Imitation Banks:
Abusing the Public's Faith in Banks

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Introduction

In recent years, a number of financial technology (fintech) firms have used clever but misleading marketing to create online-only presences and act like banks while evading the banking laws that protect customers and the financial system. These "imitation banks," so named because they imitate banks to intentionally lure in customers, are actively putting users' livelihoods at risk.

Policymakers and scholars alike have long recognized the importance of regulating banks as unique institutions that engage in activities critical to depositors and the macroeconomy, such as deposit-taking and lending. Yet shadow banks, which are institutions that function as banks but are not regulated as such, have a history of evading government oversight and causing harm to the financial system and millions of users. Imitation banks are just another in a long line of shadow banking endeavors. Among the many examples are the private bankers who accepted deposits and made loans without government supervision and helped contribute to the Panic of 1929; the large broker-dealers, for whom the term "shadow bank" was coined, that helped cause the 2008 financial crisis; and money market mutual funds, which were created as a regulatory arbitrage alternative to bank deposits and required government bailouts in 2008 and 2020.

Imitation banks, despite how much they rely on modern technology and exploit the language of innovation, carry similar risks to the general public whose money is at stake. Like other shadow banks, imitation banks are at risk of running, yet are not subject to capital, liquidity, disclosure, and other regulatory requirements, nor to prudential or consumer protection supervision; do not have access to the Federal Reserve's discount window; and have depositors that do not receive federal deposit insurance. But unlike other shadow banks, imitation banks use the misleading language of banking, not investment, to appeal to depositors. And like the rise of crypto assets over the past decade, imitation banks tend to promise unusually high returns, thereby marketing themselves as attractive options for the millions of low-income and/or Black or brown Americans who have been historically locked out of more traditional paths to wealth building. Indeed, the chairman of the Senate Banking, Housing, and Urban Affairs Committee has raised concerns that imitation banks "may give consumers the false impression that their money is as safe as a deposit at an FDIC-insured bank" (Brown 2023).

As has been seen time and again—from automated mortgage origination that caused the housing bubble in the early aughts to the rise and fall of crypto assets this decade—technological innovation has opened new horizons to exploitative finance that puts people and their livelihoods at risk. We need a broad and coordinated governmental approach to rein in imitation banks. Because they borrow on the faith the public has in banks and the institutions that regulate them, the imitation banks that are gaining ground today must be recognized as the dangerous shadow banks that they are before they can further take root and harm customers.

Regulators should use their authorities to shut down imitation banks or subject them to the same regulation as traditional banks. And because unregulated deposit-taking is dangerous to depositors and the financial system, Congress should consider legislation that would permit *only* prudentially regulated institutions to take deposits.

The Threat of Imitation Banks

Who They Are and How They Work

Imitation banks are firms with advertising and offerings that look like those of traditional banks all while being exempt from banks' regulatory oversight (Sanneh 2023). Historically, banks have been institutions that issue deposits, which are debts owed to account holders in exchange for cash borrowed, and lend those borrowed assets to new borrowers.[1] Today, banks are also a significant part of the payment system, in that bank deposits are used in payments (Ricks 2016).

Although their business models are varied, all imitation banks look and act akin to traditional banks. Their offerings mimic deposits and savings accounts, and some even use the terms "deposit," "savings," and "accounts." They permit customers to withdraw their money at any time, just like traditional bank demand deposits. They have web portals and phone applications that look like those of traditional banks and use advertising language that misleads customers into thinking that they are as safe as traditional banks, including by comparing their offerings to account yields at institutions insured by the Federal Deposit Insurance Corporation (FDIC). Moreover, they do so while promising higher returns than most customers would expect from their traditional banks (between 17 and 150 times greater), without acknowledging the risks taken to attain those returns. Furthermore, as traditional bank yields have increased as a result of rising interest rates, it may be easier for consumers to fail to differentiate imitation banks from traditional banks as their interest rates

[1] At their most basic, "deposits are IOUs that mature instantaneously and are rolled over by account holders each instant that they are not redeemed" (Ricks 2016). The imitation banks all have different models and borrow money from customers using different financial instruments, but, fundamentally, they all provide IOUs in this basic form. Their offerings, therefore, can be considered deposits.

converge. All of these marketing ploys imply to prospective customers that the imitation banks are as safe as, or even better than, regular banks.

Although it is impossible to know imitation banks' total size and impact, the risk they pose is widespread. Imitation banks are not the only institutions that have engaged in unregulated deposit-taking activities; the crypto lenders that declared bankruptcy in 2022 also took deposits and left consumers with billions of dollars in claims (Gorton and Zhang 2023).

This brief identifies four imitation banks, though there are certainly others, and certain to be others created in the future unless regulators shut down or regulate these institutions.

Compound Real Estate

Compound, formerly known as Compound Banc, has directly borrowed the vernacular of traditional banks to capitalize on the faith the public has in banks and the institutions that regulate them. Compound's deposits are its own bonds, called "Compound Bonds," that are purchased and sold to Compound account holders through its web portal and phone application (Compound Real Estate Bonds, Inc. 2022). Although Compound may argue that it is only selling bonds, that customers may only purchase and redeem bonds through Compound's web portal makes the transactions similar to traditional banks' deposits. Unlike the other imitation banks, Compound's bond offering has been registered with the Securities and Exchange Commission, which allows investors to investigate the purchasing risk. Compound invests customer funds in real estate assets, and—notably—many of the statements in the bonds' offering circular contradict statements made on Compound's website. For example, whereas Compound's website states that bonds can be redeemed for cash at any point, the 2022 offering circular stated that "[y]ou should be prepared to hold your Compound Bonds as [they] are expected to be highly illiquid investments."

Tellus

Tellus is a fintech backed by the venture capital firm Andreessen Horowitz that, in addition to serving as an imitation bank, is also a tool for property managers (Tellus 2023). The debt Tellus offers to customers serves as its deposits, and it uses the cash received for residential real estate lending. That is, it borrows cash from customers and uses it to make loans, just like banks. Unlike Compound, Tellus's accounts are not registered as investment products with the Securities and Exchange Commission, and the only information available on Tellus's risks is from its website and media reporting. Although Tellus advertises the high quality of its assets, media reports note that Tellus "fund[s] riskier types of borrowers than it advertises," such as real estate speculators and subprime borrowers (Adelman 2023).

Zera Financial

Zera advertises to customers three percent interest *every month* on deposits, which amounts to a whopping 42.6 percent annual return (Zera 2023). Yet its barebones website fails to explain at all how it achieves these astronomical returns or their associated risks. At most, Zera explains that "customers give us an unsecured loan and in return we give you a fixed interest rate"—the very definition of a bank deposit. Unlike the other imitation banks, Zera asks customers to lock-up their deposits for a set period of time (e.g., six months, 12 months), with interest rates dependent on the term period, akin to bank certificates of deposit. Zera claimed that customer deposits were insured by the FDIC, including claiming that deposits were insured "with no max limit," until the FDIC issued a cease-and-desist letter in February 2023 (FDIC 2023).

Confetti

Confetti is an imitation bank that failed. Like the other imitation banks, Confetti issued debt to customers that it lent to borrowers. But unlike the others, it lent customer deposits to crypto speculators, all the while explaining that deposits are "lent out to trustworthy, vetted financial institutions." To illustrate its supposed safety, Confetti's website explained that borrowers post collateral valued at more than their loan, and described three scenarios that could occur:

1. First, borrowers could repay their loans, in which case Confetti's depositors would be repaid with interest.
2. Second, the value of borrowers' collateral could fall below 150 percent of their loans. Borrowers would then face margin calls and, if they could not post additional collateral, the initial collateral would be liquidated to repay Confetti's depositors.
3. Third, if borrowers could not repay their loans, their initial collateral would be liquidated and Confetti's depositors would be repaid.

Nothing on Confetti's website indicated that what actually *did* happen was a possibility: Borrowers did not repay their loans, their collateral precipitously dropped in value, and Confetti's depositor accounts lost value. Despite some acknowledgment that depositors could face losses, the website urged that depositors can be assured that "your funds are safe and your account is secure."

Imitation Banks Use the Language of Banking to Deceive Customers

The activities in which imitation banks are engaged are not particularly novel, even outside the banking system. Many firms issue demand notes, which are debt instruments that may be redeemed by holders at any time and which function akin to deposits. For example, General Motors offers Right Notes, Dominion Energy offers Reliability Investments, and Ford Motor Company offers Ford Interest Advantage Floating Rate Demand Notes, which are used to fund these firms' operations and are redeemable at any time. Just like with traditional banks and imitation banks, noteholders face the risk that they will not be repaid, and the firms themselves could see runs if noteholders become concerned about the firms' health. Ford even allows online bill pay, check writing, and a website and phone application, perhaps making it *more* like a traditional bank than the imitation banks. The only practical difference—for creditors—is that bank deposits maintain FDIC insurance.

The imitation banks are more concerning than these note issuers, however, because of the difference in how they use language and advertising. Note issuers like Ford Motor Company do not call their products "savings" or compare their yield to those of named FDIC-insured banks. Instead, they call their offerings "investments" and discuss their modest returns compared with other investing opportunities. Their "accounts" are not a selling point, but instead are for investment management purposes only. In short, traditional demand note issuers use the language of *investing*, whereas imitation banks use the language of *banking*. Given the fact that *all* traditional banks in the United States have been subject to federal deposit insurance for decades (Wilmarth 2022), the use of banking terms can make customers believe the imitation banks' offers are safer than they actually are, making imitation banks' offerings more abusive than note issuers.

Imitation Banks' Playbook: Skirting Regulations and Leveraging Clever Marketing Puts Customer Money at Risk

Today, imitation banks threaten depositors by acting in a predatory manner and posing many of the same kinds of risks as do traditional banks but without sufficient regulatory oversight and greater consequences.

First and foremost, imitation banks prey on potential depositors. They frequently describe their services as being better than those of traditional institutions without also describing the downside risks. Compound, for example, advertises that it offers services that were "previously reserved for the top 1 percent" or "for Wall Street," implying that it was this type of opportunity that helped the wealthy get and stay wealthy (Compound Real Estate Bonds, Inc. 2023). This suggestion can be a powerful and tempting one—especially for the millions of low-income and/or Black or brown Americans historically locked out of safer wealth-building opportunities. In fact, Compound uses the same types of language that crypto promoters use to talk about wealth building: the need to eliminate barriers to wealth building, taking power away from Wall Street, and providing low-fee alternatives. Of course, Compound's offerings are not only in no way novel, but are also riskier for investors than comparable products that have been on the market for decades, such as real estate investment trusts.

Beyond exploiting the public's general desire for wealth-building opportunities, imitation banks market themselves as atypically safe investment opportunities. Tellus, for example, notes that its depositors can "avoid the extra volatility that is typically found in markets with exposure to high inflation environments," without discussing the risks that come from investing in a single asset class (Tellus 2023). Compound explains that its portfolio is "powered by high-quality, cash-generating real assets," "diversified and resilient," and "not tied to the volatility of the stock markets or interest rate fluctuations set by the Federal Reserve" (Compound Real Estate Bonds, Inc. 2023). But it does not disclose its actual assets, that investing solely in real estate is not diversified, or that real estate investment performance *is tied to Federal Reserve interest rates*; its offering circular, at least, calls some of these assertions into question, explicitly rebuts others, and is linked to in the website's fine print. Confetti, before its failure, noted that "borrowers are overcollateralized—they must post more collateral than their loan—which ensures your funds remain secure" (Confetti 2021). Confetti failed when borrowers could not repay their loans.

Second, although traditional banks and imitation banks sometimes operate in similar ways, the latter are not subject to the rules and regulations—like capital requirements, prudential investment regulations, disclosure rules, and deposit insurance—that would keep customer money safe and minimize contagion (the spread of disturbances across financial institutions) in times of crisis. Both traditional and imitation banks face moral hazard: the incentive to take increased risks because they are using customer deposits to make loans, rather than their own capital, so losses will be borne by depositors. Because deposits are simply loans or investments from depositors to the institutions, banks' failures will result in depositor losses. (One imitation bank, Confetti, has already failed while making risky investments with client money. It lent customer deposits to cryptocurrency speculators, and collapsed when the crypto bubble popped.) Moreover, unlike traditional nonbank investments, imitation banks—except for Compound—do not provide depositors with disclosures or audits so depositors can understand the risks.

Third and finally, though all deposit-taking institutions can face withdrawal panic, only the banks that are regulated by the Office of the Comptroller of the Currency (OCC), Federal Reserve, or FDIC can reasonably expect government backstops in times of crisis. Because depositors may withdraw their funds at any time, both traditional and imitation banks engage in maturity transformation—the making of longer-term investments with shorter-term loans—and face runs. By turning deposits into loans, these institutions do not have cash on hand to meet redemptions if depositors decide to withdraw en masse. Also, because they promise that deposits may be withdrawn at par, their depositors face an incentive to withdraw before others and while reserves are still available; first-movers are made whole while later redeemers face haircuts (Pennacchi 2010). Accordingly, even solvent banks, both traditional and imitation, may run (Diamond and Dybvig 1983). But the Federal Reserve, the lender of last resort for traditional banks, provides capital to solvent traditional banks facing runs, whereas solvent imitation banks lack any kind of government backstop, putting their depositors at greater risk if there is a run. This is no mere speculative risk: One media report noted that, after the banking crisis prompted by the failures of Silicon Valley Bank and Signature Bank this past March, depositors in Tellus withdrew funds, fearing their institution would fail, too (Adelman 2023).

Additionally, if left to grow sufficiently large, imitation banks could pose threats to the financial system in the same way large shadow banks did prior to the 2008 financial crisis. In the leadup to that crisis, several institutions engaged in maturity transformation without sufficient supervision and regulation. The insurer AIG, for example, essentially offered coverage for financial assets that decreased in value, but when financial institution creditors demanded payment at the same time, AIG could not satisfy all requests. AIG's threat to haircut claims posed such a threat to other financial institutions that AIG was bailed out so it could pay out creditors (FCIC 2011). Similarly, when the Reserve Primary Fund money market mutual fund broke the buck due to falling asset values, shareholders of other money funds demanded redemptions, causing runs, further exacerbating falling asset values, and resulting in another bailout. And when Lehman Brothers failed, again because of falling asset prices, contagion spread to other institutions that likely would have failed without government intervention.

Imitation banks, like the shadow banks of yesteryear, could present similar threats if they become as large and systemically important as Lehman or AIG. Were the investments of one such imitation bank to go south, depositors could demand redemptions that the imitation bank could not pay without haircuts that would cause depositors to take losses. If those depositors were other financial institutions, the knowledge that they were not fully repaid could cause them to run as well. Further, the sale of assets to partially or fully meet redemption requests could result in a fire sale, causing asset valuations to drop system wide. Similarly, if one imitation bank fails, it could result in contagion—sparking fear among depositors about the health of and causing runs at other imitation banks, traditional banks, insurers, and other financial institutions. To this end, if even one imitation bank grows so large as to be systemically important, its failure could cause ripples throughout the broader financial system.

A Broad and Coordinated Approach to Regulating Imitation Banks

Imitation banks pose risks to depositors today and could pose risks to the financial system in the future if they are permitted to grow. While there are a few regulatory regimes that could be applied to imitation banks, the variety of business models they exhibit necessitates a broad and coordinated approach to regulating them in all their forms.

Securities Regulation

The nation's securities laws, which require issuers to register certain securities sold to the general public with the Securities and Exchange Commission and to disclose accurate and specific information to potential investors, is certainly applicable to some, if not all, of the imitation banks. Not only are Compound's bonds already registered, but the Supreme Court has declared that demand notes sold to the public must be registered as well (*Reves v. Ernst & Young*), and the SEC has alleged that deposit accounts like those offered by the imitation banks are notes requiring disclosure (In the Matter of BlockFi Lending LLC). It is unclear how Tellus, Zera, and other imitation banks have thus far avoided registering and providing SEC-required disclosures.

Nevertheless, current securities laws' disclosure requirements are insufficient to effectively protect customers from the potential harms of imitation banks. They can certainly address the existence of predatory and misleading statements, as even statements made outside of official securities disclosures can violate prohibitions against securities fraud. For example, the statements on Compound's website that are contrary to those contained in its prospectus may be actionable. But even then, although the securities laws permit private plaintiffs to sue for decreases in securities' value resulting from erroneous statements, the value of imitation banks' securities will not actually decrease as long as imitation banks are solvent. And once imitation banks become insolvent, no losses may be recouped.

The securities laws' disclosures also may not address concerns of moral hazard inherent in the imitation bank funding model. Although disclosure should address this issue—with disclosures, depositors may ensure that firms act consistent with their risk tolerance—it not only requires investors to read and understand complex disclosure documents, but it also requires disclosures to be sufficiently detailed that depositors can understand the types of risks that imitation banks are taking. In addition, securities disclosures do not require imitation banks to make investments with, in part, their own funding, which would also address moral hazard.

Lastly, the securities laws are incapable of addressing the largest concern for traditional banks and imitation banks: runs from maturity transformation. Issuers of demand notes need not provide continuing disclosures of their assets, and therefore investors cannot know whether issuers are solvent. If noteholders all at once decide to redeem, even solvent issuers will be unable to repay them all, and no deposit insurance is available to protect investors. Investment companies must provide periodic audited financial statements that help inhibit runs, but mutual funds have been shown to run in times of stress—especially when their shares may always be redeemed for a fixed rate. This is because the SEC cannot subject investment companies to the type of supervision and regulation that is necessary to address maturity transformation concern—the type of regulation the banking supervisors offer.

Banking Regulation

The banking laws are the only federal statutes that are designed explicitly to address run risks, through mechanisms such as capital and liquidity requirements, examinations, and discount window access. Yet, despite the logic of applying bank regulation to imitation banks, the banking regulators' authority is limited to depository institutions that are chartered by the OCC or members of the Federal Reserve System, or have deposit insurance through the FDIC. Because imitation banks are none of these three and cannot be compelled to convert to a banking charter, they cannot be covered by federal banking laws—with one exception.

That caveat is Section 21 of the Banking Act of 1933, better known as the Glass-Steagall Act (12 U.S.C. § 378). Section 21 criminalizes "the business of receiving deposits" unless an institution is subject to examination like traditional banks. This law is in some sense ambiguous (it does not clearly define the term "deposit," leaving unclear whether bonds and notes can be deemed deposits) and this path would be difficult for a number of reasons: Section 21's *mens rea* requirement as a criminal statute is a high bar, the Department of Justice is likely the only agency that may enforce its prohibition, and prior court opinions have implied that fraud or other criminal activity is required for Section 21 to be applicable. But perhaps it would not be impossible.

State banking laws may be better positioned to intervene between imitation banks and at-risk customers. Every jurisdiction in the United States regulates the business of banking; for example, New York State prohibits nonbanks from receiving deposits (N.Y. Banking Law § 131 [2014]). Prosecutors could endeavor to prevent imitation banks from operating within their states. However, each state's law is unique, and this path could result in a patchwork where imitation banks are prohibited in some states but permitted in others.

Consumer Finance Regulation

Federal consumer financial regulation is perhaps the easiest path forward for regulating imitation banks, but it still has limits. The Consumer Financial Protection Bureau (CFPB) maintains two specific existing authorities that could be applied: a prohibition on unfair, deceptive, and abusive acts and practices (UDAAP), and regulating disclosures of deposit-taking activities.

The UDAAP prohibition stops providers of consumer financial services—which includes deposit-taking activities (12 U.S.C. § 5481)—from, among other things, making deceptive statements or omissions that mislead customers or abusing customers' lack of understanding of products' risks or reliance on providers to act in their best interests (CFPB 2022a). This UDAAP prohibition could potentially address the existence of deceptive and misleading statements by imitation banks about the safety of customer deposits or, in the case of Zera, the lack of indications of how it uses its deposits. Similarly, UDAAP's prohibition on abusive practices could also apply to any of the imitation banks that take unreasonable advantage of gaps in depositors' understanding about the risk of potential losses related to any assets that are invested in unreasonably risky ventures. The CFPB could perhaps even deem the use of the terms "deposit" or "saving" to describe imitation banks' products a violation, since the public generally understands these terms as banking-specific and their use by nonbanks could be misleading. Importantly, because enforcement is conducted by the CFPB and state attorneys general, it is liable to be readily enforced.

The CFPB may also regulate disclosures from depository institutions that lack federal deposit insurance under Section 43 of the Federal Deposit Insurance Act (12 U.S.C. § 1831t). Specifically, if depository institutions do not have FDIC insurance, the CFPB can require that they make this fact clear to potential depositors and require depositors to sign "a written acknowledgement" that the government does not insure their deposits. The law also permits the CFPB to regulate how those disclosures are made; if applicable, the CFPB could, for example, require depositors to provide physical signatures acknowledging that their deposits are not insured, which would decrease the likelihood that consumers would participate.

Of course, there is no guarantee that the nation's consumer financial laws may be effectively applied to the imitation banks. Although the implication from the CFPB's statute is that any type of firm may take deposits,[2] the term "deposit" itself is defined surprisingly narrowly: Deposits are "the unpaid balance of money or its equivalent received or held by a bank . . . for which it has given or is obligated to give credit ... to [an] account ..." (12 U.S.C. § 1813). The imitation banks all meet the definition of taking deposits in that they all owe debts to customer accounts (even Compound, which pays bond coupons to accounts), with the exception that they are, obviously, not banks. Although the CFPB has successfully settled at least one case with a nonbank for accepting deposits, no court has ruled on the issue (CFPB 2022b).

Further, even if the imitation banks may be considered as deposit-taking, UDAAP prohibitions cannot address all the risks imitation banks pose. Most obviously, even imitation banks that do not engage in unfair, deceptive, or abusive practices still face moral hazard, engage in maturity transformation, and are subject to runs. Additionally, it is not even clear that the UDAAP laws apply; the SEC has previously argued that deposit accounts at nonbanks are notes subject to the securities laws and not consumer financial products subject to the CFPB's jurisdiction (In the Matter of BlockFi Lending LLC).

Congressional Action

Having regulators enforce the laws noted above would be a good start to addressing the problems of imitation banks, but there are flaws to each existing regulatory regime. Fully addressing the problem of imitation banks—and shadow banking in general—requires Congress to enact legislation.

Congress should make three targeted changes. First, it must strengthen the prohibition of nonbanks taking deposits by providing a more inclusive definition of the term "deposit." Professor Morgan Ricks would define the term as covering debt instruments with maturity generally of less than one year that are payable in the medium of exchange (Ricks 2016), whereas Professor John Crawford would define it more broadly as simply short-term debt claims (Crawford 2017). Crawford's definition would provide that debts repayable in stocks, bonds, and other securities; crypto assets; or other financial instruments would be considered deposits whereas Ricks's would limit deposits to only those debts repayable in dollars. Neither change would address the maturity transformation problems with money market mutual funds, which are equity instruments, but they would certainly stop imitation banks from taking deposits.

[2] The "term 'deposit-taking activity' means ... the acceptance of deposits, maintenance of deposit accounts, or the provision of services related to the acceptance of deposits or the maintenance of deposit accounts" (12 U.S.C. § 5481).

Second, Congress should make Section 21 of Glass-Steagall a civil statute and explicitly allow the banking agencies and/or the CFPB to enforce it. Given that Section 21 contains criminal penalties, not only is its *mens rea* requirement a high bar to clear, but enforcement most likely relies on the Department of Justice, which does not have the expertise to understand the dire need by depositors and the financial system to enforce its provisions. Although Professors Ricks and Howell Jackson have suggested that it may be possible for the Federal Reserve or other agencies to bring civil lawsuits under Section 21 as it is today (Jackson and Ricks 2021), such a suit has never been attempted and its potential success is unclear; having Congress change the statute would simply make enforcement easier.

Lastly, imitation banks should be prohibited from using the terms "deposit" or "savings" to describe their activities—thus eliminating one way the public is invited to view them favorably through implicit association with traditional banks. Although, as above, it is possible that the CFPB could deem nonbanks' use of the terms to be UDAAP violations, and although nonbanks taking deposits is a crime, courts may disagree that the CFPB has this authority. Congress should clarify that this misuse of terminology is illegal.

Conclusion

The internet has enabled great efficiencies in finance, but it has also opened new horizons to exploitative finance. Imitation banks, which could only exist because of the internet, pose risks to their depositors. Like crypto issuers in years past, they make specious promises of high returns to gain ground with consumers who may have been historically locked out of more traditional wealth-building opportunities. And they're doing so without the necessary government oversight and accountability mechanisms to ever make them safe for consumers or the US financial system as a whole. Regulators and Congress must act to address these harms.

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12 U.S.C. § 378.

12 U.S.C. § 1813.

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