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Squeezed by the Shorts: Time to Ban Short Selling?

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Short sellers have made a killing in the recent banking crisis, scalping $14.3 billion from bank stock owners just in March of this year. Short sellers "borrow" stock they don't own and immediately sell it, driving the price down. Then they buy it back at the lower price, return the stock, and pocket the difference. Bankers say the practice is threatening the stability of the banking system and are calling for a ban on short sales of bank stock. The SEC is expected to decline but is investigating whether the practice constitutes illegal market manipulation intended to deceive investors.

It is argued here that short selling is fraudulent by its very nature – it is a fraud on the legitimate stock owners – and should be banned across the board. But first a closer look at the issues and some recent developments.

Flaws in the Banking Model

The banking crisis lingers on. Zerohedge reported on May 12 that U.S. deposit outflows from banks to money market funds continue, and small bank lending is collapsing. According to a Hoover Institution report by Stanford Finance Professor Amit Seru et al., around 2,315 banks – more than half the banks in the U.S. — are sitting on assets worth less than their liabilities, due to the radical increase in interest rates over the past year. As a result, the banks are "potentially insolvent."

In fact, as economist Murray Rothbard pointed out decades ago, all banks are technically insolvent, due to their standard business model. They "borrow short to lend long" — borrow from depositors who expect to get their money back "on demand" and use the funds to back long-term loans. If the depositors all come for their money at once, the liquidity (readily available funds) would not be there to repay them; but the model works because most people leave their money in the bank. The banks are "sound" so long as no one shouts "fire!" and drives the depositors to all run for the exits at the same time.

For decades, the reserve requirement – the funds a bank must hold in reserve to meet sudden withdrawals — was around 10% of deposits. In March 2020, due to the Covid crisis, the Fed dropped the reserve requirement to zero, where it remains today. But bankers still assume they need to keep about 10% of their deposits in reserve in order to meet transfers and withdrawals. That works in "ordinary" times; but even with 10% in reserve, a bank would fail if more than 20% of its deposits were withdrawn in a single day, and that is what happened to Silicon Valley Bank on March 9. According to written testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on May 16 by Gregory W. Becker, Former Chief Executive Officer of Silicon Valley Bank:

> By the end of the day on March 9, $42 billion in deposits were withdrawn from SVB in ten hours, or roughly $1 million every second.
>
> As the bank run was ongoing, we were working to access additional liquidity when I was informed the morning of March 10 that the FDIC would be taking possession of SVB. That day, another roughly $100 billion in deposits were requested to be withdrawn, bringing the total actual and requested deposit outflow to roughly $142 billion, or about 80 percent of total deposits, over two days.

Four major banks have failed in the last two months – Silvergate Bank, Silicon Valley Bank, Signature Bank, and First Republic. Why those four? As explained in my last article, the first three were "crypto" banks, which have been under attack by government agencies. First Republic was not in that category, but it was considered "crypto friendly" – you could deposit funds in a cryptocurrency exchange through the bank.

What rendered First Republic insolvent, however, was a business model in which it made very cheap loans to wealthy clients for commercial real estate. The loans were made at a time when the bank itself could borrow nearly interest-free, so interest-only loans seemed reasonable. The spread between the 0.12% at which the bank borrowed and the 3% at which it was lending was essentially free money to the bank, the principal balance to be collected after a lengthy interest-only period. The model worked until interest rates shot up and the bank could no longer borrow cheaply to fund the loans.

For the depositors of Silicon Valley Bank and Signature, the FDIC came to the rescue, returning not just the insured deposits (those in accounts under the $250,000 insurance cap) but all of the deposits. This move was justified as avoiding the "systemic risk" of triggering bank runs elsewhere. For First Republic, the FDIC arranged a sale on quite favorable terms to Chase Manhattan Bank. Silvergate wound itself down voluntarily.

The FDIC rescues cost the agency an estimated $35.5 billion, taking a major chunk out of the $128.2 billion in its insurance fund; but at least, it was thought, the banking crisis was over. So it was thought, until a handful of vulnerable banks including Pacific West and Western Alliance showed similar distress, losing between 45% and 60% of their year-to-date stock value versus a 27% decline in the regional bank index.

Attacked by the Shorts

Many banks have major unrealized losses on their balance sheets, however, and they have not been subjected to runs by depositors. The runs on First Republic and Silicon Valley Bank were evidently triggered by targeted short selling of their stock. First Republic was one of the most heavily shorted U.S. bank stocks as of one week before it failed, with one-third of its outstanding shares shorted. As of March 31, it had the second largest short position of any U.S. bank, the largest being in Silvergate Bank.

After J.P. Morgan bought First Republic out of receivership, the share prices of other midsized banks dropped during most of the rest of the week. They were easy targets for short sellers. As described in an article by Matt Levin titled "When Short Sellers Bet Against Banks," "basically, it was like shooting fish in a barrel."

A May 8 article in American Banker observed that the KBW NASDAQ bank index fell by 7.6% over the week. But Western Alliance was down 28% and PacWest was down 43%. Concerns over apparent market manipulation prompted Rob Nichols, CEO of the American Bankers Association, to write a letter to the SEC seeking an investigation. He said:

> Since the two bank failures in March, some of our members have experienced significant short sales of their publicly traded equity securities that do not appear to reflect the issuers' financial status or general industry conditions — indeed, short sales have followed relatively favorable earnings reports from some of the banks in question and from peer institutions.
>
> We have also observed extensive social media engagement about the health of various banks and the sector generally that appears disconnected from the underlying financial realities. We urge the SEC to investigate this behavior.

The Consumer Bankers Association also issued a statement, urging policymakers to call out what it called "unethical behavior." The concern is that "rock-bottom share prices could spark large deposit outflows, undermining the health of otherwise solid banks."

Other banking experts, including Chase CEO Jamie Dimon, have called for an outright ban on short sales of bank stocks.

U.S. Bans on Short Selling Historically

Bans on short sales are not new. Napoleon not only outlawed the practice but had perpetrators imprisoned. In the first half of the 19th century, short selling was banned in the U.S. due to speculation regarding the War of 1812. The ban remained in place until the 1850s.

After the market crash of 1929, short selling was restricted again. During the four-year industry-wide bear raid initiating the Great Depression, the Dow Jones Industrial Average was reduced to 10 percent of its former value. Whenever the market decline slowed, speculators would step in to sell millions of dollars' worth of stock they did not own but had ostensibly borrowed just for purposes of sale. Concerned about reports of bear raids by short sellers, Congress gave the newly created Securities Exchange Commission (SEC) power to regulate the practice. Today short selling is not illegal, but market manipulation – intentional conduct aimed at deceiving investors by artificially affecting stock prices – is.

When Lehman Brothers went bankrupt in September 2008, some analysts thought the investment firm's condition was no worse than its competitors'. What brought it down was not undercapitalization but a massive bear raid on 9–11 of that year, when its stock price dropped by 41% in a single day. In 2008, the SEC took temporary emergency action to prohibit short selling in financial companies. But research by the Fed showed that the ban had little impact on stock prices, while it increased trading costs.

As posited by Matt Levine, banning short sales in a particular stock could itself trigger a run:

> Depositors might deduce that the state of the banking industry is pretty bad if the government is stopping people from betting that First Republic might fail, and they would withdraw whatever is left of their deposits.

For that reason, a temporary ban on particular stocks might be counterproductive. But what about banning short sales altogether?

A Blanket Ban on Short Selling?

The SEC's mandate includes preventing fraud in securities transactions, and shortselling is inherently fraudulent without the express consent of the stock's true owners. It is a fraud on the owners, who bought the stock because they believed in the company and wanted to see its business thrive, not dive.

They may have checked the box that said they had read and agreed to the obscure terms in the multi-page contract involved in signing up for a brokerage account; but even if they did actually read it, they probably did not understand what they were agreeing to. As explained by securities fraud attorney Jeff Sonn:

> [Y]our brokerage firm cannot lend out your stocks without your permission. However, you may have signed a customer agreement that explicitly allows your broker to lend out your securities.
>
> This clause is often tucked deep within the customer agreement, and few investors pay much attention to it. In many cases, investors who have a margin account with their brokerage firm will be asked to sign a hypothecation agreement. This agreement generally gives the brokerage firm the right to lend shares of securities that you own.

The brokers can "rent" the stock in a margin account for a substantial fee—sometimes as much as 30% interest for a stock in short supply. But the real shareholders get none of this tidy profit, and they can be seriously harmed by the practice.

Many investors protect themselves from sudden drops in price by placing a standing "stop loss" order, which is activated if the market price falls below a certain price. Short sellers need only trigger these orders to initiate a cascade of selling. The stop loss orders act like a pre-programmed panic button, which can trigger further selling and more downward pressure on the stock price.

Some of the damage caused by short selling was blunted by the Securities Act of 1933, which imposed an "uptick" rule and forbade "naked" short selling. But both of these regulations have been circumvented today.

Short selling is sometimes justified as being necessary to keep a brake on the "irrational exuberance" that might otherwise drive popular stocks into dangerous "bubbles." But if that were a necessary feature of functioning markets, short selling would also be happening in the markets for cars, television sets and computers, which it obviously isn't. The reason it isn't is that these goods can't be "hypothecated" or duplicated on a computer screen the way stock shares can. Short selling is made possible because the brokers are not dealing with physical things but are simply moving numbers around on a computer monitor.

Short selling is market manipulation for private profit, intended to drive down targeted stock prices. It was banned early in U.S. history and a good case can be made that it should be banned again.

The Public Banking Option

While we're waiting for federal action, there is a way that states can protect themselves from this sort of instability in the banking sector. The stellar model is North Dakota, where headlines claim "ND Financial Institutions Assert Good Health in Wake of Bank Failures Elsewhere." North Dakota has its own "mini-Fed," the Bank of North Dakota (BND). The bank is wholly owned by the state and is not publicly listed, so its shares cannot be shorted by speculators; and the vast majority of its deposits are state revenues, so there is no fear of a run on the bank.

Local North Dakota banks partner with the BND and can sell a portion of their loans to it if they need liquidity. The BND also guarantees many of the loans in which it takes a partnership interest. By increasing lending, the BND has increased the local money supply and stabilized the entire North Dakota economy, so there has been no decline to trigger a run on the banks.

As detailed by Stacy Mitchell, co-director of the Institute for Local Self-Reliance, North Dakota has six times as many locally owned financial institutions per person as the rest of the nation. These local banks and credit unions control fully 83 percent of deposits in the state — more than twice the 30 percent market share that small and mid-sized financial institutions have nationally. The state-owned BND backstops the local banks that service the economy, keeps North Dakota's money local, augments the local money supply, and provides an additional source of revenue for the state.

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