Why Friedman would back CLOs not banks

During the great depression, eminent economists had a radical solution to the problem of failing banks – and it looks a lot like a CLO, argues Joe Pimbley

The Earth is flat. Man will never fly. Maturity transformation is a prudent, sound, and necessary function of global banks. The hindsight of history will mark this last idea as being especially ridiculous.

It's amazing how many otherwise intelligent economists, regulators and risk managers (!) believe that the hoary banking practice of deliberately mismatching assets and liabilities is both sustainable and desirable. Yet from experience and logic the world knows that "borrowing short and lending long" is risky.

The fancy, obfuscating name "maturity transformation" is a bit like re-labelling the Dutch government's expropriation of bank sub-debt as "ownership transformation".

In a nutshell, here's the dilemma of modern banking. Ordinary people – also known as taxpayers and voters – save money in bank deposits that their governments then guarantee. Being broadly sensible, however, these folks will quickly withdraw their funds despite this guarantee when a bank looks shaky.

Banks use this on-demand money along with other short-term borrowing, such as commercial paper and repurchase transactions, to make long-term corporate and consumer loans.

When the bank funding markets weaken or disappear, whether due to a worsening economic climate or to losses among the banks, governments feel obligated to support and bail out all creditors of needy banks – not just the guaranteed depositors.

Two critical and related steps will make bank deposits safer, release governments from liability for the banks and provide better monetary policy. These are: firstly, the imposition of "full reserve banking" to split bank deposits and payments systems from lending; and, secondly, the creation of a system where lenders fail when they cannot pay their debts.

It is the current "fractional reserve banking" that encourages the banks' acceptance of deposits (liabilities for which creditors can demand payment immediately) to fund long-term loans.

Prior to and during the Great Depression, there was a groundswell of support among eminent economists for "full reserve banking": this required that deposits would be held in cash or near-cash securities.

Henry Simons and Irving Fisher, leading experts of the period, also argued that "investment trusts" could step in to fill the lending void created by the removal of bank deposits as a funding source.

In fact, these "investment trusts" are today's CLOs, as an IMF working paper from August 2012 points out. "The Chicago Plan Revisited" says: "The original [Chicago Plan of the 1930s] advocated the replacement of traditional banks with investment trusts that issue equity, and that in addition sell their own private non-monetary interest-bearing securities to fund lending." This description fits today's CLOs, with the "interest-bearing securities" being the CLO debt tranches.

The forces in favour of full reserve banking failed to carry the day back in the 1930s and 1940s, even with the later backing of Milton Friedman. But the credit crisis that began in 2007 has revived the old cause.

The CLO market and technology stands ready to replace banks as corporate lenders. Needless to say, the asset-liability matching of cash flow CLOs is not just good, it's perfect. CLOs are "self-liquidating", as the economists like to say.

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