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ABSTRACT

This article examines the role and continued relevance of entry restriction provisions in banking law, including their pertinence to ongoing debates over strategies for regulating the shadow banking system.

Entry restriction has a noble pedigree in banking law. Soon after the founding of the Bank of England in 1694, Parliament forbade all other business entities apart from small partnerships from issuing bank notes and their equivalents.[1] Subsequent acts of Parliament confirmed that the object of the prohibition was to give the Bank of England the 'privilege or power' of 'exclusive banking'.[2] In the USA, similar prohibitions, called 'restraining acts', were established at the state level in the early nineteenth century.[3] Later, when Congress established the national banking system in the early 1860s, it prohibited (through the device of punitive taxation[4]) all other entities from issuing bank notes. Entry restriction remains at the core of US banking law today: it is axiomatic that no person or entity may maintain 'deposit' liabilities without a banking charter.[5]

Entry restriction laws take the form of a blanket prohibition, binding not on banks but on everyone else. These laws define the privilege that a banking charter conveys; a banking charter confers an exemption from the prohibition. It is noteworthy that these prohibitions apply to a particular *liability* structure. The liabilities in question—bank notes and deposits—are widely understood to serve a distinctly monetary function. A central object of entry restriction laws, then, is to confine 'money' creation to the government itself and to one or more specially chartered banks.

When it comes to modern financial stability regulation, a seldom asked question is whether banking law's traditional entry restriction provisions might be due for

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1 Bank of England Act 1708, 7 Anne, c 30, s 66.

2 Banking Act 1742, 15 George II, c 13, s 5; Bank of England Act 1800, 39 & 40 George III, c 28, s 15.

3 See Bray Hammond, *Banks and Politics in America from the Revolution to the Civil War* (Princeton University Press 1957) 184–85.

4 See Act of March 3, 1865, ch 78, s 6, 13 Stat 469, 484 (as amended by Act of February 8, 1875, ch 36, s 19, 18 Stat 307, 311).

5 See 12 USC s 378(a)(2).

modernization. This question is among the topics addressed in a recently published book, *The Money Problem: Rethinking Financial Regulation* (University of Chicago Press), in which I argue that financial instability is largely a problem of monetary system design. This brief article expands on the book's treatment of the entry restriction question.

To see the relevance of revitalized entry restriction to modern financial stability regulation, a useful entry point is the 'shadow banking system'. This term has taken on various meanings in recent years, but I use 'shadow bank' narrowly to refer to entities that lack a banking charter but that use large quantities of short-term or demandable debt, continuously rolled over, to fund portfolios of financial assets. There is increasing recognition that the shadow banking system constitutes a parallel system of money creation, inasmuch as shadow banks' short-term liabilities are, functionally speaking, quite similar to bank deposits.[6] These instruments are classifiable as 'cash equivalents' for accounting purposes[7]; the terms 'near money' and 'money market' also apply. (A non-exclusive list of cash equivalents would include: financial commercial paper; asset-backed commercial paper; Eurodollars; short-term repurchase agreements; securities lending collateral delivery obligations; auction rate securities; variable rate demand notes; and money market mutual fund shares.) In 2007 and 2008, these markets unraveled in a series of classic runs or panics, precipitating the USA's worst economic calamity since the Great Depression.

The recognition that shadow banks are engaged in money creation raises basic questions of institutional design. As noted above, in the USA today no person or entity may incur 'deposit' liabilities without a banking charter. But the emergence of shadow banking on a large scale raises the question whether the legal category 'deposit' is formalistic and obsolete. Is there a respectable basis for the differential legal status of deposits and (non-deposit) cash equivalents? More pointedly: if the issuance of deposit liabilities is a legally privileged activity with restricted entry, should not the issuance of cash equivalents be so as well? Note that the question here is *not* whether bank regulation should somehow be 'extended' to the shadow banking system. The question is much more fundamental: it is whether non-bank entities should be prohibited from issuing cash equivalents—defined on some functional basis—just as they are now prohibited from issuing deposit liabilities. Insofar as any 'extension' is pertinent to this question, it is an extension of our conception (and our legal specification) of what constitutes a monetary instrument.

The case for modernizing entry restriction into money creation presupposes that such entry restrictions have a sound policy justification to begin with. The alternative is 'free banking', or free entry into the business of issuing monetary instruments (however defined).[8] The rationale for entry restriction rests in part on the

6 For example, Paul Tucker has observed that shadow banking involves 'monetary services'. Paul Tucker, Deputy Governor for Financial Stability, Bank of England, 'Shadow Banking: Thoughts for a Possible Policy Agenda' speech at the European Commission High Level Conference, Brussels, 27 April 2012.

7 Financial Accounting Standards Board, 'Statement of Cash Flows' Statement of Financial Accounting Standards 95, ss 8–9; International Accounting Standards Board, 'Statement of Cash Flows' International Accounting Standard 7, s 7.

8 Free entry into money creation does not necessarily imply absence of regulation. During the USA's 'Free Banking Era' (1836–63), many states liberalized entry into bank note issuance but continued to regulate the activity by, for example, requiring that bank notes be collateralized by government bonds. See, for instance, New York Free Banking Act 1838 NY Laws 245, c 260. The modern 'free banking school' favours both free entry and deregulation.

observation that the funding model in question—the use of large quantities of short-term or demandable debt, continuously rolled over—is uniquely fragile. (Walter Bagehot in 1873 described the English money market as 'by far the greatest combination of economical power and economical delicacy that the world has ever seen'.[9]) Further, the instability of this funding model exposes the broader economy to disaster. In their seminal study of nearly a century of US monetary history, Milton Friedman and Anna Schwartz concluded that 'banking panics have occurred only during severe contractions and have greatly intensified such contractions, if indeed they have not been the primary factor converting what would otherwise have been mild contractions into severe ones'.[10] It is a remarkable fact that *every* major banking panic in US history has been accompanied by a severe recession, and most of the worst recessions have been accompanied by panics.[11]

The issue, however, transcends instability; it also involves monetary control, as well as 'seigniorage', or government revenue that arises from money creation. The monetary control issues are fairly obvious. When money creation is confined to the chartered banking system, the government can employ standard tools to limit the banking system's creation of money balances. In particular, reserve requirements are a textbook tool for monetary policy implementation, though they have not been binding in the USA for some time. The creation of deposit substitutes outside the regulatory perimeter may, therefore, complicate the implementation of monetary policy—an issue that has long been recognized in the Eurodollar literature.[12] We take for granted that public authorities should adjust the *base* money supply in the public interest through the conduct of monetary policy; base money creation is widely regarded as properly a matter of public control. The same logic can be straightforwardly extended to privately issued monies, including deposit equivalents. Absent entry restriction, public control of deposit equivalents is hopeless.

Somewhat less obvious are the seigniorage implications of private sector money creation. A growing body of finance literature has documented the puzzlingly low yields that characterize the short end of the US Treasury yield curve. Specifically, short-term Treasury yields are much lower than an extrapolation of longer term yields would predict.[13] This 'convenience yield' or 'money premium' confers a pecuniary benefit on the issuer. Presumably private sector issuers of high-quality short-term debt receive a similar benefit. It is a legitimate question whether these private issuers thereby capture what is properly a public asset: value that arises from money creation, or private seigniorage.

9 Walter Bagehot, *Lombard Street: A Description of the Money Market* (1873; reprint, John Wiley 1999) 4.

10 Milton Friedman and Anna J Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton University Press 1963) 441–2.

11 For the period prior to the Great Depression, see Andrew J Jalil, 'A New History of Banking Panics in the United States, 1825–1929: Construction and Implications' (2015) 7 American Economic Journal: Macroeconomics 295. Since that time, the USA has had two periods of banking panics: 1930–33 and 2007–09. Both of these periods were associated with severe recessions.

12 See, for instance, Edward J Frydl, 'The Eurodollar Conundrum' (1982) 7 Federal Reserve Bank of New York Quarterly Review 11.

13 See, for instance, Robin Greenwood, Samuel G Hanson, and Jeremy C Stein, 'A Comparative-Advantage Approach to Government Debt Maturity' (2015) 70 Journal of Finance 1683; Gary Gorton, 'Safe Assets' (2016) Annual Review of Economics (forthcoming).

The topic of private seigniorage, while virtually unheard of today, has received sporadic attention in the past. In its 1810 'Bullion Report', the Select Committee on the High Price of Gold Bullion, appointed by the House of Commons during England's 'era of inconvertibility',[14] observed that bank profits from money creation were 'unnatural' and 'prejudicial to the public welfare'. It concluded that, barring another remedy, 'some mode ought to be devised of enabling the State to participate much more largely in the profits accruing from the present system'.[15] (As Christine Desan observes in her marvelous book *Making Money: Coin, Currency, and the Coming of Capitalism,* inconvertibility only made private seigniorage 'more conspicuous' to the Bullion Committee[16]; inconvertibility was not then, nor is it today, a prerequisite to private seigniorage.) Along similar lines, Princeton economist Frank Graham wrote in 1936 that banks earn 'seigniorage profits in the nature of a tax on the community at large'.[17] According to Graham, 'It would seem only common sense that the government should get the seigniorage on the new issues of money' rather than 'divesting itself of its prerogative in favor of the banks, and losing the seigniorage profits on the new supply of money'.[18] Graham lamented that 'The social implications of the private issue of money have . . . grown more obscure, though not less vital, as we have become inured to the present practice."[19]

In short, several interlocking considerations—involving financial and macroeconomic instability, monetary control, and private seigniorage—cast doubt on the wisdom of free entry into money creation. Indeed, they supply a compelling justification for entry restriction. Crucially, these considerations apply equally to non-deposit cash equivalents (deposit substitutes) as they do to deposits. Hence, I argue in *The Money Problem* that a central but overlooked task for modern financial regulatory policy is to reach a *functional* legal definition of what constitutes a monetary instrument, and to then confine the issuance of those instruments to the chartered banking system.

Once broad money issuance is so confined, the question remains how to regulate chartered banks. I argue in the book that the longstanding system of insured banking in the USA—which involves explicit government backing of the banking system's monetary liabilities, together with risk-based fees, strict portfolio constraints, and capital requirements—embodies a coherent economic logic. Insured balances amount to sovereign money; they are non-defaultable and, therefore, practically immune to runs. The macroeconomic consequences of panics are thus taken off the table. Risk-based fees compensate the government for its commitment. (These fees could—and I argue in the book should—be calibrated to cause insured banks to disgorge private seigniorage.) Reserve requirements allow the monetary authority to cap money creation by chartered banks; they provide a tool of monetary control, at

14 From 1797 to 1821, the Bank of England was relieved of the obligation to convert bank notes into gold.

15 Select Committee on the High Price of Gold Bullion, House of Commons, Great Britain, Report 71–72 (London, 1810).

16 Christine Desan, *Making Money: Coin, Currency, and the Coming of Capitalism* (OUP 2014) 419.

17 Frank D Graham, 'Partial Reserve Money and the 100 Per Cent Proposal' (1936) 26 American Economic Review 428, 430.

18 Ibid 434.

19 Ibid 440.

least when they are binding. Portfolio constraints and capital requirements mirror standard private-sector techniques, ubiquitous in insurance and debt markets, for counteracting the effects of moral hazard. This system can be understood as a public–private partnership for money creation and circulation.

Establishing entry restriction into broad money creation should be expected to enhance the 'resolvability' of non-bank financial firms. Arguably, then, entry restriction could create the conditions for the credible withdrawal of implicit public backstops from large segments of the financial sector (including, for example, securities dealers that are bank affiliates), thereby ameliorating too big to fail. In this sense, suppressing non-bank money creation represents a *containment* strategy for moral hazard.

Recent and pending financial reforms in the USA and abroad have recognized the dangers inherent in the financial sector's heavy reliance on short-term debt funding. For example, the Basel III Net Stable Funding Ratio treats financial institutions' debt obligations as highly stable only if their maturity exceeds one year.[20] More tellingly, various bail-in strategies—including new Total Loss-Absorbing Capital regulatory principles[21]—presuppose that financial institutions' longer term debt obligations are defaultable, in the sense that they can be impaired without triggering disastrous consequences. These are welcome reforms, but they are but a pale shadow of entry restriction. Rather than being generally applicable, these reforms apply to only a subset of financial firms. And even if they meaningfully enhance financial stability, they have little or no bearing on other vital implications of private money creation, including monetary control and private seigniorage. The structuring of monetary institutions is a multifaceted institutional design challenge, one that calls out for integrated study along its multiple dimensions. *The Money Problem* aims to shed some light on these issues.

20 Basel Committee on Banking Supervision, *Basel III: The Net Stable Funding Ratio* (October 2014) (applying a 100 per cent 'available stable funding factor' to 'secured and unsecured borrowings and liabilities (including term deposits) with effective residual maturities of one year or more').

21 Financial Stability Board, *Principles on Loss-Absorbing and Recapitalisation Capacity of G-SIBs in Resolution* (November 2015).