Banking Without Banks:
Regulatory Arbitrage and What to Do About It

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- Nonbank financial companies now have almost three times more macroeconomic impact than banks and are primed to grow still bigger without regulatory barriers.
- Banking regulators are crafting rules with blinders on believing that others are responsible for nonbanks' systemic risk and will clean up after them when it comes to product and service migration.
- Others – i.e., the FSOC – are unable to limit much migration no matter how hard they now say they'll try.
- Bank regulation must take regulatory arbitrage into account and, where necessary standards adversely affect bank competitiveness, address inter-connectedness to give both banks and the financial system a fighting chance.
- A critical and overlooked channel of systemic risk arises from massive nonbank providers of critical financial infrastructure. These can and should be quickly designated as financial market utilities.

It is a real pleasure being here with such an impressive audience on this high-impact panel. We will surely discuss a host of significant policy considerations as the banking agencies rewrite franchise-critical rules without taking account of anything other than a wish that FSOC would someday, somehow do something about it.[1]

This is a grievous omission not because all nonbank financial intermediaries require federal regulation, but because some of them do and any form of unregulated, critical financial infrastructure absolutely and immediately warrants standards as close as possible to the like-kind-risk/like-kind-rule principle espoused by federal and global regulators.

Still, all they seem able to do is espouse, not regulate nonbanks even as the chasm between bank and nonbank rules grows into a Grand Canyon. Banking rules that create market vacuums will be filled by nonbanks exempt from like-kind rules wherever there is money to be made.

And money there is to be made in many once-core banking businesses as the relative size and growth of banks versus nonbanks makes clear. In 2010, bank assets were 61 percent of GDP, rising to 74 percent by 2020, or a 17.5 percent gain.[2] In contrast, nonbank assets as a share of GDP in 2010 were 155 percent and stood at 197 percent in 2020, a gain of 27 percent.[3] And, as these data show, nonbanks have almost three times as large a macroeconomic role as banks. The U.S. financial system is in fact uniquely dependent on nonbank financial intermediation – so called "shadow banks."[4]

So, what can be done?

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First, we need to know which nonbank financial entities are systemic not necessarily to regulate them, but always to understand how nonbanks intersect with the U.S. and global financial system to ensure that no nonbank has a stranglehold on financial stability and no entity serving as a financial-market utility (FMU) controls vital oxygen flows throughout the financial infrastructure. The FSOC's newly-proposed methodology for identifying systemic risks is for the first time and rightly focused on identifying these inter-connections as well as deploying the criteria long used by the Federal Reserve to designate global systemically-important banks (GSIBs).[5]

Mr. Gruenberg's speech suggests that FSOC can grandly start to regulate once it knows which nonbanks are systemic. This is true as far as FMUs are concerned – and I'll turn to this in a moment – but it's emphatically not true for most nonbank financial intermediaries (NBFIs). FSOC can certainly designate an NBFI and its new approach also suggests it may well do so.[6] However, FSOC is toothless in any sectors where systemic risk is present in aggregate instead of deriving from one or another firm. Here, all the Dodd-Frank Act allows is an FSOC plea to a primary federal regulator to do something.[7] If the primary federal regulator declines or – as is often the case – there is no primary federal regulator with prudential authority, then FSOC can do little more than bleat.

As a result, bank regulators must be mindful of how bank rules enable nonbank regulatory arbitrage to quickly transform into key market dominance. Some sectors should stay beyond bank reach because they are unduly risky or manifestly predatory, but the more banks are able to maintain core, resilient roles in arenas essential to systemic stability and equitable growth, the more resilient the system as a whole.

Given this, it's a mystery why the banking agencies have proposed a "higher-of" standard for credit-risk capital charges now that they have banned the internal models whose opacity warranted the current higher-of requirement.[8] The banking agencies have proposed a lower risk-based capital charge for higher-quality corporate lending reflecting known risks but then won't let banks use it unless it somehow works into one of the capital proposal's most baffling requirements: the output floor. At a time when nonbank providers of private capital are planning to be a $40 trillion sector in five years[9] and banks are already clinging to larger loans by their fingertips,[10] all the banking agencies are doing is giving away the store.

Given FSOC's limits, the banking agencies should make substantive revisions to the pending risk-based capital rules to ensure that big banks are capital-whacked only when big-bank risk warrants a smack-down. There are plenty of areas in the proposal where capital would go up for demonstrable reasons. Where history and analytics warrant capital relief, capital relief should follow or banks will exit still more arenas at still greater systemic risk.

FMUs: The Next Frontier

Finally, I'd like to turn back to FMUs. These are all too often ignored in the debate over nonbank systemic risk, but any entity that controls key parts of the payment, settlement, or clearing system is essential to systemic stability. If any of these systems goes out for more than a minute and maybe even in a minute, the financial system would grind to a very costly halt.

Title VIII of Dodd-Frank recognized this, giving FSOC the power to designate FMUs and designate it did shortly thereafter for entities such as The Clearing House on which payments depend and the Depository Trust Corporation on which markets rely.[11] However, after a bout of FMU designations in 2012, FSOC has left untouched growing nonbank utilities – think Amazon in cloud and payment services – even though the systemic-infrastructure landscape has dramatically changed.

One reason why nonbanks are playing an ever-greater role as FMUs without being designated as FMUs is that, even as FSOC looked away, significant nonbank consolidation faces none of the limits or opprobrium that goes with bank mergers and acquisitions. The Department of Justice and Federal Trade Commission are now in the process of revising federal antitrust policy,[12] but these standards only indirectly allow consideration of systemic risk and, in the first case study since they were released, the FTC failed to do so.

The case in question is the now-approved acquisition by Intercontinental Exchange (ICE) with Black Knight Inc. (BKI) to create a mammoth entity controlling much of U.S. residential-mortgage infrastructure.[13] If something goes wrong in ICE/BKI systems, mortgage origination and servicing would slow or even stop, putting billions of payments at immediate risk along with the stability of the super-systemic secondary mortgage market. One aspect of ICE's empire – its credit-default swap clearing activities – is systemically designated in the U.S.[14] and U.K.,[15] but all the rest of its giant energy, bond, equity, and trading platforms are not. Importantly, ICE plans to integrate the knowledge its infrastructure gives it over mortgage payments and prices new mortgage-futures and even securitization markets that might just tackle government and government-sponsored enterprises.

To me, that's systemic. Once FSOC finalizes its new standards, it plans to get around to systemic activity-and-practice recommendations – for all the good these may do – and a few systemic designations sure to face costly litigation. Some of this makes sense, but none of it is quick or certain. FSOC can and should act now under its current FMU-designation standards to look hard at ICE and other behemoths dominating critical payment, settlement, and clearing systems.

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When banking isn't all about banks, bank standards need to take full account of how bank rules redefine nonbank markets and FSOC has to make effective, ample, timely, and effective use of the powers it has and make the most of them in high-risk sectors posing near-term threats. So far, there's no sign that bank regulators will reckon with the unintended, but clear consequences of the bank-only blinders the FDIC chairman urged them only last week to clasp to their brows. There's more hope that FSOC will act, but little likelihood that anything it does anytime soon will matter unless it pressures bank regulators to address inter-connectedness and on its own moves quickly to designate new-age FMUs.

What's next if none of this happens? I would guess more systemic crises in which banks play a smaller and increasingly irrelevant role as systemic guardrails while the Fed opens wider and wider rescue windows for nonbanks that then grow bigger and bigger. Been there, done this since 2008 and so it goes unless we can stop it.

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