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Stopping Bank Crises Before They Start

By John Cochrane – June 23rd, 2013

In recent months the realization has sunk in across the country that the 2010 Dodd-Frank financial-reform legislation is a colossal mess. Yet we obviously can't go back to the status quo that produced a financial catastrophe in 2007-08. Fortunately, there is an alternative.

At its core, the recent financial crisis was a run. The run was concentrated in the "shadow banking system" of overnight repurchase agreements, asset-backed securities, broker-dealers and investment banks, but it was a classic run nonetheless.

The run made the crisis. In the 2000 tech bust, people lost a lot of money, but there was no crisis. Why not? Because tech firms were funded by stock. When stock values fall you can't run to get your money out first, and you can't take a company to bankruptcy court.

This is a vital and liberating insight: To stop future crises, the financial system needs to be reformed so that it is not prone to runs. Americans do not have to trust newly wise regulators to fix Fannie Mae FNMA -5.41% and Freddie Mac, FMCC -4.02% end rating-agency shenanigans, clairvoyantly spot and prick "bubbles," and address every other real or perceived shortcoming of our financial system.

Runs are a pathology of financial contracts, such as bank deposits, that promise investors a fixed amount of money and the right to withdraw that amount at any time. A run also requires that the issuing institution can't raise cash by selling assets, borrowing or issuing equity. If I see you taking your money out, then I have an incentive to take my money out too. When a run at one institution causes people to question the finances of others, the run becomes "systemic," which is practically the definition of a crisis.

By the time they failed in 2008, Lehman Brothers and Bear Stearns were funding portfolios of mortgage-backed securities with overnight debt leveraged 30 to 1. For each $1 of equity capital, the banks borrowed $30. Then, every single day, they had to borrow 30 new dollars to pay off the previous day's loans.

When investors sniffed trouble, they refused to roll over the loans. The bank's broker-dealer customers and derivatives counterparties also pulled their money out, each also having the right to money immediately, but each contract also serving as a source of short-term funding for the banks. When this short-term funding evaporated, the banks instantly failed.

Clearly, overnight debt is the problem. The solution is just as clear: Don't let financial institutions issue run-prone liabilities. Run-prone contracts generate an externality, like pollution, and merit severe regulation on that basis.

Institutions that want to take deposits, borrow overnight, issue fixed-value money-market shares or any similar runnable contract must back those liabilities 100% by short-term Treasurys or reserves at the Fed. Institutions that want to invest in risky or illiquid assets, like loans or mortgage-backed securities, have to fund those investments with equity and long-term debt. Then they can invest as they please, as their problems cannot start a crisis.

Money-market funds that want to offer better returns by investing in riskier securities must let their values float, rather than promise a fixed value of $1 per share. Mortgage-backed securities also belong in floating-value funds, like equity mutual funds or exchange-traded funds. The run-prone nature of broker-dealer and derivatives contracts can also be reformed at small cost by fixing the terms of those contracts and their treatment in bankruptcy.

The bottom line: People who want better returns must transparently shoulder additional risk.

Some people will argue: Don't we need banks to "transform maturity" and provide abundant "safe and liquid" assets for people to invest in? Not anymore.

First, $16 trillion of government debt is enough to back any conceivable demand for fixed-value liquid assets. Money-market funds that hold Treasurys can expand to enormous size. The Federal Reserve should continue to provide abundant reserves to banks, paying market interest. The Treasury could offer reserves to the rest of us—floating-rate, fixed-value, electronically-transferable debt. There is no reason that the Fed and Treasury should artificially starve the economy of completely safe, interest-paying cash.

Second, financial and technical innovations can deliver the liquidity that once only banks could provide. Today, you can pay your monthly credit-card bill from your exchange-traded stock fund. Tomorrow, your ATM could sell $100 of that fund if you want cash, or you could bump your smartphone on a cash register to buy coffee with that fund. Liquidity no longer requires that anyone hold risk-free or fixed-value assets.

Others will object: Won't eliminating short-term funding for long-term investments drive up rates for borrowers? Not much. Floating-value investments such as equity and long-term debt that go unlevered into loans are very safe and need to pay correspondingly low returns. If borrowers pay a bit more than now, it is only because banks lose their government guarantees and subsidies.

In the 19th century, private banks issued currency. A few crises later, we stopped that and gave the federal government a monopoly on currency issue. Now that short-term debt is our money, we should treat it the same way, and for exactly the same reasons.

In the wake of Great Depression bank runs, the U.S. government chose to guarantee bank deposits, so that people no longer had the incentive to get out first. But guaranteeing a bank's deposits gives bank managers a huge incentive to take risks.

So we tried to regulate the banks from taking risks. The banks got around the regulations, and "shadow banks" grew around the regulated system. Since then we have been on a treadmill of ever-larger bailouts, ever-expanding government guarantees, ever-expanding attempts to regulate risks, ever-more powerful regulators and ever-larger crises.

This approach will never work. Rather than try to regulate the riskiness of bank assets, we should fix the run-prone nature of their liabilities. Fortunately, modern financial technology surmounts the economic obstacles that impeded this approach in the 1930s. Now we only have to surmount the obstacle of entrenched interests that profit from the current dysfunctional system.