THE SHADOW BANKING CHARADE

By

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Shadow banking emerged in the regulated banking system in the 1980s and 1990s when the traditional banking model became outmoded. Banking regulators encouraged shadow banking as the only way to preserve banks as viable entities in the financial system. They did not call it "shadow banking," but rather treated it as part of the evolution of the business of banking and extolled its benefits. Not until the financial crisis occurred did regulators begin the illusion of shadow banking as something sinister outside the regulated banking system.

In adopting the shadow banking mythology, banking regulators deceived themselves as to the true nature of the forces that destabilized the financial system and misinformed policymakers in Congress. Now, having gained new powers to rid "systemic risk" anywhere in the financial system, they are seeking to uproot shadow banking competitors of banks that operate outside the regulated banking system. Chief among their targets is the highly successful money market fund industry, notwithstanding that money market funds are highly regulated and bear none of the key risk factors of shadow banks.

This paper urges regulators to take a more introspective look at shadow banking as an invention of their own making within the regulated banking system and to avoid nullifying the positive aspects of shadow banking in their financial reform efforts.

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I. INTRODUCTION

"Shadow banking" is a term used by banking regulators, academics, the media, and others when attempting to explain the financial crisis of 2007-2008. It has become a slogan of U.S. and international reforms efforts aimed at nonbank financial activities said to form an unregulated "shadow banking system" capable of destabilizing the global financial system.[1] Yet, when examined closely, it appears to subsist mainly within the regulated banking system, raising questions about its validity as a concept for reform of entities outside the banking system. This paper examines the shadow banking concept and its legitimacy as a basis for reform.

A. The Shadow Banking Bandwagon

The term "shadow banking" was used in a *Fortune Magazine* article in 2007 to highlight what was then described as "a secret banking system built on derivatives and untouched by regulation."[2] Bill Gross, president of Pimco, wrote:

> Beware our shadow banking system. . . . What we are witnessing is essentially the breakdown of our modern-day banking system, a complex of leveraged lending so hard to understand that Federal Reserve chairman Ben Bernanke required a face-to-face refresher course from hedge fund managers in mid-August. My Pimco colleague Paul McCulley has labeled it the "shadow banking system" because it has lain hidden for years, untouched by regulation, yet free to magically and mystically create and then package subprime loans into a host of three-letter conduits that only Wall Street wizards could explain.[3]

This depiction of shadow banking as a mysterious unregulated force in the financial system captured the imagination of regulators, academic

[1] See, e.g., Financial Stability Board, Consultative Document, Strengthening Oversight and Regulation of Shadow Banking: An Integrated Overview of Policy Recommendations, Nov. 18, 2012; European Commission, Green Paper—Shadow Banking, March 19, 2012.

[2] Bill Gross, Beware Our Shadow Banking System, Fortune Magazine, reprinted at http://money.cnn.com/2007/11/27/news/newsmakers/gross_banking.fortune, Nov. 28, 2007.

[3] *Id.*

economists, and the media and has distorted their views of the financial crisis ever since. Banking regulators have used it to explain how the crisis arose outside the regulated banking system beyond their powers of perception.[4] Academics whose econometric models failed to forecast the crisis have said it was invisible.[5] Consulting firms have converted it into an "index."[6] The media has bandied it about like "greed" as a glib explanation of what went wrong with the financial system.[7]

A shadow banking bandwagon has gathered steam and is rolling around like a loose cannon ready to crush nonbank entities that were involved in the financial crisis regardless of whether they had anything to do its causes. Shadow banks have become a target of insistent regulatory reform efforts even though who, what, and why they are is not clearly understood. This paper sheds light on shadow banking and shows it is largely a myth.

The Appendix hereto lists some of the numerous articles, studies, academic papers, speeches, and media commentary devoted to shadow banking. Some of these represent serious efforts to identify sources of systemic risk and to formulate remedies to prevent another financial crisis. Many treat the subject superficially and contribute nothing to illuminate the crisis or its causes and potential cures. Most identify shadow banks as something other than traditional banks. All have difficulty finding a logical meaning of shadow banking and its role in the financial system. None recognizes shadow banking for what it really is—a chimera that has fogged the lens of inquiry into the true sources of systemic risk and clouded meaningful reform efforts.

This paper disputes the characterization of shadow banking adopted by banking regulators and shows that, contrary to the picture they have painted, it exists as an integral part of the regulated banking system. This paper also shows that the regulators' definition of shadow banking mistakenly includes nonbank entities—in particular money market funds—that are highly regulated, not a

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[4] See Statement of Treasury Secretary Timothy F. Geithner at a hearing on Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner, before the House Committee on Financial Services, April 20, 2010, Serial No. 111–124, at 13; Tim Geithner, Financial Crisis Amnesia, N.Y. Times, March 1, 2012.

[5] See generally, Gary B. Gorton, Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007, May 9, 2009; Gary B. Gorton, Misunderstanding Financial Crises: Why We Don't See Them Coming, Oxford University Press, 2012.

[6] See, e.g., Deloitte Center for Financial Services, Shedding Light on Banking's Shadows, The Shadow Banking Index, June 2012.

[7] See, e.g., Wall Street Journal, Time to Cast More Light on Finance's "Shadows," by Francesco Guerrera, April 9, 2012 ("If you look closely, the turmoil in 2008 and 2009 in the U.S. wasn't a 'banking crisis.' It was a shadow-banking crisis that engulfed traditional banks.").

cause of the financial crisis, and otherwise lacking in risk features attributed to shadow banks.

This paper argues that shadow banking is a flawed concept that has distracted regulators and hindered their progress toward a rational framework for a resilient financial system going forward. The concept of shadow banking ignores the important benefits of nontraditional financial products and services and may lead to misguided regulatory measures that extinguish innovation, efficiency, and competition without offsetting gains in systemic safety.

B. What Is "Shadow Banking"?

Shadow banking is a global phenomenon and focus of regulatory reform efforts by both U.S. and European banking regulators. The size of the shadow banking system varies under different measures. The Financial Stability Board—an organization of global banking regulators—has estimated the size of the shadow banking system to be as large as $67 trillion as of 2011, representing 25 percent of the total international financial system.[8] In contrast, the Federal Reserve Bank of New York has estimated the size of the shadow banking system at approximately $16 trillion as of 2010.[9]

Various definitions of shadow banking exist. Most of the definitions are broad and encompass a diverse range of entities other than regulated banks that provide financial products and services. Most of the definitions identify shadow banks as unregulated or lightly regulated entities operating outside the regulated banking system.[10] Under the definitions adopted by banking regulators, nearly the entire universe of financial firms not regulated by them is a shadow bank.

The key characteristics of shadow banking as conceived by regulators are credit intermediation in the capital markets, maturity transformation, leverage,

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[8] Financial Stability Board, Global Shadow Banking Monitoring Report 2012, Nov. 18, 2012. The Financial Stability Board is an international body of financial regulators from major industrial economies, including the Federal Reserve Board, Securities and Exchange Commission, and Secretary of the Treasury. The Financial Stability Board claims that the United States has the largest shadow banking system, with assets of $23 trillion as of 2011, representing 35 percent of the global shadow banking system.

[9] See Pozsar, Zoltan, Tobias Adrian, Adam Ashcraft, and Hayley Boesky, "Shadow Banking," Federal Reserve Bank of New York Staff Report No. 458, 2010.

[10] See, e.g., Financial Stability Board, Consultative Document: Strengthening Oversight and Regulation of Shadow Banking, A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities, Nov. 18, 2012 at ii ("whereas banks are subject to a well-developed system of prudential regulation and other safeguards, the shadow banking system is typically subject to less stringent, or no, oversight arrangements.").

and susceptibility to runs. The principal shadow banking activities and entities identified by regulators include the following:

- Securitization vehicles such as asset-backed commercial paper conduits (ABCP) and structured investment vehicles (SIVs);
- Securities lending;
- Repurchase agreements;
- Money market funds;
- Securities broker-dealers;
- Investment funds, including exchange traded funds and hedge funds that provide credit or are leveraged;
- Finance companies, including auto finance companies and leasing companies;
- Providers of credit insurance and financial guarantees.[11]

All of these entities or activities perform a useful function in the financial system and are not inherently risky or harmful. They improve efficiency in the delivery of financial services, increase the supply of credit to the economy, facilitate greater diversification of risk, enhance innovation and competition, and reallocate risks away from the federal safety net.[12] Like traditional banking activities, they need to be regulated in proportion to the risks they pose. To a large extent, they already are regulated and some—in particular money market funds—are more highly regulated than traditional banks.

What makes these activities "shadowy" in the eyes of banking regulators is the perception that they crept into the financial system largely unseen and for the purpose of evading regulatory requirements, bringing unsuspected hazards. Yet, the facts show that all of these activities emerged in broad daylight right under the nose of regulators. Indeed, prior to the crisis, regulators approved and touted the benefits of activities they now label as shadow banking and paved the way for banking organizations to become leaders in the shadow banking system.[13] That they did not sufficiently understand the risks of the activities they approved or the evolution of risks in the financial system as a whole is surely the most consequential failure in the history of banking supervision and regulation.

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[11] See Financial Stability Board, Consultative Document: Strengthening Oversight and Regulation of Shadow Banking, A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities, Nov. 18, 2012. See also European Commission, Green Paper: Shadow Banking, March 19, 2012.

[12] See Appendix hereto—"The Benefits of Shadow Banking."

[13] See Appendix hereto—"How Traditional Banks Became Shadow Banks."

II. THE SHADOW BANKING MYTH

Banking regulators have embraced shadow banking as an explanation of the financial crisis and made it a major focus of reform efforts to prevent a future crisis. By treating shadow banking as something outside the regulated banking system, however, they have created a myth rather than a concrete foundation for constructive reform.

A. The Shadow Banking Delusion

Banking regulators have depicted shadow banks as largely unregulated entities operating *outside* the banking system beyond their supervisory purview. The Federal Reserve Board has described shadow banks as follows:

> *Shadow banks* are financial entities other than regulated depository institutions (commercial banks, thrifts, and credit unions) that serve as intermediaries to channel savings into investment. Securitization vehicles, ABCP vehicles, money market funds, investment banks, mortgage companies, and a variety of other entities are part of the shadow banking system. Before the crisis, the shadow banking system had come to play a major role in global finance; with hindsight, we can see that shadow banking was also the source of some key vulnerabilities. . . . Critically, shadow banks were, for the most part, not subject to consistent and effective regulatory oversight.[14]

The Financial Stability Oversight Council has echoed this view of shadow banking as "outside" the banking system and said that shadow banking became a source of vulnerability to the commercial banking system:

> Credit intermediation involving entities *outside* the banking system—so-called shadow banking—increased substantially leading up to the crisis. Significant reliance on short-term wholesale funding made these entities and the complex web of activities they supported more vulnerable to shocks than insured depository institutions. These entities also became a source of vulnerability to the commercial banking system.[15]

[14] Statement by Ben S. Bernanke, Chairman, Federal Reserve Board, before the Financial Crisis Inquiry Commission, Sept. 2, 2010.

[15] Financial Stability Oversight Council, Annual Report 2011, at 70-71 (emphasis added). The Council was created by the Dodd-Frank Act and is comprised of all of the federal bank regulatory agencies and other financial regulators.

The Financial Stability Board similarly has described shadow banking as "outside" the regular banking system:

> The "shadow banking system" can broadly be described as "credit intermediation involving entities and activities *outside* the regular banking system".[16]

The European Central Bank also has defined shadow banking as beyond the realm of banking regulation:

> The term shadow banking is widely used to cover activities related to credit intermediation, liquidity and maturity transformation taking place *outside* the regulated banking system. . . .[17]

These statements reflect a delusion among banking regulators that the shadow banking system is something other than the regulated banking system. This supposition contradicts reality and suggests that regulators lack a sound grasp of the forces that destabilized the financial system and caused the financial crisis.[18]

B. The Shadow Banking Surprise

Given the shadow banking delusion, it perhaps is not surprising that banking regulators were ill-prepared for events in the shadow banking system that destabilized the financial system in 2007 and 2008. As the regulators have admitted, they were caught off guard by runs in the markets for repurchase agreements ("repos") and asset-backed commercial paper ("ABCP"). Economists have said these runs marked the beginning of the financial crisis:

> [We] have learned that the crisis originated as a run on the liabilities of issuers of asset-backed commercial paper (ABCP).[19]

[16] Financial Stability Board, "Shadow Banking: Strengthening Oversight and Regulation," Oct. 27, 2011 at 1 (emphasis added).

[17] Vítor Constâncio, Vice-President, European Central Bank, "Shadow Banking — The ECB perspective," speech dated 27 April 2012 (emphasis added).

[18] Prominent economists and academics also have described shadow banking as a force outside the regulated banking system and not understood by regulators. See Gary Gorton, Stefan Lewellen, Andrew Metrick, The Safe Asset Share, Jan. 17, 2012 ("Over the past thirty years, . . . an entirely new segment of the financial sector known as the 'shadow banking sector' has emerged . . . . The shadow banking sector has largely escaped (and continues to escape) the attention of regulators and policymakers.").

[19] Nicola Ceterelli, Benjamin H. Mandel, and Lindsay Mollineaux, The Evolution of Banks and Financial Intermediation: Framing the Analysis. See also Covitz, Liang,

> [T]he initial decline of outstanding ABCP is often used to date the beginning of the first wave of the 2007-2009 financial crisis.[20]
>
> [T]he the crisis was triggered by a run, on repo and on asset-backed commercial paper.[21]

What is surprising is that banking regulators failed to recognize these runs as runs on the banking system. Banks were—and are—key players in the repo and ABCP markets. Economists have said that these runs left the banking system "effectively insolvent."[22]

Yet, Federal Reserve Chairman Bernanke has said the runs occurred "outside" the traditional banking system in the "shadow banking system":

> [We] experienced the equivalent of runs on the network of nonbank financial institutions that has come to be called the shadow banking system. . . .This was a new type of run, analogous in many ways to the bank runs of the 1930s, but in a form which was not well anticipated by financial institutions or regulators.[23]
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> [I]n this case, the run occurred outside the traditional banking system, in the shadow banking system—consisting of financial institutions other than regulated depository institutions, such as securitization vehicles, money market funds, and investment banks. . . . Because the runs on the shadow banking system occurred in a historically unfamiliar context, *outside* the commercial banking system,

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and Suarez, "The Evolution of a Financial Crisis: Panic in the Asset-Backed Commercial Paper Market," August 24, 2009.

[20] Tobias Adrian, Karin Kimbrough, and Dina Marchioni, The Federal Reserve's Commercial Paper Funding Facility, Federal Reserve Bank of New York Economic Policy Review, May 2011, at 27.

[21] Gary B. Gorton, Misunderstanding Financial Crises—Why We Don't See Them Coming, Oxford University Press, 2012, at 39 and 183.

[22] Gary B. Gorton and Andrew Metrick, "Securitized Banking and the Run on Repo," November 9, 2010, Yale ICF Working Paper No. 09-14 ("The U.S. banking system was effectively insolvent for the first time since the Great Depression."). See also Gary B. Gorton, "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007" at 37 ("How do we know that the banking system was insolvent? There is no direct evidence, although back-of the envelope calculations suggest that the banking system needed to replace about $2 trillion of financing. . . .").

[23] Ben S. Bernanke, Chairman, Federal Reserve Board, Economic Policy: Lessons from History, Speech dated April 8, 2010.

> both the private sector and the regulators insufficiently anticipated the risk that such runs might occur. . . .[24]
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> The financial crisis of 2007-09 was difficult to anticipate for two reasons: First, financial panics, being to a significant extent self-fulfilling crises of confidence, are inherently difficult to foresee. Second, although the crisis bore some resemblance at a conceptual level to the panics known to Bagehot, it occurred in a rather different institutional context and was propagated and amplified by a number of vulnerabilities that had developed *outside* the traditional banking sector.[25]

The fact that the runs took regulators by surprise demonstrates their failure to grasp the nature and scope of shadow banking risks prior to the crisis. Chairman Bernanke has admitted as much:

> These failures in turn were partly the result of a regulatory structure that had not adapted adequately to the rise of shadow banking and that placed insufficient emphasis on the detection of systemic risks, as opposed to risks to individual institutions and markets.[26]

What regulators have been slow to acknowledge, however, is the extent to which regulated banking organizations had become part of the shadow banking system and a source of systemic risk well before the crisis. Regulators failed to perceive that large commercial banks had become the largest shadow banks. As their post-crisis expostulating reveals, the regulators still have not fully grasped the transformation of traditional banks into shadow banks.

Economists have admitted their own failure, along with that of the regulators, to anticipate the financial crisis:

> Think of economists and bank regulators looking out at the financial landscape prior to the financial crisis. What did

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[24] Ben S. Bernanke, Chairman, Federal Reserve Board, speech dated Sept. 24, 2010 (emphasis added). See also Gary B. Gorton, Misunderstanding Financial Crises—Why We Don't See Them Coming, Oxford University Press, 2012, at 177 ("The crisis was not observed and not understood. Regulators, academics, and the media did not understand that there was a crisis.").

[25] Ben S. Bernanke, Chairman, Federal Reserve Board, Some Reflections on the Crisis and the Policy Response, April 13, 2012 (emphasis added).

[26] Ben S. Bernanke, Chairman, Federal Reserve Board, speech before a conference co-sponsored by the Center for Economic Policy Studies and the Bendheim Center for Finance, Sept. 24, 2010.

> they see? They did not see the possibility of a systemic crisis. Nor did they see how capital markets and the banking system had evolved in the last thirty years. . . . The blindness is astounding.[27]

If economists were blindsided by the shadow banking blowups that occurred in the repo and ABCP markets, banking regulators should not have been. Given the extensive involvement of regulated banking organizations in these markets, there is no obvious reason why banking regulators were not more attuned to the risk forces at work. What is surprising is that the regulators continue to delude themselves with the myth of shadow banking as something outside the regulated banking system.

C. The Shadow Banking Deception

The shadow banking delusion has led banking regulators to adopt a misleading narrative of the financial crisis. Their failure to properly understand the runs that occurred has led to specious explanations, as one economist has observed:

> The fact that the run was not observed by regulators, politicians, the media, or ordinary Americans has made the events particularly hard to understand. It has opened the door to spurious, superficial, and politically expedient "explanations" and demagoguery.[28]

The shadow banking deception is exemplified in the following statement by former Treasury Secretary Geithner explaining the causes of the crisis to Congress and blaming it on risky unregulated shadow banking activities:

> [O]ur system allowed large institutions to take on excessive risk without effective constraints. In particular, this system allowed the emergence of a parallel financial system—what some have called the shadow banking system. This system operated alongside and grew to be almost as big as the regulated banking system. But it lacked the basic protections and constraints necessary to protect the economy from classic financial failures.

[27] Gary B. Gorton, Misunderstanding Financial Crises—Why We Don't See Them Coming, Oxford University Press, 2012, at viii, 195 ("The financial crisis of 2007-8 was unexpected. It was unexpected because the evolution of the financial system over a thirty-year period was not understood."); *Id.* at 157 ("an entire shadow banking system had developed, completely undetected by bank regulators.").

[28] Gary Gorton, Questions and Answers About the Financial Crisis, prepared for the U.S. Financial Crisis Inquiry Commission, Feb. 20, 2010, at 2.

> Imagine building a national highway system with two sets of drivers. The first group has to abide by the speed limit, wear seatbelts, buy cars with anti-lock brakes. The second group can drive as fast as they choose with no safety features and without any fear of getting pulled over by the police. Imagine both groups are driving on the same roads. That system would inevitably cause serious collisions, and drivers following the rules of the game would inevitably get hit by drivers who weren't. A system like that makes no sense. We would never allow it on the roads, so why do we allow it in our economy?[29]

Secretary Geithner also wrote in the New York Times:

> Regulators did not have the authority they needed to oversee and impose prudent limits on overall risk and leverage on large nonbank financial institutions. . . . A large shadow banking system had developed without meaningful regulation, using trillions of dollars in short-term debt to fund inherently risky financial activity.[30]

Federal Reserve Board Chairman Bernanke also has blamed the financial crisis on shadow banking.

> [A]n important lesson learned from the financial crisis is that the growth of what has been termed "shadow banking" creates additional potential channels for the propagation of shocks through the financial system and the economy.[31]

> Relative to the global financial system, the market for subprime mortgages was quite small, probably less than 1 percent of global financial assets. How, then, did problems in this market appear to have such widespread

[29] Statement of Treasury Secretary Timothy F. Geithner at a hearing on Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner, before the House Committee on Financial Services, April 20, 2010, Serial No. 111–124, at 13.

[30] Tim Geithner, Financial Crisis Amnesia, N.Y. Times, March 1, 2012. These statements seem particularly disingenuous in view of Mr. Geithner's position, prior to his term as Treasury Secretary, as president of the Federal Reserve Bank of New York which has principal supervisory responsibility over the largest global banking organizations operating in the United States. The "risky" financial activities to which he refers were conducted largely by those global banking organizations, subject to his oversight and purview.

[31] Ben S. Bernanke, Chairman, Federal Reserve Board, Fostering Financial Stability, speech dated April 9, 2012.

> consequences? One important reason is that the subprime mortgage market was closely linked to a broader framework for credit provision that came to be known as the shadow banking system.[32]

These statements are deceptive because they fail to account for the extensive involvement of banking organizations in shadow banking activities and lay disproportionate blame for the financial crisis on entities outside the regulated banking system. These statements are troubling because they suggest that banking regulators are operating under false premises in their pursuit of financial reforms. The shadow banking deception is harmful enough as an obfuscation of the facts concerning the financial crisis. Yet, banking regulators have used it as a pretext for exerting regulatory influence and control over nonbank financial entities outside the regulated banking system that had nothing to do with causing the financial crisis.

The shadow banking ruse did not prevent Congress from imposing harsh new regulatory requirements on banking organizations in the Dodd-Frank Act, which regulators still are in the process of implementing.[33] But banking regulators also gained new powers to regulate nonbank financial companies. The principal vehicle for this purpose is the Financial Stability Oversight Council, comprised of the banking regulators and other financial overseers.[34] Congress empowered the Council to subject any nonbank financial company to stringent prudential supervision by the Federal Reserve Board if the Council finds the company poses a threat to the financial stability of the United States.[35] The

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[32] Ben S. Bernanke, Chairman, Federal Reserve Board, Economic Challenges: Past, Present, and Future, Speech before the Federal Reserve Bank of Dallas, April 7, 2010. In recent testimony to Congress, Federal Reserve Governor Tarullo continued the shadow banking deception . Daniel K. Tarullo, Governor, Federal Reserve Board, Statement before the Senate Committee on Banking, Housing, and Urban Affairs, Feb. 14, 2013.

[33] The Dodd-Frank Act requires regulators to adopt a multitude of new regulations to strengthen bank capital, liquidity, and risk management. Nearly three years later, regulators still are grappling with the Dodd-Frank Act banking reforms and are uncertain how to fulfill the Act's mandate of ensuring that no banking organization is "too-big-to-fail."

[34] The voting members of the Financial Stability Oversight Council include the Secretary of the Treasury and the heads of the Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Consumer Financial Protection Bureau, Securities and Exchange Commission, Commodity Futures Trading Commission, Federal Housing Finance Agency, and National Credit Union Administration.

[35] By a 2/3's vote, the Council is authorized to determine that a nonbank financial company shall be supervised by the Federal Reserve Board and be subject to "more stringent" prudential standards imposed by the Board. Any such determination must be

Council also has limited authority to recommend new or heightened standards or safeguards to address risks posed by activities of nonbank financial companies.

Notwithstanding the narrow circumstances in which it may act, the Council has interpreted its authority broadly. Among its first targets are money market funds. Although nothing in the Dodd-Frank Act suggests that Congress viewed MMFs as a cause of the financial crisis or a menace to financial stability, the Council has tagged MMFs as systemically risky and in 2012 formulated proposals to subject MMFs to bank-like capital requirements.[36] Numerous commenters on the Council's proposals have disputed the Council's facts and conclusions and said its proposals could potentially destroy the MMF industry and inflict harm on investors and the economy.[37] Yet, despite comprehensive regulation of MMFs under the Investment Company Act and reforms adopted by the SEC in 2010, banking regulators have said that MMFs are a part of the shadow banking system "in most need of further attention and regulatory action" and require "immediate action."[38]

The shadow banking myth has led to a potentially vast expansion of bank regulatory jurisdiction over nonbank financial institutions such as MMFs. These entities are already highly regulated under a different regime and have operated successfully for decades without reliance on government subsidies and without posing risks to the financial system. The Council's attack on MMFs strongly suggests that banking regulators have deluded themselves as to the true sources of systemic risk and are intent on perpetuating the shadow banking deception as a means of expanding their regulatory reach into every corner of the financial system.

III. THE SHADOW BANKING REALITY

Contrary to the shadow banking myth propagated by banking regulators, the reality is that shadow banking is an integral part of the regulated banking system. Banking organizations have engaged extensively in shadow banking

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based on a finding by the Council that material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities, could pose a threat to the financial stability of the United States. Among other things, the Council is required to consider the extent to which the company is already subject to regulation.

[36] Financial Stability Oversight Council, Annual Reports, 2011, 2012, 77 Fed. Reg. 69455 (Nov. 19, 2012).

[37] See public record of comments on Proposed Recommendations Regarding Money Market Mutual Fund Reform, Docket FSOC-2012-0003, available at http://www.regulations.gov/#!docketBrowser;rpp=25;po=0;D=FSOC-2012-0003.

[38] Daniel K. Tarullo, Governor, Federal Reserve Board, Statement before the Senate Committee on Banking, Housing, and Urban Affairs, Feb. 14, 2013.

activities for years and in many ways today *are* the shadow banking system. The financial crisis was caused largely by shadow banking activities of banking organizations and the failure of banking supervisors to understand the risks of such activities and appropriately supervise them.

A. An Integral Part of the Regulated Banking System

All of the activities classified by regulators as shadow banking are core activities of large banking organizations, both directly and through affiliated entities. It is anomalous to call them "shadow" activities since they occur in the supervisory headlights of banking regulators.

The shadow banking system could not exist without banks and their affiliates. Banks are instrumental in the securitization of assets, which forms the backbone of the shadow banking system. They have been the primary sponsors, issuers, and guarantors of mortgage-backed securities and asset-backed commercial paper for years. Large banks command the repo market as borrowers, lenders, dealers, and custodian banks. They are leaders in securities lending activities. Banks also sponsor and advise numerous types of investment funds, including hedge funds and approximately one-half of all money market funds. All of the major securities broker-dealers in the United States are subsidiaries of banks or bank holding companies. Banking organizations control finance companies of all kinds, including auto finance and leasing companies. They provide credit insurance and financial guarantees to support their activities and those of their customers. To the extent shadow banking has any meaning, regulated banks and their affiliates are an integral part of it.[39]

Banking regulators possess broad supervisory and enforcement authority over these activities under the banking laws. Historically, banking regulators have determined which activities are permissible for banking organizations and which are not, and under what conditions. Banking organizations are subject to extensive examination and supervision under the National Bank Act, Federal Reserve Act, Federal Deposit Insurance Act, and Bank Holding Company Act. Regulators maintain teams of on-site examiners at the largest banking organizations year round.

Prior to the crisis, the regulators professed to be monitoring the financial system for systemic risks. The Federal Reserve described its mission as

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[39] Prior to the financial crisis, large investment banks also engaged in securitization and other shadow banking activities. All of those firms became bank holding companies or subsidiaries thereof (Bear Stearns, Morgan Stanley, Goldman Sachs, and Merrill Lynch) or went bankrupt (Lehman Brothers) in 2008.

including "maintaining the stability of the financial system and containing systemic risk that may arise in financial markets."[40] The Board stated:

> [T]he Federal Reserve can contribute to financial stability and better economic performance by acting to contain financial disruptions and preventing their spread outside the financial sector. Modern financial systems are highly complex and interdependent and may be vulnerable to wide-scale systemic disruptions, such as those that can occur during a plunge in stock prices. The Federal Reserve can enhance the financial system's resilience to such shocks through its regulatory policies toward banking institutions and payment systems. If a threatening disturbance develops, the Federal Reserve can also cushion the impact on financial markets and the economy by aggressively and visibly providing liquidity through open market operations or discount window lending.[41]

The Comptroller of the Currency declared that a major goal of its supervisory program was to "identify, analyze, and respond to emerging systemic risks and trends that could affect an individual national bank or the entire national banking system."[42] The OCC said it "conducts regular surveys to identify and monitor systemic trends in credit risk and emerging credit risk" and claimed that systemic risk was a focus of its horizontal reviews of large banks with similar characteristics.[43]

The inability of regulators to detect and regulate systemic risks associated with shadow banking prior to the financial crisis was not because they lacked night vision goggles. The crisis occurred because they failed to wear them, or were insensible to what they saw. Federal Reserve Governor Tarullo has conceded that regulators "largely neglected systemic concerns in the decades preceding the crisis."[44]

The involvement of banking organizations in shadow banking activities is obscured to the public by the fact that these activities frequently occur through off-balance sheet entities and separate subsidiaries operating under different names. Large banking organizations conduct their operations through hundreds,

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[40] Federal Reserve Board, Federal Reserve System Purposes and Functions, 9th edition, June 2005, at 1.

[41] Federal Reserve Board, Federal Reserve System Purposes and Functions, 9th edition, June 2005, at 16.

[42] Office of the Comptroller of the Currency, Annual Report, Fiscal Year 2005.

[43] Office of the Comptroller of the Currency, Annual Report, Fiscal Year 2007.

[44] Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, Financial Stability Regulation, speech dated Oct. 10, 2012.

indeed thousands, of subsidiaries.[45] These subsidiaries typically are wholly-owned and operated in tandem with other affiliates under the same corporate umbrella. The growing size and complexity of these organizations has made them increasingly opaque. Nevertheless, the extent to which banking organizations were immersed in shadow banking activities prior to the crisis should not have been indiscernable to banking regulators with their legions of examiners and arsenal of supervisory tools.

Economists at the Federal Reserve Bank of New York have begun to see shadow banking as part of the regulated banking system. Indeed, they have identified banking organizations as the "drivers" of the shadow banking system:

> The principal drivers of the growth of the shadow banking system have been the transformation of the largest banks since the early-1980s from low return on-equity (RoE) utilities that originate loans and hold and fund them until maturity with deposits, to high RoE entities that originate loans in order to warehouse and later securitize and distribute them, or retain securitized loans through off-balance sheet asset management vehicles. In conjunction with this transformation, the nature of banking changed from a credit-risk intensive, deposit-funded, spread-based process, to a less credit-risk intensive, but more *market*-risk intensive, wholesale funded, fee-based process. The transformation of banks occurred within the legal framework of financial holding companies (FHC), which through the acquisition of broker-dealers and asset managers, allowed large banks to transform their traditional process of hold-to-maturity, spread-banking to a more profitable process of originate-to-distribute, fee-banking. The FHC concept was legitimized by the abolishment of the Glass-Steagall Act of 1932, and codified by the Gramm-Leach-Bliley Act of 1999.[46]

The Reserve Bank's economists recently published research empirically documenting the rise of shadow banking as an outgrowth of securitization

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[45] See generally Dafna Avraham, Patricia Selvaggi, and James Vickery, A Structural View of U.S. Bank Holding Companies, Federal Reserve Bank of New York, Economic Policy Review, July 2012, noting that the most complex bank holding companies control up to several thousand separate subsidiaries each.

[46] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, Shadow Banking, Federal Reserve Bank of New York, Staff Report no. 458, July 2010, at 29. Financial holding companies are bank holding companies with expanded powers. All of the major bank holding companies in the U.S. are financial holding companies.

activities of banks and the integration of banking with the capital markets.[47] This research has led one Reserve Bank economist to remark, "When looked at closely, modern financial intermediation seems less 'shadowy' than we thought."[48]

Other economists also have commented on the transformation of banks into shadow banks:

> [W]e have known for a long time that the banking system was metamorphosing into an off-balance sheet and derivatives world—the shadow banking system.[49]

Regulators in the United Kingdom have come to see shadow banking as "deeply entwined" with the regulated banking system:

> We need to understand shadow banking not as something parallel to and separate from the core banking system, but deeply intertwined with it.[50]

The Financial Stability Board recently conceded that shadow banking exists "fully or partially outside" the regular banking system.[51] Federal Reserve Governor Tarullo also has allowed that shadow banking exists "wholly or partly outside" the traditional banking system.[52]

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[47] Tobias Adrian, Hyun Song Shin, Federal Reserve Bank of New York Staff Reports, The Shadow Banking System: Implications for Financial Regulation, Staff Report no. 382 (July 2009) ("The current financial crisis has highlighted the growing importance of the 'shadow banking system,' which grew out of the securitization of assets and the integration of banking with capital market developments.").

[48] Remarks by Nicola Cetorelli, Federal Reserve Bank of New York, at the Second Annual Conference of the Office of Financial Research and Financial Stability Oversight Council, Assessing Financial Intermediation: Measurement and Analysis, Dec. 6, 2012.

[49] Gary B. Gorton, The Panic of 2007, NBER Working Paper No. 14358, September 2008 at 1.

[50] Adair Turner, Chairman, Financial Services Authority, United Kingdom, Shadow Banking and Financial Instability, before the Cass Business School, March 14, 2012.

[51] Financial Stability Board, Consultative Document: Strengthening Oversight and Regulation of Shadow Banking, A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities, Nov. 18, 2012 at 3.

[52] Daniel K. Tarullo, Governor, Federal Reserve Board, Financial Stability Regulation, University of Pennsylvania Law School, Distinguished Jurist Lecture, Oct. 10, 2012 ("shadow banking . . . is credit intermediation involving maturity transformation, and often significant leverage, that is wholly or partly outside the traditional banking system.").

The reality is that, without banks and their affiliates, the shadow banking system would not exist, at least not on a scale capable of destabilizing the financial system.

B. A Creation of Banking Regulators

Shadow banking is largely the creation of banking regulators who fostered and nurtured it over three decades. It took hold in the banking system in the 1980s when the financial markets began to evolve rapidly in response to technological innovations, volatile interest rates, and new sources of competition. Banking regulators feared that the traditional deposit-based model of banking would become unviable if banks were not empowered to seek funding and fee-based revenue from activities in the capital markets. In 1987, the Comptroller of the Currency urged Congress to expand the statutory authority of banks to engage in nontraditional activities, declaring:

> [T]here is a disturbing longer-term trend that indicates that profitability and asset quality may continue to deteriorate. Current restrictions on banks' ability to diversify their assets and sources of income make it cumbersome, if not impossible, to restructure the products and services they offer in line with changing market conditions and consumer demands. Furthermore, only if banks have the authority to deliver the products customers demand will they be able to earn returns that can attract capital.[53]

The Comptroller warned that, "unless something is done to give banks additional flexibility to respond to competitive pressures, there exists the potential for an erosion of the safety and soundness of the banking system."[54] The Federal Reserve and FDIC echoed this appeal to Congress.

When Congress failed to broaden the powers of banking organizations, the regulators acted on their own. Notwithstanding restrictions in the Glass-Steagall Act, Bank Holding Company Act, and National Bank Act, the regulators found ways of allowing banks into the capital markets. Through a succession of novel legal interpretations and regulatory approvals, the regulators authorized banking organizations to securitize their assets, acquire securities broker-dealers, underwrite and deal in commercial paper and other securities, and engage in securities lending and other capital markets activities. The regulators did not call

[53] Financial Condition of Federally Insured Depository Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 9 (1987) (Statement of Robert L. Clarke, Comptroller of the Currency).

[54] *Id.* at 11.

these activities "shadow banking" but rather referred to them as part of the "business of banking."[55]

Shadow banking filled financial needs not met by the traditional deposit-based banking model. It grew and expanded as the traditional model became outmoded and shrank, and ultimately subsumed the deposit-based lending model.

Regulators claim that shadow banking arose as a product of regulatory arbitrage. "Regulatory arbitrage" refers to the creation of new ways of doing business in order to avoid regulatory restrictions. In the case of shadow banking, the regulatory restrictions being arbitraged were mainly those imposed under the banking regime, primarily capital requirements.[56] It thus should be no surprise that banking organizations, as the institutions primarily subject to such restrictions, were the most flagrant arbitrageurs.

At one time, regulators spoke of regulatory arbitrage as a "good thing" to be encouraged.[57] Securitization particularly was viewed favorably by regulators as a means of avoiding regulatory costs:

> [T]here are essentially five benefits that can be derived from securitization transactions. First, the sale of assets may reduce regulatory costs. The removal of an asset from an institution's books reduces capital requirements and reserve requirements on deposits funding the asset. . . .[58]

Incredibly, the very same banking regulators who now malign shadow banking as a blight on the financial system fought numerous legal battles in the courts to defend such activities. In repeated lawsuits, the securities industry challenged the regulators' approval of bank securities activities as contrary to the Glass-Steagall Act, Bank Holding Company Act, and National Bank Act.[59] Having the benefit of judicial deference, the regulators won nearly every case.

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[55] See Appendix hereto, "How Traditional Banks Became Shadow Banks."

[56] See Viral V. Acharya, Philipp Schnabl, and Gustavo Suarez, Securitization Without Risk Transfer, Aug. 8, 2011.

[57] See, e.g., Remarks by Federal Reserve Board Governor Laurence H. Meyer, Financial Globalization and Efficient Banking Regulation, March 2, 1998 ("Regulatory arbitrage, from the perspective of proper resource allocation, can be a good thing. If there were no way for the bank to avoid the uneconomically high regulatory requirement, it would need eventually to exit its low risk businesses because of insufficient returns to equity. In the long run, this would serve no purpose other than causing the regulated entity to shrink in size relative to its unregulated competitor.").

[58] Federal Reserve Board, Bank Holding Company Supervision Manual § 2128.02 (Risk Management and Internal Controls).

[59] These cases are discussed in detail in M. Fein, Securities Activities of Banks, Fourth Ed., Aspen Publishers, 2011, and in the Appendix hereto.

The Supreme Court said the Board's interpretations were entitled to both "the greatest deference" and "substantial deference" under doctrines of judicial review.[60] Banking organizations thus gained an open door into the shadow banking world.

Banking regulators allowed banks to become shadow banks in order to preserve the regulated banking system, but failed to adapt their supervisory programs to account for the evolution of financial risks that followed. A former vice chairman of the Federal Reserve Board has faulted banking regulators for inattentive oversight as banks proliferated off-balance sheet structured investment vehicles (SIVs) and filled them with subprime mortgages:

> Under the Fed's unwatchful eye, banks proliferated the SIVs. . . . They granted hundreds of billions of dollars' worth of embarrassingly bad subprime mortgages, many of them designed to default. . . . And they invested huge sums in risky assets that they portrayed as, and maybe even believed were, safe. Each of these disgraceful banking practices was, as they say, hidden in plain sight. Incurious regulators just didn't look. * * * * [N]one of the banking regulators . . . saw the complete sorry picture for what it was. . . . federal regulators should have seen more than enough shenanigans to make them sit up and take notice. But they didn't.[61]

But banking supervisors were not merely inattentive. They actively encouraged banks to expand their shadow banking activities. They relaxed the capital standards for SIVs and other bank securitization activities, granted regulatory exemptions, and tolerated weak liquidity and risk management at large banks engaged in shadow banking activities. The regulators prodded Congress to adopt legislation permitting banks to become even more fully immersed in shadow banking activities, culminating in the Gramm-Leach-Bliley Act in 1999, which allowed banking organizations to dominate the shadow banking system. The Appendix hereto describes in detail how regulators aided and abetted the growth of the shadow banking system over a period of three decades.

In the process, banking regulators vastly expanded the federal safety net and exposed U.S. taxpayers to ever-increasing hazards as large banking organizations used their franchise to feed on the capital markets and became

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[60] See Board of Governors v. Investment Company Institute, 450 U.S. 46, 56 (1981).

[61] Alan S. Blinder, After the Music Stopped, The Financial Crisis, the Response, and the Work Ahead, The Penguin Press, 2013, at 57, 59.

even larger shadow banks, operating without adequate capital, liquidity, or risk controls to support increased levels of risk. In their post-crisis quest to explain what happened, the regulators incredibly have pointed to shadow banking as if they had nothing to do with it.

C. Securitization—Part of the "Business of Banking"

The extent of bank involvement in the shadow banking system is exemplified by their securitization activities. Securitization lies at the heart of the shadow banking system. Yet, it also is undeniably a core banking activity. Without securitization, the shadow banking system would not exist.[62] Without banks, securitization would not exist. Some economists have said that, without securitization, banks would not exist:

> [T]he shadow banking system is essentially how the traditional banking, regulated, banking system is funded. The two banking systems are intimately connected. This is very important to recognize. It means that without the securitization markets the traditional banking system is not going to function.[63]

Securitization is the means by which banks convert loans into securities for sale to investors. Securitization involves the origination of loans, packaging of them into pooled trusts, and selling interests (i.e., securities) in the trust to investors, along with various intermediate steps, including warehousing and servicing.

Securitization became a permissible activity for banks in 1986 when the Comptroller of the Currency determined that such activities are part of the "business of banking" under the National Bank Act and not prohibited by the Glass-Steagall Act.[64] The securities industry sued to overturn the Comptroller's interpretation, but lost.[65] Within a few years, securitization replaced the traditional originate-to-hold model of bank lending with the originate-to-distribute model, along with its attendant moral hazard and proliferation of new types of risk throughout the financial system.

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[62] See Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, "Shadow Banking," Federal Reserve Bank of New York Staff Reports, Staff Report no. 458, July 2010 (rev. Feb. 2012), at 10 ("The shadow banking system is organized around securitization and wholesale funding.").

[63] Gary Gorton, "Questions and Answers About the Financial Crisis," prepared for the U.S. Financial Crisis Inquiry Commission, Feb. 20, 2010, at 8.

[64] OCC Interpretive Letter No. 362 (May 22, 1986).

[65] Securities Industry Association v. Clarke, 885 F.2d 1034 (2d Cir. 1989), cert. denied, 493 U.S. 1070 (1990). The Court deferred to the OCC's determination that securitization is part of the "business of banking."

Banking organizations became key operators at every level of the securitization network and remain instrumental in securitization activities today. They establish credit underwriting standards for loans, originate loans, purchase loans from other originators, warehouse loans, structure vehicles to hold the loans, issue securities (including commercial paper) backed by the loans, guarantee the securities and the vehicles, secure a credit rating, sell the securities to investors, and buy back the securities when the underlying loans default. Banks and their affiliates are present at every inch of the shadow banking pipeline.

Economists at the Federal Reserve Bank of New York have empirically examined the role of banking organizations in securitization activities and recently published the results of their study.[66] Based on an analysis of "virtually the entire universe of non-agency asset-backed activities from 1978 to 2008," they found as follows:

> [B]anks are *by far* the predominant force in the securitization market.[67]
>
> [T]he evidence suggests that very little securitization-based intermediation is actually in the shadow, with much of it remaining within the scope of regulated bank entities."[68]

Among other things, the Reserve Bank economists concluded that banks provide the "magic elixir" that makes securitization possible through credit enhancements:

> [B]anks play a vital role in the securitization process at a number of stages, including the provision of credit enhancements. Credit enhancements are . . . in effect the 'magic elixir' that enables bankers to convert pools of even poorly rated loans or mortgages into highly rated securities.[69]

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[66] Nicola Cetorelli and Stavros Peristiani, The Role of Banks in Asset Securitization, Federal Reserve Bank of New York Economic Policy Review, July 2012.

[67] *Id.* at 58 (emphasis added).

[68] Nicola Cetorelli, Benjamin H. Mandel, and Lindsay Mollineaux, The Evolution of Banks and Financial Intermediation, Federal Reserve Bank of New York Economic Policy Review, July 2012, at 10.

[69] Benjamin H. Mandel, Donald Morgan, and Chenyang Wei, The Role of Bank Credit Enhancements in Securitization, Federal Reserve Bank of New York Economic Policy Review, July 2012.

The Reserve Bank economists presented empirical data showing that banks have been a significant force in securitization "all along" and that their dominance varies depending on their role with different products:

> We show that the degree of bank domination varies according to product type and securitization role. Banks are inherently better suited to compete for the data-intensive trustee business, capturing in most cases more than 90 percent of these services. Having a strong role in securities underwriting, banks are able to exploit their expertise to capture a significant fraction of asset-backed underwriting as well. Naturally, in issuing and servicing the different segments of the securitization market, banks face competition from nonbank mortgage lenders and consumer finance companies. Nevertheless, we show that banks were able to retain a significant and growing share of issuance and servicing rights as well. Despite the greater complexity of a system of intermediation based on asset securitization, which appears to have migrated and proliferated outside of the traditional boundaries of banking, our findings suggest that banks maintained a significant footprint in much of this activity through time.[70]

These findings led the Reserve Bank economists to conclude that regulated banking organizations "have in fact played a dominant role in the emergence and growth of asset-backed securitization" and that "once their roles are explicitly acknowledged, a considerable segment of modern financial intermediation appears more under the regulatory lamppost than previously thought."[71]

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[70] Nicola Cetorelli and Stavros Peristiani, The Role of Banks in Asset Securitization, Federal Reserve Bank of New York Economic Policy Review, July 2012, at 48. See also Nicola Cetorelli and Stavros Peristiani, The Dominant Role of Banks in Asset Securitization, Liberty Street Economics Blog, Federal Reserve Bank of New York, July 19, 2012, http://libertystreeteconomics.newyorkfed.org/2012/07/the-dominant-role-of-banks-in-asset-securitization-.html ("we provide a comprehensive quantitative mapping of the primary roles in securitization. We document that banks were responsible for the majority of these activities. Their dominance indicates that the modern securitization-based system of financial intermediation is less "shadowy" than previously considered."). See also Vitaly M. Bord and João A. C. Santos, The Rise of the Originate-to-Distribute Model and the Role of Banks in Financial Intermediation, Federal Reserve Bank of New York Economic Policy Review, July 2012 at 32 ("Our findings also show that banks have been an important contributor to the so-called shadow banking system.").

[71] Nicola Cetorelli and Stavros Peristiani, The Role of Banks in Asset Securitization, Federal Reserve Bank of New York Economic Policy Review, July 2012,

These conclusions should persuade banking regulators to abandon the shadow banking mythology and pursue more enlightened reforms aimed at the true sources of systemic risk within the regulated banking system itself.

IV. SHADOW BANKING REFORM

A. Shadow Banking—A Flawed Reform Concept

Shadow banking is a flawed concept for regulatory reform for several reasons. As articulated by banking regulators, the shadow banking theory provides a largely bogus explanation of what caused the financial crisis and thus lacks factual credibility as a basis for reform. To the extent shadow banking caused the crisis, it did so because banking regulators misjudged the evolution of financial risks within the regulated banking system and allowed large banking organizations to become immersed in shadow banking activities with insufficient capital, liquidity, or supervisory oversight. The crisis in the shadow banking system was a crisis of the regulated banking system.

The inability of banking regulators to recognize their own culpability in failing to discern changing risk dynamics in the banking system strongly suggests that their assessment of systemic risks in the larger financial system is flawed and their reform efforts misguided. Among other things, their use of the pejorative "shadow bank" label to describe legitimate financial activities prejudices reform efforts by suggesting that shadow banking is inherently harmful or nefarious when in fact it has important benefits.[72] Banking regulators recognized these benefits when they first authorized banks to become involved with shadow banking as an antidote to the demise of deposit-based banking. A contorted view of shadow banking ignores its utility in meeting evolving financial needs and providing financial services more efficiently than the traditional banking model. Shadow banking contributes competition, diversity and other benefits that should be high among the reform goals of regulators.

The shadow banking fallacy especially is flawed to the extent it seeks to apply bank regulatory concepts to nonbank entities operating outside the regulated banking system and federal safety net.[73] Banking regulation originated as a tradeoff for deposit insurance and access to the Federal Reserve's discount

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at 48. See also *id.* at 60 ("We demonstrate that large bank holding companies—and, to a lesser extent, investment banks—have been significant contributors to all phases of this [securitization] process. Although much of the securitization activity appears to have been done outside the regulatory boundaries of banking, we find strong evidence to the contrary.").

[72] Many of these benefits are described in detail in the Appendix hereto.

[73] Some of these concepts even may be unsuitable even for nonbank affiliates of banks operating within the regulated banking system.

window, which is limited to insured banks. Nonbank financial institutions outside the regulated banking system engage in shadow banking without deposit insurance or access to central bank liquidity. The extension of bank regulatory concepts to these nonbank entities raises questions concerning the public policy rationale for banking regulation and the scope of the federal safety net.[74] Reforms that apply bank regulatory precepts outside the regulated banking system carry the risk of increasing moral hazard and creating a monolithic regulatory structure that will obstruct desirable innovation, efficiency, and diversity in the provision of financial services.

Critics of shadow banking imply that traditional banking is a superior form of financial activity when in fact the traditional banking model has proven inefficient and unsustainable over time. Traditional banks have depended on shadow banking activities to complement their deposit-based banking activities and could not have survived without shadow banking.

The shadow banking theory fails to adequately distinguish activities that are essential to the traditional banking business from those that are not. This distinction is vital in determining the extent to which bank regulatory concepts should govern financial activities.

The failure of banking regulators to correctly understand shadow banking suggests that their regulatory remedies are likely to be misinformed, misdirected, and counterproductive. Attempts to impose shadow banking "reforms" on nonbank entities operating outside of the regulated banking system—such as money market funds—especially are likely to be misguided.

B. Money Market Funds—A Mistaken Target

Money market funds have become an unlikely target of shadow banking reform efforts, both in the United States and abroad. Notwithstanding their lack of shadow banking attributes, they have been mislabeled as shadow banks and become entangled in the shadow banking myth.

Banking regulators have advocated subjecting MMFs to bank-like regulation on the rationale that, because a MMF "smells like a bank and quacks like a bank, [it] ought to be subject to bank-like liquidity and capital constraints.[75] This simplistic rationale ignores the attributes of MMFs that decidedly are not bank-like and overlooks the regulatory framework governing MMFs that decidedly is more rigorous than that applicable to banks.

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[74] The "federal safety net" refers to deposit insurance, access to central bank liquidity (i.e., the discount window), and supervisory oversight by the government.

[75] Adair Turner, "Shadow Banking and Financial Instability," Lecture at Cass Business School, March 14, 2012, at 34.

MMFs come within the regulators' broad definition of shadow banking only to the extent they offer a financial service and operate outside the regulated banking system. MMFs do not meet the key indicia of shadow banks—use of leverage and lack of regulation. To the contrary, MMFs are highly regulated and unleveraged.

MMFs are regulated under the Investment Company Act of 1940 and rules of the Securities and Exchange Commission thereunder. These laws impose strict credit quality, liquidity, diversification, transparency, governance, and other regulatory requirements on MMFs.[76]

MMFs seek to maintain a stable net asset value (NAV) of $1.00 but are required to calculate a market-based NAV as well. If a MMF's market-based NAV falls one-half a penny below $1.00, it must cease offering its shares at $1.00 or liquidate. This requirement minimizes losses to fund shareholders in the event a MMF "breaks the buck." Only two MMFs in the United States ever have broken the buck, and shareholders in these funds got back nearly their entire investment.[77]

MMFs lack the mechanism by which banks generate and multiply risk—leverage. MMFs do not issue debt or rely on borrowings and are almost completely unleveraged. Whereas banks generate assets equal to approximately ten times their capital, MMFs generate just $1.00 of assets for each dollar of shareholder equity. Moreover, MMF assets are short-term and capable of being liquidated to meet shareholder redemptions. MMFs thus do not create or spread credit risk as banks do.

MMFs also lack another key attribute of banks—opacity. MMFs are the most transparent of all financial intermediaries and cannot be said to "dwell in the shadows" of the financial system. They are required to make extensive disclosures about their operations, activities, investments, risks, service providers, fees, and other matters in prospectuses made available to investors. They also are required to disclose detailed information about each investment in

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[76] For example, MMFs are permitted to invest only in short-term debt instruments posing minimal credit risk as determined independently of any credit rating. Each MMF portfolio must have a weighted average maturity of 60 days or less and a weighted average life of 120 days or less. Each MMF must be able to convert 10 percent of its portfolio into cash within one day and 30 percent within five business days. A MMF generally may invest no more than five percent of its portfolio in securities of a single issuer.

[77] The Reserve Primary Fund, which broke a dollar in 2008, returned 99 cents on the dollar to its shareholders. A smaller fund that broke the buck in 1994 returned 96 cents on the dollar.

their portfolios and their market-based NAV.[78] Banks are not subject to such rigorous disclosure requirements.

Banks enjoy access to permanent government subsidies in the form of deposit insurance and government liquidity facilities, which give rise to ongoing moral hazard. MMFs operate successfully without these subsidies.

Nor do MMFs have other bank-like features that would justify subjecting them to bank-like regulation. MMFs do not take deposits, which are liabilities. Each share of a MMF is an equity investment rather than a liability.[79] Nor do MMFs engage in the business of making loans.[80]

As defined by banking regulators, a shadow bank is an entity not guaranteed by the government. Presumably, this factor reflects concerns that, in the absence of a government guarantee, the entity may be subject to runs. MMFs are not government guaranteed and thus, in the mind of banking regulators, are susceptible to runs and should be subject to bank-like regulation. Apart from there being no history of recurrent runs in the MMF industry, this view ignores the fact that banks themselves hold trillions of dollars in deposits that are not government guaranteed and thus are subject to runs by uninsured depositors. Banking history is replete with hundreds of bank failures and runs, including approximately 300 failures in the most recent crisis and 50 failures just last year. In contrast, only two MMFs ever have failed to pay their investors $1.00 per share.

The claim that MMFs are prone to runs has no empirical support. At the height of the financial crisis when it appeared the entire financial system was

[78] Such information includes the name of the issuer, category of investment, CUSIP number, principal amount, maturity date, final legal maturity date, coupon or yield, and amortized cost value. Banks are not required to publicly disclose any information concerning the composition of their loans or investment portfolios. MMFs regularly value their portfolios at market prices and publicly disclose their market priced net asset value to four decimal points. Banks value a substantial portion of their assets at book value, making it difficult for depositors, investors, and even regulators to know their true condition at any given time.

[79] The Glass-Steagall Act prohibits any person from taking deposits other than a bank. MMFs are not banks for this purpose. 12 U.S.C. § 378(a)(1). See Letter dated Dec. 18, 1979, from the Assistant Attorney General, Criminal Division, U.S. Department of Justice, to Martin Lybecker, Associate Director, Division of Marketing Management, Securities and Exchange Commission. See also E. Gerald Corrigan, Are Banks Still Special? The Region, Federal Reserve Bank of Minneapolis, March 1, 2000 ("Thus, while the competitive landscape continues to shift, there remains a critical aspect of the deposit gathering function which is unique to 'banks.'").

[80] Commercial paper, which MMFs invest in, is a form of security and not a loan. See Securities Industry Association v. Board of Governors, 468 U.S. 137 (1984).

collapsing, MMF investors rapidly reallocated their investments from prime MMFs to MMFs that invest only in government securities. This action reflected prudent investor behavior under unprecedented circumstances and does not signify that MMFs are subject to runs. Investors typically view MMFs as a safe haven during episodes of financial turmoil and, indeed, MMFs gained assets during the financial crisis.

To the extent the reallocation of MMF assets led to reduced funding for bank-sponsored ABCP vehicles in 2007 and 2008, the resulting disruption to large banks was due to their inadequate of capital, liquidity, and risk management prior to the crisis, which was tolerated by banking regulators. MMFs were not a factor in the "run on repo" and indeed contributed assets to the repo market during the crisis.[81]

MMFs did not cause the financial crisis. Researchers studying the crisis have pointed to a variety of factors as causes, including overly accommodative monetary policy, government homeownership policies, the originate-to-distribute model of housing finance, subprime mortgage lending, securitization of loans, over-leveraging by consumers and financial institutions, too-big-to-fail banking organizations, weak capital rules for banks, lax liquidity management, regulatory exemptions for banks, weakening of Glass-Steagall Act restrictions, unjustified credit ratings, unregulated derivatives activities, and mark-to-market accounting, among others. MMFs had nothing to do with any of these likely causes.

A recent report published by the European Commission concluded that MMFs were not a cause of the financial crisis:

> The activities of money market funds were not the underlying causes of financial instability during the financial crisis *per se*. . . .[I]n the context of the financial crisis, it must be noted that the underlying cause of risks to financial stability operating through money market funds did not originate in money markets. In particular, risks arose within the banking sector (due to securitised loan assets). . . . Moreover, the impact on MMF investors in terms of realised losses were either zero or very small.[82]

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[81] Gary Gorton and Andrew Metrick, Who Ran Repo? Oct. 4, 2012. ("As it turns out, MMFs were not at all representative during the crisis, with repo assets actually increasing for MMFs by more than $100 billion at the same time that overall repo liabilities were falling by $1.3 trillion.").

[82] European Commission, Nonbank Financial Institutions: Assessment of Their Impact on the Stability of the Financial System, Economic Paper 472, Nov. 2012, 64-66. The report found that MMFs were nevertheless affected by the crisis and became part of a "feedback loop."

The financial institutions most directly implicated in the causes of the crisis were banks, their affiliates, and their sponsored entities engaged in shadow banking activities through securitization and other highly-leveraged off-balance sheet activities.[83] Banking regulators also were a cause of the financial crisis to the extent they allowed banks to conduct such activities with insufficient capital and liquidity, and adopted regulatory exemptions that incentivized banks to increase their involvement in shadow banking activities in ways that ultimately proved devastating.[84] Banking regulators also tolerated weak risk management at large banks, allowed excessive reliance on short-term funding without appropriate safeguards, and failed to adequately monitor and oversee shadow banking activities by banks and their affiliates.[85]

In view of the foregoing, MMFs do not appear to be an appropriate target of shadow banking reforms. Recent proposals by the Financial Stability Oversight Council aimed at MMFs are the initiative primarily of banking regulators who have propagated the shadow banking myth and used it to conceal their own culpability in failing to anticipate and avert the financial crisis. Such proposals lack credibility or merit and are a questionable use of the Council's authority.[86]

C. The Challenge for Banking Regulators

The challenge for banking regulators is to abandon the shadow banking myth and confront the reality that banking organizations—not MMFs or other nonbank financial institutions—are the principal source of systemic risk in the financial system.

Banking regulators need to recognize that regulated banking organizations are the driving force in the shadow banking system and that flawed banking supervision is the principal reason why the financial crisis occurred with such severity. Not until regulators acknowledge this reality can they achieve

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[83] Researchers at the Federal Reserve Bank of New York have shown that banks were "by far the predominant force in the securitization market." Nicola Cetorelli and Stavros Peristiani, The Role of Banks in Asset Securitization, Federal Reserve Bank of New York Economic Policy Review, July 2012, at 58. See also Senior Supervisors Group, Risk Management Lessons from the Global Banking Crisis of 2008, Oct. 21, 2009, highlighting the involvement of banking organizations in overleveraged shadow banking activities without adequate liquidity, capital, or risk-management.

[84] See, e.g., Viral V. Acharya, Philipp Schnabl, and Gustavo Suarez (senior economist, Federal Reserve Board), Securitization Without Risk Transfer, Aug. 8, 2011.

[85] See Senior Supervisors Group, Risk Management Lessons from the Global Banking Crisis of 2008, Oct. 21, 2009.

[86] See M. Fein, Money Market Funds, Systemic Risk, and the Dodd-Frank Act, available at SSRN.com for the view that FSOC lacks authority to regulate MMFs.

durable reforms that will effectively address systemic risk and enhance financial stability.

The fact that traditional banks operate under the supervision of banking regulators is not a convincing reason to exclude them from the definition of shadow banking. Shadow banking activities of banking organizations pose greater risk to the financial system than such activities outside the regulated banking system. When conducted by banks and their affiliates, such activities have access to deposits (both insured and uninsured) as a source of funding and leverage.[87] Such activities thereby have greater capacity to multiply risk and threaten the safety and soundness of affiliated banks as well as to weaken the ability of parent bank holding companies to serve as a source of strength to their subsidiary banks. Because these activities occur under the immediate purview of banking regulators, they enjoy the perception of an implicit government guarantee. This guarantee gives them an artificial competitive advantage over other firms and is a source of moral hazard. Shadow banking activities conducted inside the regulated banking system are within the federal safety net and thus pose potential liability to the taxpayers.

The critical undertaking for regulators is to identify which shadow banking activities are appropriate for government-backed banking organizations and which are not. Questions such as whether nonbank affiliates of banks should have access to deposits and the federal safety net are appropriate. The policy question that arose in the 1980s concerning the viability of the traditional model of banking should be re-visited. Federal Reserve officials have said one of the key policy debates under consideration is whether to break up large financial institutions or impose other prohibitions on affiliations of commercial banks with certain business lines.[88] Certainly it is incumbent on regulators to reign in banking organizations deemed too-big-to-fail.

Regulators should take seriously the proposal put forth by the Federal Reserve Bank of Dallas to remove shadow banking from the federal safety net:

> [W]e recommend that . . . only the resulting downsized *commercial* banking operations—and not shadow banking affiliates or the parent company—would benefit from the safety net of federal deposit insurance and access to the Federal Reserve's discount window. . . .Our proposal is

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[87] Access to bank deposits as a source of funding for nonbank affiliates of banks is limited by section 23A of the Federal Reserve Act to 10 percent of the bank's capital for any single affiliate and 20 percent of the bank's capital for affiliates in the aggregate. Operating subsidiaries of banks generally are not subject to these limits.

[88] Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, "Industry Structure and Systemic Risk Regulation," Speech before the Brookings Institute, Dec. 4, 2012.

> simple and easy to understand. . . . It calls first for rolling back the federal safety net to apply only to basic, traditional commercial banking. . . . The shadow banking activities of financial institutions must not receive taxpayer support. . . . Under our proposal, only the commercial bank would have access to deposit insurance provided by the FDIC and discount window loans provided by the Federal Reserve. These two features of the safety net would explicitly, by statute, become unavailable to any shadow banking affiliate, special investment vehicle of the commercial bank or any obligations of the parent holding company. . . . This two-part step should begin to remove the implicit TBTF [too-big-to-fail] subsidy provided to BHCs and their shadow banking operations. Entities other than commercial banks have inappropriately benefited from an implicit safety net. Our proposal promotes competition in light of market and regulatory discipline, replacing the status quo of subsidized and perverse incentives to take excessive risk.[89]

An equally important challenge for banking regulators is to recognize the positive features of shadow banking and avoid reforms that negate its benefits. These include enhanced efficiency, competition, and diversity in the financial system. Shadow banking activities are not inherently risky, although they can become so when conducted by highly leveraged, government-backed institutions perceived as too-big-to-fail. Shadow banking became a menace to the financial system mainly because banking regulators failed to account for changing risk dynamics after years of financial evolution and allowed banking organizations to engage in such activities with insufficient capital, liquidity, and risk management. Suitably regulated shadow banking activities can enhance the resiliency of both the banking system and the larger financial economy.[90]

Money market funds in particular bring important benefits to the financial system and are not an appropriate target of shadow banking reform efforts by banking regulators. MMFs serve as efficient short-term cash management vehicles and investments for corporate and state treasurers, pension funds, foundations, retirement accounts, and individual investors. They are major

[89] Richard W. Fisher, President, Federal Reserve Bank of Dallas, Ending Too Big to Fail: A Proposal for Reform Before It's Too Late, Remarks before the Committee for the Republic, Washington, D.C., Jan. 16, 2013.

[90] See Gary B. Gorton, Misunderstanding Financial Crises—Why We Don't See Them Coming, Oxford University Press, 2012, at 198-99 ("Re-creating confidence in the shadow banking system is essential for economic growth. . . . the shadow banking system can fulfill its role in the economy without being crisis prone.").

purchasers of commercial paper issued by U.S. businesses to finance their payrolls, inventory, and cash flow, and hold large amounts of securities that finance municipalities. They afford investors more safety of principal, liquidity, transparency, diversification, efficiency, and convenience than any other product in the financial system.

A related challenge for banking regulators is to improve their methods of regulatory analysis by better utilizing cost-benefit analytical techniques. A recent report by the Government Accountability Office found that the regulators' rulemakings under the Dodd-Frank Act thus far have not always been supported by a comprehensive cost-benefit analysis in accordance with guidance issued by the Office of Management and Budget.[91] The GAO found that, while some regulators identified the benefits and costs of their chosen regulatory approach in proposed rules, they did not evaluate their chosen approach compared to the benefits and costs of alternative approaches.[92]

Another challenge for banking regulators is to broaden their regulatory vision to see that different schemes of regulation may be equally or more effective in controlling risk than banking regulation. Regulators' confidence in bank regulatory principles as the summum bonum of financial regulation is unjustified. The Investment Company Act of 1940 and SEC rules thereunder have been far more effective in ensuring the stability of money market funds than the banking laws have been in ensuring the stability of banks.

The fact remains that the financial crisis arose so severely due to a failure of banking supervision. It can be argued that if banking supervisors had only enforced basic credit underwriting standards in mortgage lending by banking organizations, the crisis never would have happened, or been far less severe. It would be foolhardy to assume that the application of banking supervision to nonbank financial companies outside the regulated banking system will reduce systemic risk and prevent another financial crisis. Regulators especially should

[91] Government Accountability Office, Report to Congress, Dodd-Frank Act: Agencies' Efforts to Analyze and Coordinate Their Rules, GAO-13-101, Dec. 2012. The Dodd-Frank Act requires the Government Accountability Office to review and report annually to Congress on the rulemaking activities of regulators pursuant to the Act.

[92] *Id.* ("As part of their analyses, the agencies generally considered, but typically did not quantify or monetize, the benefits and costs of these rules. . . .GAO's review of selected rules found that regulators did not consistently follow key elements of the OMB guidance in their regulatory analyses. . . .GAO previously recommended that regulators more fully incorporate the OMB guidance into their rulemaking policies, and the Office of Comptroller of the Currency and the Securities and Exchange Commission [but by implication not the Federal Reserve] have done so. By not more closely following OMB's guidance, other financial regulators continue to miss an opportunity to improve their analyses.").

not extend the bounds of banking regulation to entities such as money market funds that have operated safely and successfully for decades under a separate regulatory regime.

Some banking regulators have pushed for "immediate action" to adopt regulatory changes to money market funds and other nonbank entities said to be shadow banks notwithstanding the existence of "significant and ongoing" disagreements concerning the role of shadow banking and its utility in the financial system.[93] Their call for haste to regulate shadow banks might be more persuasive if banking regulators adopted a more credible definition of shadow banking to include the banking organizations they oversee. Their insistence on immediate action might seem less precipitous if they were not so keen on proposals that would eviscerate the money market fund industry in the face of warnings that adverse systemic consequences might ensue.[94] Their shadow

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[93] See Daniel K. Tarullo, Governor, Federal Reserve Board, Shadow Banking After the Financial Crisis, June 12, 2012 ("Today I want to focus on the development of a regulatory reform agenda for the shadow banking system. As those who have been following the academic and policy debates know, there are significant, ongoing disagreements concerning the roles of various factors contributing to the rapid growth of the shadow banking system, the precise dynamics of the runs in 2007 and 2008, and the relative social utility of some elements of this system. Conclusions drawn from these debates will be important in eventually framing a broadly directed regulatory plan for the shadow banking system. However, [] it is neither necessary nor wise to await such conclusions in order to begin implementing a regulatory response. * * * * Ideally, a regulatory response to the shadow banking system would be grounded in a full understanding of the dynamics that drove its rapid growth, the social utility of its intermediation activities, and the risks they create. Such a response would be comprehensive, meaning that it would cover in an effective and efficient manner any activities that create these vulnerabilities, without regard to how the activities were denominated, what transaction forms were used, or where they were conducted. Of course, many of the key issues are still being debated, and even those who agree on the desirability of a comprehensive response may differ on its basic form. We should continue to seek the analytic and policy consensus that must precede the creation of a regulatory program that meets these conditions. . . . But regulators need not wait for the full resolution of contested issues or the development of comprehensive alternatives, nor would it be prudent for them to do so. We should act now. . . ."). See also Daniel K. Tarullo, Statement before the Senate Committee on Banking, Housing, and Urban Affairs, Feb. 14, 2013.

[94] In contrast to his call for haste in reforming money market funds, Governor Tarullo, in explaining to Congress why the banking agencies had not completed the Dodd-Frank Act reforms within the statutorily mandated deadlines, stated that "some of the rules involve subjects that are complicated, controversial, or both" and "it is incumbent on regulators to take the time to understand the issues and to give full consideration to the many thousands of comments that were submitted on some of the proposals." Daniel K. Tarullo, Governor, Federal Reserve Board, oral statement before the Senate Committee on Banking, Housing, and Urban Affairs, Feb. 14, 2013. Mr.

banking reform ideas might be more convincing if they first completed their implementation of reforms to the regulated banking system mandated by the Dodd-Frank Act.

Numerous reforms mandated by the Dodd-Frank Act in 2010 to ensure the stability of the regulated banking system remain unimplemented.[95] These include reforms relating to bank capital, liquidity standards, and securitization activities. When complete, these reforms should help to reduce systemic vulnerabilities and may alter regulators' view of the risks posed by shadow banking activities. Rather than attempt to impose bank regulatory reforms on entities outside their jurisdiction—particularly those that are subject to other regulatory regimes—banking regulators should concentrate on reforming shadow banking activities in their own backyard.

Once regulators closely analyze the shadow banking activities of their existing regulatory clients, it should become evident that their conception of shadow banking as something outside the regulated banking system is wrong. Regulators hopefully will see that certain activities previously thought to constitute shadow banking simply do not fit the description. Foremost among these are money market funds, which lack the leverage, illiquidity, complexity, and opacity of either traditional banks or shadow banks.

Once regulators perceive the reality of the shadow banking system, they hopefully will recognize it as little more than a charade that has clouded their understanding of the financial crisis and distracted them from the important task of treating the true causes of systemic risk within the regulated banking system.

V. CONCLUSION

This paper has examined the concept of shadow banking and shown it to be a flawed construct that has confused and misguided regulators. Regulators have an erroneous conception of the shadow banking system and are using it to pursue inappropriate responses aimed at entities outside the regulated banking system that had nothing to do with causing the financial crisis.

Tarullo has called for immediate action on FSOC's MMF proposals notwithstanding that they are complicated, controversial, and opposed for sound reasons by the majority of comment letters in the public record.

[95] A prominent law firm tracking regulatory changes reported that, as of December 3, 2012, regulators had missed 61 percent of the Act's deadlines for rulemakings. Only one-third of required rulemakings had been finalized. As many as one-third of required rulemakings had not even been proposed. Davis Polk, Dodd-Frank Progress Report, Dec. 3, 2012.

Regulators have mischaracterized shadow banking as occurring *outside* the regulated banking system among unregulated entities when the facts show that the regulated banking system itself is the hub of shadow banking. The shadow banking system consists largely of regulated banking organizations operating under the supervision of banking regulators.

Shadow banking has become a significant distraction that has sidetracked policymakers from focusing on the true causes of financial instability and delayed meaningful reforms within the regulated banking system. Critical bank regulatory reforms mandated by the Dodd-Frank Act remain unimplemented. These include reforms to address the direct causes of the financial crisis by strengthening bank capital, liquidity and risk management and reforming securitization activities of banks.

The focus of regulators on shadow banking as primarily a nonbank phenomenon outside the regulated banking system threatens to harm and even eliminate beneficial elements of the financial system that counterbalance weaknesses in the banking system and contribute efficiency and competitiveness to the financial markets. This is particularly true in the case of money market funds, which are highly useful to millions of individual and institutional investors and have proven to be far more resilient than banks.

APPENDICES

I. SHADOW BANKING REFERENCES

Shadow banking has been highlighted as a phenomenon associated with the financial crisis in numerous studies, speeches, papers, reports, news articles, and other media. The vast majority of these references treat shadow banking as something outside the regulated banking system, contrary to the reality in which banking organizations are the linchpins of the shadow banking system. The extent to which shadow banking has become a focus of official study and media attention is exemplified by the following list of references, which only partially reflects the attention devoted to this subject.

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II. The Deloitte Shadow Banking Index

The shadow banking phenomenon has attracted a bandwagon of academics, consultants, lawyers, and media “experts” eager to contribute reports, papers, and commentary reflecting their views and recommendations on shadow banking.

Emblematic of the attention shadow banking has attracted is the Deloitte “Shadow Banking Index.” The Index was devised by the Deloitte Center for Financial Services to serve as a “reference tool to define, size, and frame the debate about this complex and dynamic subject.” The Index defines a shadow bank as an entity engaged in credit intermediation, credit risk transfer, and maturity transformation *outside* the regulated banking system without government support. This definition is similar to that used by banking regulators and others currently studying the shadow banking system but remarkably, unlike other definitions, it ignores arguably the most important shadow banking trait—leverage.

First on the list of shadow banks in the Deloitte Index are money market funds, followed by asset-backed commercial paper conduits, asset-backed securities, non-agency mortgage-backed securities, credit default swaps, repurchase agreements, securities lending, and agency mortgage-backed securities. Interestingly, the Deloitte Index excludes hedge funds, stating that their activity is not bank-like because their source of funds—investor capital—generally matches the liquidity and maturity constraints of their underlying investments, a statement that also applies to money market funds. Banking regulators, in contrast, have defined shadow banks to include hedge funds that provide credit or are leveraged.

Deloitte gives no explanation as to why money market funds are included in its Index but relies heavily on their lack of government support as a factor. Deloitte actually excludes money market funds from the Index for the one year when they were covered under a temporary partial government guarantee (from September 19, 2008 to September 19, 2009) but adds them back in afterwards. Similarly, the Index includes government-sponsored entities (GSEs) until 2008 but removes them after September 2008 when the government placed Fannie Mae and Freddie Mac into conservatorship, thereby effectively guaranteeing their obligations. Why the lack of government backing should be an essential characteristic of a shadow bank is unexplained.

Based on its definition of shadow banks, Deloitte estimates the size of the shadow banking system to be $9.53 trillion in assets at year-end 2011, down 25 percent from year-end 2004 and down 50 percent from its peak of almost $21 trillion in 2009. Based on its estimates, Deloitte assigns shadow banking a base Index value of 100 as of 2004 and takes it from there to a value of 75 as of year-end 2011:

> The Deloitte Shadow Banking Index shows dramatic changes in shadow banking over a few years. From a base of 100 in 2004, it reached a peak of 162.5 in Q1 2008, with the sector's assets growing to over $20 trillion. Since then, the Index has dropped steadily, primarily due to regulatory action and market conditions, reaching a value of 75 as of Q4 2011. Assets were then $9.53 trillion, over 50 percent below peak.[96]

The Deloitte Shadow Banking Index suffers from the flaws shared by most if not all of the other attempts to demarcate the shadow banking system. First, it defines shadow banking as existing outside the regulated banking system. Second, it includes entities that had nothing to do with the causes of the financial crisis, such as money market funds. Third, it depicts the shadow banking system as unregulated or less-regulated than the banking system.

The danger of the Deloitte Shadow Banking Index and similar shadow banking gimmickry is that it lends credence to a false construct built on flawed assumptions concerning the financial crisis and conveys false comfort that all will be well if only the shadow banks are brought out of the shadows into the light of banking regulation.

In fact, subjecting nonbank entities to banking regulation almost certainly will increase systemic risks by bringing more of the financial system within the

[96] Deloitte Center for Financial Services, Shedding Light on Banking's Shadows, at 2.

banking system and under the purview of banking supervisors who allowed the financial crisis to develop in the first place. In the case of money market funds, the danger is that misguided regulatory reform efforts will subject these entities to inappropriate bank regulatory concepts and destroy one of the most useful and competitive sectors in the financial system that proved far more resilient than banks during the financial crisis.

Even Deloitte has acknowledged that the shadow banking sector "provides an enormous benefit to the U.S. economy by broadening the availability of investment options and, as a result, channels credit more efficiently, enabling risk diversification and financial innovation."[97]

The Deloitte Shadow Banking Index acknowledges that "a large portion of shadow banking exists within the bank holding companies and banking institutions that are regulated by the Federal Reserve."[98] Yet, Deloitte fails to consider the implications of this revelation for regulatory reform efforts that view shadow banking as something outside the regulated banking system.

III. THE BENEFITS OF SHADOW BANKING

Shadow banking activities provide important benefits to the financial system and the economy. Nonbank credit intermediation—the essence of shadow banking—provides a direct link between the capital markets and end-users who deploy credit in economically useful ways. Among other things, shadow banking:

- Enhances credit availability in the economy;
- Increases liquidity in the financial system;
- Makes the financial system more diverse and competitive;
- Enhances efficiency in the delivery of financial products and services;
- Facilitates the tailoring of financial products and services to the needs of different customers;
- Creates tools for better risk management; and
- Reallocates risk away from the government guaranteed banking system.

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[97] *Id.* at 5.
[98] *Id.* at 12.

Banking regulators have recognized the benefits of shadow banking but become schizophrenic in their attempts to repress it while preserving its positive aspects.[99]

The Financial Stability Board has recognized that shadow banking offers important benefits:

> The "shadow banking system" . . . has become an integral part of the modern financial system that has an important role in supporting the real economy. For example, the shadow banking system provides market participants and firms with an alternative source of funding and liquidity. Furthermore, some non-bank entities may have specialised expertise to assess risks of borrowers and hence can spur competition in the allocation of credit in the economy.[100]

The European Systemic Risk Board also has emphasized the benefits of shadow banking:

> Beneficial aspects of shadow banking. The term "shadow banking" should not have a pejorative meaning per se. With appropriate safeguards in place, such as, inter alia, transparency and disclosure, the supply of financial services by the shadow banking sector can bring benefits, as listed in the Green Paper. For example, against the backdrop of the ongoing deleveraging process in the European banking sector, a well-functioning securitisation market would support the supply of credit to the real economy. The ESRB also believes that the shadow banking sector can be a source of financial innovation, which may result in increased efficiency and more complete financial markets. In addition, the shadow banking sector can provide financial services that regular banks do not necessarily offer, such as market making, thereby improving market liquidity.[101]

[99] See, e.g., Adair Turner, "Shadow Banking and Financial Instability," Lecture at Cass Business School, March 14, 2012, at 30 ("[D]o we want securitization and shadow banking to come back? We often seem schizophrenic.")

[100] Financial Stability Board, "Global Shadow Banking Monitoring Report 2012," Nov. 18, 2012 at 1.

[101] European Systemic Risk Board, Reply to the European Commission's Green Paper on Shadow Banking, May 30, 2012. The ESRB is a high level task force appointed by the European Commission to improve European financial supervision.

The Finance Ministry of the United Kingdom—HM Treasury—has recognized that shadow banking complements traditional banking and plays an increasingly important role in credit intermediation:

> Non-bank credit intermediation plays an important role in the financial system by offering an alternative source of liquidity and funding to both market participants and the real economy. It therefore acts as a complement to the traditional banking sector, a role that is of increasing importance as we seek to target growth in our economies at a time when banks are deleveraging. The non-bank sector may even be able to provide credit to the economy more efficiently than a bank could, through specialisation and competition in particular parts of the credit intermediation chain.[102]

The UK Finance Ministry views shadow banking as an important source of diversification that should be encouraged:

> Our aim should be to allow for the development of a healthy, safe and competitive non-bank intermediated sector that acts as a complement to and a diversification away from the regular banking system, rather than seeking to regulate this away.[103]

The UK Finance Ministry has said it would be a mistake to view shadow banking activities as unregulated or unduly risky:

> It is therefore important to say that inclusion or participation in the shadow banking system neither means that an entity or the activities it undertakes is unregulated (for example, many people would suggest that there are UCITS firms which engage in shadow banking – by definition they are subject to regulation) and nor does it necessarily mean that it is unacceptably risky. . . . It is vital that we seek to understand this complex system so that we distinguish between the benefits and the growth it can offer, and the specific risks that we need to address to ensure that those benefits are safely realised. [104]

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[102] HM Treasury, HMT Response to the European Commission's Green Paper on Shadow Banking (2012).
[103] *Id.*
[104] *Id.*

Unlike U.S. banking regulators, the UK Finance Ministry has acknowledged that banks are at the heart of shadow banking:

> In the first place we should recognise that banks are at the centre of the shadow banking system and should be our first port of call when considering the degree of risk posed by non-bank intermediation. Banks engage directly in activities that the Green Paper identifies as part of the shadow banking system (for example, securities lending), and indirectly though the sponsorship of, for example, exchange traded funds or securitisation vehicles.[105]

The UK Finance Ministry recognizes that bank-like prudential regulation may not be appropriate for nonbank entities:

> Even where entities share some of the characteristics of banks and can therefore be described as bank-like (because they engage in, for example, maturity or liquidity transformation, have deposit-like characteristics or facilitate the transfer of risk), it is important to be clear that this is not an a priori argument for full prudential regulation and does not imply that a shadow banking entity poses the same systemic risks as a bank. Most shadow banking entities would not be considered too big to fail, for example.[106]

In considering the regulatory response to shadow banking, the UK Finance Ministry urges that the benefits of non-bank credit intermediation be taken into consideration:

> We need to ensure that we recognise the contribution to growth that could come from this sector and consider this when debating whether, and if so where, to further regulate entities or activities involved in non-bank financial intermediation . . . . Diversity and competition should be supported by a properly functioning regulatory framework, and we should where possible seek to promote safe forms of non-bank intermediation that will complement and compete with our banking sector in providing credit to our economies – and by extension support our ambitions for growth.

[105] *Id.*
[106] *Id.*

> These benefits are made particularly pertinent by the current, broader context of bank deleveraging. We should be alive to the possibility that the shadow banking sector may offer ways to provide credit to the real economy outside the banking sector that could be important to mitigating the impact that deleveraging may have on growth in Europe. The sector may even be able to do this more efficiently and cheaply than banks are able to, by specialising in particular aspects of credit intermediation, and by connecting corporations directly to sources of funding in the capital and financial markets. Moreover, the provision of services outside of the banking sector reduces the systemic importance of banks, helping to reduce the extent of the too-big-to-fail problem. It is therefore important that we do more work to understand the benefits of the shadow banking sector as a whole so that we can properly assess its contribution to our economies.[107]

In the United States, the Financial Stability Oversight Council has acknowledged the benefits of money market funds, even while issuing proposals that would diminish their utility in the financial system:

> MMFs are a convenient and cost-effective way for investors to achieve a diversified investment in various money market instruments, such as commercial paper (CP), short-term state and local government debt, Treasury bills, and repurchase agreements (repos). This diversification, in combination with principal stability, liquidity, and short-term market yields, has made MMFs an attractive investment vehicle. MMFs provide an economically significant service by acting as intermediaries between investors who desire low-risk, liquid investments and borrowers that issue short-term funding instruments. MMFs serve an important role in the asset management industry through their investors' use of MMFs as a cash-like product in asset allocation and as a temporary investment when they choose to divest of riskier investments such as stock or long-term bond mutual funds.[108]

[107] *Id.*
[108] 77 Fed. Reg. 69457, 69455 (Nov. 19, 2012).

Prior to the financial crisis, U.S. banking regulators extolled the benefits of financial innovations of the type reflected in shadow banking.[109] As of early 2007, for example, Federal Reserve officials were publicly touting the resiliency and increased efficiency of the financial markets resulting from new technologies, the removal of legal and regulatory barriers to capital market entry by banking organizations, and increased participation by nonbank institutional investors as purchasers of credit through securitization—i.e., shadow banking activities:

> Credit markets have been evolving very rapidly in recent years. New instruments for transferring credit risk have been introduced and loan markets have become more liquid. Asset managers have become an important force in a wider range of credit markets. Taken together, these changes have transformed the process through which credit demands are met and credit risks are allocated and managed.
>
> [T]hese developments generally have enhanced the efficiency and the stability of the credit markets and the broader financial system by making credit markets more transparent and liquid, by creating new instruments for unbundling and managing credit risks, and by dispersing credit risks more broadly. * * * *
>
> Benefits of Recent Developments: The new instruments, markets, and participants I just described have brought some important benefits to credit markets. I will touch on three of these benefits: enhanced liquidity and transparency, the availability of new tools for managing credit risk, and a greater dispersion of credit risk. . . . The dramatic improvement in credit market liquidity has been spurred by credit derivatives. . . . A key factor driving the improvement in secondary-market liquidity is the expanded participation of nonbank institutional investors. These investors are active managers of credit risk, and consequently they appear to place a higher value on liquidity.
>
> Along with liquidity, transparency in credit markets has also improved over time. * * * * Enhanced liquidity and

[109] See, e.g., Speech by Federal Reserve Board Vice Chairman Donald L. Kohn at the Exchequer Club, Feb. 21, 2007 describing how innovations in the financial markets had increased the resiliency of the financial system.

> transparency should promote better risk management by market participants and facilitate broader participation in credit markets. Liquid markets make it easier to access historical price data and thus permit better measurement of credit risks. Measuring a risk more accurately allows it to be priced more accurately. A more transparent market with more accurate pricing is attractive to a wider array of investors. In effect, better liquidity and transparency have lowered the cost of entry into the credit markets.
>
> In addition to enhanced liquidity and transparency, the recent developments in credit markets have equipped market participants with new tools for taking on, hedging, and managing credit risk. . . . The enhanced transparency and liquidity of credit markets and the development of new instruments for customizing the risk characteristics of credit exposures have resulted in a wider dispersion of credit risk. Although significant participation by nonbank institutional investors has long been a hallmark of U.S. credit markets, these developments have facilitated greater risk-bearing by entities other than banks and other highly regulated depository institutions. On its face, a wider dispersion of credit risk would seem to enhance the stability of the financial system by reducing the likelihood that credit defaults will weaken any one financial institution or class of financial institutions.[110]

Federal Reserve Chairman Bernanke emphasized the importance of maintaining a broad and innovative financial sector:

> In addressing the challenges and the risks that financial innovation may create, we should also always keep in view the enormous economic benefits that flow from a healthy and innovative financial sector. The increasing sophistication and depth of financial markets promote economic growth by allocating capital where it can be most productive. And the dispersion of risk more broadly across the financial system has, thus far, increased the resilience of the system and the economy to shocks. When proposing or implementing regulation, we must seek to preserve the

[110] Recent Innovations in Credit Markets, Speech by Federal Reserve Governor Randall S. Kroszner to the 2007 Credit Markets Symposium at the Charlotte Branch of the Federal Reserve Bank of Richmond, March 22, 2007.

> benefits of financial innovation even as we address the risks that may accompany that innovation.[111]

Another Federal Reserve Board governor echoed these views:

> The Brave New World: More Complete Markets and Conflating Roles: The powerful combination of liquidity and financial innovation has made markets seemingly more complete--that is, more risks are priced and traded without undue penalty owing to their unique nature or shallowness of the relevant financial market. Financial innovation, by definition, makes markets more complete by expanding the set of available types of securities and reducing transaction costs. And liquidity provides some degree of assurance that funds will readily flow into new structures and new securities.
>
> The benefits of more complete markets are three-fold. First, they allow firms and households to hedge a variety of risks, a considerable benefit when volatility is costly. Second, they make it more feasible for investors to fine tune the risk-return profiles of their portfolios. The concomitant reduction in risk premiums required by investors should reduce capital costs for all economic agents. Third, risks once held within the four walls of financial institutions are converted into tradable securities and distributed and dispersed to a broader base of institutions and interests.[112]

Regulators should not lose sight of these shadow banking benefits as they pursue reforms to the financial system.

IV. HOW TRADITIONAL BANKS BECAME SHADOW BANKS

Shadow banking has been a part of the regulated banking system for more than three decades. Traditional banks became shadow banks through a succession of regulatory interpretations and actions that enabled them to access nondeposit funding sources through securitization, repurchase agreements, securities lending, derivatives, securities dealing, and other activities in the

[111] Regulation and Financial Innovation, Speech by Federal Reserve Chairman Ben S. Bernanke before the Federal Reserve Bank of Atlanta's 2007 Financial Markets Conference, May 15, 2007.

[112] Speech by Federal Reserve Board Governor Kevin Warsh at the European Economics and Financial Centre, June 5, 2007, “Financial Intermediation and Complete Markets.”

capital markets. With the exception of repurchase agreements, none of these activities were permissible for banks prior to 1980. Such activities would not have come to be so prominent in the financial system had banking regulators not explicitly authorized them.

Shadow banking arose because banking regulators in the early 1980s feared that traditional deposit-based banking was no longer a sustainable business model. Regulators broadened the powers of banks to enable them to remain competitive, allowing them to enter the capital markets where they ultimately became the dominant players. Banking regulators, however, failed to grasp fully the nature and extent of the risks to which banks thereby became exposed and thus failed to adopt or adapt supervisory standards and oversight appropriate for such risks.

Banking regulators themselves were the midwives and handmaidens of the shadow banking system. Over a relatively short period of time, they facilitated the conversion of traditional banks into shadow banks and gave birth to the shadow banking system.

A. Erosion of Traditional Banking

A major erosion of the traditional banking business began in the late 1970s, caused largely by technological developments that made the capital markets increasingly attractive as an alternative source of financial services for traditional banking clients.[113] Banks faced competition on both the lending and deposit sides of the ledger.

On the lending side, corporate clients began to satisfy their short- and intermediate-term credit needs by issuing commercial paper directly in the capital markets and issuing bonds, which was more cost-efficient than obtaining bank loans. Bank loans came to be a source of back-up liquidity rather than primary funding.

On the deposit side, broker-dealers offered cash management services tied to mutual funds that were functionally similar to interest-bearing checking accounts. Inflation-driven interest rates created a demand for short-term market sensitive financial instruments such as money market funds and other nonbanking investment vehicles.[114] Regulation Q prohibited banks from paying

[113] These developments included on-line databases, massive computation capacity, and telecommunication facilities. See The Financial Modernization Act of 1987 and the Financial Services Oversight Act: Hearings on S. 1886 and S. 1891 Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 9 (1987).

[114] See, e.g., Jittery Consumers Turning to Money Funds, Not Banks, American Banker, Jan. 22, 1991, at 1 ("Money market mutual funds are showing signs of replacing banks as safe haven for consumer funds.").

interest on checking accounts and limited the interest they could pay on savings and time deposits. Consequently, banks saw major outflows of deposits to money market funds (and credit unions) in the early 1980s. Even when Regulation Q restrictions eased, banks could not pay a market interest rate on deposits due to their high overhead and regulatory compliance costs.

The deposit-based banking model also was doomed by the inability of banks to offer safe deposits in excess of $100,000, which was the limit on deposit insurance until 2008.[115] Bank deposits declined dramatically as a percentage of safe debt obligations in the financial system, from approximately 70 percent in 1978 to 27 percent as of 2007.[116]

These changes caused banking regulators to question where the boundaries of banking lay and whether traditional banks were viable in the long run, as reflected in the following statement by former Federal Reserve Board Chairman Volcker:

> Irreversible technological change is fundamentally altering the financial environment; modern data processing capabilities, instantaneous and cheap communications, and relatively inexpensive and fast travel are all breaking down the traditional geographic or institutional barriers to competition and contributing to the rapid growth of new institutions able to exploit new technology. Old concepts of what is banking and what is not are blurred. Even national borders are losing their significance. We have an array of financial institutions and instruments that were simply unknown a decade or two ago. The typical customer—business or individual—no longer feels so dependent on his local bank or savings and loan for financial services. Even the distinction between commerce and finance—embodied in law and tradition—has been eroded. In the circumstances, many institutions are understandably concerned not only about the strains arising from current market conditions but about the prospects for their industries over the years ahead, and whether they, as individual institutions, will have the ability to compete fairly and effectively in the future.[117]

[115] Even at the current insurance limit of $250,000, banks are unable to offer safety to large institutional investors.

[116] See Gary B. Gorton, Stefan Lewellen, and Andrew Metrick, "The Safe-Asset Share," National Bureau of Economic Research, Working Paper 17777 (Jan. 2012) at 9.

[117] Testimony of Federal Reserve Board Chairman Paul A. Volcker before the Senate Committee on Banking, Housing, and Urban Affairs, October 29, 1981.

Regulators thus were not unsympathetic when banks sought regulatory approval to expand their product offerings to include securities products and services from which they could generate fee income and diversify their sources of revenue.[118] But a number of regulatory hurdles stood in the way, most notably the Glass-Steagall Act, adopted by Congress in 1933 to separate commercial banking from the securities business.

Banking regulators viewed the Glass-Steagall Act and other banking laws as an obstacle to the future viability of the banking system. They repeatedly cited the failure of the banking laws to keep pace with the financial markets as a cause of declining asset quality, profitability, and stock performance that threatened the safety and soundness of the banking system. In 1987, the Comptroller of the Currency warned:

> [T]here is a disturbing longer-term trend that indicates that profitability and asset quality may continue to deteriorate. Current restrictions on banks' ability to diversify their assets and sources of income make it cumbersome, if not impossible, to restructure the products and services they offer in line with changing market conditions and consumer demands. Furthermore, only if banks have the authority to deliver the products customers demand will they be able to earn returns that can attract capital.[119]

The Comptroller worried that, "unless something is done to give banks additional flexibility to respond to competitive pressures, there exists the potential for an erosion of the safety and soundness of the banking system."[120] The Chairman of the Federal Deposit Insurance Corporation echoed this sentiment:

> [A]s the result of restrictive laws, banks have lost a chunk of their traditional business. This has forced banks to go further out on the risk curve to maintain market share and profit margins.…[T]he archaic system of laws under which the banking industry operates has created inefficiencies in

[118] In some banks, fee income grew to 50 percent or more of the bank's revenues. See Fee Income Drives Profits at Super Regionals, American Banker, July 16, 1996; Fees Boost Profits at BankAmerica, Bank of N.Y., American Banker, July 18, 1996. The Federal Reserve Board estimated that, in the decade from the mid-1980s, noninterest income increased from 26 to 38 percent of total bank revenue. 84 Fed. Res. Bull. 402 (1998).

[119] Financial Condition of Federally Insured Depository Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 9 (1987) (Statement of Robert L. Clarke, Comptroller of the Currency).

[120] *Id.* at 11.

> the system that are contributing to some disturbing trends in the banking industry.…[121]

Federal Reserve Chairman Volcker jointed the OCC and FDIC in urging Congress to expand the powers of banking organizations to engage in commercial paper underwriting and dealing, among other things.[122] When Congress failed to act, the regulators themselves found ways of removing legal barriers to bank entry into the capital markets. Their actions gave birth to the shadow banking system within the regulated banking system.

B. Commercial Paper Activities

Banks entered the commercial paper market in the 1980s, initially as private placement agents, supported by a Federal Reserve Board staff study concluding that such activities did not violate the Glass-Steagall Act.[123] In 1979, the Securities Industry Association ("SIA") petitioned the Board to issue a cease and desist order prohibiting Bankers Trust Company, a state member bank, from acting as agent for issuers in privately placing commercial paper, arguing that such activity violated the Glass-Steagall Act. The Board declined to prohibit such activities, stating that commercial paper did not constitute a security for purposes of the Glass-Steagall Act but rather was similar to a commercial bank loan.[124]

The SIA then sued the Federal Reserve Board. The Supreme Court agreed to hear the case "because of the importance of the issue for the Nation's

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[121] *Id.* at 21-22 (Statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).

[122] See, e.g., testimony of Federal Reserve Board Chairman Paul A. Volcker before the Subcommittee on Commerce, Consumer & Monetary Affairs of the House Committee on Government Operations, June 11, 1986 ("We have urged that bank holding companies, through their affiliates, be able to engage in a variety of activities such as underwriting commercial paper and other instruments I mentioned earlier, real estate and insurance brokerage and travel services.").

[123] Federal Reserve Board Staff Study, Commercial Bank Private Placement Activities 81-99 (June 1977). The staff study concluded that the activity of a financial intermediary in a private placement transaction does not constitute "underwriting" for purposes of the Glass-Steagall Act because that term connotes a public offering of securities and a private placement does not involve a public offering. The Comptroller of the Currency and FDIC joined the Board in submitting a report to Congress reaching the same conclusion. Comptroller of the Currency, FDIC, Federal Reserve Board, Commercial Bank Private Placement Activities (1978).

[124] Board Letter dated September 26, 1980, to John F. Liftin and Harvey L. Pitt, enclosing Federal Reserve Board Statement Regarding Petitions to Initiate Enforcement Action.

financial markets."[125] Upon review, the Court ruled against the Board, finding commercial paper to be a "security" for purposes of the Glass-Steagall Act and thus subject to the Act's proscriptions.[126] The Court described the potential hazards of bank involvement in commercial paper activities and was almost prophetic in its prescience of future events in the commercial paper market:

> In enacting the Act, Congress' worries about commercial-bank involvement in investment-bank activities reflected two general concerns. The first of these concerns was that a commercial bank might experience large losses from investing its funds in speculative securities. In addition to this concern, however, Congress focused on the conflicts of interest that arise when a commercial bank goes beyond the business of acting as a fiduciary or managing agent and develops a pecuniary interest in marketing securities. The Act's design reflects the congressional perception that some commercial-and investment-banking activities are fundamentally incompatible and justify a strong prophylaxis.[127]

The Court said the Federal Reserve was attempting to regulate activities which the Glass-Steagall Act sought to prohibit:

> The Board's interpretation effectively converts a portion of the Act's broad prohibitions into a system of administrative regulation, since by concluding that commercial paper is not covered by the Act, the Board in effect has obtained authority to regulate the marketing of commercial paper under its general supervisory power over member banks….[128]

Notwithstanding the Supreme Court's adverse ruling, the Federal Reserve Board nevertheless permitted banking organizations to privately place commercial paper by determining that the private placement of commercial paper does not constitute "underwriting" for purposes of the Glass-Steagall

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[125] Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 137 (1984).

[126] *Id.* ("Because commercial paper falls within the plain language of the Act, and because the inclusion of commercial paper within the terms of the Act is fully consistent with its purposes, commercial paper is a "security" under the Act and therefore is subject to its proscriptions. . . .").

[127] *Id.*

[128] *Id.*

Act.[129] The Board concluded that such activities were an extension of bank lending activities and offered significant public benefits, noting that it had urged Congress to authorize bank holding companies to underwrite and distribute an even wider range of securities:

> As noted below, the proposed activity is a natural extension of commercial lending activities traditionally conducted by banks, involving little additional risk or new conflicts of interest, and potentially yielding significant public benefits in the form of increased competition and convenience. On this basis, the Board has urged the Congress to authorize bank holding companies to engage in a wider range of activities than that proposed here—underwriting and distributing commercial paper as principals, underwriting certain other types of securities that are very similar to obligations currently underwritten by banks, *i.e.*, municipal revenue bonds and mortgage related securities, and sponsoring mutual funds.
>
> . . . . Although commercial paper technically is a security for purposes of the Glass-Steagall Act, this kind of instrument has many of the characteristics of a traditional commercial loan. . . .[T]he Board concludes that the proposed commercial paper placement activity is so functionally and operationally similar to the role of a bank that arranges a loan participation or syndication that banking organizations are particularly well suited to perform the commercial paper placement function.
>
> . . . . *Public Benefits.* The Board believes that consummation of this proposal will produce significant benefits to the public in the form of increased competition and greater convenience and efficiency. . . .In light of the fact that currently the commercial paper market is dominated by a small number of dealers, the expansion of Applicant's commercial paper activities can only foster competition in that market. Moreover, the establishment of this activity in a holding company subsidiary will allow applicant to provide greater convenience to customers of the service and to offer the service more efficiently on a

[129] The SIA again challenged the Board's action as contrary to the Glass-Steagall Act. The appellate court accorded deference to the Board. The Supreme Court this time allowed the Board's order to stand. Securities Industry Association v. Board of Governors, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

> nationwide scale. The Board considers these two factors—increased competition and more convenient service to investors and borrowers—to be substantial and important public benefits.[130]

The Board later authorized bank holding companies to underwrite and deal in commercial paper and asset-backed securities.[131] The OCC similarly allowed national banks to engage in commercial paper activities. These and related regulatory actions began a broad expansion of banking organizations into the capital markets.

Commercial paper activities were the first step in the transformation of traditional banks into shadow banks. Through a series of regulatory approvals that followed, the regulators allowed banks to compete with securities firms for prime corporate customers in every corner of the capital markets in order to diversify their sources of revenue and profitability.

C. Securitization Activities

Shortly after authorizing bank commercial paper activities, banking regulators approved securitization as a permissible activity for banks. Securitization became the backbone of the shadow banking system. As Federal Reserve researchers have explained, shadow banking was largely an outgrowth of the securitization of assets by banks and the mingling of banking with the capital markets:

> The current financial crisis has highlighted the growing importance of the "shadow banking system," which grew out of the securitization of assets and the integration of banking with capital market developments.[132]

Beginning in 1986, the OCC authorized national banks to issue, underwrite, and deal in bonds collateralized by pools of mortgage loans and other

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[130] Federal Reserve Board Order dated Dec. 24, 1986 approving application by Bankers Trust New York Corporation to Engage in Commercial Paper Placement to a Limited Extent, 73 Fed. Res. Bull.138 (1986).

[131] Citicorp/J.P. Morgan & Co. Incorporated/Bankers Trust New York Corporation, 73 Fed. Res. Bull. 473 (1987); Chemical New York Corporation et al., 73 Fed. Res. Bull. 731 (1989). These Board orders also were challenged by the Securities Industry Association as contrary to the Glass-Steagall Act but were upheld by the courts. By the end of 1996, 41 subsidiaries of bank holding companies were engaged in underwriting and dealing of commercial paper and other securities.

[132] Tobias Adrian and Hyun Song Shin, The Shadow Banking System: Implications for Financial Regulation, Federal Reserve Bank of New York Staff Reports, no. 382, July 2009.

assets.[133] The Securities Industry Association challenged such activities as contrary to the Glass-Steagall Act. The OCC argued that the bank's use of mortgage pass-through certificates was a permissible means of selling bank assets under the National Bank Act and, as such, outside the reach of the Glass-Steagall Act. Even if the Glass-Steagall Act were applicable, the OCC said, the certificates were not "securities" within the meaning of the Glass-Steagall Act. Even if the certificates were securities, the OCC said the bank was not dealing in or underwriting the securities.

The U.S. Court of Appeals for the Second Circuit upheld the OCC's interpretation.[134] The court ruled that the OCC correctly found that the sale of the certificates by the bank was within the business of banking and that the Glass-Steagall Act was therefore inapplicable.[135] The court stated, "If the activity constitutes the 'business of banking,' then the Glass-Steagall Act prohibitions . . . do not apply."[136] The court failed to see any Glass-Steagall "subtle hazards," stating that the mere fact that a bank has an interest in seeing that its loans are sold does not implicate the hazards Glass-Steagall was intended to prevent.

Following the court's decision, the OCC authorized national banks to securitize assets of other lenders as well as their own assets. In 1988, the OCC permitted a bank to issue collateralized mortgage obligations where up to 50 percent of the mortgages were purchased by the bank from unaffiliated parties.[137] The OCC subsequently approved numerous asset securitization proposals by national banks.[138] In 1996, the OCC amended its rules to codify the authority of

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[133] OCC Interpretive Letter No. 362 (May 22, 1986); OCC Interpretive Letter No. 388 (June 16, 1987). See also OCC Interpretive Letter No. 1035 (July 21, 2005) ("The OCC has long held that national banks may use asset securitization as a means of selling or borrowing against their mortgage or other loan assets, and engage in securitization activities. Securitization provides banks an efficient tool for buying and selling loan assets and thereby increasing a bank's liquidity, among other advantages. Securitizations carve up the risk of credit losses from the underlying assets.").

[134] Securities Industry Association v. Clarke, 885 F.2d 1034 (2d Cir. 1989), cert. denied, 493 U.S. 1070 (1990).

[135] *Id.*

[136] *Id.* at 1048.

[137] OCC Interpretive Letter No. 418 (Feb. 17, 1988).

[138] See, e.g., OCC Interpretive Letter No. 585 (June 8, 1992) (automobile receivables); OCC Interpretive Letter No. 540 (Dec. 12,1990) (credit card receivables); OCC Interpretive Letter No. 418, supra (mortgage assets); OCC Interpretive Letter No. 417 (Feb. 17, 1988) (mortgage assets); OCC Interpretive Letter No. 416 (Feb. 16, 1988) (leases and auto receivables); Letter dated June 21, 1994, from the OCC's Chief Counsel to the General Counsel of the Federal Reserve Board, and letters cited therein; OCC Interpretive Letter No. 1035 (July 21, 2005).

national banks to securitize their assets, stating stated that such activities enhance bank safety and soundness and increase credit availability:

> The ability of banks to sell conventional bank assets through the issuance and sale of certificates evidencing interests in pools of the assets provides flexibility that can enhance banks' safety and soundness. Asset securitization provides an important source of liquidity by allowing banks to convert relatively illiquid assets into instruments with maturities and other features that investors are readily willing to purchase. Another important benefit is the increased credit available, due to the fact that a bank may make more loans with a given level of capital (when the assets are removed from the bank's balance sheet) and may diversify its lending into new markets without incurring undue risk. Also, a bank is less dependent on deposits to fund its loans, improving bank profitability, with positive implications for reducing bank failure rates and minimizing draws on the deposit insurance funds."[139]

In 1996, the OCC issued supervisory guidance to national banks regarding their securitization activities:

> The Office of the Comptroller of the Currency today issued its first guidelines to banks involved in asset securitization activities. The guidelines focus on the need for bankers to understand fully the risks involved in securitization and to take steps to manage those risks effectively. OCC issued the bulletin on securitization because a growing number of banks are increasing their reliance on securitization to diversify funding sources and efficiently manage liquidity and capital.
>
> Bank management should understand the risks of securitization under current, projected and stressed market conditions, according to the OCC. Securitization can benefit banks by enabling them to manage their exposure to credit risk in pools of assets. However, the OCC noted, because securitized asset performance is public information and monitored by market participants, securitization has the potential to highlight problems in a bank's overall portfolio performance. Performance of securitized assets that deviates from expectations will reflect poorly on the bank's

[139] 60 Fed. Reg. 66,152, at 66,155 (Dec. 21, 1995); 12 C.F.R. § 1.3(g).

> underwriting and risk assessment capabilities. Poor asset performance may limit the bank's future access to the securitization market or affect the price of subsequent issues.[140]

In 1997, the OCC issued a Handbook for Asset Securitization providing further supervisory guidance.[141]

The Federal Reserve Board similarly permitted state member banks to underwrite and deal in securitized assets[142] and also permitted bank holding companies to underwrite and deal in securitized assets of their affiliated banks.[143] The Board stated that public benefits could be expected to result from allowing banking organizations to participate to a greater degree in the growing market for securitized banking assets, such as increased competition, greater efficiency, reduced financing costs, increased availability of services to issuers and investors, and market innovation.[144]

The Federal Reserve's Division of Banking Supervision and Regulation in 1990 issued extensive guidance to Federal Reserve examiners on the supervision of securitization activities by banking organizations and set up a special task force for this purpose:

> In order to provide examiners with the information and guidance they need on asset securitization, a task force of System supervisory staff from the Reserve Banks and the Board was established. The Task Force developed materials on the mechanics of securitization and related accounting issues, as well as a set of examination guidelines. These draft materials were distributed to you last September. This letter transmits the final version of the examination guidelines and educational background material for asset securitization. Attached are 1) the Examination Guidelines, 2) An Introduction to Asset Securitization – Volume 1, and 3) Accounting Issues Relating to Asset Securitization – Volume 2.[145]

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[140] OCC NR 96-104 (Sept. 25, 1996), OCC Bulletin 96-52.

[141] Comptroller's Handbook for Asset Securitization (Nov. 1997).

[142] Board Letter dated January 17, 1995, to Meridian Bancorp, Inc.

[143] Board Order dated September 21, 1989; Bankers Trust New York Corporation, 75 Fed. Res. Bull. 829, 835 (1989).

[144] *Id.*

[145] Federal Reserve Board, Division of Banking Supervision and Regulation, SR-90-16 (FIS) (May 25, 1990); Supervision and Regulation Task Force on Securitization, Examination Guidelines for Asset Securitization.

The Reserve Banks were instructed to implement the examination guidelines and procedures as of July 1, 1990. The Division of Banking Supervision and Regulation issued extensive examination guidelines for the inspection of securitization activities.[146] The Task Force published a document describing in detail the reasons for bank securitization activities:

> Bypassing Regulatory Costs
>
> In the case of regulated institutions, i.e., banks and thrifts, the selling of assets in such a fashion as to meet the regulatory requirements for removal from the balance sheet might mean substantial cost savings by having avoided capital maintenance requirements, reserve requirements, and deposit insurance premiums. Originating and holding any given loan means maintaining a certain amount of capital in relation to that asset, and maintaining reserves against deposits funding the remainder of the credit. Also, as FDIC insurance premiums are based on deposit balances, they are affected by the funding of that asset with deposits. If, however, an asset can be originated and meet the legal and regulatory accounting requirements for a sale (the latter are discussed in a separate, complementary document entitled "Accounting Issues Relating to Asset Securitization ") and thereby be removed from its books, the costs associated with capital and reserve requirements may have been eliminated, or substantially reduced, by securitization.
>
> A bank may have the systems and loan expertise consistent with further portfolio expansion, but asset growth may often be limited by inadequate supporting capital, or concerns about concentration of risk. Securitization would afford such an institution the ability to take a more aggressive lending posture without being concerned with balance sheet effects. The bank can continue its lending with the intent of securitizing new credits and not decrease its capital ratios.
>
> Funding and Liquidity
>
> Securitization provides originators with an additional source of funding, and is sometimes referred to as

[146] Federal Reserve Board, Supervision and Regulation Task Force on Securitization, SR-90-16 (FIS) (May 25, 1990).

furthering “asset-based” liquidity. Often times, securitized issues carry a higher credit rating than the debt obligations of the originator. This is generally achieved by use of what is termed a bankruptcy-remote vehicle such as a trust which acts as a repository for the assets and issuer, or obligor, of the securities funding those assets. This improved rating (generally AAA) affords the originator savings on funding costs and also substantially broadens the investor base available to the originator. In the case of banks, credit ratings are effectively arbitraged—the credit rating of the asset-backed security is generally greater than that which would be assigned to securities directly issued by the bank and collateralized by those same assets. While there are costs associated with the mechanical process of obtaining that higher rating, often times these costs are less than those associated with direct funding, thereby making securitization a more cost effective means of funding.

The securitization process has taken a set of illiquid loans and converted them into a security with a separate rating, saleable in a secondary market. While the secondary market for these securities (other than those that are mortgage - backed) is not presently very deep, it is certainly deeper than any market for the loans themselves. While the funding/ liquidity benefits described above are perhaps most fully enjoyed by banks securitizing assets, they have also been enjoyed by other corporations as well. Sperry Corporation avoided the costs associated with borrowing directly in the markets under its BBB rating by establishing a separate company or trust to hold the lease receivables it wished to securitize. That entity in turn funded its purchase of those assets by selling its own securities which had a AAA rating.

Asset/Liability Management

Securitization of assets can be used to significantly reduce any interest rate risk associated with an asset/liability mismatch on the part of the originator. For example, during the early 1980’s, the cost of funding rose substantially as did the general level of interest rates, and many institutions—thrifts in particular—found themselves funding fixed rate, low-yielding, longer term assets with higher priced, volatile liabilities. At the same time, they had lost the opportunity to make a number of higher quality, short-term loans as large corporate customers have gone directly to the commercial paper markets for funding at cheaper rates.

As might be expected, thrifts have availed themselves of the opportunity to substantially realign their balance sheets via securitization during the recent period of falling interest rates. By selling off thirty-year fixed rate mortgages which were funded with expensive shorter-term deposits, some thrifts have better matched the maturities between their assets and liabilities. The same holds true for the captive finance subsidiaries of the major automobile makers particularly active in the securitization, or asset sales market. GMAC has securitized a large volume of its automobile paper, moving away from funding via short-term commercial paper towards funding via asset-backed securities with a closer maturity to that of the asset it funds. Securitization is one of the few means available for achieving matched funding, and is sometimes used solely for this reason. The cost of securitizing a package of assets might exceed savings on funding attributable to improved ratings; however, if the matching of asset and liability maturities is a paramount concern, an institution might choose to still securitize the assets in question.

Enhancement of Return on Assets/Return on Equity

Securitization, in and of itself, can improve a bank's return on assets and equity; however, these returns are substantially augmented by the originator customarily being retained- and paid a fee- to service the assets supporting the related securities. "By securitizing loans, banks can remove assets from their books and either invest the proceeds in a more lucrative venture or begin the loan origination process again and utilize turnover and volume to generate profits." Banks can enhance their returns on both assets and equity, as well as improve capital and leverage ratios, through the removal of assets from the books and recognition of fee income.

Setting aside the controversial issues of excess servicing fees, and "up front" fees which might be taken at the point of sale (discussed in "Accounting Issues Relating to Asset Securitization"), collecting what can sometimes be substantial servicing fees over the life of the security issue on assets removed from the books can improve an institution's reported return on assets and equity. In the case of certain money center banks active in securitizing their assets, the complexion of their earnings has been substantially changed for this very reason. Comparison of 1988 earnings performance to that of 1987 is somewhat distorted as a result. If current asset sales trends continue/ the change in the nature of bank earnings may be expected to become even more pronounced, with even greater dependency on fee income as a source of earnings. A detailed discussion of accounting standards governing fee income may be found in “Accounting Issues Relating to Asset Securitization”.

Specialization/Market Penetration/Diversification

Securitization allows for substantial gains in these areas. Picture the institution which has made a substantial investment in both developing a staff expertise in lending of a particular type—e.g., credit cards, leveraged buy-outs—as well as the systems requisite for supporting that staff. While the advent of interstate banking opens new markets, a bank’s ability to utilize its expertise is constrained by capital growth, funding capabilities, and concern regarding concentrated exposure in that given area. The ability to originate and then sell assets may afford such an institution an ability to access a broader customer base, a self-funding mechanism for any newly-generated credits, allow it to achieve economies of scale in a given area, and yet not experience an excessive concentration in that area. In fact, the proceeds from the sale of those assets might be employed to purchase asset-backed securities from another party having expertise in some other area to which this institution has limited access.

Simultaneously, the benefits of geographic diversification are accruing to both the originator and potentially the party investing in the asset-backed securities. Dependency on local economies and their cycles may, then, be lessened in the securitization process; when local demand falls off, an institution may either (a), originate assets in other markets where a demand for its specialty continues, and then securitize those credits, or (b), invest funds which have

> been freed by slackened local demand in asset-backed securities originated in other geographic regions.[147]

The Federal Reserve also included a section in its Bank Holding Company Supervision Manual on asset securitization, noting the benefits of securitization and prescribing risk management controls for such activities.[148] The Manual states:

> Banking organizations have long been involved with asset-backed securities (ABS), both as investors in such securities and as major participants in the securitization process. In recent years, banking organizations have stepped up their involvement by increasing their participation in the long-established market for securities backed by residential mortgage loans and by expanding their securitizing activities to other types of assets, including credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables.
>
> While the objectives of securitization may vary from one depository institution to another, there are essentially five benefits that can be derived from securitization transactions. First, the sale of assets may reduce regulatory costs. The removal of an asset from an institution's books reduces capital requirements and reserve requirements on deposits funding the asset. Second, securitization provides originators with an additional source of funding and liquidity. The process of securitization is basically taking an illiquid asset and converting it into a security with greater marketability. Securitized issues often carry a higher credit rating than that which the banking organization itself could normally obtain and, consequently, may provide a cheaper form of funding. Third, securitization may be used to reduce interest-rate risk by improving the banking organization's asset-liability mix. This is especially true if the banking organization has a large investment in fixed-rate, low yield assets. Fourth, by removing assets, the banking organization enhances its return on equity and assets. Finally, the ability to sell these

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[147] Federal Reserve System, Supervision and Regulation Task Force on Securitization, An Introduction to Asset Securitization, attachment to SR-90-16 (FIS) (May 25, 1990) at 2-6.

[148] BHC Supervision Manual § 2128.02 (Risk Management and Internal Controls).

> securities worldwide diversifies the banking organization's funding base, thereby reducing dependence on local economies.
>
> It is appropriate for banking organizations to engage in securitization activities and to invest in ABS, if they do so prudently. Nonetheless, these activities can significantly affect their overall risk exposure. It is therefore of great importance, particularly given the growth and expansion of such activities, for examiners to be fully informed about the fundamentals of the securitization process, various risks that securitization and investing in ABS can create for banking organizations, and procedures that should be followed in examining banks and inspecting bank holding companies to effectively assess their exposure to risk and their management of that exposure.[149]

In 1999, the banking regulators issued interagency guidance to address "significant weaknesses" in the securitization practices of some banks.[150] The regulators expressed concern about the use of "inappropriate" valuation and modeling methodologies to determine the initial and ongoing value of retained interests and emphasized that retained interests must be supported by documentation of the interest's fair value utilizing reasonable and conservative valuation assumptions that can be objectively verified. The regulators identified the following common regulatory reporting errors stemming from securitization activities:

- Failure to include off-balance sheet assets subject to recourse treatment when calculating risk-based capital ratios;
- Failure to recognize retained interests and retained subordinate security interests as a form of credit enhancement;
- Failure to report loans sold with recourse in the appropriate section of the regulatory report; and
- Over-valuing retained interests.

In 2002, the banking regulators issued guidance on "implicit recourse" or "moral recourse" arrangements through which banks provide credit support

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[149] *Id.*

[150] Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of Thrift Supervision, Interagency Guidance on Asset Securitization Activities, Dec. 13, 1999.

beyond their contractual obligations in a securitization.[151] The agencies stated that implicit recourse "can pose a high degree of risk to a banking organization's financial condition and to the integrity of its regulatory and public financial reports." The agencies provided guidance as to what types of arrangements constitute implicit recourse and stated that the regulators might require regulatory capital to be held against the entire amount of assets sold as well as require deduction of residual interests from regulatory capital. Also in 2002, the agencies issued a joint advisory bulletin cautioning that the inclusion of certain covenants in securitization documents would be regarded by the agencies as an unsafe and unsound banking practice.[152]

The regulators thus were fully aware of the involvement of banks in securitization activities and not entirely blind to the risks prior to the financial crisis. Given the extent to which securitization became a vulnerability to banks and the financial system as a whole, the sufficiency of the regulators' oversight obviously is questionable.

D. Asset-Backed Commercial Paper

The approval of securitization and commercial paper activities by banking regulators led to the growth of asset-backed commercial paper as a significant part of the business of banking. Banks and their affiliates became the largest issuers and sponsors of asset-backed commercial paper conduits ("ABCP")—now defined by regulators as a "shadow banking" activity.

JPMorgan Chase & Co., a major banking organization, has described its extensive involvement in these activities as follows:

> JPMorgan Chase is a leading global financial services firm actively involved in many aspects of the asset-backed securities ("ABS") market. Through several subsidiaries, JPMorgan Chase is an issuer and, in some cases, a servicer of many types of ABS, including residential and commercial mortgage-backed securities (respectively, "RMBS" and "CMBS") and ABS backed by credit card receivables, auto loans and student loans, among others. JPMorgan Chase Bank, National Association is an administrator of three asset-backed commercial paper ("ABCP") conduits, which, as of June 30, 2011, had aggregate outstanding ABCP of approximately $22.25 billion. Our subsidiary, J.P. Morgan Securities LLC ("J.P.

[151] See Federal Reserve Board, SR 02-15 (May 23, 2002).

[152] Interagency Advisory on the Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents (May 23, 2002).

> Morgan"), is a broker-dealer registered under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and is a leading underwriter/placement agent and dealer in the ABS markets. As part of our Asset and Wealth Management business, J.P. Morgan Investment Management Inc. ("J.P. Morgan Investment Management") is a significant investor in many sectors of the ABS markets on behalf of our clients. In addition, our Chief Investment Office ("CIO") invests in the ABS markets as principal. We are also a servicer for residential mortgage loans and auto loans owned by unaffiliated third parties and are active in providing derivatives to ABS issuers and investors. In addition to these activities in the ABS markets, we act as sponsor, underwriter, placement agent and/or dealer with respect to other structured products, such as collateralized loan and debt obligations and municipal tender option bond transactions.
>
> In each of these businesses and across securitized and structured products, JPMorgan Chase has a leading market position. For example, JPMorgan Chase is the third largest originator and servicer of residential mortgage loans in the United States, with over 10% market share. In addition, as an issuer in 2010, JPMorgan Chase was the second largest bank originator of automobile loans and leases in the United States, the second largest originator of credit card receivables in terms of general purpose credit card receivables outstanding and sales volume, and the largest sponsor in the CMBS market. In addition, prior to the collapse of the securitization market during the recent residential mortgage crisis, JPMorgan Chase was one of the largest issuers of private-label RMBS in the United States. As an underwriter and dealer, J.P. Morgan ranked #1 in the ABS and CMBS league tables at the end of the first quarter of 2011. Finally, JPMorgan Chase is the #1 bookrunner in syndicated loans.[153]

Other major banking organizations similarly became leaders in the asset-backed commercial paper business.

The Federal Reserve's Bank Holding Company Supervision Manual provides detailed guidance on the supervision of ABCP activities of banking

[153] Letter dated July 14, 2011, from JPMorgan Chase & Co. to the Federal Reserve Board and other banking agencies concerning the agencies' risk retention proposal.

organizations. This guidance, predating the financial crisis, shows that ABCP activities were well within the awareness and supervisory focus of banking regulators prior to the crisis. Among other things, the Manual instructs bank management on the policies and procedures that should be in place with respect to ABCP:

> A banking organization (that is, a bank or a bank holding company) participating in an asset-backed commercial paper program should ensure that such participation is clearly and logically integrated into its overall strategic objectives. Furthermore, management should ensure that the risks associated with the various roles that the institution may play in such programs are fully understood and that safeguards are in place to manage the risks properly.
>
> Appropriate policies, procedures, and controls should be established by a banking organization before it participates in asset-backed commercial paper programs. Significant policies and procedures should be approved and reviewed periodically by the organization's board of directors. These policies and procedures should ensure that the organization follows prudent standards of credit assessment and approval regardless of the role an institution plays in an asset-backed commercial paper program. Such policies and procedures would be applicable to all pools of receivables to be purchased by the SPE as well as to the extension of any credit enhancements and liquidity facilities. Procedures should include an initial, thorough credit assessment of each pool for which the banking organization had assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure.
>
> Furthermore, the policies and procedures should outline the credit-approval process and establish in-house exposure limits, on a consolidated basis, with respect to particular industries or organizations, that is, companies from which the SPE purchased the receivables as well as the receivable obligors themselves. Controls should include well-developed management information systems and monitoring procedures.
>
> Institutions should analyze the receivables pools underlying the commercial paper as well as the structure of the arrangement. This analysis should include a review of—

1. the characteristics, credit quality, and expected performance of the underlying receivables;

2. the banking organization's ability to meet its obligations under the securitization arrangement; and

3. the ability of the other participants in the arrangement to meet their obligations.

Banking organizations providing credit enhancements and liquidity facilities should conduct a careful analysis of their funding capabilities to ensure that they will be able to meet their obligations under all foreseeable circumstances. The analysis should include a determination of the impact that fulfillment of these obligations would have on their interest-rate risk exposure, asset quality, liquidity position, and capital adequacy.[154]

The Manual instructs examiners to determine whether the prescribed policies and procedures are operative and whether institutions are adequately managing their risk exposure.[155] The Manual sets forth detailed inspection objectives and procedures for ABCP activities, including:

1. To determine whether the banking organization (that is, a bank or a bank holding company) participating in an asset-backed commercial paper program has included this participation in its overall strategic objectives.

2. To determine whether management fully understands the risks associated with the banking organization's involvement in credit-enhancement and asset-backed commercial paper programs and whether appropriate safeguards are in place to properly manage those risks.

3. To ascertain that the appropriate policies, procedures, and controls have been established by the banking organization before participating in asset-backed commercial paper programs.

4. To verify whether existing managerial and internal controls include well-developed management information systems and monitoring procedures.

[154] BHC Manual at § 2128.03.4, Board of Directors Policies Pertaining to Credit-Enhanced or Asset-Backed Commercial Paper.
[155] *Id.*

5. To determine whether the banking organization has conducted a careful analysis of its funding capabilities to ensure that it will be able to meet its obligations under all foreseeable circumstances.

6. To ensure that all asset-backed securities owned, any assets sold with recourse, retained interests, and variable interest entities (VIEs) (for example, asset-backed commercial paper [ABCP] programs, those that are defined as VIEs under generally accepted accounting principles) are properly accounted for on the banking organization's books and are correctly reported on its regulatory reports.

7. To determine that capital is commensurate with, and that there are accurate determinations of the risk weights for, the risk exposures arising from recourse obligations, direct-credit substitutes, asset- and mortgage-backed securities, ABCP programs and ABCP liquidity facilities, and other asset securitization transactions.[156]

The Manual sets forth the following procedures for examiners in their inspections of ABCP activities of banking organizations:

1. Review the minutes of board of directors or executive committee meetings. Establish whether the significant policies and procedures for credit-enhanced or asset-backed commercial paper have been approved and reviewed periodically by the organization's board of directors.

a. Determine whether the policies are operative and whether institutions are adequately managing their risk exposure.

b. Determine whether the policies and procedures are applicable to all pools of receivables receivables to be purchased by the SPE as well as to the extension of any credit enhancements and liquidity facilities.

2. Determine if the organization follows prudent standards of credit assessment and approval.

a. Ascertain whether the procedures include an initial, thorough credit assessment of each pool for which the

[156] Federal Reserve Board, BHC Supervision Manual § 2128.03.5, Inspection Objectives.

organization had assumed credit risk. The initial review should be followed by periodic credit reviews to monitor performance throughout the life of the exposure.

b. Determine if the policies and procedures outline the credit-approval process and establish in-house exposure limits, on a consolidated basis, with respect to particular industries or organizations, that is, companies from which the SPE purchased the receivables as well as the receivable obligors themselves.

c. Determine whether the organization analyzes the receivables pools underlying the commercial paper as well as analyzes the structure of the arrangement. Does the analysis include a review of—

• the characteristics, credit quality, and expected performance of the underlying receivables;

• the ability of the banking organization to meet its obligations under the securitization arrangement; and

• the ability of the other participants in the arrangement to meet their obligations?

3. Review the organization's funding obligations and commitments, and determine whether there is sufficient liquidity to satisfy those funding requirements. Include a determination of the impact that fulfillment of these obligations would have on their interest-rate risk exposure, asset quality, liquidity position, and capital adequacy.

4. Review carefully the risk-based capital calculations for ABCP facilities to ensure that they are applying, for risk-based capital purposes, the proper conversion factors to their obligations supporting the asset-backed commercial paper programs.

5. Determine if the banking organization consolidates, in accordance with GAAP, the assets of any ABCP program or other such program that it sponsors.

a. Determine if the banking organization's ABCP program met the definition of a sponsored ABCP program under the risk-based capital guidelines.

> b. Verify that the assets of the banking organization's eligible ABCP program and any associated minority interest were included in the banking organization's calculation of its risk-based capital ratios.
>
> c. Ascertain whether the liquidity facilities the banking organization extends to the ABCP program satisfy the risk-based capital requirements, including the appropriate asset-quality test, of an eligible ABCP program liquidity facility. . . .
>
> d. Determine whether the banking organization applied the correct credit-conversion factor to the eligible ABCP liquidity facilities when it determined the amount of risk-weighted assets for its risk-based capital ratios. . . .
>
> e. Determine if all ineligible ABCP liquidity facilities were treated as either direct credit substitutes or as recourse obligations, as required by the risk-based capital guidelines.
>
> f. If the banking organization had multiple overlapping exposures, determine if the banking organization applied the risk-based capital treatment that resulted in the highest capital charge.
>
> 6. Include in the inspection report a discussion of the size, effectiveness, and risks associated with ABCP programs (include the discussion in the confidential section of the inspection report if not appropriate for the open section).

The Bank Holding Company Supervision Manual also provides detailed guidance on the capital treatment of bank ABCP activities. The Manual instructs examiners to, among other things, "carefully review the ABCP facilities provided by banking organizations to ensure that they are applying, for risk-based capital purposes, the proper conversion factors to their obligations supporting asset-backed commercial paper programs."[157]

The above excerpts make clear that ABCP activities of banking organizations have long been part of the regulated banking system and fully under the supervision of banking regulators.

[157] Federal Reserve Board, BHC Supervision Manual § 2128.03, Credit-Supported and Asset-Backed Commercial Paper (Risk Management and Internal Controls), § 2128.03.3.1, Liquidity Facilities Supporting ABCP (Jan. 2011).

E. Securities Broker-Dealer Activities

Banking regulators have identified securities broker-dealers as among the entities comprising the shadow banking system. Securities broker-dealers are instrumental in helping the shadow banking system raise funds for credit intermediation from the capital markets. Nearly all major banking organizations have such broker-dealer affiliates. The integration of securities dealing with securitization and other activities in the 1980s and 1990s enabled banking organizations to develop into full-service shadow banks.

For many years, the Glass-Steagall Act was thought to prohibit banks from acting as securities broker-dealers or having broker-dealer affiliates. Banking regulators nevertheless approved such activities, thereby facilitating the expansion of banks in the shadow banking system.

Regulators first permitted banking organizations to acquire securities broker-dealers in the early 1980s, beginning with the acquisition of Charles Schwab & Co. by BankAmerica Corporation.[158] The Federal Reserve Board approved the acquisition under the Bank Holding Company Act, concluding that the activity was "so closely related to banking as to be a proper incident thereto." The Board stated that the acquisition would produce benefits in the form of increased competition, convenience and efficiencies that outweighed any adverse effects. The Board also concluded that the transaction did not violate the Glass-Steagall Act because Schwab was not "engaged principally" in the activities forbidden by the Act.

The Securities Industry Association sued the Board, contending that the activity of a securities broker was not "closely related to banking" and invoking the Glass-Steagall Act's prohibition on bank affiliations with securities firms. The Supreme Court heard the case and, giving judicial deference to the Board, upheld the Board's approval of the acquisition.[159] The Court's ruling opened the way for numerous acquisitions of securities broker-dealers by banks and bank holding companies.

The Federal Reserve subsequently authorized bank holding companies with broker-dealer subsidiaries to engage in underwriting and dealing in commercial paper and other securities. The SIA again sued the Board on Glass-Steagall Act grounds and again lost in the courts.[160]

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[158] BankAmerica Corporation, 69 Fed. Res. Bull. 105 (1983) (Federal Reserve Board Order approving BankAmerica Corporation's acquisition of Charles Schwab & Company).

[159] See Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 207 (1984).

[160] See Securities Industry Association v. Board of Governors, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

In 1999, Congress enacted the Gramm-Leach-Bliley Act, which among other things, repealed the Glass-Steagall Act provisions that banking regulators had already whittled away. By then, every large banking organization owned one or more securities broker-dealers. Only a handful of large broker-dealers were not owned by banking organizations. By 2009, all of the remaining large broker-dealers had become part of banking organizations.

When banks commenced securities broker-dealer activities in the 1980s, the Securities and Exchange Commission attempted to subject them to broker-dealer regulation under the Securities Exchange Act of 1934. The SEC adopted a rule requiring banks to register as securities brokers, but the rule was challenged by the American Bankers Association and struck down in the courts.[161] The SEC then sought legislation to require banks to register as broker-dealers. Congress enacted the Gramm-Leach-Bliley Act for this purpose but granted numerous exemptions covering a significant portion of bank brokerage and securities dealing activities.

The Gramm-Leach-Bliley Act gave the SEC authority to regulate bank broker-dealer activities. When the SEC attempted to adopt a regulation for this purpose, however, the banking regulators denounced it as creating "an extremely burdensome regime of overly complex, costly and unworkable requirements that effectively negate the statutory exemptions."[162] The SEC then suspended the regulation and issued another proposal in 2004, which again was opposed by the banking agencies. A final regulation was not adopted until 2007, after Congress passed a law requiring the SEC to act with the Federal Reserve in adopting a joint regulation.

F. Relaxation of Regulatory Requirements

The transformation of banking organizations into shadow banks was further facilitated by the relaxation of key regulatory requirements by banking regulators. Among other things, regulators structured their capital standards to encourage the securitization of residential mortgage loans in ways that increased the level of systemic risk in the banking system.

The bank capital rules created systemic risk in at least three ways. First, the capital rules required banks to hold less capital against residential mortgages than commercial loans. The risk weight for residential mortgage loans was (and is) 50 percent, compared to 100 percent for commercial business loans. Thus, 50 percent less capital was required for residential mortgage loans—including

[161] American Bankers Association v. Securities and Exchange Commission, 804 F.2d 739 (D.C. Cir. 1986).

[162] Letter dated June 29, 2001, to the SEC from the Federal Reserve Board, Office of the Comptroller of the Currency, and Office of the Comptroller of the Currency.

subprime loans—than commercial loans.[163] The rules thereby created an artificial incentive for banks to generate residential mortgage loans, which helped fuel the housing bubble.

Second, the capital rules required banks to hold even less capital against residential mortgage loans that were securitized. The risk weight for triple-AAA rated residential mortgage-backed securities ("RMBS") was and is 20 percent.[164] Thus, banks had incentives to sell off their residential mortgage loans to securitization vehicles and buy them back in the form of RMBS. Often, the RMBS was packaged with other assets in ABCP conduits and sold to investors. Going into the financial crisis, banks held substantial amounts of their own RMBS and ABCP as investments for their own accounts.[165]

Third, banking regulators did not require banking organizations to consolidate their ABCP conduits on their balance sheets for regulatory capital purposes, notwithstanding an interpretive standard adopted by the Financial Accounting Standards Board in 2004 that otherwise required consolidation.[166] Moreover, the regulators imposed no capital charge on bank letters of credit or other support for ABCP until 2004, when they imposed only a 10 percent conversion factor, requiring minimal capital. The availability of bank guarantees for ABCP conduits encouraged the growth of ABCP and created demand for more and more mortgage loan assets, including subprime loans. Banks could provide more guarantees to their ABCP conduits because the capital rules did not require such guarantees to be fully capitalized.[167] In 2010, after the financial crisis revealed that the banking regulators' had greatly underestimated the risks of ABCP, they eliminated the ABCP exclusion and now require full consolidation of ABCP programs on banking organization balance sheets for regulatory capital purposes.[168]

The capital rules thereby contributed to the buildup of RMBS and ABCP prior to the crisis by requiring banks to hold less capital for residential mortgage loans, even less capital for securities backed by such loans, and virtually no

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[163] See 12 C.F.R. part 225, Appendix A.

[164] *Id.*

[165] See Viral V. Acharya and Matthew Richardson, Causes of the Financial Crisis, Critical Review Vol. 21, Nos. 2–3, 2009, at 200 ("[I]n fact, investors were not the chief purchasers of these securities: banks themselves were….[T]he banks became primary investors….The goal…was…to avoid minimum capital requirements.").

[166] See 69 Fed. Reg. 44908 (July 28, 2004).

[167] Acharya and Richardson at 201 ("Designing the guarantees as 'liquidity enhancements' of less than one year maturity (to be rolled over each year) allowed banks to exploit a loophole in Basel capital requirements. The design effectively eliminated the 'capital charge' and thus banks achieved a tenfold increase in leverage for a given pool of loans.").

[168] 75 Fed. Reg. 4636, 4643 (Jan. 28, 2010); 12 C.F.R. 225, appendix A.

capital for bank letters of credit and other guarantees of ABCP conduits.[169] Economists have attributed the rapid expansion of ABCP in the years preceding the financial crisis to the relaxation of bank capital rules in 2004.[170] The Federal Reserve also exempted ABCP conduits from bank reserve requirements in 2004.[171]

The expansion of ABCP prior to the crisis also was facilitated by interpretations of the OCC allowing national banks to guarantee ABCP conduits.[172] In codifying these interpretations, the OCC stated:

> The OCC has emphasized that banks must be able to respond to the evolving needs of their customers, provided always that such guarantees be issued and managed in a safe and sound manner. Permitting national banks to exercise their broad authority to act as guarantor or surety benefits customers by giving banks greater ability to facilitate customers' financial transactions and by providing banks with greater flexibility to provide financial services in evolving markets. . . . [A]cting as a guarantor involves the core banking powers of both lending and acting as financial intermediary and is therefore a permissible banking activity.[173]

The Federal Reserve further facilitated securitization activities by allowing banks to sponsor and guarantee ABCP entities without regarding to the limitations of section 23A of the Federal Reserve Act, which imposes restrictions on transactions between banks and their affiliates.[174] ABCP conduits were not

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[169] See Viral Acharya and Philipp Schnabl, "Do Global Banks Spread Global Imbalances? The Case of Asset-Backed Commercial Paper During the Financial Crisis of 2007–09," Paper presented at the 10th Jacques Polak Annual Research Conference Hosted by the International Monetary Fund, Nov. 5–6, 2009 at 21. See also Peter J. Wallison, "How Regulators Herded Banks Into Trouble," Wall Street Journal, Dec. 3, 2011.

[170] "[T]the rapid expansion of the ABCP market in 2004 appears to be driven by changes in regulatory capital rules." Tobias Adrian Adam B. Ashcraft, Shadow Banking Regulation, Federal Reserve Bank of New York Staff Report No. 559, April 2012, at 13, citing Acharya, Schnabl, and Suarez, Securitization Without Risk Transfer, NBER Working Papers 15730 (2010).

[171] See Letter dated Jan. 26, 2004, by Stephanie Martin, Associate General Counsel, Federal Reserve Board.

[172] See 12 C.F.R. § 7.1017(b), as amended in April 2008.

[173] 73 Fed. Reg. 22215, 22226 (April 24, 2008).

[174] 12 U.S.C. § 371c. Section 23A restricts the ability of banks to provide funding to their nonbank affiliates. Generally, a bank may not loan more than 10 percent of its capital to any one affiliate or 20 percent to all affiliates in the aggregate. This restriction

treated as affiliates for purposes of section 23A. As non-affiliates, the conduits were not subject to limits on back-up credit or other guarantees from their sponsoring banks. Had the Fed treated ABCP conduits as affiliates, the section 23A limits might have prevented banks from incurring such massive exposure to their own conduits.

One academic has studied the Federal Reserve's section 23A exemptions prior to the crisis and found that the Fed "consistently failed to take into account potential systemic implications" and thereby allowed banks to acquire low quality subprime assets from affiliates.[175] This academic concluded that "the Board's extensive use of its exemptive authority, especially during the years preceding the recent financial crisis, effectively undermined the statute's ability to restrict the growth of shadow banking and discourage arbitrage-driven conglomeration."[176]

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In sum, the history of banking regulation shows that shadow banking has long been an integral part of the regulated banking system facilitated and encouraged by banking regulators.

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applies to "covered transactions" including loans, guarantees, and other means by which a bank supports an affiliate. The Act also imposes collateral requirements and prohibits a bank from purchasing low quality assets from an affiliate. The purpose of section 23A is to protect banks from excessive credit exposure to their nonbank affiliates and to minimize extension of the federal safety net (i.e., federal deposit insurance and liquidity facilities) to nonbank affiliates.

[175] Saule T. Omarova, "From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act," 89 North Carolina Law Rev. 101 (2011).

[176] *Id.* at 185.