 174 percent of the assets housed in banks in the U.S.[2] Other regions show far less striking percentages, with that in the European Union being 20 percent,[3] that in Japan pegged at 18 percent,[4] and China's shadow sector clocked in at 16 percent.[5] This might be comforting, at least for China, but staff at the Peterson Institute have recently taken issue with FSB's assessment of the Chinese shadow banking system, arguing that it did not take into account wealth-management products, the informal loan market, Internet lenders, and guarantee companies.[6]

As the China data demonstrate, the FSB's approach may not be an accurate assessment of the role of non-bank institutions because it relies on what in practice can be a narrow definition of shadow finance. Most recently, the FSB has defined this term to mean "credit intermediation involving entities and activities outside the regulated banking system."[7] This might seem a broad net in which to capture the basic business of banking, but as the China analysis suggests, it may well miss critical products and services long deemed integral to traditional banking. For example, asset management is not covered in the data except to the extent certain funds are captured, nor is providing payment services, clearing derivatives or foreign exchange transactions, or offering investment advice.

Based in part on this definition, the FSB has embarked on several projects to govern shadow activities. This further limits policy focus since these projects principally focus on money-market funds (MMFs), securitization, activities related to repurchase agreements (repos) and securities-financing transactions

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[1] G-20, *Declaration on Strengthening the Financial System – London* (Apr. 2, 2009), *available at* http://www.treasury.gov/resource-center/international/g7-g20/Documents/London%20April%202009%20Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf.
[2] FSB, *Global Shadow Banking Monitoring Report 2013* (Nov. 14, 2013), *available at* http://www.financialstabilityboard.org/publications/r_131114.pdf.
[3] *Id.* at 45.
[4] *See id.*
[5] See *id*.
[6] Borst, Nicholas, *Flying Blind, The International Economy*, 2014, *available at* http://www.international-economy.com/TIE_W14_Borst.pdf.
[7] FSB, *Shadow Banking: Strengthening Oversight and Regulation* (Oct. 27, 2011), *available at* http://www.financialstabilityboard.org/publications/r_111027a.pdf.

(SFT), and "non-traditional" insurance companies.[8] Because these business lines cross both banking and non-bank institutions, FSB proposals to date would govern both banks and "shadow" firms in theory, but likely only apply to banks because many jurisdictions – including the U.S. – lack statutory authority to apply prudential rules to non-banks.

To be sure, the FSB's work in the shadows has also focused on building out the "key attributes" of orderly resolution adopted for banking organizations[9] to include proposed resolution protocols for insurance companies,[10] financial-market infrastructure,[11] and entities like asset managers.[12] The FSB has also pushed its subsidiary organizations to designate systemically-important non-banks. The IAIS has done so for insurance companies[13] and the FSB, in conjunction with IOSCO, has proposed a methodology for doing so for financial companies that are neither banks nor insurers.[14]

Importantly, the FSB's definition is only one approach to defining "shadow banking." International Monetary Fund (IMF) staff has argued[15] that shadow banking includes all financial activities, except "traditional" banking – whatever that has become – if it requires a private or public backstop to operate. Based on this, many activities cited by the FSB would not be shadowy since many (e.g., MMFs) have no such backstop. The European Commission has concentrated on defining specific shadow activities – not firms – focusing particularly on securitization and securities lending, as well as on asset-backed commercial paper (ABCP) conduits, special-investment vehicles, MMFs, and other types of investment products with deposit-like characteristics.[16]

This paper argues that thorough assessment of the scope of shadow banking requires analysis of the complete spectrum of financial products and services key to the business of financial intermediation – that is, the business of converting savings and otherwise-idle funds into economically-active financial instruments like loans and risk-reduction products such as guarantees. Because safekeeping and transfer of funds is critical to financial intermediation, these services – e.g., providing transaction accounts and handling payments – should also be considered critical financial-intermediation services. Theoretically, asset management, traditional insurance, broker-dealer activities, and other financial services are not part of financial intermediation and thus perhaps not "shadowy." However, it is argued here that so constrained a view ignores the extent to which products that nominally do not provide maturity or liquidity transformation in fact do so. Examples include asset managers and private-equity

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[8] FSB, *Strengthening the Oversight and Regulation of Shadow Banking* (Apr. 16, 2012), *available at* http://www.financialstabilityboard.org/publications/r_120420c.pdf.
[9] FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Nov. 4, 2011), *available at* http://www.financialstabilityboard.org/publications/r_111104cc.pdf.
[10] FSB, *Consultative Document on Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* (Aug. 12, 2013), *available at* http://www.financialstabilityboard.org/publications/r_130812a.pdf.
[11] *Id.* at 15.
[12] *Id.* at 43.
[13] IAIS, *Global Systemically Important Insurers: Initial Assessment Methodology* (Jul. 18, 2013), *available at* http://www.iaisweb.org/view/element_href.cfm?src=1/19151.pdf.
[14] FSB, *Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/publications/r_140108.pdf.
[15] Claessens, Stijn and Ratnovski, Lev (2014) *"What Is Shadow Banking?"* Working Paper, IMF.
[16] European Commission, *Green Paper on Shadow Banking* (Mar. 19, 2012), *available at* http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf.

firms making loans, insurance companies providing credit products, and hybrid equity products that are in fact sources of credit intermediation.

Even if one could further disaggregate financial products, a focus on them does not provide a firm platform for risk identification and systemic regulation when rules are based on form, not function. As shall be detailed in the discussion of key business lines, many financial services – e.g., asset management – are very differently regulated when conducted in a bank versus a non-bank. These regulatory drivers pose both competitive and policy challenges, as also discussed below.

B. United States

In recent remarks, including those at the 2014 conference of the Federal Reserve Bank of Atlanta,[17] Federal Reserve Board (FRB) Chair Janet Yellen signaled concern that tough new rules such as the "enhanced supplementary leverage" capital requirements for G-SIBs could drive finance outside the regulated banking system. FRB Governors Tarullo[18] and Stein[19] have also addressed this, albeit with a specific focus on repurchase agreements (repos), securities-financing transactions (SFT), and the possible benefits of "universal margin" or similar standards in a sector also under active review by the FSB.[20]

However, the focus of U.S. policy to date has principally been to impose new rules on the biggest banks and gradually to designate non-bank systemically-important financial institutions (SIFIs) under the auspices of the Financial Stability Oversight Council (FSOC) chaired by the Secretary of the Treasury. Since the enactment of the Dodd-Frank Wall Street Reform and Recovery Act (Dodd-Frank) in 2010 allowed SIFI designation,[21] FSOC has to date designated only three companies (two insurers and one large finance company).

FSOC has also proposed that MMFs be designated as a systemic activity or practice pursuant to Dodd-Frank,[22] leading the Securities and Exchange Commission (SEC) to propose MMF rules on which action to date remains incomplete.[23] This activity-or-practice authority may be found in Section 120 of Dodd-Frank, which gives FSOC authority to designate such ventures and recommend action by the primary regulator. FSOC cannot, however, compel a dissenting regulator to take its recommended course.

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[17] FRB Chair Janet L. Yellen, *Opening Remarks at the Federal Reserve Bank of Atlanta's 2014 Financial Markets Conference* (Apr. 15, 2014), *available a:* http://www.federalreserve.gov/newsevents/speech/yellen20140415a.htm.

[18] FRB Governor Daniel K. Tarullo, *Speech at the Americans for Financial Reform and Economic Policy Institute Conference, "Shadow Banking and Systemic Risk Regulation"* (Nov. 22, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20131122a.htm.

[19] FRB Governor Jeremy C. Stein*, Speech at the Federal Reserve Bank of New York Workshop on Fire Sales as a Driver of Systemic Risk in Triparty Repo and other Secured Funding Markets, "The Fire-Sales Problem and Securities Financing Transactions"* (Oct. 4, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/stein20131004a.htm.

[20] FSB, *Strengthening Oversight and Regulation of Shadow Banking*, *op. cit.*

[21] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

[22] FSOC, *Proposed Recommendation Regarding Money Market Mutual Fund Reform,* 77 Fed. Reg. 69455 (Nov. 19, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-11-19/pdf/2012-28041.pdf.

[23] SEC, *Proposed Rule on Money Market Fund Reform; Amendments to Form PF,* 78 Fed. Reg. 36834 (Jun. 19, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-06-19/pdf/2013-13687.pdf.

Thus, the extent to which the FSOC can mandate like-kind regulation is limited. It would not, however, be irrelevant were FSOC to exercise it since primary regulators need at the least to respond to FSOC in a fashion similar to the SEC's and, should a primary regulator decide against action, others may intervene to limit the interconnectedness between designated systemic activities and the firms they regulate. Market discipline could also improve were FSOC guidance to make clear where emerging financial-market risks have been identified. This has, for example, been the result of a recent study by the Office of Financial Research (OFR) within Treasury when it identified asset management as a systemic worry.[24]

In addition to the FSOC's various authorities, Dodd-Frank addressed shadow banking in another key respect. With the creation of the Bureau of Consumer Financial Protection (CFPB), the law created a regulator with the power to govern retail consumer-financial services (other than insurance or broker-dealer operations) in like-kind and to supervise or, if necessary, enforce its rules in comparable fashion across the spectrum of entities offering designated products. To date, the CFPB has done so for mortgage origination (QM),[25] mortgage servicing,[26] debt collection[27] and remittance transfers.[28] The Federal Reserve also has limited authority to govern like-kind payment activities pursuant to the Electronic Fund Transfer Act,[29] although numerous exceptions in the law do not fully address many recent payment-technology innovations.

C. Other Nations

The European Union (EU) has taken more forceful action – albeit still just in proposed form – to address shadow banking. In the closing days before the election of a new European Parliament, Commissioner Michel Barnier laid out a new shadow-bank regulatory framework.[30] Much in it is designed to isolate non-banks from large banking organizations – a strategy with greater potential to curtail market realignment than comparable U.S. actions because of the far more dominant role of banks in EU financial markets.

Like the new framework in the United Kingdom, EU standards also are far less sector-specific than the U.S. For example, the EU's version of the Basel Committee's bank capital rules,[31] applies to all firms

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[24] OFR, *Asset Management and Financial Stability* (Sep. 30, 2013), *available at* http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.

[25] CFPB, *Final Rule on Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z),* 78 Fed. Reg. 6408 (Jan. 30, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-01-30/pdf/2013-00736.pdf.

[26] CFPB, *Final Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X),* 78 Fed. Reg. 10696 (Feb. 14, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-02-14/pdf/2013-01248.pdf.

[27] CFPB, *Advance Notice of Proposed Rulemaking on Debt Collection (Regulation F),* 78 Fed. Reg. 67848 (Nov. 12, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-11-12/pdf/2013-26875.pdf.

[28] CFPB, *Final Rule on Electronic Fund Transfers (Regulation E),* 78 Fed. Reg. 30662 (May 22, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-05-22/pdf/2013-10604.pdf.

[29] Financial Institutions Regulatory and Interest Rate Institutions Control Act, Pub. L. 95-630 (1978).

[30] European Commission, *Proposal for a Regulation of the European Parliament and of the Council on Structural Measures Improving the Resilience of EU Credit Institutions,* COM (2014) 43 final, Jan. 14, 2014, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014PC0043&from=EN.

[31] Regulation (EU) 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN.

active in covered activities, in sharp contrast to the U.S. approach[32] that covers only banking organizations.

Outside the U.S. and EU, shadow banking has been a major concern only in China. However, as noted, shadow products in China often fall well outside the FSB's framework because many are wealth-management or lending products created by bank and/or non-bank entities to skirt reporting, anti-corruption, and similar regulations. China's true "shadow" finance system is thus among the hardest accurately to measure or regulate, although that nation's regulators have begun to try to do so by dramatic and sudden changes to the cost of funding designed to choke off further growth.

II. What Drives Business from Banks

Historically, banks have been slow to change, in part because regulations make this difficult and in part because people do not become bankers because they are ready to take a walk on the wild side. And, when bankers and wild-side walkers are one and the same, bad things happen as was all too evident in recent years. Differentiating where competitive forces disadvantage banks solely because bankers fail to see change coming, where rules rightly inhibit adaptation, and where rules simply drive business outside banking for no sound reason is a complex undertaking. Understanding where comparative advantage is driven by innovativeness versus where it is defined instead by rule is critical to assessing the extent to which non-banks will win market share largely through the action of regulatory decisions, not endogenous competitive factors.

Historically, it was largely irrelevant that banks could not compete because they had few competitors due to the fact that banks had unique government-bestowed advantages that more than offset the cost of regulation or their own reluctance to take chances. Critical advantages were:

- History: Hard experience during the 1930s taught depositors and investors that banks were safe havens for funds and trusted custodians of other assets.

- Deposit Insurance: Even with waning tradition, customers understood that funds housed at a bank had government insurance well above the usual amounts retail customers held at them. Brokered deposits and other products also created effective safety nets well beyond nominal insurance limits

- Too-Big-to-Fail Expectations: Even when funds exceeded insurance thresholds or were other obligations of an insured depository or its parent holding company, markets expected federal backstops not just for the largest banks, but even for small ones resolved through government-assisted transactions that obviated loss to all but the failed bank's shareholders – and, sometimes, not even for them.

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[32] OCC, FRB, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule,* 78 Fed. Reg. 62017 (Oct. 13, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf.

- Liquidity Support: Only insured depositories in the U.S. have access to the Federal Reserve's discount window and, thus, to emergency support, as well as to funding that smoothes over seasonal or other factors that could otherwise create market uncertainty.

These factors effectively created monopoly franchises – that is, firms that could offer products – e.g., government-protected safe havens – that ensured sufficiently stable returns to investors to create capital that supports steady industry growth. Size – not rules – created competitive disparities in terms of the cost of regulation, operational efficiency, and the ability to invest in technology and other infrastructure to support more complex undertakings like asset securitization as technology and other factors began to redefine finance in the late 1970s. Very limited non-traditional activities were allowed in bank holding companies (BHCs), but the inter-affiliate transaction limits in Sections 23A and 23B of the Federal Reserve Act[33] were intended to insulate the insured depository from risk and, thus, to preserve the value of the monopoly franchise not just to shareholders, but also to the broader public-policy goals for which these benefits were first afforded.

What changed? Space does not here permit an extensive analysis of the transition from traditional banks and BHCs (firms where the insured depository constituted the vast majority of assets and earnings) to diversified holding companies engaged in a wide array of financial – and sometimes even commercial – services with widely varying risk profiles. Analysis often points to the 1999 enactment of the Gramm-Leach-Bliley Act[34] as the cause of the break-down in traditional banking, but its source actually can be found far earlier in the U.S.

Starting in the late 1970s, sharp spikes in inflation and, thus, in interest rates created serious problems for insured depositories that were then under restrictions (known as Regulation Q) that imposed ceilings on the rates that could be paid to depositors. As money-market and mutual funds evolved in rapid order to meet customer demand for economic return under inflationary conditions, banks lost a critical leg in the financial-intermediation process: cash-equivalent liabilities. They retained, however, the other benchmarks of their monopoly franchises – deposit insurance, TBTF status, and FRB access.

As the Monetary Control Act of 1980[35] ended Regulation Q, the reason not to be a bank abated and many firms sought to gain these advantages. This lead quickly to the proliferation of "non-bank banks" – that is, firms that owned insured depositories that were not forced under the activity restrictions applicable to BHCs. The Competitive Equality Banking Act of 1987[36] sought to limit this, but did so in an imperfect way that did little to quash non-bank entry into banking products and services backed by all the government-afforded benefits once premised on costly regulation and activity restrictions.

By 2007, markets largely discounted regulatory differences between banks and non-banks in like-kind products because non-banks owned banks and banks engaged in all sorts of non-bank activities. Because the regulatory burden of being a bank was often less than the value of transferring monopoly-franchise benefits afforded only to banks (e.g., low-cost, insured deposits as a funding source), many activities occurred in increasingly giant financial holding companies that housed insured depositories and a wide range of activities also of competitive interest to insurance companies, hedge funds, private-equity firms, broker-dealers and other non-bank entities. Non-bank banks like AIG and Merrill Lynch

[33] The Federal Reserve Act, Pub. L. No. 63–43 (1913), §§ 23A-23B.
[34] Financial Services Modernization Act, Pub. L. No. 106-102 (1999).
[35] Depository Institutions Deregulation and Monetary Control Act, Pub. L. No. 96-221 (1980).
[36] Competitive Equality Banking Act, Pub. L. No. 100-86 (1987).

also used insured depositories to gather hundreds of billions in insured deposits and, thus, advantageously to fund non-banking activity without any meaningful regulatory-cost obstacles.

The 2008 crisis and all the reforms subsequent to it have reversed this integration, but largely only with regard to companies that own insured depositories and, even then, not entirely unless the parent organization is a BHC or foreign banking organization (FBO). Because like-kind activity does not now require like-kind regulation or necessarily limit access to benefits once afforded only to monopoly franchises, regulations increasingly drive competitiveness and, thus, market structure, as shall be demonstrated in the review of competitiveness by sector according to regulation for business lines key to financial intermediation.

Nothing in the analysis presented below should be interpreted as a criticism of the rules analyzed here for their impact as competition drivers of various financial-intermediation business lines. Many will have a major and beneficial impact in preventing renewed systemic risk, especially to the extent it may originate in regulated banking organizations. However, virtue is not always its own reward – in this instance, it may have unintended costs. Key drivers in the wake of the Dodd-Frank Act and related actions include:

- Capital: This is the driver typically cited as the major propellant of finance from traditional banks into the shadows. It is indeed a major determinant of who does what in the financial-services industry because earnings across the sector are judged in large part by return on equity (ROE). The higher the amount of common equity a firm must hold, the greater the revenue it must achieve from capital-bearing assets to be competitive from a market-capitalization perspective unless its cost of capital goes down in lock-step. It is critical in assessing the competitive consequences of capital regulation to conduct these analyses not only in the risk-based context discussed above, but also to factor in the global and U.S. leverage requirements. These demand a simple amount of capital against both on-and off-balance sheet assets regardless of risk, with these levels now set at 5% for the largest BHCs and 6% for their insured-depository subsidiaries.[37] These capital charges are uneconomic for low-risk assets like cash and quality sovereign obligations, thus creating significant potential market distortions, whatever their prudential benefit.

- Liquidity: Compounding the capital-driven changes are new liquidity rules. The most immediate of these in the U.S. is a liquidity coverage ratio (LCR).[38] This will be followed shortly by a net stable funding ratio (NSFR).[39] Each will require banks to hold large amounts of "high-quality liquid assets" that are penalized under the leverage rules cited above. New "systemic" liquidity standards promulgated by the Federal Reserve[40] may also soon be joined by a capital surcharge

[37] OCC, FRB, FDIC, *Final Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions* (Apr. 8, 2014), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140408a1.pdf.

[38] OCC, FRB, FDIC, *Proposed Rules on the Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring*, 78 Fed. Reg. 71818 (Nov. 29, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-11-29/pdf/2013-27082.pdf.

[39] Basel Committee, *Consultative Document, Basel III: The Net Stable Funding Ratio* (Jan. 14, 2014), *available at* http://www.bis.org/publ/bcbs271.pdf.

[40] FRB, *Final Rule on Liquidity Requirements for Bank Holding Companies,* 79 Fed. Reg. 17240 (Mar. 27, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-03-27/pdf/2014-05699.pdf.

for G-SIBs found to hold undue amounts of short-term liabilities.[41] One effect of all of these rules will be for banks to reduce "runnable" liabilities, thus making them and – it is hoped – the financial system safer. However, intraday and overnight businesses that now depend on banks could transfer to shadow institutions, especially since the new liquidity rules will come in concert with margin requirements for derivatives transactions.

- Collateral Shortfalls: All of the rules cited above together could lead to a significant overall shortfall in high-quality assets. Global regulators have pointed to this problem[42] and noted fears that it will lead not only to a shift of repos and securities financing to hedge funds, but perhaps also to broader obstacles to effective monetary policy.

- Resolution: One major lesson of the crisis is the need for protocols by which SIFIs of all stripes can be resolved without resort to the trillions in taxpayer support extended during the recent crisis to banks and non-banks alike. Although work to date in the global arena has begun to consider orderly liquidation for systemic insurance companies,[43] financial-market infrastructure,[44] and asset managers,[45] the U.S. framework so far is not only largely conceptual, but also bank-centric.[46] The biggest BHCs may soon also come under a requirement to issue larger amounts of unsecured long-term debt as "contingent capital," altering funding market structures and creating new opportunities for non-banks, including SIFIs. Still more fundamental is the expectation by markets that, while the biggest banks may no longer be TBTF, other SIFIs remain effectively backed by the taxpayer because the federal government would have no alternative but to back them up in a crisis. This is particularly worrisome with regard to financial-market infrastructure like the central counterparties (CCPs) required by Dodd-Frank to takeover much derivatives trading from the largest banks.[47]

- Prudential Regulation: All of the rules summarized above and so many others are part of a micro- and macro-prudential framework being constructed by bank regulations. Non-bank regulators have over-arching priorities by law or precedent that are at significant variance from these safety-and-soundness goals. For example, securities regulators such as the SEC focus largely on investor protection. As the EU's head of securities regulation recently noted,[48] this makes them ill-suited for systemic prudential regulation. To the extent that investor protection is achieved by disclosures and/or post hoc enforcement, the structure is radically different from bank regulation and imposes very different costs that result in disparate strategic decisions by

[41] FRB Governor Daniel K. Tarullo, *Speech at the Americans for Financial Reform and Economic Policy Institute Conference*, *"Shadow Banking and Systemic Risk Regulation"* (Nov. 22, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20131122a.htm.
[42] Committee on the Global Financial System, *Asset encumbrance, financial reform and the demand for collateral assets* (May 27, 2013), *available at* http://www.bis.org/publ/cgfs49.pdf.
[43] FSB, *Consultative Document on Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions, op. cit.*
[44] *Id.* at 15.
[45] *Id.* at 43.
[46] FDIC, *Notice on Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy,* 78 Fed. Reg. 76614 (Dec. 18, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-12-18/pdf/2013-30057.pdf.
[47] Dodd-Frank Act, §§ 701-774.
[48] Fleming, Sam, and Stafford, Phillip, *Esma chief warns securities regulators on monitoring risk*, *Financial Times,* Apr. 20, 2014, *available at* http://www.ft.com/intl/cms/s/0/fe01af4e-c638-11e3-9839-00144feabdc0.html#axzz2zoCdEIC3.

affected firms offering like-kind services. The CFPB has like-kind consumer-protection authority over much of the U.S. retail-finance industry, but it is not allowed to be a prudential regulator and, thus, cannot address safety-and-soundness risk outside the scope of the federal banking agencies.

- Supervision and Examination: Reflecting their different missions, non-bank regulators often do not directly supervise the firms they regulate for prudential purposes or, where this is done, do so only for very limited matters. In sharp contrast, BHCs and insured depositories are regularly examined and, at the largest institutions, subject to extensive scrutiny by teams of often-resident examiners. Regulators also demand that banks have internal governance that sets "risk tolerances" and ensures adherence to them. The Office of the Comptroller of the Currency (OCC) has even proposed "heightened expectations" for national banks that makes safety and soundness, not return to shareholders, the principal objective of senior management and the board of directors.[49]

- Activity Restrictions: In the U.S., banking has long been subject to activity restrictions intended to separate "banking" from "commerce." Due to the legislation cited above, these terms have become increasingly ambiguous in recent years, allowing banks into non-traditional activities and giving non-banking firms new powers in both direct financial intermediation and many related services. Product choices by banks and non-banks where each is allowed to offer the same ones is driven by the regulatory factors outlined here, as well as by applicable market considerations (e.g., customer configuration and resulting demand). However, where product limitations segregate services solely on grounds of whether the offerer is or is not a bank, business will flow to unaffected firms as long as there is market demand for it. A clear case in point here results from the Volcker Rule (Section 619 of the Dodd-Frank Act). It has expressly barred banks and BHCs from certain proprietary trading and hedge/private-equity fund positions. As a result, business once done in banks has shifted to the shadows. Another example of product restrictions derives not from express law, but from regulatory pressure related to banks offering funding or other services to customers engaged in business lines of which the bank regulators or Department of Justice do not approve even though an activity – e.g., payday lending – is legal in the applicable jurisdiction.[50]

- Innovation: Technology and other market drivers apply uniformly across the economy, but may not be as easily adopted by regulated banks even if their cultures incline them towards seeking first-mover advantage. Governance standards related to the risk tolerances cited above and many specific standards applicable to individual business lines within each bank require senior management to delineate and the board to approve all relevant risk positions related to a new product and detail in advance how each is to be mitigated and the maximum threat any new venture might pose. This not only discourages risk-taking – as intended – but also speedy, albeit prudent, innovation. Regulators are also wary of new developments like social media, with the

[49] OCC, *Proposed Rules and Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations,* 79 Fed. Reg. 4282 (Jan. 27, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-01-27/pdf/2014-00639.pdf.
[50] Department of Justice Financial Fraud Enforcement Task Force Executive Director Michael J. Bresnick, *Speech at the Exchequer Club of Washington, D.C.* (Mar. 20, 2013), *available at* http://www.justice.gov/iso/opa/doj/speeches/2013/opa-speech-130320.html.

banking agencies recently issuing extensive guidance that, while again aimed at risk, may also suppress competitiveness.[51]

- Legal and Reputational Risk: Many consumer-protection, anti-money laundering (AML), tax-enforcement, and cross-border sanction rules apply regardless of an institution's charter. However, law-enforcement and other officials often are most vigilant enforcing standards against BHCs and insured depositories, with these institutions also more often than not targets of class-action litigation. This results not only from the critical role banks play in areas like cross-border finance, but also from requirements that banks hold large reserves for legal and reputational risk. This makes them more fruitful targets of enforcement action especially when, as in recent mortgage actions, other targets have gone bankrupt, revised their business plans, or operate under "haven-state" regulations in nations such as the Cayman Islands.

- Compensation: Dodd-Frank[52] and other rules now subject bank and BHC executive compensation to pending regulation. While some argue these are insufficient to restrict risk-taking, they still apply constraints not applicable in other sectors (e.g., private-equity firms, hedge funds, commodity traders). As a result, the most successful traders and/or executives may exit regulated institutions, limiting their ability to innovate not due to caution, but rather to inequitable compensation.

III. Strategic Analysis of Affected Business Lines

The analysis below is intended to be illustrative, noting several recent developments germane to critical business lines and likely regulatory drivers. Because this paper is premised on a broad definition of shadow banking's possible reach – that is, one beyond the FSB definition that drives much current regulatory work – a wide spectrum of retail, wholesale, and financial-infrastructure business activities is addressed to recommend areas of attention for both strategic planning and policy attention.

A. Retail Finance

This sector is here defined as that which provides transaction, savings, investment, and lending services to individuals, families, and small businesses that rely on small-dollar financing not typically associated with lending to small- and medium-size enterprises (SMEs) with sales up to an annual volume of $50 million. SME funding is addressed in the wholesale-finance analysis below. Business lines with particular relevance to small business other than SME are mortgage finance, credit cards and installment lending – all long used by entrepreneurs as start-up capital, along with new options such as crowd-source funding. Key products and services in the retail-finance sector and competitive realignments related to regulatory drivers are:

- Cash-Equivalent Deposit Products: As noted earlier, MMFs were largely invented to compete with deposits then subject to interest-rate restrictions. Although these rule were subsequently repealed, MMFs have become a funding-market fixture. Although treated by investors like

[51] Federal Financial Institutions Examination Council, *Social Media: Consumer Compliance Risk Management Guidance,* 78 Fed. Reg. 76297 (Dec. 17, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-12-17/pdf/2013-30004.pdf.

[52] Dodd-Frank Act, §§ 951-957.

deposits, MMFs do not pay deposit-insurance premiums or hold capital against the assets in which funds are held as is required for bank liabilities. The SEC has proposed rules in this arena,[53] but their future is uncertain and they are unlikely to impose regulatory burdens of like-kind to MMF operations within banks, let alone to insured deposits. Private-equity firms are entering this sector, often for retail investors, gaining a new source of funds for investments not allowed for banks. Banks may also offer MMFs, but when they do so they are subject to operational-risk capital, prudential supervision, and liquidity requirements not applicable to non-bank MMF providers. The FRB is also considering a special capital charge for big banks in this sector. New products in this sector – e.g., exchange-traded funds – are increasingly being provided by hedge funds and other non-banks although some banks are active in this area despite added regulatory burden.

- Payment Services: This sector is undergoing a dramatic restructuring due to factors such as new digital currencies, smart-phone payment instruments, and on-line payment options such as Amazon, PayPal and Facebook. Facebook is in fact contemplating not just traditional financial services for millions of its participants, but also even creating its own currency.[54] Surveys show that customers, especially younger ones, trust non-banks more than banks to handle transactions despite the lack of clear contractual provisions, regulations, and funds to ensure customer recovery in the wake of fraud, transaction error, or system failure.[55] As with recent cyber-attacks against non-bank vendors, risk in the payment arena can be transmitted to banks either as front-end vendors or financial-market infrastructure service providers, with contagion risk in the latter arena of potentially systemic size depending on the market role and linkage of non-bank payment-service providers. Know-your customer (KYC) and similar rules may legally apply to non-banks, but are often not complied with or enforced.

- Asset Securitization: This business line structures retail loans (e.g., mortgage, auto, student, and credit-card loans) into asset-backed securities (ABS) and is now the principal market driver in affected segments. Banks have significantly reduced their share of mortgage finance because government-sponsored enterprises (GSEs) or non-banks play major roles in securitization and related mortgage activities with few capital, liquidity, or prudential rules. The new risk-retention rules in Dodd-Frank[56] largely apply regardless of ABS issuer, but non-banks need hold no capital against their risk-retention positions and thus have major market advantage. GSE and Federal Housing Administration originations are also exempt from risk retention, providing a major avenue for non-bank lenders. Commoditized pricing in ABS-driven sectors limits the ability of banks to cross-market loans to retail customers, empowering non-bank originators using warehouse financing and other products to access secondary markets. Current risk-based and leverage rules also create incentives for banks to securitize low-risk assets and hold higher-risk ones in portfolio. The Volcker Rule also limits the ability of banks to invest in ABS for their trading book, as non-sovereign/GSE holdings are barred under proprietary-trading limitations.

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[53] SEC, *Proposed Rule on Money Market Fund Reform; Amendments to Form PF, op. cit.*

[54] Davies, Sally, Robinson, Duncan and Kuchler, Hannah, *Facebook targets financial services, Financial Times,* Apr. 13, 2014, *available at:* http://www.ft.com/intl/cms/s/0/0e0ef050-c16a-11e3-97b2-00144feabdc0.html#axzz30HQGqrMR.

[55] Bessel, Robert, *Lack of Trust Threatens the Mobile Channel, American Banker,* Mar. 11, 2014, *available at* http://www.americanbanker.com/bankthink/lack-of-trust-threatens-the-mobile-channel-1066108-1.html.

[56] Dodd-Frank Act, § 941.

- Mortgage Finance: Even where securitization is not involved, non-banks have gained a major role in mortgage finance. In the run-up to the crisis, this occurred in large part due to the absence of prudential requirements and the demand from the GSEs and others for subprime mortgage-backed securities (MBS). In the wake of the crisis, market reconfiguration still favors non-banks due to the capital requirements applicable to mortgages held in portfolio (especially low-risk ones) and those applicable to mortgage servicing rights (MSRs). These capital requirements, combined with legal- and reputational-risk concerns, have led to a rapid migration of mortgage servicing from banks to non-banks.

- Private Banking: This is an array of deposit, lending, investment, and related financial services provided to high net-worth individuals and similar entities. This area is subject to significant legal and reputational risk due to the importance of AML, tax-compliance, and related requirements. KYC and other requirements applied by banks have created significant obstacles to business development and led many banks to curtail operations in this arena, where market share is also adversely affected by new product offerings often provided at lower cost by boutique investment advisers. Most net-inflow growth in this area in the U.S. and Canada is into these non-bank firms.[57]

- Small-Business Lending: Peer-to-peer finance, crowd-source funding, and retail-payment providers like PayPal have now become major participants in this sector. Capital requirements are now high for small-business loans vis-à-vis other providers exempt from comparable requirements and borrower-protection restrictions. The ability of banks to fund small businesses through home-equity mortgages or credit cards has been constrained by applicable rules on these products. The Small Business Administration (SBA) has recently sought to promote non-bank entry into this sector, with Treasury Secretary Lew pushing for it to increase credit availability.

- Consumer Lending: The FSB has defined "finance companies" as a potential "shadow" sector in its most recent analysis, although no rules related to them have advanced in the global arena. The FSOC has designated GE Capital – a major force in this arena – as a non-bank SIFI. However, little has occurred to curtail non-bank finance other than in the payday arena, with the FSOC most recently measuring this sector at $840 billion.[58]

B. Wholesale Finance

This sector is defined here to cover a wide array of corporate-financial services, capital-markets activities, and complex financial-product offerings. Note that some offerings included in the above retail analysis also apply to wholesale finance (e.g., asset securitization, MMFs).

- Corporate Finance: Bank activity in this sector is constrained by an array of regulatory drivers, with capital standards and the Volcker Rule (which limits holdings in collateralized loan obligations) perhaps the biggest bank-specific factors. However, 2013 guidance on leveraged

[57] McKinsey & Company, *Global Private Banking Survey 2013* (Jul. 2013), *available at* http://www.mckinsey.com/~/media/McKinsey/dotcom/client_service/Financial%20Services/Latest%20thinking/Wealth%20management/Global_private_banking_survey_2013_Capturing_the_new_generation_of_clients.ashx.
[58] FSOC, *2013 Annual Report* (Jun. 26, 2013), *available at* http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf.

loans from the OCC and FRB[59] has also made certain transactions off-limits. Prudential restrictions also limit bank activity in corporate loans with flexible terms ("cov-light" paper) with private-equity firms and hedge funds now holding a sixty percent share in this sector. Peer-to-peer lending and crowd-source funding are also creating alternative non-bank channels that fund business ventures, as are insurance companies and private-equity firms that have begun not just to invest in companies, but also to lend to them.

- Asset Management: This business line sweeps from retail investors who use MMFs or have firms manage their hoped-for wealth to institutional investors that rely on complex products, trading services, and proprietary advice. With very few exceptions, activities allowed for non-bank asset managers are fully possible within banks and BHCs. However, applicable rules are often different not just for traditional asset-management services (banks are subject to trading-book, operational-risk and equity-tranche capital), but also for the array of new services – e.g., credit-risk products – increasingly on offer from non-bank firms in this sector. As noted, global and U.S. regulators are considering systemic designation for some asset managers, in part because the largest may pose systemic risk given the absence of applicable resolution protocols that prevent contagion risk related to rehypothecation or panic-driven investor requests for secure funds.

- Commercial Real Estate (CRE): Tough new capital rules and concentration restrictions now constrain CRE, especially loans suitable for securitization as commercial MBS (CMBS). The risk-retention rules cited above are a particular concern, but other prudential standards also limit the role banks play vis-à-vis that of insurance companies, foreign investors, and other lenders and securitizers.

- Securities-Financing Transactions: SFT is an area particularly subject to disintermediation because of the leverage and liquidity rules, as well as pending margin and "runnable" liability surcharges. Insurance companies and hedge funds are likely to be the most significant competitors here even though pending credit-exposure rules[60] for now do not constrain bank SFT.

- Real Estate Investment Trusts (REITs): Although various regulators have expressed fears that REITs are systemic, no prudential or investment-company registration rules now apply to this highly-concentrated sector with approximately $350 billion in assets[61] subject to potential interest-rate risk and solvency pressure depending on the status of GSE reform.

- Private Equity: The FSOC has estimated this sector as holding approximately $2 trillion in assets in 2012.[62] These firms can rebate transaction fees in a manner barred for broker-dealers,

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[59] OCC, FRB, FDIC, *Final Interagency Guidance on Leveraged Lending,* 78 Fed. Reg. 17766 (Mar. 22, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-03-22/pdf/2013-06567.pdf.

[60] Basel Committee, *Supervisory framework for measuring and controlling large exposures - final standard* (Apr. 15, 2014), *available at* http://www.bis.org/publ/bcbs283.pdf.

[61] OFR, *2013 Annual Report* (Dec. 17, 2013), *available at* http://www.treasury.gov/initiatives/ofr/about/Documents/OFR_AnnualReport2013_FINAL_12-17-2013_Accessible.pdf.

[62] FSOC, *2013 Annual Report, op. cit.*

including those owned by BHCs, giving them a competitive edge compounded by exemptions from capital, liquidity, conflict-of-interest, and other rules.

- Hedge Funds: These funds hold $2.8 trillion in assets,[63] with significant growth in the wake of the financial crisis. The Volcker Rule now bars bank and BHC holdings in hedge funds, but new U.S. law[64] allows solicitation of retail investors with few restrictions. Private-equity funds have thus begun to sponsor retail-focused hedge funds. Hedge funds may now account for up to 50% of foreign exchange and interest-rate risk trading.[65]

- Commodities Trading: Following press and Congressional pressure, the Federal Reserve has proposed to limit or even bar BHC activities related to physical commodities.[66] However, the distinction between financial activities in this sector and commercial ones has become increasingly blurred, with very large commodity firms taking an increasing role in finance even as a combination of activity limits and prudential rules has led several large banks to exit this sector. Hedge funds and private-equity firms have also begun to play a far larger role in hedging and related finance in this sector free from Volcker Rule and other restrictions. Legal and reputational risk plays a major role here, as investigations related to benchmark violations may further constrain bank involvement in remaining permissible commodities activities.

- Broker-Dealers: Different capital regimes have major impact here since bank capital rules sharply curtail trading inventories under current rules, a problem exacerbated by Volcker constraints on proprietary trading and possible limitations on the interaction between banks and permissible broker-dealer operations. The FRB continues to consider a surcharge for large banks/BHCs that control broker-dealers, challenging current bank concentration in this sector, especially with regard to prime brokerage activities.

C. Financial-Market Infrastructure

Financial-market infrastructure providers are called financial-market utilities in the Dodd-Frank Act.[67] Subject there to designation by the FSOC and regulation by the FRB, SEC, and/or CFTC, the framework actually applicable to them remains very much under development. As noted above, prudential rules vary dramatically across firms in this sector and resolution protocols to prevent TBTF status do not yet exist for them. Margin, credit-exposure, and similar requirements applicable to use of CCPs has higher costs for banks versus non-banks, and operational-risk, compliance, and other requirements generally do not apply to infrastructure operations in the payment, settlement, and clearing arenas outside of BHCs or insured depositories.

[63] Foley, Stephen, *Hedge holdings soar despite returns trailing behind equities*, *Financial Times*, Dec. 11, 2013, *available at* http://www.ft.com/intl/cms/s/0/5ed8bd60-61a5-11e3-916e-00144feabdc0.html#axzz30CPeL4wv.
[64] Jumpstart Our Business Startups Act, Pub. L. No. 112–106 (2012).
[65] Jenkins, Patrick and Schäfer, Daniel, *Derivatives move from banks into the shadows, Financial Times*, Sep. 11, 2013, *available at* http://www.ft.com/intl/cms/s/0/b98ec11c-1b07-11e3-a605-00144feab7de.html#axzz30CPeL4wv.
[66] FRB, *Advance Notice of Proposed Rulemaking on Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities,* 79 Fed. Reg. 12414 (Mar. 5, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-03-05/pdf/2014-04742.pdf.
[67] Dodd-Frank Act, §§ 801-814.

As more business is concentrated in CCPs as a result of G-20 and Dodd-Frank requirements, systemic liquidity risk in these ventures has become a major concern of central banks. Some have proposed providing them with access to central-bank liquidity facilities such as the FRB's discount window, but it is unclear whether bank-like rules would apply were this to occur. The FRB has authority under Title XI of the Dodd-Frank Act to provide emergency liquidity to CCPs under certain circumstances, perhaps encouraging risky behavior at these entities or members since standards applicable to banks do not apply.

IV. Policy Ramifications of the Shift to Shadow Banking

As the analysis above demonstrates, markets for retail and wholesale finance, as well as the overall infrastructure of the financial system, are rapidly realigning into a competitive landscape in which non-bank institutions – including some of seeming systemic size and heft – play major roles that could put regulated banks – even the very biggest ones – under acute franchise-value pressure.

Given that realignment has begun largely ahead of the effective date and even of the finalization of many of the regulatory drivers noted above, it appears clear that a paradigm shift in U.S. financial services is well under way. Nevertheless, a response to this transition is so far only fragmentary and in large part inconsistent. Efforts to date in the U.S. include:

- Systemic Designation: A key plank in Dodd-Frank is the authority granted to the FSOC to designate non-bank SIFIs so that regulation addresses potential risk and resolution protocols to prevent bail-outs. Since 2010, however, the FSOC has designated eight financial-market utilities and only three SIFIs (AIG, GE Capital, and Prudential). No systemic rules have been developed for any of them, although the FRB has said it is beginning to supervise their operations to some degree. As noted above, the FDIC has yet even to consider how it might approach orderly liquidation of a non-bank.

- Systemic Activities or Practices: Perhaps anticipating the problematic nature of firm-by-firm SIFI designation, Section 120 of Dodd-Frank gives FSOC power also to designate activities or practices (including those with undue impact on low-income individuals) as systemic. Upon such designation, the FSOC is to lay out its preferred regulatory framework and the appropriate federal regulator is either to implement it or explain in writing why it decided not to do so. Since 2010, the FSOC has proposed only the MMF framework described above, with the SEC so far hesitant to act upon it. Treasury's Federal Insurance Office (FIO) has also suggested that private mortgage insurance be subject to systemic designation.[68]

- Like-Kind Rules: So far, outside of the limited number of CFPB rules described above, the only sector where these are contemplated is repos, with the FSB proposing the "universal margin" rules noted above and the FRB planning to implement them to the extent of its current statutory authority. This may permit application of margin requirements not just to banks and BHCs, but also to broker-dealers. It will not, however, allow similar standards for hedge funds and other key participants in repos and securities financing. There has been talk of enhancing inter-affiliate transaction restrictions so that the unique benefits afforded insured depositories are

[68] FIO, *How to Modernize and Improve the System of Insurance Regulation in the United States* (Dec. 12, 2013), *available at* http://www.treasury.gov/initiatives/fio/reports-and-notices/Pages/default.aspx.

not transmitted to parent organizations, with Dodd-Frank even imposing a three-year moratorium – now lapsed – on chartering new non-bank banks.[69] However, to date, inter-affiliate transaction rules remain largely as before the crisis.

The effect of this patchwork framework is sometime designation of non-bank SIFIs, sometime activity-or-practice regulation (or at least proposals for it), and sometime like-kind standards. Where this patchwork of rules does not apply, the following concerns arise:

- Retail borrowers and investors are at risk of loss of principal, their homes, or other crucial assets depending on their product and service provider.

- "Haven" jurisdictions are created because federal or state law does not apply, encouraging the flight of certain services to lax prudential or consumer-protection regimes.

- Product innovation based on technological feasibility outstrips prudential and social-policy concerns, especially where these protections apply only to "legacy" providers.

- Resolution protocols are incomplete, exposing the financial system and broader economies to volatility or even crisis if systemically-SIFIs – especially non-bank or utility ones – come under stress.

The last concern – renewed systemic risk – is perhaps the most sobering of these worries, although regulatory arbitrage also creates noted equity and consumer-investor hazards of mounting proportions. FSOC statements and those of many other regulators since the crisis have concluded that all of the new capital, liquidity, and – when finalized – resolution standards for big banks will not just make them bullet-proof, but also largely end TBTF. This forecast may be true for the biggest BHCs given the extreme scenarios required in recent Federal Reserve stress tests, but even for them it is far from certain. Systemic risk arises not just from the risks evident in the run-up to the crisis – i.e., low capital, limited liquidity, poor governance – but also from exogenous shocks far afield from those bankers and their regulators can anticipate or prevent. Operational risk is critical here – that is, the potential that natural or man-made disasters like the 9/11 attacks – cripple financial-market infrastructure, but geopolitical risk such as that now evident in the Ukraine is also a major source of systemic risk evident in past crises. Since operational and geopolitical risk strike SIFIs without regard to charter or rule, the risk of misaligned regulation can create severe shock if market power is concentrated outside the scope of prudential rules and resolution protocols.

V. Further Considerations

This paper does not argue that some or all of the firms cited above – e.g., MMFs, asset managers, hedge funds – are systemic and should be regulated as such. As noted, just because a business line is shifting from banks to non-banks does not necessarily mean regulatory risk results from lax rules – it could just as easily mean that the rules applied to banks are unduly restrictive or that the bank rules are irrelevant to competitive realignment because bankers are slow to change. The unique advantages afforded insured depositories – FDIC insurance and FRB liquidity support – also argue for differential regulation where these unique benefits afford unique privileges.

[69] Dodd-Frank Act, § 603.

What this paper does argue is that the increasingly stringent rules applied almost exclusively to the very largest U.S. banks are combining with rapid market change to create a major risk to financial stability and even macroeconomic prosperity. This risk arises because like-kind activities are increasingly not regulated in like-kind fashion. Regulation largely follows form – that is, the charter a firm selects – not function – the services provided and the risks presented.

Because several large non-banks were spark-plugs to the 2008 Great Recession, policy-makers have generally recognized that "shadow" firms may pose profound risk. However, actions remain largely bank-centric, creating still stronger drivers of financial activity outside of the regulated-banking sector that is unlikely to be reversed when or if regulators finish designating systemic non-banks or building out prudential standards for particularly important business lines.

As the slow pace of action in the six-plus years since the crisis demonstrates, policy-maker consensus is slow-moving. In contrast, CEOs and their boards of directors often make competitive decisions on a quarter-by-quarter basis. One may bemoan a lack of long-term planning, but "business is business" and firms must thus rapidly reposition themselves as conditions – including regulatory ones – evolve.

There is no quick fix to the asymmetries rapidly defining the financial-services industry. There are, though, two recommended actions to mitigate risk to shareholders and those to the broader market. These are:

- For financial-services firms, competitiveness is increasingly defined by all of the regulatory drivers noted above, with this particularly true in the affected business lines also addressed here. Strategic planning thus should take a forward-looking approach to regulatory analytics, not looking in the rulebook to see what compliance steps are required once a massive new standard is promulgated, but rather forecasting the policy framework to optimize comparative advantage. At the least, firms facing unique rules will know this first and win first-mover advantage as they divest newly-unprofitable activities. At best, first-mover advantage will define innovative products offered with policy advantage.

- For policy-makers, it is time to reassess all of the work still being dedicated to painstaking efforts to define systemic risk on a firm-by-firm basis. Instead, clear standards should define what protections – e.g., deposit insurance, central-bank liquidity support – apply to banking organizations and how these backstops will be protected when a bank – including a very big one – comes under stress. If government protection is carefully confined to limited counterparties under specific circumstances, then banks – including very big ones – will be far less systemic and thus need far fewer bank-centric rules. Activities they offer will still pose risks to consumers and investors, as well as to financial stability. However, these risks in banks are generally no different than the risks posed by non-banks. Policy-makers must thus as a matter of urgency identify which activities pose the greatest risk, what rules mitigate them, and how like-kind requirements can be applied across the spectrum of like-kind financial institutions. Law often allows action now, especially in the U.S., so lack of authority is scant rationale for lack of definitive action.