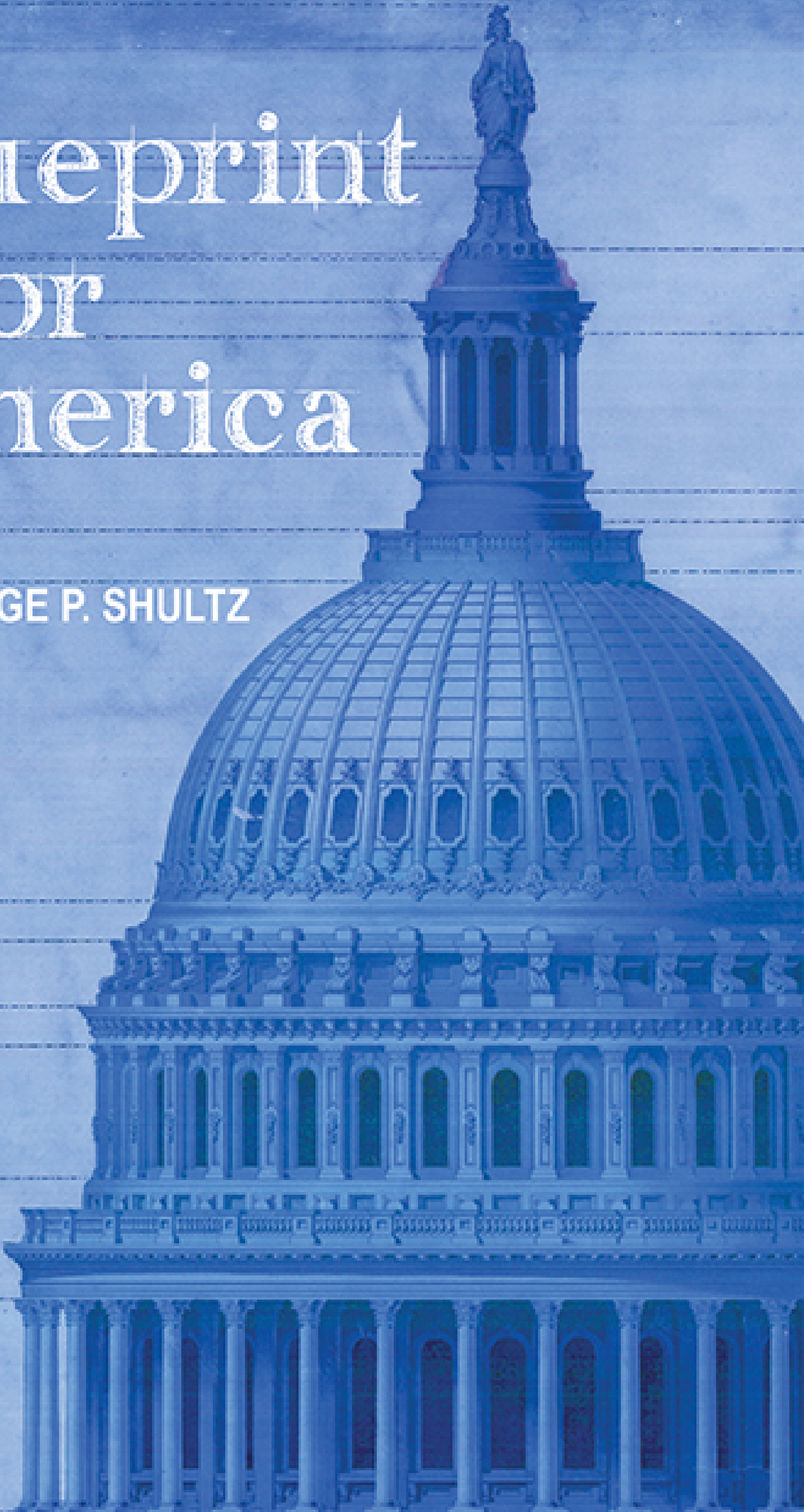
Blueprint for America

EDITED BY
GEORGE P. SHULTZ



CHAPTER 7

A BLUEPRINT FOR EFFECTIVE FINANCIAL REFORM

John H. Cochrane

The most recent financial regulatory expansion, under the Dodd-Frank Act in the United States and similar actions by foreign countries and international organizations, is a failure. It is leading to a sclerotic, inefficient, and politicized financial system. Most of all, it won't work, neither stopping a new crisis from emerging nor stopping another round of bailouts if a crisis does occur.[1]

Rather than stress these failures, which many eloquent authors have done, I focus here on the essential question: *What is the alternative?*

A VISION

Let us start with a vision of what a healthy financial system looks like. Then, we can consider policy paths to take us there.

We want a financial system that is immune from crises. We also want an innovative, competitive financial system, one that brings all the advantages that the revolutions in computation, communication, and finance can bring to savers and investors.

As much as possible, we want to minimize government direc-

I thank John Cogan, Chris Dauer, and Michael Boskin for very helpful comments.

tion of the financial system. Where regulation is necessary, we want it to operate by clear, simple laws and rules, not by the discretionary decisions of powerful agencies and by tens of thousands of pages of inscrutable regulations. Limited rule-based regulation is not necessarily a goal in itself; instead, it springs from long experience that vast and powerful regulatory bureaucracies do not produce innovative, competitive, and apolitical financial systems, a better allocation of investment capital, less risk-taking, or immunity from crises.

On the other hand, given our government's irresistible temptation to meddle, especially where large amounts of money are involved, we want a financial system that is resistant to such meddling, one for which regulation and cross-subsidization will not induce financial instability as our previous regulatory regime so obviously did.

What would a structure that embodies these goals look like?

Equity-financed banking

First, and most importantly: banks and similar financial institutions will get their money almost entirely by selling stock or by retaining earnings—rather than paying earnings out as dividends —and by long-term borrowing. They will not be funded by large amounts of short-term debt. (Retained earnings raise the value of current shares, so selling stock and retaining earnings are the same thing.)

Financial crises are runs, no more and no less. A run occurs when creditors such as depositors or overnight lenders, unsure of a bank's long-run prospects, demand their money immediately, each anxious to be repaid first. When the bank cannot borrow elsewhere, issue equity, sell assets, or otherwise raise cash to fulfill its promises to such creditors, the bank fails. A crisis is a systemic run: simultaneous runs on many related banks or similar financial institutions.

If we can engineer a run-free financial system, we stop financial crises and we achieve the most important goal of financial regulation. Much additional regulation would no longer be needed. Ill-advised regulation, cronyism, protection, and capture will likely continue anyway. But without financial crises, their damage will be sharply reduced.

Equity-financed banking stops runs, and a financial system of such institutions is immune from crises. Consider the extreme case: a bank that gets all its money by issuing equity, and uses that money to make loans. Such a bank simply cannot fail. Yes, it may lose money and customers, its shareholders may lose the value of their investments, and the firm may eventually close, sell, or liquidate. But financial "failure" means failure to pay debts or other fixed promises. If a firm has no debt, it cannot fail to pay debt; it cannot go bankrupt.

A stock price decline is not a financial crisis. When stocks lose value, the stock investors cannot demand their money back from the company; they cannot seize assets or take the company to bankruptcy court; they cannot run. They can demand management changes. They can, individually, sell shares. They can, collectively, drive share prices down. Their desire to sell may even be "irrational" and subject to behavioral biases including herding, waves of optimism and pessimism, and so forth. Stock prices may be irrationally volatile or bubbly. But none of this constitutes a financial crisis. In no case is money promised and not delivered. In no case does the economy come to a standstill of broken promises to deliver nonexistent cash. Nobody goes to bankruptcy court. Companies may ignore stock prices and continue operations.

Stock price crashes are only dangerous if investors or banks have borrowed a lot of money to buy stocks. Then, the stock price crash causes debts to fail. But debt is at fault here, not the stock market.

Long-term debt may cause a failure, if a company cannot make a scheduled interest or principal payment. But long-term bondholders or lenders (certificates of deposit, for example) do not have the right to demand their money immediately. If the value of a company's assets falls, or the assets become illiquid so nobody really knows what they are worth, long-term bondholders, like stockholders, see the resale value of their investment shrink, possibly temporarily; but there is nothing they can do about it right away either. Long-term debt is not quite as good as common equity for preventing crises, but it is a lot better than short-term debt.

We do not need to regulate this level of perfection. An institution that is funded 95 percent by equity and long-term debt is so unlikely to suffer a run that it is for all intents and purposes completely safe.

Second: short-term, run-prone financing will be absent. Short-term debt is the poison in the well. Our crisis-free economy will treat it as such.

Investors will transparently bear risks, rather than pretend that each can get out first with full value and that risk has somehow been "transformed" or magically wished away. Banks and similar financial institutions will not fund the bulk of their investments with overnight debt, interbank lending, short-term commercial paper, or other wholesale, very short-term financing, all of which suffered runs in 2008.

Short-term debt is the means by which problems at one firm spread to the rest of the system. When Lehman Brothers failed, it was leveraged thirty to one overnight. For each dollar of capital, each morning, it had to borrow 30 new dollars to pay off 30 dollars borrowed the previous evening. That this system fell apart should not be much of a surprise. That our regulatory effort concentrates on regulators overseeing the safety of such firms' investments, rather than eliminating this obviously run-prone means of financing investments, is the surprise.

I emphasize the absence of short-term "financing." Companies do, and must, engage in lots of short-term or fixed-payment contracts, including receivables, trade credit, and derivatives. But, first, many such contracts do not have the feature that the counterparty can demand repayment at any time and put the company into bankruptcy if not paid; and, second, such contracts are usually matched by offsetting assets so the firm has little net short-term exposure and a large equity cushion. The danger lies when firms finance a risky asset position with a large net amount of short-term, instantly demandable debt, whose failure to pay triggers bankruptcy.

Mortgages will still be bundled into mortgage-backed securities, hopefully without Fannie Mae and Freddie Mac and government guarantees. But mortgage-backed securities will be held in long-only mutual and exchange traded funds, by pension funds, insurance companies, endowments, by everyday investors in retirement accounts, and even by equity-financed banks. Mortgage-backed securities are not particularly risky—they are far safer than most corporate equity.

But mortgage-backed securities will not be funded by constantly rolled-over short-term borrowing in a bank or in "shadow banks" such as auction-rate securities or special-purpose vehicles with off-balance-sheet bank guarantees. Then, when the market value or liquidity of mortgage-backed securities declines, even temporarily (as it turned out in many cases), you and I suffer small mark-to-market losses on our investment portfolios. Panicked investors may sell to others at a loss. Others step in to make fortunes buying when others panic—your "fire sale" is my "buying opportunity." But nobody can demand their money back immediately, so the issuing institutions do not fail, and the financial world does not end.

Deposits and payments

With no fixed-value, immediately demandable deposits, where will people put their money, and where will money for loans come from? The broad answer is that this financial system can provide the same or better menu of assets to savers, and as much or more credit and investment capital to businesses and homebuyers, as our current one does.

Those wishing to have immediately available, completely liquid, fixed-value investments will still have them. Banks may still offer deposits and checking accounts. However, such liabilities must be backed 100 percent by short-term Treasuries or interest-paying reserves, in ways that are completely insulated from bankruptcy of the parent company. For example, banks could set up money market funds that hold interest-paying reserves or short-term Treasuries. Deposits and withdrawals at an ATM machine are simply bank-managed purchases and sales of such funds.

To accommodate this demand, the Fed could keep its large balance sheet of Treasury securities and allow individuals and non-bank businesses to have interest-paying accounts. Better, in my view, the Treasury could offer fixed-value floating-rate debt, with cheap electronic transfers, reserves for everyone. If people do not hold these securities directly, they can hold funds that in turn hold these securities.[2]

Deposits backed by short-term Treasuries or reserves can't fail. This fact can substitute for today's deposit insurance. More importantly, it can substitute for the Federal Deposit Insurance Corporation's resolution mechanism, which promptly takes over banks at the FDIC's discretion, and the ominous Dodd-Frank resolution authority. More importantly still, large depositors are not currently protected by deposit insurance and have turned to "shadow banking" of overnight but run-prone debt as a result. Deposits consisting of, or backed 100 percent by, reserves or Treasury debt can completely substitute for these demands.

We are actually on the way to this vision now. The Treasury has introduced floating-rate debt whose value fluctuates very little. The Federal Reserve pays interest on bank reserves, and its enormous balance sheet implies that we now have about $2 trillion of narrow banking—$2 trillion of bank deposits that are backed by interest-paying Fed reserves. The Fed has also introduced segregated accounts and reverse repurchase agreements, which allow large depositors to invest in interest-paying reserves.

However, though consumers and businesses can choose to hold the same assets as they have today, they are likely to choose differently. In today's financial system, and more so in the future, transactions services and liquidity no longer require fixed-value, run-prone accounts. You could easily make purchases with a credit card, debit card, or cell phone and pay the bill by selling shares of a floating-value stock fund, bond fund, mortgage-backed security, or shares of bank stock. In the 1930s, or even the 1960s, this was not possible. Buying and selling assets took large commissions, bid-ask spreads, and days of time to clear. People had to park a considerable amount of wealth in low-yielding, fixed-value investments in order to make payments. Now, people who want greater returns than short-term Treasury debt or Fed reserves offer, but who need liquid assets to pay bills, can do both by taking on some price risk. Given the option, they may choose to do so, and the large amounts of short-term, run-prone securities held for transactions purposes may evaporate. Banks may even offer products that look much like savings accounts—except that, like all proper long-term debt, the face value fluctuates over time.

What investors will not have are accounts that promise fixed values and instant withdrawals, but generate high yields by investing in risky private securities. If savers want higher interest rates than are offered on short-term Treasury securities, they will shoulder price risks rather than demand full value back from the issuer.

Equity-financed banks will not lack for funds to lend out. The same flow of savings ends up in the same amount of loans and government debt. Investors and taxpayers need not provide the banks any more funds than they do now, and need not shoulder any more risk. The equity of an unleveraged bank would have very low volatility, roughly the volatility of the banks' combined debt and equity now. The same Treasuries that the private sector holds directly will be held via intermediaries, or in fixed-value form.

REGULATION AND DEREGULATION

How do we get there?

Before one proposes a wave of new regulations, it is wise to remove the unintended consequences of the old regulations that push the system away from this vision.

Debt deductibility

Short-term debt financing is the poison in the well, and equity financing cures crises. Yet companies can deduct interest payments against income, but not dividend payments. Our government subsidizes debt and simultaneously tries to regulate against its use. Removing this distortion is a good first step.

Abolishing the corporate tax is the purest solution. But we don't have to be that pure. At a minimum, dividend payments and interest should be treated equally, either allowing the deductibility of the latter or denying it to the former.

Other debt subsidies

Liquidity regulations are an underappreciated incentive to unstable financing. A wide swath of financial regulations prizes short-term debt as an *asset*. In doing so, they create a large market and lower interest rates, which gives other firms incentives to create lots of long-term debt as a *liability*.

Among others, Fed liquidity regulations tell banks to hold lots of short-term debt. Securities and Exchange Commission regulations tell mutual funds to hold short-term debt. Capital regulations and the Fed's stress tests use low risk-weights for short-term debt held as an asset.

Regulations that prize holding liquid assets are particularly ill-conceived. Banks plan to sell assets to raise cash if their creditors want money back. That may work in normal times. But who is going to buy assets in a crisis? The whole point of post-Dodd-Frank financial regulation is supposed to be to protect the financial *system* against *systemic* runs.

The regulators' attitude toward any short-term debt other than Treasuries should be that the purchaser is gambling that it can run first; the *lender* is as much a contributor to systemic runs as the borrower.

Deposit insurance and the wider anticipation of *ex-post* creditor guarantees are additional inducements to issue and to buy too much debt. It is easy to say that the government really, really will not bail out creditors next time they run. But that promise has been proven false time and again. Ringing just as hollow is the idea that Dodd-Frank resolution authority will impose haircuts, in a crisis, on creditors who will be screaming that the world will end if they lose money. Once the run has started, creditor guarantees are the only way to stop it, and moral hazard worriers in a crisis are as rare as the proverbial atheists in foxholes.

It is better to restructure the financial system so that runs don't happen and creditor guarantees are not needed. In the Dodd-Frank fantasy world, this happens because wise regulators stop over-leveraged institutions from ever losing money again. In this proposal, the absence of run-prone debt means that inevitable losses do not spark a panic or the need for bailouts.

Regulatory safe harbor

In the current regulatory system there is no safe harbor. There is no way a financial company can certify, "We have set up our business as you ask; we do not pose a systemic risk. Leave us alone." Even equity asset managers, who manage clients' money directly, are now being considered for "systemic" designation under the theory that they might drive stock prices down from irrational behavior.

The carrot is better than the stick. Rather than add regulations against short-term debt, we can grant regulatory safe harbor to institutions that don't use it. If a bank or other institution has a large level of capital—say 50 percent equity capital and no more than 20 percent short-term debt—then it can be automatically free from large swaths of asset risk regulation. Do what you want, as you cannot fail and cause a problem.

The current regulatory philosophy, and especially its Dodd-Frank epitome, is curiously silent on this vision thing. What is not, and cannot, be systemic? How can a financial institution structure itself so that it is so patently safe that it needs no regulation? The loud silence to these questions betrays the answer: the authors of our financial regulations do not think any financial arrangement can be conducted privately, without detailed regulatory scrutiny. We will not escape financial sclerosis with repeated crises without *some* vision for private finance safe enough not to need lots of regulation.

A debt tax

Even without subsidies, bailout guarantees, and regulatory incentives, financial companies may choose to issue too much short-term debt. We need good tools to actively discourage it.

Capital ratios are the centerpiece of current debt regulation. The trouble with these is that attention moves from the numerator to the denominator: 20 percent capital, maybe, but 20 percent of what? Currently, the answer is "risk-weighted assets." Risk-weights pose obvious problems and engender obvious games. Greek government debt still counts for essentially no risk-weight on European bank balance sheets. Mortgage-backed securities gave lower regulatory risk-weight than their equivalent portfolio of individual loans, so banks preferred the securities to the loans. Risk-weights are fundamentally mistaken, treating risks on an asset-by-asset, rather than a portfolio, basis. But raw leverage-ratio limits, ignoring the riskiness of assets, are just as perverse.

A tax on debt, with a higher tax on short-term debt, is a better way to induce firms to rely more on long-term debt and equity and to avoid risk-weight games. For each dollar of short-term borrowing, a financial institution might pay two cents per year. Each dollar of long-term borrowing (no principal payments for a year, say), would cost one cent per year.

This form of policy would give a strong incentive to reduce short-term debt, without the complexity or games involved in regulatory capital ratios. Conversely, if debt really is as vital as banks say it is when they're fighting regulators, well, then they should still be able to issue it and pay the tax.

The principle is the same as a pollution tax. Short-term debt poses an externality. It offers the option to run, and if one person runs he imposes losses on other investors. So, if you want to pollute markets with run-prone debt, pay a hefty tax to do so.

Accounting and tax reform

Arbitrary accounting and tax conventions also drive our financial system to include too much run-prone short-term debt. Short-term debt held as an asset counts as "cash" on the balance sheet, making no distinction between run-free cash (bills, Treasuries, money market funds backed by Treasuries) and run-prone short-term debt.

Accounting and tax rules keep floating-value accounts from being used for transactions, though such use is now easy given the speed of current financial transactions. If one holds a mutual fund with slightly floating values, then each transaction at slightly different prices triggers short-term capital gains and losses. These are, at a minimum, an accounting headache, and at maximum a significant drag.

These conventions need to be reformed, and it would not be too costly to do so. Even if we don't do the right thing by removing the capital gains tax entirely, floating-value accounts used for transactions can be exempt from a tax aimed at "speculators." The effort is tiny compared to the cost of financial crises or Dodd-Frank regulations.

Finally, regulation

If removing the many subsidies for short-term debt, removing the regulatory, accounting, and tax preferences for short-term debt, allowing a regulatory safe-harbor for run-proof institutions, and adding a simple tax on short-term debt do not together convert the financial system to one in which short-term debt is rare, and most institutions are financed by run-proof floating-value assets, then yes, one could add regulation. Capital standards like the ones in place now can be stiffened substantially. One could also avoid the risk-weight game by regulating the ratio of debt to market value of equity, rather than the ratio of debt to dubious measures of risk-weighted assets.

And deregulation

The key point: once run-prone liabilities are sharply reduced, and the financial system is free of the danger of crises and runs, the vast structure of asset risk regulation can be repealed or simply allowed to die on the vine. It does not matter to financial stability how a bank invests its money if losses at that bank do not cause the seizing up of a systemic run. No more stress tests, no more thousands of pages of Basel rules, no more detailed micromanagement by Fed staffers embedded in big banks—and no more creditor or bank bailouts. They simply won't be needed.

The Fed is moving this way of its own accord. It is gradually requiring once unthinkable levels of capital—through levels of capital common in the pre-regulation era—and placing less and less faith in its own clairvoyant abilities to spot the next crisis coming and tell the banks how to invest to avoid losing money in the first place.

CAVEAT

This is, in many ways, a conservative outline of monetary and financial reform.

Much else needs fixing, of course, including getting rid of Fannie and Freddie, the absurd over-regulation of institutions and markets, the witch hunt for billion-dollar settlements, the alphabet soup of regulatory agencies, the SEC, CFTC, CFPB, OCC, and so forth. A full reform proposal deconstructs this whole spaghetti tangle.

This proposal is, though, the necessary first step. "Financial stability" is the mantra under which a blanket of regulation has fallen over our markets and institutions. Once that genuine problem is solved, the rest of the blanket can be attacked. Likewise, if we can solve the one central problem of crises, then remaining bad financial regulation becomes a simple drag on the economy, just like many other regulations, not a crisis-provoker.

This proposal is conservative in another way. The monetary system I describe remains based on short-term government debt as the basic foundation of money and financial transactions. (Currency and reserves at the Fed are just short-term government debt.) I steer away from bitcoin, gold, private money, free banking, and related proposals.

Our financial system has evolved to this basic structure. With inflation near zero and demand for US government debt unprecedentedly solid, there would be little consensus for changing it. And while such a change may be desirable in the long run, it is not necessary for stopping private financial crises like the one we just experienced.

However, as a result, the system I outline requires that the United States retain a strong fiscal position so that its short-term debt is unquestionably safe. The United States could inflate, and it could even default on long-term debts. But our financial system currently, and under this proposal, requires complete faith that the United States would never default on its short-term debts.

Designing a financial system robust to sovereign default—not just defaults in private assets such as mortgage-backed securities—is an interesting challenge. If we do not get our fiscal house in order, as many of the accompanying essays stress, it is a challenge we may face sooner rather than later. But insulating the financial system from sovereign default can come second, and later. First, get rid of private, run-inducing short-term financing; and second, create better underlying money. And thinking about this issue at the end of a long road should not derail adoption of the straightforward, though fundamental, steps needed to overcome our current, enormous, and failed financial regulatory regime.