The Governance Structure of Shadow Banking

Posted by Steven L. Schwarcz, Duke University, on Thursday, February 6, 2014

Tags: Banks, Capital markets, Financial institutions, Liability standards, Moral hazard, Shadow banking, Systemic risk
More from: Steven Schwarcz

Editor's Note: Steven L. Schwarcz is the Stanley A. Star Professor of Law & Business at Duke University School of Law.

In prior articles (*see, e.g.*, **Regulating Shadows: Financial Regulation and Responsibility Failure, 70 Wash. & Lee L. Rev. 1781 (2013)**), I have argued that shadow banking is so radically transforming finance that regulatory scholars need to rethink certain of their basic assumptions. In a forthcoming new article, **The Governance Structure of Shadow Banking: Rethinking Assumptions About Limited Liability**, I argue that the governance structure of shadow banking should be redesigned to make certain investors financially responsible, by reason of their ownership interests, for their firm's liabilities beyond the capital they have invested. This argument challenges the longstanding assumption of the optimality of limited liability.

This article starts with a short history of how corporate limited liability became the norm and an overview of the general academic debate on whether it should be the norm. Historically, the legislative trend towards limited liability was heavily influenced by corporate lobbying. In the United States, that trend was further influenced by fear of capital flight to other states. The judicial progression towards limited liability also had a "fairness" rationale: to protect innocent shareholders who are not in a "capacity to control" or influence management decisions.

The academic debate over limited liability recognizes that limited liability can create moral hazard, leading to excessive corporate risk-taking, but that limited liability also encourages equity-capital investment by addressing investor risk aversion. Empirically, scholars are uncertain how those factors should be balanced.

My article examines limited liability in the shadow-banking context. Although limited liability has always been a potential source of moral hazard and externalities, I find that it is a uniquely fertile source of externalities for shadow-banking firms. That's because shadow banking is more likely to have systemic consequences. Decentralization, for example, can motivate managers of limited liability shadow-banking firms to take greater risks than managers of other limited liability firms. The relatively small firms, such as hedge funds, that operate in the shadow-banking system are often managed directly by their primary investors. Because such investor-managers typically are entitled to a significant share of their firm's profits, they have strong incentives to take risks that could generate outsized profits. Yet if a risky action exposes their firm to significant liability for externalized harm, limited liability protects those investor-managers from losing more than their invested capital.

This is radically unlike the management incentives in non-shadow banking firms, in which senior managers tend to share only indirectly in profits, such as through stock options. Furthermore, managers of non-shadow banking firms are often more invested in maintaining their jobs and thus less motivated to take actions that risk the firm.

The consequences of a shadow-banking firm's failure are also more likely to be systemic than the consequences of an ordinary firm's failure. Like traditional banks, shadow-banking firms engage in financial intermediation on which the real economy is dependent. Because all financial intermediaries—including shadow-banking firms and traditional banks—tend to be highly interconnected, the failure of a shadow-banking firm could trigger the failures of other financial intermediaries. Such a chain of failures would be the epitome of a systemic event, especially if it materially reduced the availability of financial intermediation. Additionally, shadow banking's reliance on short-term funding of long-term projects not only increases the likelihood of a shadow-banking firm's failure but also can increase the systemic consequences of that failure. Economists have identified the failure of shadow-banking firms to roll over short-term debt as a contributing factor to the recent financial crisis.

I also argue that tort law, the traditional legal mechanism for internalizing externalities, is not as effective in the shadow-banking context. To win a tort lawsuit, injured third parties normally must show their harm to be a causal and foreseeable consequence of the firm's actions. Third parties injured by systemic harm caused by the firm's actions would be unlikely to be able to show that, however. Systemic harm can affect a wide range of third parties in unpredictable ways, such as an individual who is forced to close her family-owned restaurant during a systemically caused recession. Nor is it likely that changing the causation-and-foreseeability standard to enable third parties to win those lawsuits would be an efficient solution. At the very least, courts would face a line-drawing problem and would be forced to make complicated decisions as to what systemic externalities should (or should not) be considered compensable.

Finally, I examine whether and how limited liability should be redesigned, taking into account the traditional justifications for limited liability. Among other things, I argue that any such redesign should ensure that any given investor's liability would be independent of the liability of other investors. Such an independent-liability redesign might, for example, include double liability. He also argues that imposing additional liability only on investor-managers—and perhaps only on investor-managers with the power to "control" the firm—should be more consistent with the traditional fairness justification.

Regardless of how limited liability is redesigned, it still faces the dilemma that investor-managers would have relatively little incentive to monitor and guard against their firm's potential to trigger systemic risk if tort law bars third parties injured by systemic harm from recovering damages therefor. A possible solution to this dilemma would be to couple any increase in limited liability with a privatized systemic risk fund—which would be used to mitigate systemic harm—into which systemically risky shadow-banking firms would be required to contribute. Privatizing the funding would help to reduce a shadow-banking firm's incentive to create systemic externalities by engaging in financially risky activities; indeed, the likelihood that firms will have to make additional contributions to the fund to replenish bailout monies should motivate them to monitor each other and help control each other's risky behavior. Making investor-managers personally liable for all or a portion of their firm's insufficient capital to make initial or additional fund contributions would likewise motivate them to monitor and help control their firm's systemically risky behavior.

The full article is available for download **here**.